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By email to: director@gasb.org

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Governmental Accounting Standards Board
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Re: Proposed Pension Accounting and Financial Reporting

Dear Mr. Bean:

Thank you for allowing us to comment on this evolving guidance. I will discuss two major points in this letter; viz., 1) that the liability discount rate should not be restricted to referencing “long-term” investment strategies, and that the conditions under which earnings expectations are appropriate as the rate for discounting liabilities; and 2) the need for a clear and simple “point-in-time” funding ratio disclosure that is comparable across plans with a wide range of current and emerging turnover rates, demographic and pay population mixes, and accrual formulas.

THE USE OF AN ASSET EARNINGS ASSUMPTION IS APPROPRIATE FOR DISCOUNTING ACCRUED BENEFIT LIABILITIES TO THE EXTENT THAT, AND ONLY TO THE EXTENT THAT, PLAN INVESTMENTS ARE ORDERED TOWARD ACHIEVING THE FUNDING POLICY OBJECTIVES OF A PENSION PLAN.

To the extent that there are assets in trust, the expected return on a pension investment portfolio can be an appropriate liability discount rate. GASB need not, and should not, develop its whole accounting scheme around a requirement that the investment strategy behind that return expectation must be a “long-term” only strategy. The returns for other investment strategies are equally, or even more, appropriate.

The risks to current benefit security from any investment strategy are risks that need to be plan’s funding policy objectives. While there are presumably some rational limits to funding ratio risk that GASB would not consider acceptable, to the extent that an investment strategy is ordered toward attaining a plan’s funding policy, the inevitable financial transfer of any materialization of those risks to the real present value of future contributions will have been part of the formal investment strategy development and evaluation process. Ultimately, of course, these risks and the funding policy objectives of a plan are a matter for the plan sponsor, and/or the plan sponsor and public employee representatives, and not for an accounting standards board. But an accounting standard for the measurement of liabilities that states or implies that funding policy objectives and funding ratio risk evaluation need not be considered – in the exposure draft actually implies that they can not be considered – is no standard at all.

An asset return based discount rate is only appropriate when the investment strategy behind that rate is established in order to achieve legitimate funding policy objectives; it is not appropriate when motivated by a purpose to artificially reduce accounting liability disclosures or current annual expense recognition. The discount rate that GASB currently allows and continues, in large part, to propose is very different from both U.S. private sector and international pension accounting.

Many financial economists argue that this difference hides (short-term) real risks to public employees. But investment volatility risks need not be referenced to only the insurance or indemnification cost of eliminating benefit payment risk; they can also be referenced to the risk that existing trust assets will be insufficient to pay benefits in the near and intermediate-term. Dealing with those risks is the essence of a plan's funding policy and of prudent investment policies that are implemented to deal with funding policy objectives.¹

It is largely for this reason that -- while there are always reasonableness and materiality considerations as well as the professional opinions of accountants and actuaries -- the use of a liability discount rate based on relationship of an investment strategy to a plan's funding policy objectives is a matter for a plan sponsor and/or the plan sponsor and the representatives of the public employees covered by a pension plan. Risk must be taken into account in the setting of a reasonable liability discount rate; but this is exactly what happens in the normal governance process of a well run pension plan. Investment strategies are ordered toward the development of funding policy objectives.

The nature of the relationship between the risk objectives of the funding policy and the constantly changing nature of a particular plan's investment strategy is not a matter for an accounting standards board to address -- especially through a restrictive reference to something that it calls a "long-term" investment strategy.

Even simple models of funding policy risk demonstrate significant probabilities that the use of volatile long-term oriented investment strategies in mature plans will -- even those with relatively decent funding ratios with respect to actual trust assets -- use 100% of the existing trust assets on expected benefit payments in under ten (10) years.² Of course, a government can extend the cross-over point by projecting, or even actually making, contributions. In contrast, under the exposure draft proposal, a government pension with zero or virtually zero trust assets will have a positive "plan net position" relative to its pension liabilities (even projected benefit obligations) because the exposure draft includes future projected contributions as an element of the net position.

Because of how this net position impacts liability discount rate setting rules in the exposure draft, governments are allowed to discount all or most liabilities at an expected "long-term" asset return assumption even for periods where trust assets are projected to be depleted (on the assumption that there is no volatility to returns as benefit payments are being made) except where "assets" are projected to in the trust as a result of contributions that are expected to be made -- even where those contributions are not for the purpose of funding retiree and other accrued benefits, but rather for future accruals, or even when there are no assets in the trust even from the start. This is an egregious mistake.

Government pension plans with relatively unsophisticated advisors may very well be guided by the naïve investment paradigm that appears to be referenced by the current exposure draft language. Unless the exposure draft is changed to allow governments to discount liabilities with reference to rational investment strategies ordered toward achieving plan funding policy objectives, we can expect serious adverse funding ratio consequences to materialize in many government plans as a result of using a "long-term" investment strategy liability discount rate standard.

¹ Every ERISA pension plan ***must*** have a funding policy. Perhaps in part because of the role that GASB accounting standards have on the formation of the government pension plan risk management culture, even the fundamental and common sense concept of a funding policy is foreign to some public pension trustee boards and their investment advisors.

² It is worth noting here that the stochastic investment optimization that is part of the setting of a plan's asset allocation policy and the setting of portfolio return expectations requires an annual arithmetic return expectation greater than X for any expected geometric return of X. In addition, geometric return expectations decrease with the number of years projected, and that decrease is higher still with each higher standard deviation of the portfolio return.

On the other hand, as I read the proposed standard, and the comments of supporters of that standard, there is already an assumption that the investment strategies used by the trustee or other investment fiduciary of a government pension plan are, or should be, reasonable strategies developed in order to attain and maintain (whether explicit or implicit) rationale funding policy objectives, including the management of funding ratio risk. In other words, the exposure draft was obviously written with the understanding that higher discount rates would result as investment strategies took on more risk and volatility in order to attain, in the long-run, higher expected earnings. But no rational person would think it reasonable to discount liabilities at an asset return rate that contained so much volatility that the short-term and intermediate term solvency of the trust fund would be at risk.

Except for my recommendation that the discount rate only be available to the extent that existing trust assets are available to fund the liabilities, the implicit constraint on the explicit rule, therefore, is already the GASB accounting standard principle that I am recommending here. Accordingly, an exposure draft change to more clearly reference a rationale asset return based liability discount rule will, if it also restricts the use of that rate to liabilities that do not exceed the existing assets in the trust, reflect principles that are already implicitly contained in the draft language; namely,

- i) That the liability discount rate can be a plan's expected asset return, to the extent that assets equal or exceed liabilities, even when a plan's funding policy objectives result in the use of an investment strategy that is, in whole or in part, not a long-term strategy; and
- ii) The use of any expected asset return as a liability discount rate is only appropriate when it is based on an investment strategy that is reasonably consistent with meeting a plan's funding policy objectives.

In short, the accounting standard should be revised so that even unsophisticated government plan sponsors will not read the standard as endorsing a "long-term" investment approach paradigm regardless of whether such an investment strategy is an appropriate approach for attaining reasonable funding policy objectives. In any case, there is no justification for prohibiting the use of a plan's asset earnings rate as a liability discount rate just because the plan's investment strategy is rationally related to the attainment of a plan's funding policy objectives, rather than being entirely a "long-term" investment strategy.

The proposal also needs to eliminate the convoluted structure of its draft approach that makes it appear – even to relatively sophisticated commentators -- that an asset return based liability discount rate will no longer apply to the extent that existing trust assets do not exist. Of course, the current structure does allow the use of the plan's asset return rate as a liability discount rate when existing trust assets are insufficient to cover liabilities when the government includes in its accounting calculations the obviously much more dubious expectation of future contributions to the trust.³ The simple rule here should be whether or not existing assets are likely to be sufficient to cover accrued benefit obligations.⁴

³ If GASB standards are not going to reflect either the accounting standards for private pensions in the United States, or even international standards, if GASB standards are not going to reflect the view that finance theory "is unambiguous that the discount rate used to value future pension obligations should reflect the riskiness of the liabilities" (Brown, Jeffrey R., and David W. Wilcox. 2009 "Discounting State and Local Pension Liabilities." *American Economic Review*, vol. 99, no 2 (May) p. 538.) then the standards need another principled theory. And there is no principle or intellectual integrity in an accounting standard that uses an expected asset return on trust assets, regardless of the extent to which those assets are expected to be sufficient to pay for the short-term and intermediate term liabilities. As far as I can determine, even the arguments of economists who support the use of a long-term asset rates as a liability discount rate do so on the good faith assumption that the strategy has been rationally designed to achieve funding policy objectives.

The essence of the principle that I am recommending that GASB incorporate into its standards is precisely what any observer would expect from a discount liability rate based on an expected asset return assumption; namely, that the investment strategy on which the rate is premised have been developed taking into account at least expected asset

A funding ratio is a point-in-time measure; but it is a very important measure that needs to be disclosed. Projected future contributions have no part in that disclosure.⁵ Especially where funding ratio volatility mitigation is an important funding policy objective, the exposure draft creates a clear moral hazard situation for the trustee or other investment fiduciary by providing an incentive to use a long-term investment strategy for the smoke and mirror accounting advantages; albeit, ephemeral and short-term, that such an accounting may seem to provide.⁶

Accordingly, the final Statement should also make clear that when the investment fiduciary of a government pension plan rejects volatile long-run investment approaches as poor, or even dangerous, real world strategies for attaining funding policy objectives, that GASB is not providing a magic formula alternative for government plan sponsors to make right what is clearly wrong.

Prudent trustees and investment advisors of government pension plans already order investment strategies toward the real world maintenance and/or attainment of rational funding policy objectives. Smoke and mirrors accounting should not override such prudence and diligence; and liability accounting should not drive investment policy.

Liability discount rates can be rationally consistent with the expected returns of investment strategies to the extent that they are ordered toward the meeting of each particular plan's funding policy objectives.

volatility and the risks that existing trust assets will not be sufficient to pay for expected benefit payment obligations in the near-term and intermediate-term. Moreover, while this principle does require something that some unsophisticated government plans lack – a funding policy – a GASB revised to reflect this principle would give all governments more freedom to reference, with intellectual integrity, the expected returns of their actual investment strategies whether or not those strategies are “long-term” investment strategies.

⁴ In the next section I will more fully address my view that this exposure draft fails to adequately deal with the current lack of confidence in government pension liability accounting. This lack of confidence is largely the result of the current practice of using an asset return assumption as the discount rate, even when the investment strategy bears no relationship to, and are not ordered in response to even very substantial and material risks that the existing trust assets, earning the expected return with the expected volatility in returns, will not be sufficient to provide for short-term and intermediate term benefit payment cash flows. Of course, that is only to be expected when the proposed standards calling for the use of “long-term” investment strategies allow a government plan sponsor to count contributions that it expects to make to the trust, for moving out the cross-over point for when a trust will deplete its assets on the payment of existing retiree and other accrued benefits. This allowance for future contributions as the source of payment for current retiree benefits will presumably include even contributions that are intended to cover future benefit accruals.

The goal of public employee and taxpayer confidence in government pension liability accounting will only be addressed by a simple, reliable, and understandable measure of a plan's accounting liabilities that does not directly assault the expectation that governments and public employee Unions may very well negotiate different future accrual patterns for compensation and benefits over the next 5, 10, 20, or even 30 and 40 years. Bottom line, financial statements should reference a simple ratio of the value of accrued benefits to the value of existing plan assets. Neither projected future contributions nor projected future accruals should be included in that funding ratio.

⁵ Adopting this principle would be a major step forward. It would also set up a more rationale structure for when to use some long-term tax-exempt municipal bond rate. The current exposure draft calls for using the “long-term” asset rate on the shortest duration liabilities until the cross-over point at which assets are no longer sufficient to cover the projected benefit cash flows. An alternative framework would be to use the expected returns from an appropriate investment strategy (whether or not the strategy was long-term) for accrued benefits, and then to use an appropriate tax-exempt municipal bond rate for all accrued and projected future accruals for which there are no existing assets.

⁶ Any artificial decrease in the present value of the liability that is not backed up with risk-appropriate assets relative to short-term, intermediate-term, and to a lesser extent, long-term benefit cash flows, essentially transfers the value of that artificial risk reduction onto the projected future contributions as an expected interest and/or funding cost.

THE EXPOSURE DRAFT FAILS TO PROVIDE FOR A CLEAR, REASONABLE, AND USEFUL POINT-IN-TIME FUNDING RATIO DISCLOSURE.

The inclusion of future pension obligations and future contributions in point-in-time pension financial statement disclosures does not permit the new standards to adequately address the public's longstanding concerns about transparency, consistency, and reasonableness in state and local pension accounting and reporting. In fact, it is this inclusion that is driving the convoluted exposure draft's definition of "plan net position" so as to allow a long-term investment strategy expected return on assets even when there are no assets.

The failure of the accounting standard to require a simple disclosure of an accrued benefit funding ratio adversely affects three major stakeholder groups:

- 1) Public employees will benefit the most from ending smoke and mirrors accounting in the public sector; and they have the greatest need for realistic measures of a plan's funding status. Essential to meeting these needs is a straightforward measure of whether existing plan assets are adequate to pay for the benefits that public employees have already accrued;
- 2) Government Plan Sponsors need a more reliable measure of liabilities than a bootstrapped discount rate that is contingent on the amount of projected future contributions to a pension trust where the amount of those contributions, in turn, will likely reflect decisions made on the liability discount rate resulting from consideration of these expected contributions; and finally,
- 3) Taxpayers are more likely to be affected by higher taxes or reductions in service if existing trust assets are not sufficient to pay existing accrued benefits. Moreover, to the extent that trustees and other professionals fail to order investment strategies toward achieving funding policy objectives, taxpayers are also more likely to elect public officials to balance the cost of future benefit accruals against the cost of future taxes and/or the continuation of services to the public. The public absolutely deserves the respect that a clear and reasonable accounting of existing liabilities against existing assets provides.

The projection of sufficient employer or public employee contributions to cover the expected benefit cash flows will lead to confusion on the part of public employees, the taxpaying public, and even government officials. Moreover, in no small part because of that confusion, future public employee pensions are more likely to be reduced, eliminated in moves to defined contribution or cash balance plans, or affected by increasing public employee contributions.⁷

The primary objectives of funding policies for an ongoing pension plan are to have:

- 1) sufficient trust funds to pay accumulated plan benefits taking into account asset volatility and benefit payment cash flows, regardless of any future (expected or unexpected) constraints on the ability of the plan sponsor to make additional contributions to the pension trust; and

⁷ Of course, there is a strong correlation between: i) the public's lack of confidence in the stability and security of government pension plan funding – based in part on a perception of hidden liabilities in the past accounting disclosures for those plans – and, ii) the fact that so many government plans have been or are in the process of changing future benefit accruals by increasing public employee contributions. As a side note, it is clear that the probability goes up that the existing value of trust assets (plus earnings on those assets) in underfunded government pension plans will be entirely used to pay for benefit cash flow obligations in less than ten years for plans with higher short term liquidity needs and for plans with shorter pension durations. But this is exactly what happens when a government defined benefit pension plan substitutes employee contributions for employer contributions. An accounting standard that blesses "long-term" investment strategies as the source of liability discount rates without giving even a nod to the need for an investment strategies to be ordered toward achieving funding policy objectives has been, and will clearly continue to contribute to, increasing risks for government pensions plans.

2) a stable and sustainable cost, as a percent of current covered payroll, taking into account expected future participants, future accruals, and future administrative and oversight expenses, and future investment returns net of manager and/or investment fund expenses.

From the point of view of public employees, and logically the representatives of public employees who negotiate compensation and benefits on behalf of these employees, one dollar of funded accrued benefit in 1) above is worth significantly more than one dollar of unfunded pension expense in 2) above.⁸ Because of this, no accounting regime should ignore the need for accounting disclosures related to the first objective. Of course, the other important reason for such a disclosure is that this accrued benefit funding ratio is a minimum threshold for determining the extent to which an asset return expectation can serve as the accounting discount rate for determining the present value of liabilities.

Moreover, when dealing with ongoing defined benefit pension plans (where all or part of the benefit accruals have not been frozen) plan sponsors who take seriously the ongoing nature of those plans do not see these plans through the lens of restricted actuarial methods that essentially allocate plan costs with respect to a frozen and static workforce. Regardless of the snap-shot actuarial methods used to allocate expense (and contributions) over the career of current participants, the actual expense of an ongoing plan depends very much on relationship of the particular actuarial method used, the benefits paid to current and future participants, expenses incurred today and in the future for both administration and investment oversight; and the future (net) investment earnings on trust assets.⁹ The commonly used actuarial tools for allocating expense are very primitive with respect to this ongoing plan perspective.¹⁰

I make this observation not to argue for one actuarial method over another, especially when there are so many methods (each producing very large variations in the allocations of cost) and where each of these methods is limited to a snapshot view of the employee population as if the plan was a “frozen” plan. Instead, my purpose for pointing out that none of the alternative methods take into account projections for the hiring of new employees, the salary and demographic characteristics of those employees, the turnover patterns of the future workforce, or even for the future size of that ongoing workforce, is to reinforce the importance of a simple point-in-time funding ratio disclosure.

The most critical accounting need is, regardless of the method(s) used for ongoing expense and contribution allocation purposes, and perhaps especially because different methods with different reasonable allocations can be used for those purposes, for...¹¹

...clear and simple disclosure of a funding ratio that represents the present value of accrued liabilities funded by existing trust fund assets.

⁸ This is true even when negotiating with a government employer.

⁹For most defined benefit formulas, any increases in the accrued benefit cost in the first year of participation for a young employee may only be a small fraction of one percent of pay; but the real accrual may increase to 100% or more of pay in the years immediately before retirement. The choice of actuarial method (e.g., projected unit credit vs entry age normal) will have a dramatic impact on the way projected liability accruals are allocated depending on whether the workforce is generally older or younger, on whether the pension formula has a front loaded or back loaded accrual, and even depending upon past turnover patterns employees for each plan.

¹⁰ Because the entry age normal may have more problems here than other methods, many government plans determine annual contributions using a projected unit credit method.

¹¹ At the same time.

CONCLUSION

The ultimate goal of pension funding is to have assets to pay benefit cash flow obligations.

This goal is unlikely to be met without a significant impact on future contributions, and the ability of the plan sponsor to make those future contributions, when plan assets are subject to large variations in value, at least where such volatility is inconsistent with a rational funding policy. Moreover, the failure to order investment strategies toward the attainment of rational funding policies is more likely when investment strategies are unduly influenced by an accounting standard that only recognizes “long-term” investment strategies – whatever that means -- and when the standard recognizes the expected asset returns from such strategies even when the strategies are inconsistent with the plan’s funding policy objectives.

This moral hazard risk is an issue of the highest order for the integrity of, and the public’s confidence in, public sector (GASB) pension accounting standards. Accordingly, the exposure draft should not condition the availability of an asset return related discount rate on the use of long-term investment strategies.

The GASB accounting standard should instead allow the use of the asset return expectation from any appropriate investment strategies, whether long-term, short-term, in-between, or strategies developed on risk parameters other than time, so long as the strategy is reasonably consistent with, and/or adopted with the purpose of furthering the plan sponsor’s funding policy objectives.

This funding policy related asset return expectation should be used to discount accrued liabilities – to the extent that real trust assets are sufficient to meet this threshold benchmark -- in order that a straightforward funding ratio with a funding policy rationale can be disclosed to public employees and the taxpaying public in general.

Best regards,



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