

June 6, 2008

The Board of Directors
The American Academy of Actuaries
1100 17th Street NW, 7th floor
Washington, DC 20036

Dear Members of the Board:

On behalf of the undersigned organizations representing governmental employers, employees, and their retirement systems, we are writing to express our serious concerns with mandating that governmental pension plans report their financial condition as if they were able to be immediately terminated. We are also very disturbed by the apparent approach to this subject currently being pursued by the American Academy of Actuaries (“the Academy”).

We appreciate the Academy’s interest in the adequacy of public pension plan disclosures. Ultimately, however, such disclosures must provide information that is meaningful and useful to stakeholders in this process, namely public employers/legislators, public employees, creditors and potential creditors of governments, and taxpayers. Any changes in the nature or amount of information currently disclosed under existing governmental accounting and financial reporting standards should therefore enhance the overall value of such disclosures to these users. We firmly believe that the reporting of the liabilities of public pension plans at so-called “market value,” often referred to as Market Value Liability (MVL), not only fails to offer such an improvement, but could actually serve to provide a distorted view of plan funding that would confuse rather than inform the public and provide misleading information to decision-makers.

This is not to say that current governmental accounting and financial reporting standards should be considered as cast in stone. Governments and the world in which they must operate are not static; the manner in which the need for public accountability is satisfied must therefore be capable of reflecting such an ever-changing environment. This evolution in standards, however, should continue to respect the unique nature of government and the differing needs of the users of governmental financial reports as compared to other business enterprises and their stakeholders. MVL disclosure fails in this regard as well.

To summarize our concerns, which are discussed in more detail in the attached Joint Statement, we believe the application of the MVL approach to governmental plans would be harmful for the following reasons:

- It could lead to the disclosure of plan costs and liabilities that do not accurately represent the dynamics of governmental plans and are therefore unnecessarily high;
- It could lead to the application of investment approaches that would unnecessarily limit the asset allocation and investments returns that can be earned by plans; and
- It would create confusion among decisions-makers, taxpayers, and the media about the funded levels of public pension plans, potentially leading to their disuse or abandonment.

We therefore urge the Academy to offer additional opportunities to discuss this topic with affected stakeholders and to approach the subject of MVL as applied to public plans in a deliberate, balanced and transparent manner, giving full support and exposure to all viewpoints.

Governmental accounting and financial reporting standards should continue to reflect the substantial differences, particularly in long-term sustainability and benefit protections, between

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State and local governments and private sector employers and the pension plans that they sponsor. We therefore reiterate our belief that financial reporting models applicable to terminable private sector corporations and their pension plans that require the reporting of MVL are inappropriate for governments and are inconsistent with the nature and purpose of public retirement systems.

Sincerely,

Leigh Snell
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Jeannine Markoe Raymond
National Association of State Retirement Administrators (NASRA), (202) 624-1417

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Ed Jayne
American Federation of State, County and Municipal Employees (AFSCME), (202) 429-1188

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Attachment

CC: Public Interest Committee

**NATIONAL COUNCIL ON TEACHER RETIREMENT
NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS
NATIONAL CONFERENCE ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS
NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND
TREASURERS
NATIONAL EDUCATION ASSOCIATION
AMERICAN FEDERATION OF TEACHERS
NATIONAL ASSOCIATION OF POLICE ORGANIZATIONS
AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES
SERVICE EMPLOYEES INTERNATIONAL UNION**

JOINT STATEMENT ON GOVERNMENTAL PLAN DISCLOSURES AND MVL

The submitters of this Joint Statement appreciate the interest of the American Academy of Actuaries (“the Academy”) in the adequacy of public pension plan disclosures. Ultimately, however, such disclosures must provide information that is meaningful and useful to stakeholders in this process, namely public employers/legislators, public employees, creditors and potential creditors of governments, and taxpayers. Any changes in the nature or amount of information currently disclosed under existing governmental accounting and financial reporting standards should therefore enhance the overall value of such disclosures to these users. We firmly believe that the reporting of the liabilities of public pension plans at so-called “market value,” often referred to as Market Value Liability (MVL), not only fails to offer such an improvement, but could actually serve to provide a distorted view of plan funding that would confuse rather than inform the public and provide misleading information to decision-makers.

This is not to say that current governmental accounting and financial reporting standards should be considered as cast in stone. Governments and the world in which they must operate are not static; the manner in which the need for public accountability is satisfied must therefore be capable of reflecting such an ever-changing environment. This evolution in standards, however, should continue to respect the unique nature of government and the differing needs of the users of governmental financial reports as compared to other business enterprises and their stakeholders. MVL disclosure fails in this regard as well.

Our purpose is not to enumerate the many specific reasons why we believe MVL disclosure is inappropriate for public pensions, nor to rebut the arguments of the proponents of this approach. We will leave that exercise for actuaries, academicians and economic theoreticians. Our objections, grounded as they are in the real world of governing and the provision of public services, are much more pragmatic.

First, governments simply are very different from for-profit businesses in any number of fundamental ways: different goals and purposes; different stakeholders; different revenue streams; different budgetary demands; different longevity; and different standards and mechanisms of accountability to the public interest. These differences result in informational needs of users of governmental financial reports that differ from those of users of for-profit business enterprises’ financial reports. This is particularly true in the case of pensions, where stakeholders of governmental plans are seeking disclosures of the systems’ financial condition, funded status, on-going costs, investment objectives and benefit structure that are meaningful, appropriate and relevant to the operation and purpose of government and reflect the underlying nature and dynamics of the plan.

For example, since pension plans sponsored by single employers in the private sector can be terminated at will and their sponsors can go out of business, be acquired or file for bankruptcy, MVL-like measures have helped respond to the needs of investors and others, such as the Pension Benefit Guaranty Corporation (PBGC), by providing a measure of settlement liability. However, unlike the situation in the private sector, where there *is* and must be a market for corporate pension obligations, for governmental plans such disclosure serves no similar purpose. This is because governmental plans are independent entities, and because their government sponsors are essentially permanent. Moreover, since the benefits promised by governmental plans are typically protected by constitutional or statutory provisions giving members a contractual right to the benefits as promised, they are long-term in nature and cannot be adjusted for current members.

Therefore, we agree with the conclusion of the Governmental Accounting Standards Board (GASB) that separate accounting and financial reporting standards for governments are not only justified, but also “essential.” (See GASB White Paper: “Why Governmental Accounting and Financial Reporting Is—and Should Be—Different” 2006). Otherwise, public accountability - the responsibility of the government to justify the raising of public revenues and to account for the use of those funds so that the public can judge the political, social and economic decisions that support such utilization - cannot be adequately accomplished.

Second, governmental pension plans are designed to allocate a portion of the cost of an ongoing benefit program, typically guaranteed by law, over a long-term investment horizon among successive generations of taxpayers at a cost lower than the beneficiary could individually secure. Given that the assurances applicable to governmental pensions guarantee not just the accrued benefits but, in most cases, the projected benefits of system members, information relevant to the sufficiency of current revenues to provide future cash flows adequate for the funding of these long-term benefit obligations is paramount.

For governmental plans, plan funding is therefore inextricably linked to the incidence of the long term cost of benefit obligations, and so plan disclosures should be based on the funding methods being used. Since MVL is not linked directly to funding methods, it does nothing to help stakeholders in this process determine the stability, adequacy and appropriateness of funding for such a long-term enterprise.

On the contrary, MVL disclosure will only serve to create confusion among stakeholders by calling into question the measurements of liabilities traditionally used by plans – and the reliability of actuarial assumptions in general. Presenting different measurements of the same funded ratio will not enhance plan governance or funding, but will simply invite different and often competing interest groups to choose whatever number best suits their own political agendas – a clear invitation to misuse actuarial work product. Furthermore, by increasing the measurement of liabilities, thereby decreasing apparent funding levels, MVL disclosure could serve to only further exacerbate the challenges that already exist in seeing that annual required contributions are adequately satisfied.

Neither does MVL provide relevant information about the future potential risk profile of the plan, which is critical to the development of appropriate investment strategies. Instead, by arguing against equity and for more “bond-like” investments, MVL proponents appear to contradict modern portfolio theory’s recognition of the role of risk and the standard practices of risk management, and would have plan fiduciaries abandon decades of reliance on reasonable assumptions related to rates of return based on a range of variables using past experience and expectations for future returns for capital markets. Ironically, the PBGC has recently determined

to do just the opposite of the MVL related strategy, announcing in February, 2008, that it is dropping its liability-driven investment (LDI) policy, which it has used for the last four years, and is reallocating almost \$15 billion to equities and alternative investments.

The new investment policy repudiates the idea of matching assets with liabilities, and would change the PBGC's old asset allocation, which was 75 percent to 85 percent fixed income and 15 percent to 25 percent equities, to one with 45 percent targeted to equities, 45 percent to fixed income and 10 percent to alternative investments, including private equity and real estate. The PBGC noted at the time that because its obligations are paid over many years, their new investment policy is "designed to take advantage of a long-term investment horizon," providing "superior protection against ultimate downside risks over time."

Why, then, is MVL disclosure - and its associated implied conclusion that equity investments by pension plans are inappropriate - being pursued, and who, specifically, is asking for it? None of our organizations, which represent many of the stakeholders in this process, see any need for MVL disclosure and are not asking for it to be required, either as a substitute for or in addition to current requirements. Indeed, with investment returns providing between 70-75 percent of the funding of governmental plans over the past decade, it would appear to be in none of our best interests to move to an actuarial basis that will increase the measured cost of benefits and possibly lead to the exclusion of equity participation.

Nor are other users of governmental pension financial statements urging us to adopt MVL disclosure. Currently, governmental accounting standards permit plans to use a number of actuarial cost methods typically utilized in actuarial valuations for funding purposes that are also appropriate for accrual accounting purposes, and we are not aware of any bond underwriters or rating agencies who believe that this current process is inadequate for their purposes.

Some would suggest that ideological opponents of defined benefit (DB) plans (the predominant model in the governmental sector) would be happy to see the use of MVL disclosure required, since MVL funding ratios could be used to support their arguments that DB plans are too financially burdensome and should be replaced with defined contribution (DC) plans. Whether or not the Academy has an interest in the outcome of this so-called DB/DC debate, the MVL approach would likely result in greater reported unfunded liabilities for governmental DB plans with the predictable political downsides associated with such a situation. Given what we know from recent Government Accountability Office (GAO) studies and other research concerning the current inadequacy of DC plans to ensure broad-based retirement security when they are used as the primary retirement savings vehicle, effectively encouraging the replacement of DB plans with a DC-only system would have serious negative retirement policy implications that should not be overlooked.

Finally, we also want to note briefly the concerns of some proponents of MVL with the moral hazard they believe is inherent in governmental plans' current approach to the use of equity investments, which they argue inappropriately shifts investment risks to future generations of taxpayers. While it may go without saying, perhaps it is useful to remember that government spending decisions are not made in a vacuum. The use of revenues in one area directly affects the availability of funds for other purposes. Therefore, unnecessary increases in pension liabilities that produce increased funding demands can mean that spending in other areas such as public education, public safety and infrastructure could be reduced. The results can be that the risks - both financial as well as societal - of such underfunding of these essential services will be shifted to future generations with perhaps even more catastrophic results than the more theoretical potential investment risks with which MVL advocates concern themselves.

Using current pension accounting standards for governmental plans, pension expenses have been allocated to periods in such a manner that each period is charged a level percentage of payroll for normal costs, which equitably spreads the burden of an ongoing benefit program among different generations of taxpayers. (GASB White Paper 2006) Furthermore, using reasonable assumptions for future equity returns, governmental plans have been able to fashion investment strategies that have generally produced annualized rates of return that have far exceeded those for bonds over most 20-year periods ending in the past 50 years, with cumulative savings to the taxpayers in the form of lower employer contributions totaling in the billions.

Consequently, the Government Accountability Office (GAO) stated in a report on “State and Local Government Retiree Benefits,” September, 2007, that governmental plans are generally well-funded and that, for the sector as a whole, estimated future pension costs (currently about 9 percent of employee pay) would require an increase in annual government contribution rates of less than a half percent, assuming future rates of return are more or less in line with historic experience. (The GAO simulation based its expected real yield on actual returns on various investment instruments over the last 40 years as well as the disposition of the portfolio of assets held by the sector over the last 10 years, generating a real yield of 5 percent.)

Interestingly, when the GAO estimated the necessary steady level of employer contributions holding all elements in its model stable except the real expected yield, and used a 3 percent real yield which GAO said is a reasonable proxy for a riskless rate of return, the GAO found that the necessary required contribution rates would need to be much higher -- nearly 18.6 percent of wages. Thus, following the investment precepts of some proponents of MVL could result in more than a doubling of the annual government required contribution rates, resulting in an increase *19 times greater* than the expected increase of less than a half percent (assuming only a 5 percent real yield) under the current approach used by public plans.

In closing, we would also like to register our strong concerns with the manner in which the Academy appears to be considering this subject. In February, 2008, the Academy and the Society of Actuaries (SOA) held a roundtable meeting in New York City entitled “Public Pension Plan Disclosure: Who Needs to Know What – and Why.” The nominal topic was disclosure in general, but the focus was actually on whether or not public plans should be required to report the “market value” of their liabilities.

As we have noted earlier, we appreciate the interest of the Academy in the subject of disclosure and how possible enhancements could improve plan governance and funding policies, for example. However, to focus discussion effectively on only MVL appears to be an unduly narrow approach and suggests to some that the purpose of the roundtable was to advance a specific conclusion rather than to identify and discuss general problems. The fact that the event was also “by invitation only” and was limited to a relatively small group of representatives of our diverse memberships served to further the sense that the event was more for appearance’s sake rather than substance. The limited time for discussion and the resulting inability of the breakout groups to develop any consensus was another shortcoming.

Finally, despite requests for additional opportunities to discuss this topic with the Academy, and assurances that no decisions had been made and that the Academy would not move forward on the issue without providing a very open and transparent process to accommodate public comment, there has been nothing further in this regard. We trust you are aware that the Academy’s Public Plans Subcommittee, which represents the actuaries who are by far the most familiar with governmental plans and issues, is overwhelmingly opposed to MVL as a required liability

measure for such plans. The recent change in leadership of the Public Plans Subcommittee is also troubling, in that it suggests that a healthy difference of opinion and professional debate on a subject whose consequences are so far-reaching are not to be encouraged.

We therefore urge the Academy to consider offering additional opportunities to discuss this topic with affected stakeholders and to approach the subject of MVL as applied to public plans in a balanced and transparent manner, one that gives full support and exposure to all viewpoints on this important issue.

Governmental accounting and financial reporting standards should continue to reflect the substantial differences, particularly in long-term sustainability and benefit protections, between State and local governments and private sector employers and the pension plans that they sponsor. We therefore reiterate our belief that financial reporting models applicable to terminable private sector corporations and their pension plans are inappropriate for governments and are inconsistent with the nature and purpose of public retirement systems.

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