



August 29, 2008

Steve Lehmann
Chairman, Public Interest Committee
American Academy of Actuaries
1100 17th Street NW, 7th floor
Washington, DC 20036

Re: American Academy of Actuaries Public Interest Committee Public Pension Plan Forum

Dear Mr. Lehmann:

Bartel Associates is a California based actuarial consulting firm providing services to over three hundred public sector entities. This letter provides a very brief summary of my opinion on the relevance of MVL disclosure for public sector entities and a short comment on process. However, the opinions expressed in this letter are mine and not necessarily that of my partners or Bartel Associates employees. I want to thank the American Academy of Actuaries Public Interest Committee for hosting this forum on the disclosure of market value of assets and liabilities for public pension plans. In short I believe it is not in the public's best interest for the Academy to take a position on this issue. The issue is extremely technical and there is a deep difference of opinion among actuaries on this issue.

Relevance of MVL Disclosure for Public Sector Entities

Generally, public sector actuaries are strongly opposed to the Academy taking a position encouraging MVL disclosure. There have been informal polls which seem to indicate that 80% of public sector actuaries, perhaps more than 90%, oppose mandatory MVL disclosure. I think it's fair to say most public sector actuaries favor disclosure based on the expected long term rate of return of plan assets. If the Academy renders an opinion it will be diametrically opposed to what most public sector actuaries (the segment of the Academy with background and experience in the area) believe is appropriate. Following are the primary reasons the Academy should not advocate MVL disclosure for public sector entities:

1. Advocating or encouraging MVL disclosure implies the Academy is taking sides in, what is already a very political discussion. The Academy should not advocate a particular liability measure to public sector actuaries against their objections.
2. Under stochastic analysis MVL is a 90-95% confidence level number. It only shows one end of the probability spectrum. If the Academy advocates MVL disclosure then it should also advocate disclosure under a higher (5-10% confidence level) discount rate.
3. A statement from the Academy supporting one end of the probability spectrum rather than a balanced disclosure would suggest there should be a cost shift from one generation to another. In other words such a statement would suggest it's more important to show conservative results with the implication there is a shift in cost from the current to future generations.
4. Private sector corporations can (and do) go out of business, terminating their pension plans. MVL disclosure, since it closely approximates a termination liability, is quite



appropriate for private sector pension plan plans and adds value. However, public sector entities rarely go out of business or terminate their plans. Consequently I struggle to understand what, if any, value MVL disclosure adds to readers of a Public Sector Entity's financial statement.

5. While there certainly are exceptions, public sector defined benefit plans have generally provided an efficient and effective use of tax payer dollars. Adding MVL disclosure runs a significant risk of impacting this balance.
6. If there is an area where public sector defined benefit plans have not worked well, it is in the governance area. The introduction of MVL into disclosure does not improve governance at all. Instead it complicates and confuses how well funded a plan is. This sort of complication and confusion may lead to further governance issues.
7. MVL disclosure would likely encourage plans to be funded on an MVL basis. This funding approach is very conservative. Funding on this basis, without changes in asset allocation, will create an intergenerational shift in cost.
8. If plans fund on an MVL basis, they may be encouraged to change their investment mix to be consistent with their funding basis.

Academy Process for Discussing MVL Disclosure for Public Sector Entities

Ever since I decided (over 30 years ago) to be an actuary I have consistently believed that, while actuaries might disagree, we would never try to silence those we disagree with. Politics has consistently taken a back seat to legitimate discussion and doing the right thing has always been paramount. The MVL conversation is beginning to change my mind. In May 2007, the Pension Practice Council (PPC), with no notice to the Public Plan Sub-committee (PPS) and despite assurances to some PPS members a vote would not occur, approved the following statement:

The American Academy of Actuaries supports retirement systems measurement and reporting of the market values of assets and liabilities by defined benefit pension plans.

At a subsequent July 2007 PPC meeting representatives of the PPS presented an alternative statement, with supporting information. That statement was:

The Public Plans Subcommittee recommends that the PPC revisit their resolution supporting the disclosure of Market Value Liabilities (MVL) for public sector pension plans, because the relevance of MVL to public plans is an open question within the actuarial community.

A copy of the entire document presented to the PPC is attached. To date there has been no response from the PPC to the PPS.

The Academy co-sponsored a February 6th Roundtable titled "Public Pension Plan Disclosures: Who Needs to Know What—and Why". I understood this roundtable was the beginning of a conversation on the issue. While I applaud the Academy for holding the Roundtable, there has been no follow-up that I'm aware of.

I am struggling with how an organization established to help actuaries address professionalism issues can be non responsive on this important issue. What we need is substantial dialogue

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between those that favor MVL disclosure and public sector actuaries. Without such a dialogue it is substantially premature for the Academy to issue a statement of public interest.

Please call me (650-377-1601) with any questions about this letter.

Sincerely,

A handwritten signature in black ink that reads "John E. Bartel".

John E. Bartel
President
jb: JEB

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American Academy of Actuaries
Pension Practice Council
July 29, 2007
Vancouver, Canada

Presented on behalf of the Public Plans Subcommittee of the Pension Committee

Issue: The Public Plans Subcommittee recommends that the PPC revisit their resolution supporting the disclosure of Market Value Liabilities (MVL) for public sector pension plans, because the relevance of MVL to public plans is an open question within the actuarial community.

Introduction

Financial Economics (FE) is a broad discipline. Public sector actuaries are not saying it is irrelevant as a method of analysis, and we look forward to exploring its relevance. The objection is to jumping directly to routine MVL disclosure as a packaged result.

Consider this: MVL differs from current funding liabilities in two ways:

1. The measure: MVL is a change from established level funding methods (EAN, PUC, etc.) to a simple present value of accrued benefits measure (PVAB).
2. The discount rate: MVL is a change from one that includes an equity risk premium to one that does not (shorthand: from long term earnings rate to bond rates).

We believe that our substantive discussion ultimately will center on the discount rate. Should liability methods now in place be revalued - for funding and/or disclosure - at bond discount rates?

However, the only justification for introducing a PVAB liability measure is as part of the MVL package. And those justifications must be sufficient to overcome the clear drawbacks of:

1. Introducing ANY second measure of accrued liability into a pension valuation framework.
2. Linking public plans to a market volatile, low discount rate liability.

This outline summarizes the critiques of the justifications most often presented for MVL disclosure, followed by a summary of the harmful consequences of MVL disclosure.

Our task should be to explore the applicability of FE to public plans. MVL disclosure is tempting since it is already worked out for corporate plans. But it tries to grab too much too fast. The sooner we can start a principles-down instead of results-up approach, the sooner we can address the important issues facing public plans.

Arguments for the relevance and need for MVL disclosure for public plans

1. **Empirical.** MVL can be forced onto a pension framework as a settlement liability. That is what happened to corporate plans, starting in 1987 in the forms of current liability and ABO. Fortunately, this is substantially not an issue for public plans. FE proponents play down this distinction but to the public plan audience this is crucial. The only empirical reason that corporate plans ever cared about MVL in the first place was that it was forced on them as a settlement liability measure.
2. **FE theory.** MVL can be derived from a set of FE postulates that are market based, and presume a relationship between cost and market price. One of our members has developed an argument that, absent the need for a market based settlement liability, those postulates are inconsistent with the nature and purpose of a pension plan. This is a high level, first principles analysis that requires revisiting what exactly is a pension plan, what is its purpose and what is its cost. The postulates and very brief summaries of their inconsistencies are as follows:
 - a. *A pension plan is a transfer of wealth or value.* This denies the *nature* of a pension plan. A pension promise has only one inherent form – a series of payments for the life of the recipient. A pension plan is an *exchange* of the *incurral of cost* for the *provision of a pension*.
 - b. *The cost of a pension is the price the member would have to pay to reproduce the pension in the open market.* This denies the *purpose* of a pension plan, which is to provide the pension at a lower cost than the recipient could obtain on her own.
 - c. *The exchange of wealth should be transparent, with no intermediaries between the source and recipient.* This denies the *very role* or *existence* of a pension plan, which would seem to limit FE as a general model for analyzing pension plans.

The fact that these postulates appear true for corporate plans traces to the fact that a corporation is inherently a market entity, that corporate pensions are incidental to the purpose of a corporation, and that thus a corporate pension plan must always stay in balance with the market. None of those conditions apply to a public pension plan.

3. **External voices.** The most common argument heard for the need for urgent action on endorsing MVL disclosure is that there is some authority or audience external to the profession that says we should disclose MVL, claims to need MVL disclosure and/or is already moving in that direction. This is then related to maintaining the relevance, reputation and credibility of the profession, and taking a leading role in the move to MVL disclosure. There are many questions raised by this argument:
 - a. Credibility and reputation with whom? Client systems, employers and participants? Bond underwriters? The community of financial analysts?

- b. Whose credibility and reputation? Public actuaries? Corporate actuaries? The SOA / Academy as organizations?
 - c. Which audience matters, and why? Which audience matters to which actuaries? And if these interests are in conflict - which they already appear to be - who decides which are more important?
 - d. Centering on the authorities, who exactly are these authorities? How does their authority relate to public plans? What are their arguments, and do those arguments really extend to public plans?
 - e. If these voices are in fact wrong about MVL disclosure for public plans, then would not true leadership require taking the lead in educating them on appropriate liability and cost measures for public plans?
4. **Consistency and comparability.** Much is made of the need for improved disclosure for public plans, and we strongly endorse the development of a more complete and consistent framework for such disclosure. But unless MVL is inherently relevant to public plans - as it clearly is to corporate plans - then it is of little value other than consistency. Furthermore, it invites an oversimplified view of a complex entity (the public pension plan). The idea that any single number can provide useful comparisons of different ongoing funding obligations and policies is inherently questionable.
5. **Moral hazard.** This is a catch all term for the problems evident in public plans today, as well as FE's theoretical analysis of some of those problems. These include intergenerational risk transfer and surplus abuse as well as governance issues. FE presents its own various possible ways to address these problems.
- a. FE solutions, including MVL, should be evaluated along with solutions based on ongoing funding practices, based on their relative merits, costs and advantages. FE in general does not have any a priori claim to have the "right" solutions.
 - b. FE solutions, especially linkage to MVL, come at a high cost, as evidenced by their effect on corporate plans. Those costs were forced on corporate plans by the empirical need for a settlement liability. For public plans those costs must be justified relative to alternative solutions.
 - c. MVL disclosure is proposed as a solution even to problems that are clearly unrelated to the measure of plan liabilities, e.g., the governance issues in New Jersey and the City of San Diego. In fact, of the various FE based solutions, MVL disclosure may be the least effective against moral hazard risks. The most credible FE based solutions will trace back to the discount rate, not the MVL.
 - d. The last ten years have provided an enormous amount of diverse experience on how the moral hazard risks for public plans can be managed through disciplined use of traditional, long-term funding practices. In many cases, we are learning from mistakes, but that is the nature of an empirical science.

Arguments against MVL disclosure for public plans.

These fall into two main categories:

- the harm caused to public sector retirement by introducing MVL disclosure without substantial justification and
- the credibility our profession will lose with the public sector - including public sector actuaries - by enabling such disclosure.

The list of “harms” provided here is not exhaustive. Please be assured these are all more or less obvious to public sector actuaries, trustees, administrators and legal counsels.

1. First, there will be substantial confusion and loss of credibility (by the systems). EAN is hard enough to explain. Two liabilities invites the question of which is the real one. And FE then will argue MVL is the real one. See for example Richard Ennis of Ennis+Knupp in his widely circulated paper.
2. MVL funding ratios will be used - and abused - to attack public plans. This is simply reality. For example, political opponents will say systems - perfectly well-run systems - have lied about the real liabilities all along.
3. Then there is the fact that in public sector you cannot separate disclosure from funding. This is reflected (and stated) in GASB 25, and is related to the essential advantages of a single liability framework. So ultimately there will be pressure to use MVL as the funding liability. In fact, many if not most FE proponents already make this argument.
4. Once we get to MVL as a funding liability, we need look no further than to see what it did to corporate plans: higher and more volatile costs, and a shift away from pension plans. At least for corporate plans there was a clear, empirical need, the termination scenario. FE and MVL obtain the same undesirable result for public pensions without the empirical justification.
5. Ultimately, MVL may be used to argue against equity investments in pension plans. We assume the PPC is familiar with Bader/Gold's paper, "The Case against Stocks in Public Plans". That is the logical conclusion of a process that begins with MVL disclosure for public plans.
6. In effect this will mean that the pension function of society is relegated to the role of lender, rather than being allowed an ownership participation in the economy. Since FE clearly allows individual account plans to invest in equities, this puts pension plans at a clear disadvantage relative to DC plans.

In summary, the introduction of any second measure of accrued liability requires a compelling justification, and a market volatile, low discount rate liability requires the most justification of all. If we as a profession endorse this introduction of MVL into the "routine disclosure" for these systems, then we must take responsibility for how it will be used and

where it will very likely lead, including encouraging the shift from pension plans to individual account plans.

As for the damage to the credibility of the profession, we urge a realistic consideration of how the public pension plan market would react to a statement by the Academy saying it endorses the routine disclosure of market value of liabilities.

Based on conversations that have already taken place both among public sector actuaries and with their client systems, a likely response would go as follows:

1. The profession, as represented by the Academy, will forfeit any credibility with public sector systems and their national organizations.
2. The profession will be viewed as an adversary to public pensions, with connections made to the “DB – DC” debate.
3. The profession will have its motives questioned. Already “why are they doing this?” is the most common question raised.
4. Most individual public actuaries will maintain their client relationships by either distancing themselves from the endorsement or even by taking a clear and opposing position.

We would hope that the PPC would take seriously the fact that so many the members of the Academy who work most closely with public plans believe that an Academy endorsement of MVL disclosure for their client systems is certainly premature and ultimately against the best interest of public retirement. For example, here is but one statement of opinion from the staff actuary of a major statewide retirement system:

I am strongly opposed the AAA Pension Practice Council taking a position on this at this time. There is no widespread agreement in our profession on how or if Financial Economics should be applied to the profession. Any attempt to do so at this time is very pre mature, and may not help the debate or practicing actuaries reach a conclusion. I don't believe that all of the implications of this move has been debated.

In fact it may even backfire, closing the debate for some and producing a strong backlash.

As another data point, an admittedly unscientific survey at a recent EA meeting workshop on public plans showed overwhelming opposition to routine MVL disclosure. Whatever this may say about the merits of MVL disclosure, we have a clear sense that the Academy members who are in the best position to assess the real-world effect of such disclosure oppose it at this time.

What we should be discussing

A principles-down discussion of FE would include many issues, including:

- What is a pension liability: a stream of payments, a present value, an accrual of cost?
- What does a pension liability measure, what real world information does it provide?
- What is the cost of a pension plan? What are the relationships among cost, price and value?

- If not MVL, what are the useful applications of FE to public plans?
 - Analysis of the discount rate risk
 - Pricing liability for withdrawing employers
 - Analysis of employer financing, including pension obligation bonds
 - Asset allocation analyses and strategies

- How should the Academy deal with deeply felt and possibly irreconcilable professional differences of opinion among different segments of its membership

In fact, a consensus view of the Public Plans Subcommittee is that our immediate purpose should be broader than just a discussion of MVL disclosure, broader even than the more general FE discussion outlined above. That purpose would seek to apply the full range of our expertise in governance and funding policies to the issues facing public plans today. FE principles would be part of that expertise, but this narrow focus on MVL disclosure runs the risk of being more a divisive distraction than part of the development of an integrated set of solutions.

We urge the PPC to consider that the Academy members who specialize in public plans have both an essential contribution to make and an essential right to full participation in the discussion, a discussion that is only now beginning.

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