

# MEMORANDUM

TO: Members of the Board of Directors of the American Academy of Actuaries

FROM: Public Plans Subcommittee of the Pension Committee

DATE: May 15, 2008

SUBJECT: Public Statement concerning market value of pension liabilities

There is a controversy among actuaries concerning a public statement that *might* be issued by the Academy concerning measurement of pension liabilities. Following is a statement which might be presented by the Vice President for Pensions (VPP) to the Board for action at its May 21, 2008 Meeting.

***The American Academy of Actuaries supports the measurement and reporting by actuaries of the market value of assets and liabilities of defined benefit pension plans.***

On May 4, our Vice President for Pensions (VPP) informed the Pension Practice Council (PPC) that the current version of the Statement would be presented to the Board for action. Having rejected a motion in the PPC meeting to consider an alternative statement approved and submitted by the PPS, our VPP informed the PPC that he would take this Statement forward to the Board individually, without an affirmative vote from the PPC.

The Public Plans Subcommittee (PPS) is opposed to the content of the VPP Statement and the process by which it appears to be coming before the Board. If any Statement is to be considered by the Board for release, the Public Plans Subcommittee proposes the following two-part alternative Statement:

***The American Academy of Actuaries acknowledges that there is a legitimate and substantive difference of professional opinion within the actuarial community regarding the applicability of “market value liability” measures to public pension plans. The Academy encourages continued development and discussion of this issue.***

***The American Academy of Actuaries supports and encourages the use of tools beyond traditional actuarial techniques in assessing and explaining the risk of the investment return assumptions not being met. These tools may include use of a risk free or market rate of interest, sensitivity analysis, stochastic simulation and other techniques for measuring investment risk.***

There are serious weaknesses of the ***VPP Statement***.

1. A substantial majority of actuaries practicing in the public sector are opposed to it.
2. The “market value” of liabilities has little relevance to public sector plans.
3. The Statement applies to all defined benefit plans, without qualification.
4. Market value of liabilities is not a well-defined term and the association with market value of assets is misleading.
5. This Statement will likely inhibit our profession’s ability to have a substantive and effective role in public policy.
6. There are likely other unintended consequences which should be considered.

The PPS favors the ***PPS Statement*** because:

1. It acknowledges and permits diversity of opinions within the profession.
2. It encourages movement from the traditional one-number approach to risk measurement.
3. It encourages actuaries to be proactive in the risk measurement and management of public sector pension plans.

Please refer to the attached Discussion for more details on these matters. Thank you for your consideration.

# Discussion of Public Plans Subcommittee Memorandum

## May 15, 2008

### Proposed Academy Statements regarding Market Value Liabilities and Public Pension Plans. Presented by the Public Plans Subcommittee of the AAA Pension Committee.

There is a controversy among actuaries concerning a public statement that *might* be issued by the Academy regarding the market value of liabilities either for public sector defined benefit pension plans or for defined benefit plans in general. We understand that such a statement will be proposed for adoption at the May 21, 2008 Academy Board meeting. If so, we wish to propose our alternative statement for adoption.

#### The Proposed Statements

Statement Proposed by the Vice President for Pensions (VPP), as presented to the Pension Practice Council (PPC) on May 4, 2008):

*The American Academy of Actuaries supports the measurement and reporting by actuaries of the market value of assets and liabilities of defined benefit pension plans.*

Alternative Statement Proposed by the Public Plans Subcommittee (PPS) as presented to the Pension Practice Council (PPC) on May 4, 2008):

*The American Academy of Actuaries acknowledges that there is a legitimate and substantive difference of professional opinion within the actuarial community regarding the applicability of "market value liability" measures to public pension plans. The Academy encourages continued development and discussion of this issue.*

*The American Academy of Actuaries supports and encourages the use of tools beyond traditional actuarial techniques in assessing and explaining the risk of the investment return assumptions not being met. These tools may include use of a risk free or market rate of interest, sensitivity analysis, stochastic simulation and other techniques for measuring investment risk.*

#### Background

On May 4, our Vice President for Pensions (VPP) informed the Pension Practice Council (PPC) that the version of the Statement shown first above would be presented to the Academy Board for action. A motion by a PPC member to consider the Public Plans Subcommittee (PPS) alternative statement was disallowed by the VPP in his ex-officio role as chair of the PPC. The VPP informed the PPC that he would take his version forward to the Academy Board as an individual, not as a statement adopted by the PPC.

While previous versions of the VPP Statement referred only to public sector pension plans, the May 4 version refers to all defined benefit plans. This extension to multiemployer and Federal plans is new, and has not been part of the ongoing discussion regarding public pension plans.

Statements have been made in public suggesting to the public plan retirement community and the general public that the Academy will not soon be issuing a statement on the market value liability issue. As you may know, an AAA/SOA sponsored Roundtable was held in February 2008 to discuss "The Role of Financial Disclosure" for public plans. This Roundtable brought together many stakeholders and experts to address the issue of public plan disclosures, including considerable discussion of market value liability.

The Roundtable was closed with a statement by the VPP (and PPC Chair) that this was only "opening up a public discussion on this topic". The March *Actuarial Update* reported the same statement. Many public retirement stakeholders who share our concerns regarding market value liability for public plans are relying on these statements as accurate. If the Academy were to take a one-sided position so soon after the Roundtable without opportunities for further public discussion, the Roundtable may be seen as something other than a genuine opportunity for substantive public discussion.

## Discussion of the VPP Statement

*The American Academy of Actuaries supports the measurement and reporting by actuaries of the market value of assets and liabilities of defined benefit pension plans.*

The Public Plans Subcommittee (PPS) is opposed to both the content of this statement and the process by which it has been brought before the Board. While a detailed discussion of our objections are beyond the scope of this document, here are some of the main reasons why the PPS objects to the VPP Statement being issued by the Academy or by any of its Committees or Officers:

1. A substantial majority of actuaries practicing in the public sector are opposed to it.

Much of the push for applying market liability measures to public plans comes from professionals, including actuaries, who work primarily in the investment area, and are applying investment models developed for corporate pension plans. We respectfully request the Board give appropriate weight to the opinion of its members who specialize in the valuation of public plan liabilities.

2. The “market value” of liabilities has little relevance to public sector plans.

In the environment of state and local governments, no one is asking, “How much is the employer worth?”, as they do in the private sector. No one is buying stock in government employers at any market value. This means that the so-called market value of public sector pension liabilities is a purely theoretical construct.

The Governmental Accounting Standards Board (GASB) issues GAAP Standards for state and local governments. GAAP does not require market value of pension liabilities to be disclosed or otherwise reported for governmental entities. In fact, GASB recently published a White Paper titled *Why Governmental Accounting and Financial Reporting Is – and Should Be – Different*. Similarly, the agencies which rate government bonds are not asking for the market value of pension liabilities. They are more interested in sustainability over time than in a point-in-time hypothetical market price.

Market based liabilities for pension plans are well established both in theory and in practice for private sector plans. Neither the theory (corporate financial economics) nor the practical applications (as a settlement liability) are applicable to the environment of state and local governments and their retirement systems. The “pass-through” concept of corporate pension assets and liabilities does not apply to public plans, which are far more independent of their sponsoring employers. Furthermore, government employers seldom ever go out of business or terminate their pension plans, and discharge their liabilities in an open market.

3. The Statement applies to all defined benefit plans, without qualification.

Previous versions of this Statement explicitly targeted public sector pension plans. This new version would include not only private sector pension plans and public sector pension plans, but also multiemployer plans as well as Federal retirement and social security defined benefit systems. Furthermore, what applies to pensions usually applies to other post-employment benefits (OPEBs) like retiree medical plans. This extension to multiemployer and Federal plans is new, and has not been part of the ongoing discussion regarding public pension plans.

4. Market value of liabilities is not a well-defined term and the association with market value of assets is misleading.

Pension plan assets are traded in open markets and have objective, market-determined market values. In contrast, public plan pension liabilities are not traded. Thus, their “market” values are only a theoretical construct of how an idealized “market” would price these liabilities. To a lay audience, comparing market assets to “market” liabilities sounds reasonable, but in fact it gives to the hypothetical market liability an appearance of credibility and objectivity that is only appropriate for true market determined values.

In current actuarial and financial usage, “market value liability” means the present value of accrued benefits discounted at a “risk free” market interest rate. There is no general agreement how to determine a risk free rate and even the current private sector standard (high quality corporate bonds yields) is not risk free. Furthermore, a true market-determined value would also adjust for various non-investment risks.

5. This Statement will likely inhibit our profession's ability to have a substantive and effective role in public policy.

While most public pension systems are well managed, clearly there is a role for actuaries to advise and influence public retirement systems, employers and legislatures in the areas of improving public plan governance and funding. Our experience is that the recent narrow debate on market liability has and will continue to distract our resources from addressing a broader range of governance, risk management and funding policy issues and solutions.

Furthermore, a narrow statement supporting corporate pension measures for public plans could harm the credibility and image of actuaries and the Academy with the very public sector pension systems, organizations and policymakers we hope to advise and influence. One such national organization has already gone on record opposing this type of reporting. These industry leaders understand the liability measures being considered. What they oppose is simply porting these concepts over to the public sector without justification or consideration of their consequences.

6. There will likely be unintended consequences that should be considered.

We suggest that the Board consider the risk of other potential unintended consequences, including the confusion created in the public (and the press) by unnecessarily introducing multiple measures of pension liabilities, the use of such measures by those who oppose defined benefit plans, and the extension of corporate pension finance principles into the areas of public plan funding and investments. These risks are heightened by the fact that the market value liability is often characterized by its proponents as the sole "true" measure of pension liability. This calls into question the validity of established actuarial policies and practices, and has immediate and practical consequences for plan funding and investment policies.

#### **Discussion of the PPS Statement**

*The American Academy of Actuaries acknowledges that there is a legitimate and substantive difference of professional opinion within the actuarial community regarding the applicability of market value liability measures to public pension plans. The Academy encourages continued development and discussion of this issue.*

*The American Academy of Actuaries supports and encourages the use of tools beyond traditional actuarial techniques in assessing and explaining the risk of the investment return assumptions not being met. These tools may include use of a risk free or market rate of interest, sensitivity analysis, stochastic simulation and other techniques for measuring investment risk.*

If it is determined that the Academy must make a Statement on the issue of market value liability and public plans, the PPS proposes the above two-part statement.

The first part lets the public know that the narrow issue of market value liability and public plans is in fact an open issue within our profession. We submit that it is not only appropriate but essential for the Academy to encourage and facilitate an open discussion of this issue, rather than restrict that debate by taking a position on one side. We also suggest that it speaks well of any profession that it can acknowledge an honest and well-informed difference of professional opinion within its membership. Finally this statement is consistent with the representations that have been made to the public regarding "opening up a public discussion on this topic", as we have discussed in our "Background" section.

The second part encourages a broader analysis of investment risk, including possible use of a risk free discount rate as one of several analytical tools, without endorsing the simplistic single-number application and reporting of corporate pension finance measures for public plans. This is part of the broader discussion of public plan governance, risk management and funding policy that we identified in item 5 of our "Discussion of the VPP Statement".

If a Statement is adopted, while the PPS would prefer the two-part statement presented here, we would also endorse the separate adoption of either of the two parts as stand-alone statements.