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# ACADEMY/SOA ROUNDTABLE DISCUSSES PUBLIC PENSION PLAN DISCLOSURES

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***Editor's note:*** *In February, the Academy and Pension Section Council co-sponsored a lively discussion of the role of funding, disclosure and investment for public pension plans. This article reflects the observations of one participant. We encourage other attendees who might have different observations to send them to the Pension Section News for future publication.*

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On February 6, 2008, the American Academy of Actuaries and the Society of Actuaries (SOA) co-sponsored a roundtable titled "Public Pension Plan Disclosures: Who Needs to Know What—and Why." Held at New York University, the meeting was attended by over 40 participants representing the actuarial profession, state and local governments, public retirement systems, public employees, legislative and regulatory organizations, credit rating agencies, academics and others. Another 50 professionals attended as audience to the discussion. The following presents the author's observations and interpretations of the roundtable discussion.

Tom Terry, Chairperson of the Academy's Pension Practice Council, moderated the meeting. In his introduction, he noted the meeting's purpose was not so much to debate or seek consensus but rather to give participants an opportunity to listen to each other. He framed the meeting's three central questions as:

1. Who are the users of public pension plan disclosures?
2. What questions are they trying to answer?
3. What information is needed to answer their questions?

As arranged before the meeting, four participants acted as "table setters" to start the discussion. Laurie Hacking, Executive Director of the Minnesota Teachers Retirement Association, spoke about the importance of public pensions in assuring quality public services, especially with regard to public safety and education. She also discussed the related underlying goals of the various stakeholders. For employers, the goals are to attract and retain qualified employees while balancing the affordability and stability of pension costs. For employees, the goals are to ensure adequate and secure benefits related to retirement, disability, and death. For taxpayers, the goals are to assure quality public services while seeking to reduce the overall tax burden. She noted that public plans also contribute to the larger economy by providing $3.2 trillion in financial market capital and $150 billion in annual

This year, the 2008 Halmstad Prize will be awarded to the best actuarial science paper published in 2006. The selection committee makes its determination taking into account the originality and thoroughness of the ideas expressed in the paper, the readability of the paper, and the timeliness and relevance of the research.

Nominations for papers on pension-related topics are being sought. Please send a brief email that includes the name of the paper, the journal (with volume number) in which it was published, and a few sentences explaining why the paper should be considered to kelley.mckeating@sympatico.ca before June 15, 2008.

Nominations for the 2009 prize (for the best paper published in 2007) are also welcome at this time.

For more information on the Halmstad Prize, click here.

retirement income to state and local economies.

Jeremy Bulow, Professor of Economics at Stanford University's Graduate School of Business, noted that the key issue surrounding pension disclosures is how to solve the "moral hazard" problem – that is, to prevent pressures by various stakeholders from influencing actuaries with regard to their assumptions.

Michael Peskin, Chairperson of the Joint Academy/SOA Pension Finance Task Force, stated that, with regard to sustainable benefits, the key underlying issues include:

1. How much risk should be allowed in a public pension system?
2. How should related costs be measured (especially with regard to the discount rate)?
3. How should the risks related to mismatched assets and liabilities be measured?
4. How can decision-makers be held accountable? He stated that, given the pressures that can be brought to bear by labor, elected officials are at a disadvantage.

Paul Angelo, former Chair of the Academy's Public Plans Subcommittee, asked participants to pay attention to the terminology used in the discussion and cautioned that words like "liabilities", "costs" and "value" mean different things in different contexts. As a result, there are reasons to measure them differently depending on the purpose of the measurement (e.g., plan termination vs. ongoing funding).

Discussion was then opened up to the roundtable participants. Although far-reaching, it primarily revolved around the following topics.

## Who, What and Why

Conference participants focused on key stakeholders, and what they need to know about the system. The table below summarizes the views of several conference participants:

| STAKEHOLDERS | RELATED INFORMATION |
|---|---|
| Employers | What do the benefits cost? How will they be paid? |
| Employees | What are the benefits? Are they secure? |
| Taxpayers | What do the benefits cost? What is the value I re-ceive for these benefits? |
| Policy Makers | Are the benefits worth the cost? How do they help attract and retain qualified employees? |
| Regulators | Does the plan comply with applicable laws and regulations? How would |

| | |
|---|---|
| | benefits be paid if the plan fails? |
| Debt Holders and Rating Agencies | Do pension obligations limit the ability of the public entity to pay for other debt? Do pension obligations change the risk to debt holders? |

Another participant noted that investors are also stakeholders and indicated that holders of governmental general obligation bonds would prefer that the government's pension discount rate reflect the government's credit quality.

Another participant observed that many of the questions related to additional public pension disclosures were addressed in the 1970s during development of the Comprehensive Annual Financial Report (CAFR) for public pension plans.  The CAFR requires detailed information about public plan funding, asset allocations, actuarial assumptions, etc.  Other participants agreed on the usefulness of the public pension CAFR.

## Measuring Liabilities

A significant portion of the discussion focused on the value of disclosing the market value of assets and liabilities for public plans.  Generally, this approach combines the accrued benefit obligation (ABO) method with a discount rate based on risk-free bond yields.  Currently, the majority of public pension plans use the entry age method combined with a discount rate based on long-term expected investment returns.  A portion of the participants favored applying the MVL to public plans for disclosure purposes, while another portion did not.  In discussing the advantages of the MVL approach, some participants argued:

- Current use of a discount rate based on expected returns does not factor the cost of investment risk into the calculations.  Investment return should not be recognized by the plan until earned.
- Use of a discount rate based on expected returns could lead public plans to take on excessive investment risk to obtain the higher returns.
- If current contributions are not sufficient to cover the cost of risk, increased contributions would be needed in the future, violating the principle of intergenerational equity.

In discussing the disadvantages of the MVL approach, other participants argued:

- The current actuarial methods and assumptions used by public plans are intended to maintain contribution rates as a level percent of pay.  Applying the MVL would likely introduce greater volatility into contribution rates, making them more difficult to budget, and resulting in inappropriate intergenerational transfers among taxpayers.
- The MVL was developed for private-sector plans that can, and often do, terminate.  Public plans are long-term entities.  For long-term entities, it is appropriate to use the long-term expected return for discounting and

disclosure.

- The ABO does not include future salary and service. Applying an ABO measure to government plans would likely result in a pattern of increasing contributions.

## Differences between Public and Private Plans

Many participants representing governments and public pension plans stated their belief that governments are fundamentally different from private-sector entities, with one of the key differences being that governments and governmental plans do not terminate. Consequently, it is appropriate for governments to apply measures of pension costs and liabilities that reflect the long-term nature of governments and their pension commitments. Another participant countered that while governments cannot be terminated, their pension plans can.

Another difference between public-sector and private-sector plans is that employee contributions are typically mandatory in public-sector plans, whereas employees rarely contribute to private-sector plans. Several of the participants representing public-sector employees emphasized that these contributions represent deferred wages and effectively give employees a property interest in the benefits.

## Moral Hazard

The term "moral hazard" is used by economists to describe the problems that can result when parties to a transaction are insulated from its risk. Several participants expressed concern over the potential moral hazards associated with pension plans, especially with regard to the tensions among stakeholders regarding the use of "excess" plan assets (i.e., plan assets that exceed actuarial accrued liabilities). However, several of the participants observed that changing measures or disclosures alone would not fully address the issue. Another observed that investment experience from 2000 to 2002 has helped reinforce the lesson that "excess assets" should be carefully managed.

## Measuring Risk

Several participants noted that a key problem with using a single-point liability measure is that a point measure does not provide information about the range and probability of outcomes. This problem applies to any single point measure. Another participant noted that risk measures showing the likelihood and range of outcomes would be useful although difficult to construct. Still another observed that while investment return volatility is an important source of risk, there are other sources that should be considered as well, including mortality, wage and price inflation, etc.

## Impact of Changing Actuarial Standards

Several participants expressed strong concerns about the impact of changing the actuarial standards, noting that the changes would likely create confusion among policy-makers (especially if the actuaries themselves did not agree) and lead to unintended consequences. Moreover, the resulting shocks to public pension systems could put many participants at risk. This would be especially harmful for the 20 percent of public employees (approximately 4 million) who are not covered under Social Security and rely largely on their public pension for retirement security.

## Breakout Group Reports

After the broad discussion, participants divided into three breakout groups to focus on how the issues affect public plan governance, funding, and investments. The following summarizes the groups' reports to the roundtable:

The Governance Group reported discussing the tensions among employers, employees, elected officials, trustees, taxpayers, and experts with regard to public pensions. Although these tensions result from inherent differences in objectives, the group suggested several areas where improvements in information and education could improve governance:

- Better understanding and communication of pension funding principles could reduce pressures to increase benefits or reduce contributions due to "excess" pension assets.
- Better education regarding fiduciary responsibilities could help strengthen the independence of pension trustees.
- Better measures of investment (and other) risks borne by the plan could help officials understand the range and likelihood of potential outcomes. These could include market-related measures, asset/liability studies, and other measures.
- Better understanding of how funding pressures affect stakeholders could be provided by developing plan "stress tests" to simulate the impact of potential risks on future contribution levels and tax rates.

The Funding Group reported discussing the role of disclosures with regard to plan funding. While generally agreeing that disclosure is important, the group also noted that different disclosures are appropriate for different purposes. Moreover, by itself disclosure does not ensure that contributions will follow, regardless of the actuarial cost method used. In addition, some members of the group were concerned about the unintended consequences that might result from a fundamental change in measurement, including the possibility of public plan terminations. In discussing additional information that would be useful with regard to plan funding, the group suggested:

- Information about the degree to which the actuarial assumptions affect the measured liability; and
- Information about the long-term sustainability of benefits.

In commenting on these suggestions, one participant referred to a recent behavioral economics study suggesting that the way information is framed and presented significantly affects the decisions made. He noted that more information is not necessarily better and that some numbers are more important than others.

The Investment Group reported that different investors have different information needs. For municipal bond investors, the cash flows related to pension payouts would be useful and could be discounted at rates deemed appropriate by the investor. For plan investment officers, asset/liability studies would be useful, as well as stochastic simulations and measures of the probability of failure.  For employers and employees, information that protects against the unwarranted use of plan surpluses would be useful. The group also discussed the possibility that information overload might result in the loss of information, and that the MVL might represent "dangerous noise" leading to unnecessary plan terminations.

In the follow-up to this discussion, a question was raised about whether use of the MVL would lead to pressure to invest in bonds.  Several participants suggested that fully funded plans might be immunized using an LDI (liability driven investment) strategy.  Others supported continued allocation in equity investments.  One expressed concern that dedicating a large portion of the portfolio to fixed-income securities would unnecessarily limit the returns earned by public plan investments.  Earlier, Laurie Hacking had noted that approximately 65 percent of annual public plan receipts are from investment earnings.

Tom Terry concluded the meeting by thanking the participants and noting that no decisions had been made on these issues. Moreover, any decisions would be made after careful deliberations and possible future group discussions.

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