

Talking points for Public Interest Committee of the American Academy of Actuaries  
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Talking points:

- Valuations of pension fund assets and liabilities of public sector pension plans serve several important purposes. They offer employees guidance on the security of their benefits, they help plans to make investment decisions, they ultimately help to determine the contributions to pension plans from employers who sponsor such plans, and they provide taxpayers with information about the future demand on them from governments.
- The goals of pension plan regulations, including rules that govern asset and liability valuations, are benefit security, investment stability, and certainty about future employer and employee contributions.
- To achieve these goals, asset and liability valuations need to impart relevant information. The information needs to be transparent, easy to understand, and should reflect the long-term nature of public sector pension plans.
- Changes in valuations need to be approached carefully. They cannot just follow a fad since they will be in place for a considerable amount of time. As a basic policy rule, valuation changes should only be considered if they make existing rules more efficient.
- Increased efficiency means that any rule changes will have to better accomplish the primary goals: secure benefits, stable investments, predictable contributions, and manageable demands on taxpayers.
- If rule changes force trade offs between these goals, public policymakers will have to establish a ranking of these goals to allow for a unique ranking of policy alternatives.
- There is little debate that the primary goal of asset and liability valuations is the security of promised benefits. A close second goal is to keep demands on taxpayers manageable. This goal, though, is implicitly directly intertwined with the predictability of employer contributions. Finally, investment stability (and with it, investor protection), as a goal separate from achieving benefit security, ranks fourth since it is not directly linked to the primary purpose of a pension plan.
- Moving from the current system of asset and liability valuations, which allows for some smoothing of such values, towards marking assets and liabilities to market is an inefficient policy move.
- The alternative policy considered here would undoubtedly increase the uncertainty of employer contributions in the long-term. In effect, contribution rules will follow funding level valuations in the future. Keeping two sets of rules -- marking assets and liabilities to market while allowing contribution levels to be based on smoothing procedures -- is internally inconsistent and politically indefensible. Consequently, employer contributions will become more volatile as funding valuations become more volatile.
- If employers do not address the volatility of their contributions, demands on taxpayers will no longer be manageable.
- If, however, employers address the volatility of their contributions -- moving towards an all-bonds portfolio or terminating their plans -- benefit security will be severely hampered. The experience in the private sector from greater marking-to-market required under the Pension Protection Act of 2006 already has shown that many plan sponsors will reduce their exposure by terminating or freezing their pension plans.

- Finally, some investors may be worse off. In particular, investors in asset classes that depend heavily on investments from public sector pension plans, such as private equity, venture capital, but also stocks, could be exposed to more volatility if public sector plans respond to the increased volatility by moving away from these asset classes. Markets for the aforementioned assets and investment strategies could become less liquid, which could imply greater volatility for the remaining investors, if public sector pension plans withdraw.
- The result is that the new set of valuation rules could move public policy further away from its intended goals.
- The primary reason for the inefficient policy outcome is that moving asset and liability valuations towards marking assets and liabilities fails to impart relevant information.
- For one, it only creates the illusion of transparency. Transparency would require that financial markets are in an efficient equilibrium so that all relevant information is accurately reflected in prices, including interest rates. The economics literature has shown that this is rarely the case. Users of marking to market valuations will thus believe that the valuations mean one set of information, while in reality they will reflect a different set of information.
- Second, the information is not easy to understand. The new valuation methods will in the first instance only impact assets and liabilities, but not contributions. Users of the information, for instance, will have no indication of how long it will take to reduce any gap between assets and liabilities. There will also be no sign of the relevant additional costs of potential gaps between assets and liabilities in relation to relevant economic variables, such as the size of an economy or payroll.
- Third, and most importantly, the new information would not reflect the nature of a pension plan. A pension plan, especially in the public sector, will invest over very long-time horizons. The valuation of its assets and liabilities needs to reflect this to account for inevitable deviations of financial market prices from their long-term equilibrium. After all, a financial entity with an infinite investment horizon, such as pension plans for state and local government employees, will face a different universe than an individual planning to retire next year or a private sector plan that is about to be terminated. Applying valuation standards that implicitly assume an impending termination of a public sector pension plan ignores the relevant economics of these plans.

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