

**The Disclosure of Market Value of Assets and Liabilities
by Public-Sector Defined-Benefit Pension Plans**

Comments before the Public Interest Committee
of the American Academy of Actuaries

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Thank you for the opportunity to appear before you today. The views I will be presenting are my own and are not necessarily shared by the members of the Federal Reserve Board or its staff. They do not represent an official position of the Federal Reserve.

The central question that you confront today is whether public plans should disclose a market-value-based estimate of their liabilities. I believe that they should, because a market-based estimate provides the truest measure of the burden on taxpayers of providing the pension benefit in question.

Some have argued that because state and local governments do not exist to generate a profit, or because public plan sponsors cannot go out of business or be acquired by a competitor, market-based estimates are irrelevant for them. Others have argued that policymakers need other information aside from market-based estimates in order to make sound decisions on behalf of their constituents.

The main point that I wish to stress today is that in order to be useful, an estimate of plan liabilities must provide an analytically sound answer to a coherent, well-specified question. Market-based estimates of plan liabilities meet that test. Specifically, they provide answers to the following questions.

- First, what will the cost to taxpayers be of meeting the obligations that have been incurred to date, and how does that cost compare to the value of the assets that have been accumulated as backing for those obligations?
- Second, what is the cost of the new obligations that have been incurred in the most recent reporting period?

These questions are intimately linked because the first pertains to the *stock* of accumulated obligations, while the second pertains to the *flow* of new obligations.

I should note that the measure of liability that I have in mind—an ABO-type measure—treats pension liabilities comparably to wage and salary expenses. No one bats an eyelash over the fact that employers recognize their cash wage and salary expenses only when they are incurred. To generate meaningful financial statements, we should treat pension expenses similarly.

Other measures of liabilities also provide answers to particular questions, but those questions are deficient in important ways. For example, one can motivate an estimate of liability based on the *expected* return on assets as providing an answer to the following

question: “Are the assets currently in the trust fund *expected* to be sufficient to pay the liabilities of the plan?” This question is deficient because it fails to take risk into account. A “yes” answer conveys nothing about the risk of a future shortfall of assets relative to accrued liabilities. And a “no” answer can always be finessed by ramping up the riskiness of the assets in the trust fund until the answer comes back as “yes.”

A key underlying question in this debate is whether state and local governments should penalize risk to the same extent that private-market participants do. One way to see the rationale for the view that they should is to recognize that doing so respects a form of the Golden Rule: Governments should value the resources that they take from their constituents in the same way that their constituents do. If constituents value the burden of providing a given pension to public employees at \$100, then policymakers should view that burden in the same way and should not deceive themselves into thinking that the burden is only \$80 or \$90. The way to measure the value that constituents place on the resources that governments take from them is by using market-based estimates.

Historically, public pension liabilities have been essentially risk-free. Even when state and local governments have run into extreme fiscal difficulty, they have made good on 100 percent of accrued liabilities. As one example, when New York City experienced a serious bout of fiscal difficulty in the 1970s, pension plan participants were paid 100 cents on the dollar of accrued liabilities, even though bondholders were not.

The fact that the sponsor is not at risk of going under implies that its liabilities are safe, and should be discounted accordingly. As Donald Kohn, the Vice Chairman of the Federal Reserve Board, stated recently, “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 implications of the opposing point of view—that governments can afford to be more tolerant of risk than other market participants—are profound. If that argument is to be taken seriously, then governments should be the preferred providers of *all* types of financial products involving financial risk, including life insurance, commercial loans, and mortgages. But I doubt that anyone really believes that the government is the preferred provider of such products.

The method of computing the value of liabilities is separable from the question of how the assets in the trust fund should be invested. Adopting a market-based measure of liability does not mean that the trust fund must be invested in fixed-income securities designed to mimic the properties of the liabilities. If a state or local government believed, for example, that it had superior stock-picking ability, then that government could add value for taxpayers by investing the trust fund in equities. But let us be clear about two points:

- First, if the government has superior stock-picking ability, there is no reason to tie that function to the size of the pension plan. The government could add even more value by issuing as much debt as possible and investing all of the proceeds

in equities. I am highly skeptical of any claim that a public plan sponsor could consistently out-perform the market.

- Second, boosting the expected rate of return by taking on additional risk does not add value for taxpayers. That is merely an even trade, with no net change in value.

Thank you again for the opportunity to address these issues.