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IN THIS ISSUE

LINKS

Pension Section Council

20 / 20 Web site

Contact the Editor

Calendar of Events

EVENTS

PERSPECTIVES FROM THE FUTURE OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS CONFERENCE

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This May, I attended the annual research conference of the Pension Research Council, and as usual, it was a lively and interesting discussion. The activities and publications of the Council bring together diverse perspectives including those of economists, actuaries, attorneys, plan sponsors, representatives of labor and government. This is a forum where academic researchers and practitioners come together to exchange ideas and learn from each other. I am proud to serve on the Advisory Board of the Council, and feel that over the years, I have learned a lot from this association and have made connections with many people who I have had the chance to learn from and exchange views with. This article will focus on the 2008 conference and what I and some of the actuaries attending it took away from the conference.

At this year's conference, the diverse and lively group of actuaries, academics, financial experts, regulators, and plan sponsors discussed the challenges facing public retirement systems in the United States and around the world. Several actuaries were on the program as paper writers and discussants, and more were in attendance. The presentations are available on the Pension Research Council Web site, here, and the papers will be available as working papers and later in a conference volume. Thanks are due to conference organizers Olivia Mitchell and Gary Anderson for assembling the paper writers, presenters and participants.

Big Picture Perspectives

The conference included papers on a wide range of topics. Steve McElhaney, the author of a conference paper, and an actuary from Mercer specializing in public plans offered the following perspectives:

One thing that impressed me about the conference was that the participants came from so many different fields and had many different perspectives on issues regarding public employee retirement systems. Regardless whether one agreed with a presenter's opinion, it was clear that these opinions were well developed and researched. The primary area where disagreement occurred concerned the measurement of pension liabilities. There were convincing arguments made for continuing to use traditional actuarial measures, and arguments just as convincing on the other side from those who believe that the public sector should move to a financial economics approach.

Several of the papers presented were non-controversial and included valuable information and data. One particularly valuable paper outlined best practices for public sector defined

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contribution plans ("Defined Contribution Pension Plans in the Public Sector: A Best Practice Benchmark Analysis," by Roderick B. Crane, Michael Heller, and Paul Yakoboski from TIAA-CREF). Since it appears likely that public sector employers will be moving more towards defined contribution plans, a resource such as this one will be much appreciated.

-Steve McElhaney

The program traced the history of public sector pensions and retiree health programs, compared public with private sector pay and benefits, and offered perspectives on public policy concerns regarding accounting and management in public employee plans in the United States, focusing on ways to properly measure liabilities and how to make the plans more cost effective. It was clear that some of the topics discussed were very controversial. The discussion also focused on both defined contribution versus defined benefit plans in the public sector, and offered best practices for defined contribution plans. An international focus was included with a discussion of reforms in the German, the Japanese, and the Canadian public employee plans.

I liked many of the papers. I was particularly interested in some of the papers that included research and ideas that were entirely new to me. For example, Brad M. Barber of UC Davis, presented a paper on "Pension Fund Activism: The Double Edged Sword." Barber focuses on the effectiveness and implications of social and shareholder activism, and has studied the returns of CalPERS. He says "Using simple empirical methods, I estimate the gains to the high profile activism of CalPERS focus list firms over the period 1992 to 2007." His conclusions tell us that "Institutional activism is a two edged sword. When prudently applied, shareholder activism can provide effective monitoring of publicly traded corporations. When abused, portfolio managers can pursue social activities to advance their personal agendas at the expense of those whose money they manage." I encourage actuaries to look at the working papers for new insights.

Controversy and Discussion about the Appropriate Ways to Measure Assets and Liabilities

One of the interesting aspects of the discussion was the clear difference in perspectives on whether market values should be used to determine pension liabilities in the public sector, and if so for what purpose. The papers and discussions showed different perspectives on this topic. In his discussion, Robert North, chief actuary for the New York City Retirement System, explained that they disclose market values in their actuarial reports, and believes that it is helpful to all concerned. Jeremy Gold and Gordon Latter, co-authored a paper and provided their case for "Marking Public Plan Liabilities to Market."

The actuarial profession has recognized that this a major issue, and it sponsored a symposium on this topic earlier this year and on Sept. 4, 2008, the Public Interest Committee of the American Academy of Actuaries conducted a public forum on this topic. The purpose of the forum was to hear the views of stakeholders in the debate over the disclosure of the market value of assets and liabilities in public pension plans.

In May, the Academy Board of Directors asked the Public Interest Committee to determine whether a Board statement advocating such disclosures in public pension plans would be in the public interest. The daylong public forum was part of the information-gathering process toward making that determination.

Paul Angelo, an actuary from the Segal Company specializing in public plans, was a speaker assigned to discuss the papers focusing on financial issues, and he provided a perspective on the conference and what he learned. I asked Paul the question: What single comment or insight from the Wharton Conference captured your attention or advanced your understanding? He provided me a very thoughtful response:

There were two, one immediate and encouraging, one more long simmering and illuminating. I'll start with the second one.

I was invited as a discussant of the "new developments" papers and I knew that the main focus for me would be on the controversy surrounding applying the extension of market value liability (MVL) measures from corporate plans to public sector plans. Also since this was Wharton, I anticipated I would be in a minority position as one critical of applying corporate financial economics (FE) methods and measures to public plans. That certainly was the case, but there was also the opportunity to hear from FE proponents— economists—outside the usual actuarial FE circuit.

One of those economists was David Wilcox, deputy director, Division of Research and Statistics, Federal Reserve Board, at the Federal Reserve. In terms of financial economics, David is very well respected, a formidable, compelling and articulate proponent of market valuation of pension promises. I spent some time after my session talking with him and one of his colleagues, Columbia economist Steve Zeldes.

One thing I learned from our side talk was that these two economists were much less familiar with pension cost accrual methods than I expected. Level cost entry age normal vs. back loaded unit credit all seemed pretty new to them. I found that significant since one of the main objections to MVL for public plans is the unit credit accrual pattern, which I argue is simply not "decision useful" (to use the GASB term) for a public plan.

But their focus was almost entirely on the discount rate, and the fact that—from a market perspective—the more sure a promise is, the lower the discount rate, and so the higher the value assigned by the market. I noted how counterintuitive that is from a funding perspective, where if you have a flaky funding source you would charge them more, not less.

Eventually for me this distilled into a basic distinction between market pricing and funding, the fact that in those two measurements the discount rate behaves in the opposite direction. In market pricing, the discount rate is the cost to the borrower, so the less dependable borrower (think junk bonds) gets a higher rate, and so pays a higher cost. In funding, the discount rate anticipates investment earnings, which is an offset to cost (ultimately contributions equal benefit payments plus expenses minus investment income). So a higher discount rate actually anticipates a lower cost to the plan sponsor (or "borrower" in the FE identification of pensions with debt). That is one reason why, when it comes to discount rates, pensions and debt are not identical. And that, ultimately, is what I learned from Wharton.

And how did I happen to have such illuminating discussions with these two economists, my academic adversaries? I owe that to David Wilcox. Earlier in the day, during the Q&A after my presentation, David observed to the audience that my understanding of a pension liability, while no doubt carefully considered, was utterly foreign to him. We somehow see the pension liability completely differently. He likened discussions between financial economists and pension actuaries to talking to someone with whom you do not share a common language. At first you talk slowly, then slowly and loudly, and eventually frustration and impatience take over.

And then he said something that I have not heard in all the FE/MVL discussions going on in the actuarial community. He said, with a sincerity and sense of invitation that I cannot really describe, that what he would like to do is come to understand how we can see things the way we do, a way that is so different from the way he sees them.

So I took him up on his offer and in the process of trying to make my position more understandable to him, gained a better understanding of it myself. Now I owe it to David —and myself —to cycle back to him and see if I can help him, as he put it, understand how to see things my way!

-Paul Angelo

Thinking About Risk in New Ways

Chris Bone, long-time leader in thinking about emerging paradigms for risk, an independent consulting actuary and former member of the Pension Research Council Advisory Board answered my questions by focusing us on perspectives from Germany:

As anticipated, there was a lively exchange of views on the topic of whether, when and how to determine market value of liabilities for public sector pension plans. Sessions, and discussions between the sessions, featured comments about not only the difference in perspectives, but also about the difficulties of transition from one perspective to the other.

But this conference also presented new ways of looking at issues of public sector finance that integrate actuarial and economic techniques and with potential new perspectives for application to asset allocation, public sector employer risk, surplus ownership, etc. In particular my attention was caught by the presentation by Raimond Maurer (see Maurer, Mitchell and Rogalla, "Reforming German Civil Servant Pensions: Funding Policy, Investment Strategy, and Intertemporal Risk Budgeting") This looked at first to be a typical stochastic asset allocation study but presented some new ideas in how to measure risk and rewards of different asset allocations.

In the study, the authors looked at a 50 year projection of the civil servant pension plan for the German state of Hesse. Applying the somewhat arbitrary constraint that the plan would be terminated in 50 years with no reversion of any surplus assets they derived a deterministic plan valuation of the liabilities, contribution rates needed to fund the liabilities, etc. They then proceed to look at asset allocation methodologies *that minimize risk. This may at first sound rather typical of such studies today, but several items of interest jump out. First is the discussion of risk minimization and, in particular, of the risk to be minimized. Rather than minimizing risk of asset fluctuation (the classic asset allocation model that minimizes variance of asset returns) or asset/liability mismatch (minimizing underfunding risk), the authors focus on minimizing the conditional value at risk of the present value of future pension contributions (including penalty contributions assessed on underfunding). In other words, the authors' model looks at minimizing the value of future contributions should worst case (five percent) conditions prevail. Whether the authors' choice of risks to minimize is correct is perhaps less important than the perspective it affords of opening up a dialogue about measuring acceptable levels of risk to a more comprehensive and more intuitive basis. It can be difficult to get plan sponsors to agree that they should minimize asset return variance—since most sponsors believe that only downside risk matters—they are perfectly happy to accept upside variation. But by beginning to look at conditional downside risks we start a discussion that can be translated into terms accessible by our public clients.*

Also of interest is the paper's finding that so long as the 50 year constraint on termination applies with no surplus reversion, the optimal asset allocation is dominated by bonds. But when surplus reversion is allowed, optimal asset allocation is radically different, dominated by equities and looking quite similar to the asset allocation prevalent among U.S. public sector plans today. Of course, if the plan were not assumed to terminate at year 50, the ability to finance future pension accruals might be of similar value to a reversion.

There were many other papers of interest, but in many ways the above paper captures many of the values this symposium offers —with a vibrant exchange of views among economists, actuaries, demographers, plan sponsors and others interested in pension policy today and in the future.

-Chris Bone

Insights Helpful in the DB-DC Debate

The patterns of benefits in the public and private sectors in the United States (and in other countries) are quite different. DB is much more common in the public sector. Several of the papers and discussions offered interesting insights.

Beth Almeida of the National Institute on Retirement Security has done a research study on reasons public plans convert from DB to DC or consider it seriously. This study suggests that an important factor is when the legislature and governor are both Republican. There are also key lobbying interest groups and she argues that economics is not the driver in most of these cases. This is a fascinating study and well worth looking at and analyzing seriously. It uses different methodologies than actuaries and economists commonly use. If the findings could be applied on a widespread basis, it would be very important to understand them.

Ed Hustead provided a new look at the administrative costs of DB and DC systems in the public sector, and his research shows very positive results for DB plans.

Keith Brainard of NASRA offered us insights into developments and variations in plan design.

And there was a lot more.

Great Networking Opportunities and New Collaborations

William (Flick) Fornia, an actuary from Aon specializing in public plans, was a speaker assigned to discuss the papers focusing on reform paths for public plans. He provided a perspective on the conference and what he learned. I asked Flick the question: What single comment or insight from the Wharton Conference captured your attention or advanced your understanding? Flick said:

> *What made the conference so valuable was the collection of brilliant thought leaders that I either came to know or got to know and understand better. It was a pleasure to have in depth discussions with my old friends Jon Forman, Keith Brainard, Rod Crane and Paul Angelo, plus new thinkers such as David Wilcox, Parry Young and Stephen Zeldes.*
>
> *But the most fruitful discussion was when I sat down to dinner across the table from Beth Almeida, an economist and the director of the new organization "National Institute on Retirement Security." We began to discuss her and my presentation and discovered that we have many of the same views.*
>
> *We began to collaborate on a paper on the financial advantages of defined benefit plans, which NIRS will release later this year. Beth and I presented our work in July at the National Conference of State Legislators and it was well received.*
>
> *I'm hopeful that our work will add to the pension body of knowledge.*
>
> \- Flick Fornia

Thinking About the Future—Some More Ideas

I want to add my overall comments. I thought the Future of Public Employee Retirement Systems conference was outstanding. I liked the papers and mix of people.

There was a lot ot be said about the success of public sector DB plans that was hidden in the papers, but these comments were not well integrated into a summary. My take is that we have heard a lot about DB failures but we rarely hear about successes.

Some key points about public sector DB plans:

- Many people are getting benefits.
- These plans offer strong support for the employment deal.
- They offer more cost effective delivery of benefits than DC plans.

Unfortunately, the press lives on reporting about failures and unusual events and not on reporting about the things that happen every day and not about reporting on successes. If we lived in Europe and followed the press, we might well think that American cities were full of murders and fires and never have any idea about the beauty, nice things or great places to live in many locations.

Some of my top observations are as follows:

Moves and attempted moves to DC—the role of interest groups and ideology seemed very important to me in understanding what has happened, what might be expected and what actions make sense. I do not usually focus on this topic. I want to learn more about how ideology factors in driving decisions for change and would like to see more research on this topic.

Labor deal and the role of pensions—I heard a little about this at the conference, and I think it is central to the importance of the plans. One of the big questions to me is whether long term employment will continue to be very popular in public employment. I wish this had been discussed more.

Changes in retirement ages—the keynote speaker said this issue was off the table in the discussions about Social Security, but I see this as a critical issue going forward. This issue needs to be on the table in pension discussions, and particularly in regard to public employee plans.

Evolving plan designs—the introduction of some hybrid features is public plans is very interesting.

Comparative costs of DB and DC—there are lots of different ways to think about this, including the cost of a dollar of retirement benefit delivered. It is important to also understand what goes to administrative expenses.

Conclusion

There was a lot to think about at this conference, including some that is beyond what we traditionally think about as actuaries. Thanks to the Pension Research Council for a provocative discussion. Many actuaries already are affiliated with the Pension Research Council or closely follow its work. I encourage more to do so, and I encourage all actuaries to participate in multi-disciplinary efforts.

Note about the Pension Research Council—For more than 50 years, the Pension Research Council of the Wharton School of the University of Pennsylvania has been committed to generating debate on key policy issues affecting pensions and other employee benefits. The Council sponsors interdisciplinary research on the entire range of private pension and social security programs, as well as related benefit plans in the United States and around the world. Actuaries serving as Advisory Board members and participating in events have made many valuable connections. Individuals can get copies of publications and news by e-mail. Membership is open to organizations as Senior Partners or Institutional members. *http://www.pensionresearchcouncil.org/membership/*

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Contributing to the article were Paul Angelo, FSA, MAAA, EA (of the Segal Company in San Francisco, Calif.), Chris Bone, FSA, MAAA, EA (of Edth Limited, LLC in Flemington, N.J.), William (Flick) Fornia, FSA, MAAA, EA (of Aon Consulting in Denver, Colo.), and Steve McElhaney, FSA, MAAA, EA (of Mercer in Richmond, Va.).