

DISCLOSURE IN PUBLIC PENSION PLANS

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July 30, 2008

Thank you for the invitation to submit written comments on the issue of the disclosure of the market value of assets (MVA) and the market value of liabilities (MVL) in public pension plans, an issue that evolved from the debate on the application of the principles of financial economics (FE) to public plans. The MVA should be disclosed. It is not unreasonable to disclose the MVL. There is concern that the disclosure of the MVL would be used to mislead. Proponents of FE suggest that not only should the MVA and the MVL be disclosed, they should be used to determine funding amounts and the asset mix. The disclosure of MVL should not be misleading as long as it is clear that the best practice for the funding policy and the investment policy is to use conventional methods rather than FE. The use of FE for funding would lead to significantly increased contribution requirements without improving intergenerational equity. The use of FE for investment policy would lead to an inappropriate increase in the allocation of assets to fixed income investments. Public plans should resist using FE methods for the funding policy and asset mix decisions and continue to use conventional methods.

Discount Rates

The FE method produces significantly greater liabilities from using lower discount rates. The proponents of FE argue that the equity risk premium needs to be excluded from the expected return of the portfolio to determine the rate at which to discount the liabilities. The appropriate discount rate is the long-term expected return on the portfolio, reduced for volatility. Based on the asset mix and using the building-block method, the expected compounded return assumption before expenses can be developed by taking the expected annual return and subtracting about one-half of the variance. The inter-quartile range can be developed by using a corridor within one-tenth of a standard deviation around the expected compounded return.

Cost Method

FE uses the Unit Credit cost method, a method that excludes liabilities for future pay increases. Conventional methods appropriately include projected pay in the liabilities. The FE cost method is an unreasonable method for the funding policy. The Unit Credit cost method produces a normal cost pattern that increases significantly as a percent of pay.

Amortization Methods

The FE method has no amortization of unfunded liabilities and requires immediate recognition of all changes in the liability. The fact that traditional approaches allow for payments on the unfunded liability that are less than the interest is used by FE proponents to make a case for not having any amortization at all. It would be preferable to use the amortization methods under conventional approaches using reasonable assumptions than to use the FE method which has no amortization. The FE method of immediate recognition of all changes in the liability is unreasonable for the funding policy.

Contribution Requirements

The contribution requirements under traditional approaches are based on the sum of the normal cost plus an amortization payment. The contribution requirement under FE is the difference in the MVL at the end of the year and the MVL at the beginning of the year. The FE method would produce an excessively large and extremely volatile contribution because the cost changes from any gains and losses, plan changes, or assumption changes would need to be recognized in a single year. The FE method for determining contribution requirements is unreasonable.

Asset Smoothing

The FE method uses the MVA. It is appropriate to use the MVA for disclosure purposes. The conventional approach for funding purposes is to allow the use of the MVA or a smoothed actuarial value of assets. The use of a smoothing method reduces the volatility in contribution rates due to short term investment gains and losses. Stable and predictable contribution rates are preferable to volatile rates. The FE method of not allowing smoothing of investment gains and losses in the asset method is unreasonable for the funding policy.

Asset Mixes

The typical asset mix is a balanced portfolio with a mix of equities and fixed income investment vehicles. Proponents of FE argue that the typical asset mix includes excessive equity exposure. A portfolio invested 100% in bonds would have a significantly lower long-term expected rate of return than a portfolio with the more traditional mix of equities and fixed income. To make up for lower investment earnings, contribution requirements would be greater. Another problem with a 100% fixed income mix is that it does not appear on the efficient frontier. Conventional methods that use a balanced portfolio are more appropriate than FE.

Conclusion

Actuaries should disclose the MVA and use their own professional judgment on the issue of MVL disclosure. It should not be considered unreasonable to disclose the MVL. Without any regulatory agency such as GASB or any rating agencies requesting the MVL, it should not be necessary to disclose it. An issue with the MVL is that there is no active market for the liabilities. Proponents of FE would have funding calculations based on the MVA and the MVL with no amortization. The appropriate funding method is to use the conventional approaches with minor improvements, including selecting a rate of return assumption that reflects the impact of volatility on the compounded return; allowing smoothing of investment gains and losses within limits such as a maximum of five years of smoothing with a corridor of 80% to 120% of the MVA; and at least for plans that are below 60% funded, requiring accelerated amortization payments and descending amortization periods, with a minimum amortization payment of the interest on the unfunded liability. The appropriate asset mix is a balanced portfolio that includes equities. The FE solution is worse than the problem with conventional approaches. To make sure that methods and assumptions are reasonable, public plans should continue to use conventional approaches that have a real world application rather than the theory of FE.