

Dear Members of the AAA Public Interest Committee:

Although we understand why the PIC imposes a 1000 word limit, we hope to persuade you to read two documents one of which is much longer. We include extracts from each in this note in the hope that will entice further reading.

The first is the speech made by the Vice-Chairman of the Federal Reserve Board Donald L. Kohn to the National Conference on Public Employee Retirement Systems on May 20, 2008 in New Orleans. You may have already seen this:

<http://www.federalreserve.gov/newsevents/speech/kohn20080520a.htm>

In particular we call your attention to the last section: Lessons for Public Pension Systems where he contrasts actuarial measures of liability with those of economists:

"I mentioned earlier that current measures of pension liabilities might be less than fully revealing. Why might that be so? The chief reason is that public pension benefits are essentially bullet-proof promises to pay. We all have read about instances in which benefits were lost when a private-sector pension sponsor declared bankruptcy and terminated the plan. In the public sector, that just hasn't happened, even when the plan sponsor has run into serious financial difficulty. For all intents and purposes, accrued benefits have turned out to be riskless obligations. **While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate.**"

The second is a paper we wrote for the Pension Research Council (PRC) at the Wharton School of the University of Pennsylvania. The PRC has been an intellectual partner to the SOA for at least four decades and PRC publications have appeared continuously on the pension syllabus throughout those years. Our paper will be published by the PRC in a book on public pensions. The PRC director recently commented "your contribution is one of the most important in the book and a key contribution to the literature." In the first chapter of the forthcoming book, the PRC says: "Latter [Gold] notes that actuaries are good at developing long-term projections and budgets, but those projections need not necessarily link economic values or market conditions. No sector of the economy can escape the hard rules of the capital markets, he argues. When asset and liability figures differ, and in this case significantly, it inevitably results in a misallocation of resources,"

Although the paper has a point of view, it is not political. It develops the case for market value disclosure in an organized way providing more than twenty references to other papers and studies written by economists, actuaries and accounting authorities world wide. The working paper is here:

<http://www.pensionfinance.org/papers/TheCaseforMarkingPublicPensionPlanLiabilitiestoMarket.pdf>

We hope that members of the PIC will choose to read the paper in its entirety. It is directly on point with your current efforts. Here is the abstract:

The Case for Marking Public Pension Plan Liabilities to Market

Abstract

"Pension plans covering employees who work for state and local governments in the U.S. hold an estimated \$3 trillion in assets. The market value of the assets of such plans is regularly disclosed

in the financial statements of the plans and their sponsors. Plan liabilities, however, are routinely reported at actuarial values which may differ substantially from market values. In addition, the disclosed funded ratio is often based on a smoothed value of assets which may differ substantially from market value.

We define a market-based value for plan liabilities (MVL): the present value of accrued benefits discounted at market interest rates for fixed income investments that are, or are nearly, default free. The MVL, viewed in conjunction with the market value of plan assets (MVA), can inform taxpayers, public sector employees, and the agents who make decisions on their behalf (e.g., elected officials, labor representatives, plan administrators, etc.). Lenders (municipal bond buyers) and the rating agencies who serve them will also find value in the transparency represented by the MVL and MVA. Among the questions that these disclosures can help to answer, we include:

- 1) Will future taxpayers be paying for services provided to current and previous generations of taxpayers? Or might the opposite be true?
- 2) How does the funding level, and benefit security, of this plan compare to plans in other jurisdictions in the U.S.?
- 3) What is the market value of benefits being earned by public employees this year? What does this tell us about their total compensation?

These questions cannot generally be answered by reference to the actuarial value of the accrued liability, which is regularly presented in the comprehensive annual financial report (CAFR) of the plan sponsor. Because these important questions deserve answers, we call upon public pension plans to measure and report MVL.

Although accurate measurement of the MVL is best done by plan actuaries who have access to the participant data, we attempt to measure the MVL for an arbitrary sample of public sector pension plans using publicly available information. We comment on the difficulties we and other outsiders have in making such estimates."

Thank you for addressing this important issue and for inviting comments.

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