



Missouri State Employees' Retirement System

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TO: Public Interest Committee – American Academy of Actuaries

August 12, 2008

Re: Public Forum on Public Pension Disclosures September 4, 2008

This is with reference to the AAA's announcement that the Public Interest Committee has been requested to obtain information through a September 4, 2008 forum that will be used by Committee members to determine if a statement from the Academy's board of directors on the issue of market value disclosures for public employee retirement systems would be in the public interest.

I believe a thoughtful, thorough, non-conflicted evaluation of this issue will lead Committee members to the logical conclusion that such disclosures for public employee retirement systems would not be in the public interest or in the interest of members of the actuarial profession. At the highest level I think members of the profession should make a concerted effort to avoid disclosures that have significant potential for misleading inference – of the proposals I have seen forwarded in the past 35 years, this one would top my list in that regard. Accordingly, I think it would be appropriate and timely for the Academy's board to go on the record with a statement that *such disclosures would not be in the public interest.*

In communications with the public, terminology is extremely important, particularly when the potential exists for misinterpretations associated with terms that are being used in a context that deviates from their everyday meaning. For example, objections to the use of terms like “market value” and “risk free rate” have seemingly been dismissed in a rather cavalier manner. However, they lie at the heart of the matter for many of us charged with the responsibility for accurately communicating information regarding governmental plan financial position and financial condition. The implications that (1) there is relevance to a termination-like liability for a plan that cannot be terminated (in the private sector sense) and (2) there is a discount rate that removes risk from the equation, appear by many of us to be targeted at misleading the general public as well as wrongfully alarming many state and local policy makers.

The matter of presenting plan termination-like disclosures for a plan believed to be a going concern, computed using assumptions that simply reflect short term market conditions was addressed very pointedly in a September 21, 1979 communiqué to the FASB from the Dale Gustafson (then AAA President) on behalf of the AAA Task Force on Review of Revised FASB Exposure Draft on Accounting and Reporting by Defined Benefit Pension Plans. An excerpt from that document follows:

In order to comply with the guidelines of the Exposure Draft, the actuary might be required, at certain times, to prepare actuarial values and information for inclusion in the financial statements of the plan which, (1) do not represent his best estimate of the future experience,

etc. under the plan, as required by ERISA, (2) in his opinion, are prepared or presented in a manner inconsistent with the guides and opinions to conduct of his profession, and/or (3) are inconsistent with the Schedule B prepared by the actuary for the actuarial statement filed for the plan.

If faced with this problem of supplying information that he believes is inappropriate, Enrolled Actuaries and/or members of the Academy preparing such information would seem to have two choices:

- (1) Refuse to prepare the actuarial information on the basis requested, or
- (2) Supply the requested information on the basis requested, but with an accompanying statement which states that the values are inappropriate for the purpose.


The individuals responsible for this statement did not arrive at it lightly nor did they reach their conclusions based on their failure to grasp the complexity of the issues at hand. The problem they were referencing was eventually resolved through subsequent statements from the FASB. However, it seems strange (at least to me) that the AAA may be considering pronouncements that would effectively put many of their own members in the position that was earlier viewed by the AAA as a threat to proper professional conduct.

There are two overarching principles that I hope committee members will weigh heavily in their deliberations:

- (1) There is no snapshot view (regardless of how calculated) that will allow an interested party to develop a thoroughly informed opinion about a going concern plan's financial condition or position.
- (2) It is possible, through the distribution of misleading information, to perpetuate the demise of defined benefit pension plans which, in my view, runs counter to the public interest for a variety of reasons. (Some of those reasons are addressed in the attached op-ed piece.)

I do think the members of the Public Interest Committee could probably benefit from an extensive review of the history of accounting and reporting by defined benefit pension plans and, in particular, such governmental plans. However, that is something that cannot be addressed in a five minute presentation or in 1,000 written words. If the Committee is interested in such a review, I (and others) will make the time available.

Sincerely,


Gary Findlay
Executive Director



Shifting pension plans there are consequences

By Gary W. Findlay

Sunday, May. 28 2006

I'm sure you have noticed a number of articles lately like the one I just read regarding a company that was replacing its traditional defined-benefit pension plan with a defined-contribution plan, such as a 401(k).

The article reported that the company "... will cut retirement costs by about \$700 million over the next 10 years by revamping its U.S. pension plans." While these stories are becoming commonplace and are accurately reported, there is another side that is not told.

For example, it would have been equally factual if the report had noted that the company "... took action that, over the next 10 years, will result in reductions in retirement benefits for their future retirees of \$700 million plus the amount that \$700 million would have earned had it been deposited in a traditional pension plan."

If the pensions that would have been paid would have provided for a subsistence level of income for the masses among the former employees of these companies (which is probably the case), how is the shortfall going to be covered?

If I were a betting person, I'd bet on it being government-sponsored entitlement programs -- in essence, it is likely that this will increase the burden on working taxpayers to fund retiree benefits on a pay-as-you-go basis.

I'm not faulting the corporations -- their behavior seems quite rational. We reward management for increasing net earnings and for increasing prices per share, and the defined-benefit to defined-contribution switches we are seeing can have a significant impact on both.

It just seems incongruous to me that, on the one hand, we are critical of the pay-as-you-go Social Security system because of the increasing burden it will place on taxpayers as the result of shifting demographics and, on the other hand, we applaud and reward corporate behavior that is likely to exacerbate the problem.

Regardless of whether these consequences are intended or unintended, they are predictable.

While I am at it, I probably should mention some of the other probable outcomes of the defined-benefit to defined-contribution switches that make the trend seem attractive to certain special interests.

- A number of people who change employers will take a distribution from their defined-contribution-plan accounts and not roll it over to another retirement savings vehicle. This potentially benefits at least two special-interest groups in the short term. Retailers of consumer products will benefit from the windfalls in discretionary income that will end up in the hands of consumers. Governments also will benefit because tax revenue will increase as the result of both the premature distribution tax and the ordinary income tax on amounts that would have otherwise remained in a defined-benefit retirement plan.

- Shareholder activism is seen by many poorly performing corporations as a thorn in their side. If the private-sector trend in switching to defined-contribution from defined-benefit plans migrates to the public sector, it will break up the large blocks of stock that are now being voted to effect

positive long-term changes in corporate behavior. As a practical matter, the watchdog role of large institutional investors would be eliminated. (My guess is that the Business Roundtable and the Chamber of Commerce would not object to this outcome.)

- High-level corporate managers frequently have a good deal of their net worth tied up in company stock and options on their company stock. It seems reasonable to conclude that those who are nearing retirement might find a pop in their stock price to be quite attractive -- the only thing they have to do to achieve it is "follow the trend" of reducing corporate expenses by promoting a switch to defined contribution.

- Investment-market service providers will benefit because they can get away with charging much higher fees for their services to individually directed defined contribution plans than they can for services to efficiently managed asset pools in defined-benefit plans.

As mentioned earlier, if retirement-plan contribution rates are reduced by virtue of defined-benefit-to defined-contribution-plan conversions, aggregate benefit payments will be reduced even more. Some of the additional probable fallout from a defined-benefit to defined-contribution switch will include:

- Higher rates of employee turnover, resulting in higher training costs and lower productivity.

- Higher poverty rates among retirees (particularly females).

- Increased demands by employees for investment education.

- Potential lawsuits by older employees who believe they were disadvantaged by the switch.

- Bear-market-generated delays in retirement by employees who otherwise would have left the work force (but instead end up being retired on the job).

- Lower rates of retirement income per dollar of retirement contributions.

- Reductions in the national savings rate.

When long-term universal good must contend with short-term special interest, the outcome is commonly predictable and unfortunate, with the short term being the winner.

It seems to me we already are passing on significant amounts of economic trash that future generations will be required to clean up. If we are going to add to it by shifts to defined contribution plans from defined benefit plans, at least I think we have an obligation to let the masses know what is happening.

Gary W. Findlay is executive director of the Missouri State Employees' Retirement System, Jefferson City. This article originally appeared in Pensions & Investments magazine. Copyright Crain Communications Inc.



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TO: Public Interest Committee – American Academy of Actuaries

August 28, 2008

Re: Follow up on original submission to the PIC re MVL for PERS

Since the time of my 8/12/08 communication with you on this matter, additional information has surfaced (at least for me), and it is my hope that you will include this as a supplement to the memo I initially submitted.

Point 1

As I understand it, the statement has been repeatedly made that since public fund officials are opposed to MVL type disclosures, it necessarily follows that they generally oppose transparency regarding the plans for which they are responsible. Let there be no mistake – public fund representatives do not oppose transparency. In fact, a review of history will make it clear that the report preparers for state and local plans covering in excess of 80% of such plan participants have voluntarily subscribed to reporting standards that provide for extensive transparency.¹

The opposition to MVL that you are witnessing is the outgrowth of concern by report preparers that the reporting and disclosure of information that systemically lags behind the expected values based on any set of reasonable possible future outcomes for their plans is simply irresponsible. These people take their fiduciary responsibilities seriously – knowingly reporting misleading information about their plans would be a violation of those responsibilities.

The pushback regarding MVL is reminiscent of what happened when the FASB issued their first exposure draft of what eventually became Statement 35. The FASB received over 700 letters (including many from actuaries) objecting to the proposal. Based on this, the project director concluded that he must be on the right track, otherwise there would not have been so many objections – it never occurred to him that the proposed standard might simply be significantly flawed. Well it was flawed and even the FASB acknowledged the flaws through their subsequent pronouncements; however, while it was the prevailing standard, a lot of people

¹ Report preparers saw the need to address the information needs of a variety of stakeholders, including, without limitation by enumeration, plan participants, a range of legislative and executive branch representatives, budget officers, rating agencies, investment bankers and last, but certainly not least, taxpayers. The demands for information addressing all of their needs led to the development of the GFOA Guidelines for the Preparation of a Comprehensive Annual Financial Report – these guidelines are followed by the vast majority of the larger state and local public pension plans.

jumped through a lot of needless hoops to do damage control that could have been avoided had the standard setters been more attuned to reality.

Pushback – yes. Reluctance to embrace transparency – absolutely not.

There is one additional issue here that probably merits mentioning. The GASB eventually recognized that there were a handful of plans using the aggregate funding method and that their related disclosures provided no useful information in assessing the progress being made in accumulating the assets needed to meet their going concern liabilities. (To almost any student of the subject, a method that would result in even social security appearing to be fully funded was seen to be lacking in terms of adequate disclosures.) The GASB addressed this problem by requiring plans using the aggregate method to provide additional information. Unfortunately, they did not extend this requirement to plans using frozen initial liability methods. Regardless of whether it was by design or by happenstance, there are a couple of high profile large public plans using FIL methods that consequently are not required to provide meaningful disclosures regarding their funding status and funding trends. The GASB staff is aware of this problem and I suspect it will be addressed in subsequent GASB pronouncements.

Point 2

My guess is that you will receive one or more academic appearing treatises describing why the so called market value of liabilities should be determined and reported for public employee retirement plans. While there are very few absolute truths in life, in reviewing such documents, I was able to come up with at least three:

1. If you begin with a false premise, you can rationalize practically any conclusion you wish.
2. If you begin with a preconceived conclusion, you can easily justify it as long as you are willing to disregard material facts in your analysis.
3. Complex mathematical and statistical analysis may be satisfying to workaholics and craftsmen, but there is no evidence that they can produce the unknowable. (Do not allow the elegant trappings of multifaceted formulas to lull you into thinking they are a roadmap to the truth.)


Plain and simple, MVL for public plans is a roadmap to deception.

While of less immediate concern to me, I also seriously question the wisdom and reasonableness of MVL when it results in LDI funding strategies for private sector DB plans. The fact is that there is a case to be made for charging corporate executives with violating their responsibility to shareholders if they adopt a funding approach for their pension plans that results in a greater than necessary demand on corporate resources. We, as institutional investors, pick up the tab when management at the companies we own embrace inefficient benefit financing policies. They may not object to leaving money on the table but then it's not their money. It belongs to the institutional and individual stockholders and these owners should object.

Point 3

The case for negative fallout from MVL disclosures has been made by many knowledgeable practitioners. The theoreticians, on the other hand, will blithely say that the consequences should not matter in the pursuit of truth. It's not that simple. The fact is that truth is in the eye of the beholder. In this instance, let's follow the current written guidance of MVL proponents for a private sector plan and recognize that it demands a change in investment policy. Please take a moment to recognize that MVL disclosure must be disassociated from investment policy on both sides of the discussion before anyone decides on an advocacy position. Regardless, some MVL proponents who are totally convinced of its propriety for the private sector, make the quantum leap to concluding it necessarily follows that it is appropriate for public sector plans. Again, it's not that simple. In my view, that line of reasoning is a classic example of what Emerson called "a foolish consistency." The fact is that if you can exert enough pressure you can probably force a round peg into a square hole, despite the significant potential for harm and no detectable positive outcome (other than for the benefit that accrues to those who are selling round pegs).

Sincerely,


Gary W. Findlay
Executive Director