Article from

In the Public Interest

March 2017
Issue 14

Funding Public Pension Plans—Show me the money!

By Lance Weiss

The views expressed in this article are solely those of the author, and not necessarily those of his employer. The Society of Actuaries takes no position on the views of the author.

The controversy over the question of what is the "right" measure of pension liabilities continues to gain momentum in the press. In fact, it seems like everyone has an opinion on the issue today, including economists, finance professionals, the press and actuaries. I have a different view of the subject—I believe that all of the rhetoric, debate and even angst over this issue is misguided and actually distracts everyone from addressing the real critical issue facing public pension plans today—**the need for improved public pension plan funding**. I firmly believe the public would receive more value if, instead of just focusing on the very narrow issue of what is the "right" measure of pension liabilities, we all, instead, focus on actions that should be taken to encourage actuarially-based funding of public pension plans. This is the issue on which we all should be spending our time and knowledge—in order to provide our hard working public employees with a sound and secure retirement benefit.

By way of background, in the January 2016 issue of *In the Public Interest*, Paul Angelo discussed the current controversy around the measurement of the liabilities of public pension plans. In this article Angelo did an excellent job of comparing and contrasting the two competing measures of liabilities: current practice using long-term assumptions and methods, including an expected rate of return on plan assets, and an alternative market-based measure using current market rates of interest on relatively secure fixed-income instruments (for example, U.S. Department of the Treasury rates or high-grade corporate bond rates).

The Wall Street Journal, in its Aug. 26, 2016, issue, published an opinion piece on this topic written by Steven Malanga, a Manhattan Institute senior fellow, titled, "Covering up the Pension Crisis." In this opinion piece Malanga presents a number of arguments supporting the use of a market-based measure of pension liabilities. Malanga says, "States and actuaries are trying to stifle debate about the growing shortfall in fund assets."

Malanga, in his opinion, also states, "On Aug. 1, the American Academy of Actuaries and the Society of Actuaries shut down a 14-year-old task force on pension financing when several members were about to publish a paper that found many state and local retirement systems calculate their obligations using overly optimistic future rates of return. The authors want the states and municipalities to adopt new valuation standards that would make projecting the cost of future benefits more predictable. The problem is that this change would also make many public pension funds seem far more indebted than they are under current standards. Such a change would produce more pressure on politicians to boost funding and cut benefits." In fact, the referenced paper was made available online in September 2016 in several places after the publication of Malanga's piece.

With regard to Malanga's insinuation that adopting a market-based measure of pension liabilities will produce more pressure on politicians to boost funding and cut benefits, Malanga failed to recognize that this has already occurred. According to Keith Brainard, Georgetown, Texas-based research director of the National Association of State Retirement Administrators, every state except Idaho has already implemented some kind of pension reform. Further, in a study of 32 plans in 15 states representing 65 percent of participants in its public plans database, the Center for Retirement Research at Boston College found most have already taken steps to reduce future pension costs by some combination of increasing employee contributions, raising age and service requirements for retirement eligibility, trimming salary calculation formulas used to calculate pension benefits and reducing cost-of-living increases.

With regard to his statement that, "Some actuaries say they've been reluctant to speak up about optimistic valuations because they could lose their jobs," Malanga may not have known or considered that actuaries practicing in the United States are bound to follow the Actuarial Standards of Practice and the Code of Professional Conduct.

The Code of Professional Conduct, for example, requires that:

- "An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession's responsibility to the public and to uphold the reputation of the actuarial profession.
- "An Actuary shall ensure that Actuarial Services performed by or under the direction of the Actuary satisfy applicable standards of practice.
- "An Actuary who issues an Actuarial Communication shall take appropriate steps to ensure that the Actuarial Communication is clear and appropriate to the circumstances and its intended audience, and satisfies applicable standards of practice."

With regard to the Actuarial Standards of Practice, there are multiple standards that are applicable to pension plan funding and actuarial assumptions, including the following:

- ASOP No. 4, Measuring Pension Obligations and Determining Pension Plan Costs or Contributions
- ASOP No. 27, Selection of Economic Assumptions for Measuring Pension Obligations
- ASOP No. 35, Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations
- ASOP No. 44, Selection and Use of Asset Valuation Methods for Pension Valuations

Accordingly, actuaries must provide advice that is accurate, meets the actuarial standards of practice and is clear and appropriate to the circumstances and its intended audience—not advice tailored or massaged to the financial and/or political constraints of our clients or the plan sponsors of our clients.

Further, actuaries are certainly not reluctant to speak up. In addition, actuaries are not in any way trying to stifle debate about the growing shortfall in fund assets. In fact, the Actuarial Standards Board (ASB) created a Pension Task Force (PTF) in December 2014 for the purpose of considering the standards implications of many proposals for change related to public pension plans that the ASB has received over the past few years. The input considered by the PTF included, among other items: (1) recommendations/reports/articles pertaining to public plan funding from the Conference of Consulting Actuaries (CCA), American Academy of Actuaries (AAA), California Actuarial Advisory Panel (CAAP), Society of Actuaries (SOA) Blue Ribbon Panel and Government Finance Officers Association (GFOA); (2) responses to the ASB's "Request for Comments-ASOPs and Public Pension Plan Funding and Accounting," issued in July 2014; and (3) testimony provided at the ASB's July 2015 hearing on public pension plans. Based on its review the PTF suggested potential changes for consideration by the ASB. After extensive discussion of these suggestions the ASB directed its Pension Committee to draft appropriate proposed modifications to the pension Actuarial Standards of Practice (ASOPs), based on the suggestions of the PTF. The proposed changes to the ASOPs are part of a larger, ongoing, effort by the ASB in recent years to strengthen pension-related ASOPs.

I realize that the article titled, "Covering up the Pension Crisis" is merely an opinion piece, so Malanga can take some liberties with the facts. However, I believe that readers of this article would have been better served if *The Wall Street Journal* had also included in the same issue a counterpoint from actuaries who are well-versed in the intricacies of public pension plan finance. Further, I believe that Malanga's inflammatory rhetoric

> … actuaries must provide advice that is accurate, meets the actuarial standards of practice and is clear and appropriate. …

does nothing to help solve the problem of public pension plan underfunding.

In addition to the arguments voiced in Malanga's opinion piece, another common reason given for the use of a market-based measurement of pension liabilities is the lack of meaningful disclosure regarding the value of state or local government employee pension benefit plan assets and liabilities. This lack of meaningful disclosure supposedly impairs the ability of state and local government taxpayers and officials to understand the financial obligations of their government, and reduces the likelihood that state and local government processes will be effective in assuring the prudent management of their plans. In fact, in the preamble to the release of GASB Statements 67 and 68, GASB chairman Robert H. Attmore stated on June 25, 2012, "The Governmental Accounting Standards Board (GASB) today voted to approve two new standards that will substantially improve the accounting and financial reporting of public employee pensions by state and local governments. The new standards will improve the way state and local governments report their pension liabilities and expenses, resulting in a more faithful representation of the full impact of these obligations."

In its preliminary views document published in June 2010, the GASB considered, but rejected, the market-based measure methodology for valuing future liabilities, stating, instead, that the interest rate used should be a reasonable estimate of the rate at which plan assets are expected to grow as a result of investment earnings. Paragraph 228 of GASB Statement No. 68 describes the rationale for this conclusion, "The Board believes that the approach required by this Statement—which incorporates projections of future cash inflows from pension plan investment earnings into the measurement of service cost and the total pension liability—is consistent with its views related to the projection of benefit payments, in which all reasonably anticipated future events are incorporated into the estimate of the total obligation that will be incurred by the employer over the course of an employee's career. The amounts that are projected to be provided by pension plan investment earnings represent a reduction in the employer's expected sacrifice of resources to satisfy the obligation for pensions. Therefore, if the potentially

significant effect of pension plan investment earnings is not considered in the measurement of the pension liability, the Board believes that amounts recognized by the employer, including the employer's cost of services associated with pensions as they are earned, potentially would be misstated and would fail to provide information appropriate for use in assessing the degree to which interperiod equity is achieved."

In summary, while not perfect, GASB Statements 67 and 68 do require disclosures that result in a more complete representation of the full impact of public pension obligations. This includes anticipation of "the effect of pension plan investment earnings."

So, now on to what I consider to be the real essence of the issue—whether a disclosure of pension liability based on a market-based measure adds any meaningful value—in addition to the disclosures already mandated by GASB Statements 67 and 68. To answer this question, let's put aside the same old "Market Value of Liabilities" and "Financial Economics" arguments for a moment and, instead, focus on the big picture. For example, according to Section 2, Paragraph 8 of the Public Employee Pension Transparency Act (H.R. 4822), introduced on March 21, 2016, (commonly referred to as PEPTA), the present value of the already promised pension liabilities of the 50 states and major municipalities, calculated using a market-based measurement, is $7.0 trillion with unfunded liabilities at $3.4 trillion. Also, according to this same paragraph of PEPTA, the present value using the methodology prescribed by GASB is "only" $4.8 trillion with unfunded liabilities of $1.2 trillion. (Note: it appears these figures were taken from a Hoover Institution Essay written by Joshua D. Rauh titled, "Hidden Debt, Hidden Deficits—How Pension Promises are Consuming State and Local Budgets.")

Now, while the unfunded liability amounts calculated under a market-based measurement ($3.4 trillion) are substantially higher than those reported by pension funds using the GASB requirements (only $1.2 trillion), is the conclusion really any different? If the value of unfunded liabilities is $1.2 trillion or $3.4 trillion, does that change the overall conclusion that we have a major pension funding crisis that needs attention now? In other words—isn't an unfunded liability of $1.2 trillion large enough to make the point that public pension underfunding is a significant issue that needs to be addressed? If the underfunding was pegged at $3.4 trillion, would the conclusion change? I certainly don't think so!

Mounting public-sector retirement costs is clearly an issue for a number of state and local governments. Unfortunately, the current funding issues facing public pension systems are complicated and multifaceted, and there is no simple strategy for dealing with them. However, I strongly believe that the current focus on the question of what is the "right" measure of pension liabilities is misguided and actually distracts everyone from addressing the real critical issue facing public pension plans today—the need for improved public plan funding. In some respects I believe this misguided focus also allows decision makers/plan sponsors and legislators the opportunity to defer making important decisions about pension plan funding until the "right" measure of pension liabilities is settled.

In her testimony to the PTF, Ms. Bailey Childers, executive director of the National Public Pension Coalition, which represents teachers, nurses, firefighters, and others who rely on public pensions, testified that, while some public plans are in poor fiscal condition, that situation is almost always due to systemic budgetary problems or a lack of funding discipline and not erroneous actuarial assumptions. I completely agree with Childers' conclusion. Actuaries cannot craft laws requiring actuarially-based funding for public pension plans, and governments don't always contribute what the actuary calculates.

Solving the public pension funding crisis requires prompt action. Unfortunately, there is no "silver bullet" for solving the public pension crisis. Public officials must confront runaway public pension and retiree health benefit costs or risk voter backlash, as these costs hit taxpayers in the pocketbook and force states to spend tax dollars on legacy obligations that, otherwise, could have been used for education, services and infrastructure. A former Illinois Governor in his annual budget address warned, "Unless we reform the way we fund our pensions . . . we will never eliminate the structural deficit that takes money away from education, from health care, from law enforcement, from parks, and from everything else we care about." Unfortunately, this will require strong political leadership and the willingness to confront entrenched interests.

Jurisdictions must develop fiscally sound funding policies for their public pension systems and then have the discipline to follow them. Officials must make the required pension contributions when times are tough. Just as important, they must resist politically expedient pension giveaways when times are good. In addition, once these policies are set, they must be reviewed periodically to ensure they remain appropriate.

In summary, I believe the public would receive more value if, instead of just focusing on the very narrow issue of what is the "right" measure of pension liabilities, everyone, instead, focused on actions that can be implemented to encourage actuarially-based funding of public pensions. This is the issue on which we all should be spending our time and knowledge—in order to provide our hard working public employees with a sound and secure retirement benefit. ■

Lance Weiss, MAAA, EA, FCA, is a senior consultant and the team leader in the Chicago Office of Gabriel, Roeder, Smith & Company. He can be contacted at *Lance.Weiss@grsconsulting.com*.