



Use of Corporate Pension Standards to Measure Public Pension Funding Levels

Recent news stories and opinion pieces have stated or implied that public pensions should be using a corporate pension accounting standard to measure actuarial funding levels. This line of thinking suggests that public pensions should use a risk-free investment return assumption rather than the investment return assumption used by most plans of between 7.5 percent and 8.5 percent.

To acquaint readers with this argument and the responses, NASRA has compiled below an opinion piece published in the Boston Globe, and NASRA's unedited response; and a New York Times story and the unedited (and unpublished) response from NASRA and NCTR.

NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS

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Letters to the Editor
The Boston Globe
P.O. Box 55819
Boston, MA 02205-5819

To the Editor:

Thomas J. Healey's assertions about public pensions ("The ticking time bomb in state pensions," 11/28), reflect a significant misunderstanding of public pension funding and accounting issues.

According to Mr. Healey, public pension funds should lower their projected investment return assumptions to match the projections used by corporations. He offers no justification for applying the corporate method to public funds, leaving readers to accept that whatever corporate pensions do must also be good for state and local government pension plans. Mr. Healey does not appear to understand that accounting rules for corporate and public pensions are entirely different and for good cause. Federal law prescribes the method corporations must use to calculate their pension liabilities. This method is conservative in the extreme, designed to enable the corporation to settle its pension obligations in case of bankruptcy, a contingency cities and states are highly unlikely to encounter.

Mr. Healey implies that public pension assets should be shifted from diversified portfolios into 10-year Treasury notes. This would create a giant mismatch between pension assets and liabilities, sending taxpayer costs spiraling upward to fund the shortfall created by the lower earnings. He also objects to public pensions' use of an investment return projection of eight percent. Yet, public pension fund investment returns have exceeded that benchmark over the past 10 and 20 year periods. This performance has resulted in nearly two-thirds of all public pension revenues coming from returns on investments since 1982, requiring taxpayers to pay less than one-fourth of the cost of public pensions. The balance has come from employee contributions.

Despite good intentions, corporate accounting regulations and one-size-fits-all federal laws governing corporate pensions bear much of the responsibility for the large number of terminated corporate pension plans during the last 30 years. Declining private sector pension coverage has seriously diminished the retirement security of the nation's aging population. This decline in retirement security is likely to lead to increased reliance on taxpayer-financed entitlement programs as workers retire with inadequate financial resources.

Public retirement funds provide a regular stream of retirement income for nearly seven million Americans, and in so doing also contribute to the economy and the retirement security of a large segment of the nation's aging population. With nearly \$3 trillion in assets, these funds will continue to do so unless they are terminated by well intended but misinformed policymakers.

Keith Brainard, Research Director, National Association of State Retirement Administrators

Opinion: The ticking time bomb in state pensions

Thomas J. Healey Boston Globe November 28, 2006

PRESIDENT BUSH recently signed into law the Pension Protective Act of 2006 in an effort to strengthen the financial health of corporate defined benefit pension plans. However, little attention is paid to a retirement sector in even greater financial straits: state government pension plans. These plans are facing a \$1.3 trillion shortfall that presents a serious threat to their very survival -- as well as to every taxpayer in the country.

State pension programs -- which cover 12.8 million Americans and manage assets worth \$2.3 trillion -- are a pillar of the nation's retirement system. By comparison, corporate defined benefit pension plans cover 44.1 million participants but possess fewer assets -- about \$1.7 trillion.

At first glance, state plans seem to be nearly as healthy as their corporate counterparts: they face a shortfall of \$348 billion under current accounting rules, according to the National Association of State Retirement Administrators. This implies they are 86 percent funded, versus 90 percent for corporate plans.

However, these projections are misleading. The real shortfall of state-defined benefit pension programs is closer to \$1.3 trillion, which translates into the plans being 64 percent funded. This alarming gap could set off a crisis whose magnitude would dwarf the \$200 billion government bailout of the savings and loan industry in the 1980s. Just as disturbing, this threat is largely ignored because of opaque accounting.

Opaque accounting dramatically distorts the liability side of the pension ledger. The key question is whether pension plan liabilities are being properly measured. The liabilities of defined benefit pension plans are measured by using a discount -- or interest -- rate.

Unlike corporate plans, which must use high-quality corporate bond rates as their discount rate, state pension plans are allowed to use the much higher expected return on the assets they manage, artificially shrinking their liabilities.

This practice perniciously disguises the actual health of state-funded pension programs. As with corporate plans, state plans should be discounted using long-term corporate bond rates instead of the expected rate of return on assets, which is the current practice of most state governments.

Consider how distorting this practice is. Specifically, the average expected return on assets across state pension plans today is about 7.89 percent, according to the NASRA. Based on this return, their liabilities are estimated at \$2.5 trillion. If, however, the plans use as their discount rate the more credible 10-year Treasury rate, at about 4.9 percent, their liabilities would weigh in at \$3.5 trillion -- a whopping 42 percent increase.

Startling as this finding is, it simply stems from applying to state-defined benefit pension plans the same accounting principles that corporate plans must live by.

In New York City, the chief actuary recently released supplemental financial projections that show that instead of its public pension plan being 100 percent funded, the level is only 60 percent if the more realistic accounting principles of corporations are used. This would leave New York City with a pension deficit of \$49 billion.

States must be honest about their pension liabilities and the true value of plan underfunding. They must then take assertive steps to close the gap through a combination of benefit reductions, tax increases, and tapping other sources of non recurring revenues. Issuing bonds to fund pension liabilities, for example, doesn't solve the problem, but it makes it more visible by moving the obligation onto the state's balance sheet, thus encouraging more responsible management.

Longer term, states will probably follow in the footsteps of the corporate sector and both freeze their defined benefit plans and shift employees to defined contribution plans.

While not as economically advantageous in the long term, the latter are often more popular among workers and are more transparent. Under defined contribution programs, politicians would not have the luxury of granting employees generous pension allowances that state plans are ill-equipped to afford, or to consistently defer contributions.

And that would be a relief to taxpayers, once they become aware of the \$1 trillion pension bombshell headed their way.

Thomas J. Healey is a retired partner of Goldman Sachs & Co., and currently a senior fellow at Harvard University's Kennedy School of Government. He served as assistant secretary of the Treasury under President Reagan.

**NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS
NATIONAL COUNCIL ON TEACHER RETIREMENT**

January 3, 2007

Editor
The New York Times
229 W 43rd Street
New York, NY 10036

To the Editor:

The latest in a series of articles ("Estimates for Pensions Tighten," 12/29/06) continues a pattern that reflects a troubling misunderstanding of public pensions. Select quotes from individuals lacking public sector expertise and a focus on only a few pension funds paints an incomplete and misleading picture.

A more complete depiction would note that state and local government pension plans on the whole continue to meet the test of accounting and fiscal responsibility. Collectively, these systems are financially sound and have pre-funded nearly 90 percent of their future liabilities rather than leaving the costs to future generations.

Although the article discusses the Governmental Accounting Standards Board, it ignores GASB's recent paper, "Why Government Accounting and Financial Reporting Is – And Should Be – Different."

This paper indicates that the differences between public and private sector accounting for pension plans results from a different approach for governmental accounting standards that "explicitly harmonize accounting with the actuarial funding characteristics of the plan."

The article also implies that whatever applies to the private sector should also apply to the public sector. Nothing could be further from the truth. Federal law prescribes the method corporations must use to calculate their pension liabilities, a method that is conservative in the extreme designed to calculate insurance premiums and address corporate risks such as bankruptcy, mergers, or acquisitions – contingencies generally not applicable to cities and states.

Public pensions, on average, assume an investment return of less than eight percent. Actual public pension investment returns over the past 10- and 20-year periods have *exceeded* that benchmark. If, as the article suggests, public pensions lowered their investment return assumptions to the discount rate used by corporations, there would be a mismatch between pension assets and liabilities that would unnecessarily send taxpayer costs spiraling upward.

State and local governments use investment earnings to appropriately defray costs over the career of their employees, which *lowers* overall retirement costs. For example, since 1982 nearly two-thirds of all public pension revenue has come from investment returns. Taxpayers pay less than one-fourth of the cost of public pensions. The balance comes from employee contributions, which typically are not required in the private sector.

Public retirement funds provide a regular stream of retirement income for nearly seven million Americans. In doing so, these systems contribute to the economy and retirement security of a large segment of the nation's aging population. With nearly \$3 trillion in assets, these funds will continue to do so unless they are undermined by policymakers who rely on incomplete and misleading information.

M. Steve Yoakum

President, National Association of State Retirement Administrators

Meredith Williams

President, National Council on Teacher Retirement

Estimates for Pensions Tightens

New York Times December 29, 2006 MARY WILLIAMS WALSH

The states of New York, New Hampshire, Tennessee and about a dozen other governments may no longer be able to say their pension funds are fully funded no matter how the markets perform.

Accounting rule makers have proposed an amendment that would force these governments to provide a more realistic estimate of how much they owe retirees over time. They would also have to compare this with the assets they have set aside, showing whether they have enough to make good on their promises.

The Governmental Accounting Standards Board, an independent body that sets the rules for state and local governments, is also proposing that an outside auditor be required to vet this new financial

snapshot. That is not now required of the pension funds that would be affected by the rule change, believed to make up about 8 percent of the nation's public pension funds.

"That's just the first step," said Timothy S. Lucas, a former research director for the accounting board's sister organization, the [Financial Accounting Standards Board](#). He oversaw that body's slow and tortured efforts years ago to issue pension accounting rules for corporations.

"Small changes are important," said Mr. Lucas, who now has his own consulting firm in Connecticut. "A journey of a thousand miles starts with a single step."

It is not yet clear whether the rule change will give rise to any big new pension shortfalls in New York or elsewhere. The new rule is expected to take effect near the end of 2007, and the market conditions prevailing then will determine whether any shortfalls — or surpluses — appear.

Officials representing the New York State pension funds say they stand behind the existing financial report. But, they added, if there were changes, the effects would not be damaging.

The rule change would also force the incoming governor, [Eliot Spitzer](#), to modify his previous assertion that the state pension fund "is fully funded," and that the numbers his predecessors issued were accurate.

The method Albany has been using "doesn't provide adequate information for disclosure purposes," said David R. Bean, director of research and technical activities for the government accounting board, known as GASB and pronounced "gaz-b."

New York City, meanwhile, will not be directly affected by the proposed rule change, because it does not use the same method of tracking its pension fund as New York State and the others in the affected group. But New York City's unique methodology also greatly distorts its pension fund's appearance, experts agree.

The city's chief actuary, Robert C. North, suggested that the city might voluntarily provide the same type of numbers the accounting board will be requiring the state to report. He declined to be specific, saying he had not had a chance to study the accounting proposal yet, or discuss it with the city's pension trustees.

Perhaps more important than the proposed rule change, GASB said it was beginning to research other possible changes in pension accounting, long one of the most controversial areas of financial reporting.

The board is responding to mounting concern about whether the benefits being promised to retired public workers are being accurately measured. Because employee compensation is usually a big part of government budgets, miscalculating benefits can cause significant problems.

Officials could award benefits that are unaffordably rich, for instance, or unions could sign off on benefits plans that are not really secure. Local residents may not understand why taxes are going up. Credit analysts might rate municipal bonds inaccurately.

Similar problems have already come to light with the pension accounting rules for the private sector — the ones Mr. Lucas helped to draft. Last year, the Securities and Exchange Commission told the rule makers to make improvements.

The S.E.C. has not delved into accounting rules for the public sector, but other authorities are venturing in. The [Government Accountability Office](#), a nonpartisan research arm of Congress, has been studying the rules for public pensions and retiree health plans at the request of the Senate Finance Committee. The International Public Sector Accounting Standards Board issued a proposal in October for making public pension disclosures more comparable from one country to another.

Closer to home, the New York State Insurance Department has been reviewing the public pension funds in the state, over which it has regulatory authority.

The governmental accounting board has no legal authority to enforce the rules it issues, and must therefore rely on each pension fund's outside auditor to provide monitoring and enforcement. But the outside auditor's ability to be a whistle-blower is severely limited by client confidentiality rules.

The audit industry itself got its own oversight body, the [Public Company Accounting Oversight Board](#), after the scandals at Enron, WorldCom and other companies in 2002. But this new watchdog has no jurisdiction over the auditors working for governments.

Jack R. Buchmiller, a risk management specialist with the New York State Insurance Department, said he had taken a professional and personal interest in the controversy over pension measurements — particularly the question of whether the sector is habitually underestimating its obligations to retirees through the use of faulty actuarial methods and assumptions.

Public pension plans usually make assumptions about their investment income over the long term, then use these assumptions to measure the value, in today's dollars, of the benefits they must pay in the future. Many economists consider this practice incorrect, and corporate pension plans are not permitted to use it.

"It's circular logic," Mr. Buchmiller said.

Pension funds in the private sector are required instead to measure their obligations using a conservative bond rate. The thinking is that an interest rate associated with a safe bond is appropriate because the pensions themselves are supposed to be safe.

Mr. Buchmiller, who worked on Wall Street before going to work for the state, has been completing a study of what the nation's public pension funds would look like if they were required to calculate their obligations in a way closer to what corporate plans must do — though he noted that economists criticize corporate pension measurements, too. A draft of his paper, which he hopes to publish in a financial journal, showed that when potentially misleading investment assumptions were replaced with conservative bond rates, tens of billions of dollars worth of unfunded obligations appeared.

Mr. Buchmiller stressed that the views expressed in his paper were his own, and his calculations should not be taken as a sign of any coming regulatory changes.

For now, the only imminent change is the one being proposed by GASB for the New York State pension fund and others like it. The board will be receiving public comments on the proposal until the end of February.

The rule change takes aim at a type of pension calculation that makes public pension funds look fully funded at all times. Normally, values float up and down in response to changes in the financial markets.

Actuaries use the calculation at issue as a tool for tracking pension costs over time and helping local governments decide how much money to put into their pension funds each year. Experts say the calculation — called the aggregate cost method — is a good one for that purpose because it tends to force governments to put money behind their pension promises more quickly.

The accounting board is not disputing that. But it said that when the numbers generated by the aggregate cost method were picked up by accountants and included in annual reports, they often ended up being misinterpreted.

If New York City were to voluntarily follow the proposed new method, it could reduce the friction that became apparent last summer, after a report in The New York Times cited accounting experts who said the city's pension disclosures were not compliant with the rules.

New York City maintains that there is nothing wrong with its pension accounting. When asked about the accounting proposal, Mr. North, the city's chief actuary, said he would reserve comment until he had had a chance to study it.

"The New York City Retirement Systems, and the City of New York," he said, "have always followed and will continue to follow the GASB rules and provide whatever information GASB requires, and more."

That suggested the way to a truce, in which New York City could start disclosing the type of numbers the accounting board will be making the state provide — while continuing to disclose the type of numbers it already publishes.

Because of his own concerns about the confusion that actuarial methods can cause, Mr. North has already been offering additional pension values as a supplement for the last few years. He is believed to be the only actuary for any public pension fund to report the financial condition of its fund on a market basis — the sort of calculation Mr. Buchmiller has been trying to devise.

New York City's most recent supplementary numbers showed a \$49 billion shortfall. Mr. North's calculations for the fiscal year that ended last June are scheduled to appear in January.
