



JOHN CHIANG
California State Controller

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Comments to the Public Interest Committee of the American Academy of Actuaries

I am the current Controller of California, the chief fiscal officer of the eighth-largest economy in the world. I was elected by, and represent, the taxpayers. Although, as Controller, I help administer approximately \$400 billion in state pension funds as a member of the boards of the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), I am filing these comments in my role as State Controller.

I do not support the disclosure of the market value of liabilities (MVL) for the pension plans on whose boards I sit and I am concerned about the appropriateness of such disclosure for most public pension plans. A statement from the American Academy of Actuaries on this issue would not be in the public interest.

Among other responsibilities, my office accounts for and controls disbursement of all state funds; audits various state and local government programs, and informs the public of the State's financial condition. In an effort to collect the best information possible on California's financial health and trends, I also have created a new Controller's Council of Economic Advisors to advise me on emerging strengths and vulnerabilities in California's economy and major issues and trends that may affect the State's fiscal health.

I am, therefore, very interested in the accuracy and reliability of California's accounting and financial reporting and disclosures, including the measurement of assets and liabilities. Inaccuracies in these estimates can have a significant impact on how California makes the best use of limited government revenues and resources, not only today, but in the future. Accordingly, I am very disturbed with the possible impact that a misunderstanding of the implications of the MVL could have for government spending in California.

MVL is measured using the unit credit actuarial method and a discount rate based on risk-free bond yields, with benefit obligations calculated based on years of service and salary as of the valuation date. Projected future service and salary are not included in the calculation. This differs from the current practice in use by California's pension plans and

most other governmental plans, which determines liabilities using the entry age actuarial cost method and a discount rate reflecting the expected long-term return on plan investments. The current method does include projected future service and salary in the cost calculations as the projected benefits of California public employees, and not just their accrued benefits, are guaranteed. This is similar to methods used in others states, where constitutional or statutory provisions provide members with a contractual right to the benefits as promised.

The MVL approach produces a liability that has been estimated to be at least 15 percent higher than the liability produced using California's traditional method. In one recent study for a statewide pension fund, the use of the MVL approach, instead of traditional actuarial methods, produced an increase in the total contribution rate of 34 percent, even though the MVL liability was only 13 percent higher than the actuarial accrued liability under the conventional approach.

The danger is that decision makers and members of the public will interpret this increase in the measurement of liabilities as actually requiring higher contributions. It is clear that this danger exists. For example, Jeremy Gold, a prominent actuary and proponent of MVL, was quoted recently in *The New York Times* implying that additional contributions would be required in the future. The May 21, 2008, article states, "The difference [between the liabilities as measured by traditional methods and that produced using MVL] 'is going to come out of services, and the services are for the working poor,' Mr. Gold said."

But are higher contributions necessary? After all, the use of the traditional actuarial method for measuring pension liabilities in California has adequately funded the benefits at CalPERS, CalSTRS, and many other public pension plans in California for more than 75 years. In those plans, investment earnings pay an average of approximately 75 percent of retirees' monthly checks. It would appear, therefore, that conventional actuarial methods permit the calculation of contribution rates that are certainly sufficient to maintain healthy public pension plans in California. Indeed, recent studies by a number of organizations, including the well-respected U.S. Government Accountability Office (GAO), confirm that governmental plans in general are in good shape and reasonably well funded.

I am, therefore, concerned that the use of MVL will needlessly, and artificially, inflate the perceived need for contributions to public pension plans.

Finally, pension plan funding levels will appear to be very volatile when measured using MVL due to its linkage with bond yields. Plans and plan sponsors may be tempted to employ the use of more "bond-like" investments and less equity to limit this volatility. However, the financial consequences to California of such an approach could be severe. The difference between the actual returns achieved by CalPERS and the lower returns that would have been generated if 100% of the fund were invested in bonds averaged 5.6% over the last 20 years. This loss to the California economy if CalPERS and CalSTRS were to invest solely in fixed income investments could be about \$22 billion per year. While this is

not an automatic outcome of the disclosure of the MVL, we need to be very cautious about any disclosure that may encourage this result.

If the MVL method gains traction and changes the way that public sector plans are invested, the consequences for not just our retirement systems, but other state spending programs, could be ruinous. Revenues would be unnecessarily diverted to effectively “overfund” pensions, resulting in less funds being available for spending in other areas such as public education, public safety and infrastructure – or an increase in taxes to offset the impact.

For all of these reasons, I do not support the disclosure of the market value of liabilities for public pension plans and feel that a statement on this issue would not be in the public’s best interest.

Sincerely,

Original signed by:

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California State Controller