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Retiring South Carolina's Public Workforce For Life

Comments to the
American Academy of Actuaries Public Interest Committee Public Forum
September 4, 2008
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The stated purpose of this public forum is to determine if a statement from the American Academy of Actuaries on market value of liabilities (MVL) for public pension plans is in the public interest.

As director of the South Carolina Retirement Systems, I am an advocate for 106,416 annuitants, 225,014 active members, and 176,535 inactive members (numbers as of July 1, 2007). The use of MVL in valuing public pension plan liabilities is a noteworthy concern for the members of our retirement plans and the taxpayers of South Carolina.

It seems premature at best for the Academy to issue a statement on MVL disclosure given the high level of dissent within the actuarial community. Many believe that the application of MVL is inappropriate to public pension plans and would be misleading to users and readers of the financial statements. This could result in adverse unintended consequences.

The purpose of financial statements and note disclosures is to provide clear and useful information to stakeholders. Governmental accounting and financial reporting standards provide accountability and transparency to the public and public policymakers. This is appropriate since a goal of government is to provide services as efficiently and inexpensively as possible.

Conversely, a corporation's goal is to add economic value for its shareholders; therefore, investors could find it useful to know the cost of liquidating a corporate pension plan in the event of bankruptcy, forced buyouts, mergers, etc. Public pension plan benefits are guaranteed and backed by the sponsoring government. Therefore, reporting a "termination value" for the liabilities of a governmental pension plan has no meaning to users of the financial statements and could lead to confusion.

Public pension plans are ongoing concerns that invest over the long term – multiple decades in fact. Because of this long time horizon, a change in the market's interest rate does not mean that a public pension plan's liabilities and the cost to fund those liabilities have changed. It does mean, however, that the plan's liabilities would have to be calculated as such using MVL, which could easily result in an overstatement of liabilities.

Recognizing the longevity of governmental entities, professional public pension plan actuaries use methods to smooth rates of return over a period of multiple years to even out volatility, provide a more accurate assessment of long term liabilities, and ensure predictability in contribution rates. Public policymakers and taxpayers could be misled if an unfunded accrued liability liquidation period is made unpredictable by marking to market.

The extreme volatility of marking to market public pension plan liabilities would extend to contribution rates as well, which are generally shared between employers and employees. Such unpredictability could jeopardize governmental budgeting, which is generally conducted one to two years in advance.

Keeping “two sets of books” is an unnecessary consequence of the application of MVL to public pension plans. Presenting two values of a pension plan’s liabilities would also be confusing to users of these financial statements and serve no other relevant purpose for a public pension plan.

Another concern of requiring public pensions to disclose a market value of liabilities is that it would result in higher allocations to fixed income and reduced allocations to such asset classes as private equities, especially the buyout market, and venture capital. This shift occurred among British pension funds and appears to now be occurring among corporate pension funds in the United States.

The South Carolina Retirement Systems was not allowed to invest in stocks until 1999 when the state’s constitution was amended. If our plans had been invested in a 50/50 bonds/equities portfolio from 1982 to 1999, the plans’ costs could have been reduced by more than \$15 billion. Lost income through contrary and restricted investment options increases pension plan costs and taxpayer liabilities. If MVL was applied to public sector pension plans, in addition to forcing an incompatible financial model given the longevity of the plans, there is a limited availability of bonds in comparison to the investment needs of public pension plans.

A diversified investment approach generates higher returns and provides a vital source of venture capital funding. More than 40 percent of the funding for venture capital in the United States is derived from institutional investors such as public pension funds. This investment by public pension plans results in increased initial public offerings, and creates jobs and revenue. Thousands of companies known today would not exist if not for venture capital support – traditional companies such as Federal Express and Staples, and technology giants like Google and Cisco.

Venture capitalization is a critical component of the life science industry as well. A whole host of medical innovations have resulted from funding provided by venture capital investment. Life science concerns such as Genentech, Amgen, and Medtronic received venture capital support and have benefited society through innovative pharmaceuticals to treat cancer and reduce blood clotting.

The potential loss of public sector investment for venture capital would have a profoundly negative effect on the United States economy. In 2005, venture capital backed companies in the United States generated \$2.1 trillion in revenue and comprised 16.6 percent of the U.S. gross domestic product.

The benefits of venture financing by public pension plans extend to the larger economy; benefits that would be endangered if public pensions were forbidden from making such investments.

It would be helpful for the Academy to consider the following questions in its deliberations on whether a statement on MVL disclosure is in the public interest.

- If required MVL disclosure resulted in shifting asset allocations to fixed income and away from a diversified portfolio, is there sufficient bond market capacity to fund public pension obligations? Would such a shift significantly affect bond yields?
- How would a reduction in venture capital impact the economy and firms in need of venture capital? How would a reduction in the buyout market impact foreign investment in American companies?