Ladies and Gentlemen:

Congratulations on your Exposure Draft. It’s a job very well done, overall. You are very close to designing a much-improved structure for public pension accounting and financial reporting, if you make a handful of relatively minor but important adjustments. So please take my comments in the context of positive suggestions from a strong supporter of prudent pension funding and fair financial reporting.

As always on my personal letterhead, my comments are solely my own and not those of any organization with which I am affiliated. My remarks here are focused on the employer ED (34-E) but obviously apply to the pension plans' financial reporting as well.

My issues are:

- The methodology for calculating the blended discount rate
- The municipal bond index (with an optional alternative)
- Forward-looking disclosure in the RSI

The blended discount rate conundrum. The specific method you are contemplating to calculate the blended discount rate was not clear to me from your Preliminary Views document until I saw it black and white in your illustration in the Exposure Draft. It was only then that the light went on for me, and I therefore apologize for failing to grasp sooner the significance of the methodology you have proposed, which has several defects. I had understood that your intent was to blend an underfunded plan’s discount rate, by using the expected rate of return on portfolio assets and an employer’s cost of capital for the unfunded liabilities. That is to say, I (and many others including the international financial media) thought you would treat all unfunded liabilities alike and essentially discount them at the muni index rate as part of the blending calculation. Conceptually, that would treat unfunded liabilities properly as liabilities and not as if they were assets. And I thought this would apply to all plans.

It was not obvious to some, at least, that your conceptualization of future employer contributions in this model meant more than normal service contributions for current employees. Had I realized this point a year ago in the PV, I would certainly have raised concerns back then. And I know for certain that I was not the only professional who missed
this point. Nonetheless I apologize in advance for now being late into the game on this issue. Others may be, as well, if they take the time to express themselves.

Even with your Illustration in Appendix C, it took me a while to grasp that your blended discounting convention will only apply to a very limited class of pension funds. Incidentally, that exhibit failed to disclose the funding ratio and the approximate UAAL amortization period for the plan, which appears to be misrepresentative of today's average pension fund and really should have been presented as having exceptional, not typical, characteristics. So it took me a while for this to all sink in.

First let me begin with the basic problem with the “depletion” approach you have now clarified through the illustration. I do not dispute that the data this blending model produces will have some indirect value to users of financial statements. So it's better than the status quo. By deduction, it will clearly show which pension plans are doomed to run out of money unless they are relieved by unexpectedly benevolent investment markets or a decisive future increase in actual contributions. Running out of money is a bad thing, we all can agree. So that is helpful to know. But that is about all this method will show. The model otherwise has limited value in its raw form.

Because of your reliance on the undefined concept (see glossary for omission) of "plan net position," your focus on the depletion threshold will camouflage the vast majority of pension plans that are presently under-funded with no genuine hope to achieve full funding before employees retire -- because the "expected" future contributions to amortize unfunded liabilities can now be treated as if there were assets for this purpose. Conceptually, you have converted the employers' own IOUs (shrouded as contribution policy) into pseudo-assets for purposes of your discounting convention! Mathematically this inflates the employer's own balance sheet (lower NPL as a result of the expected future UAAL contributions). Viola! An obligation thus reduces an obligation… (?)

It may now appear to critics that you are primarily interested in discounting at the employer's cost of capital the obligations of plans that will almost assuredly run out of money. And for virtually everybody else that now funds under current GAAP, it will be business as usual for the discounting convention. The markets and the media will attach a scarlet letter ‘D’ to all who fail the Depletion test (i.e., those with blended rates), thus creating an immediate stigma. Pension funds will divide into two clusters,(1) the damned with their scarlet Depletion “D’s” and (2) almost everybody else – regardless of their funding status – as long as they "expect" to contribute enough to produce sufficient future "projected resources" to avoid the depletion scenario on paper.
The Basis for Conclusions does not discuss specifically or directly the subject of employer contributions to amortize unfunded liabilities, which is where I take issue with the logic. There is only a generalized reference to "expectations of resources" in paragraph 183, and a general mention of "an analysis of cash flows in and out of the plan" in paragraph 185. The subject does not even appear contextually in your conclusions paragraph 191 which again simply references "plan resources" which could mean almost anything at that point. All we know now is that you will apply the assumed investment return to "expected resources" derived from employer contributions as part of the "projections of plan net position."

The ED does not clearly explain to us whose expectations these will be. One can only assume that like Humpty Dumpty in *Through the Looking Glass*, it will mean whatever the statement issuer means it to be -- because the ED fails to create a clear standard for qualifying these vaguely described expectations and it assigns no accountability for the process. At the very least, I encourage you to remedy this lack of specificity in the final standards.

Now let me show you a better way, as my goal is to be constructive and not merely critical.

**A constructive alternative for the blended discount rate.** Fortunately, there is a simple and superior alternative that is easy for all stakeholders to understand and use. I call it the "Forrest Gump" blending formula: It’s stupidly simple and it works. All plans can blend the discount rate using the very same components you already propose – the expected rate of return as presently calculated by most plans under current GASB standards, and the employer’s cost of borrowing — but simply blend them in proportion into the plan’s current funded ratio.

Forget all the present value of future cash flows and the three tables in your Illustration 1. If a plan is now 75 percent funded on an MVA basis (presently the average), the actuary would multiply the expected rate of return (7.5 percent in your Illustration 1) times 0.75, and then blend that with 0.25 times the cost of capital (4 percent in your Illustration 1). The result, 6.63%, is intuitively plausible in the way that most observers will think about this. That reflects an 87 basis point haircut (1/9th of the original rate) in the discount rate for a plan that is 25 percent underfunded. And to comfort the pension community, this simple algorithm produces a significantly higher discount rate than your own "illustrative" example (5.35%) -- which would thereby result in lower liabilities and employer pension expenses if that illustration were actually representative of the norm.

If you adopt this simple formula instead, and treat all unfunded liabilities alike, practitioners don’t need elaborate and lengthy examples as shown in Illustration 1, which requires three tables to construct. They don’t need to incur additional actuarial expenses. And there is no opportunity to manipulate the numbers. One simple computation using a handheld memory calculator or a 3x3 spreadsheet and basic arithmetic can do the job. You can replace three pages of illustrations with a single paragraph or a two-inch table. You just have to discard the notion that "expectations of future resources" and then the expected investment return on those expected resources are qualitatively equivalent to assets held now in the trust fund to pay for accrued liabilities. The latter (assets) are certain and tangible on the statement date, whereas the former (projections) are uncertain, qualitatively dissimilar and sometimes speculative.
If you wish to flag all plans that will probably deplete their resources to produce decision-useful information, you can easily require that this actuarial probability be disclosed prominently in the notes as a mandatory disclosure. Users can and will (avidly) read such a note, especially if the projected crossover year were disclosed. That puts the professional burden of accountability where it belongs and provides the most decision-useful depletion information in a direct, not indirect, readable form.

Knowing that the depletion model has strong professional advocacy in some parts of the community, I realize the Forrest Gump model may be snubbed by those who consider the manipulable depletion model more “elegant.” However, the simpler approach provides superior recognition of the true nature and magnitude of the employer’s unfunded (now called ‘net pension’) liabilities on the statement date. And it cannot be gamed.

Gaming, politics and skewed decision-making. Unfortunately there is presently no way for your proposed blending standard to account for manipulation or violation of funding policies by employers unless you inject additional complexity. A disingenuous trustee, union lobbyist or employer can ask its experts to calculate an amortization schedule and the expected investment rate of return that are necessary to avoid depletion on paper, and hence avoid a blended rate. The quantification of “expected future resources from employer contributions” can thus be manipulated or circumvented in some states. The proposed model creates an opportunity -- and even worse, an incentive -- to game the system. As a result, accounting standards would skew behavior, to circumvent the fundamental principle of inter-period equity. As former GASB board member Bill Holder often reminded his colleagues during his distinguished service, financial reporting standards should avoid driving management, professionals and policy-makers into such economic behaviors, but that is exactly what the ED’s depletion blending model invites.

Even without gaming, the family of “expectations” has many cousins. Some are little more than what my family elders called “a lick and a promise,” while others are more concrete and reliable. The ED provides no basis for differentiating these cousins, so we must assume for now that they all qualify.

For purposes of setting standards using the depletion model, I recognize that when state law requires a subordinate employer such as a school district and its employees to each contribute a specific percentage of pay, there is a logical basis to assume that such will be the future factual funding pattern and thus a reliable basis for the actuarial projections under your model. The same applies in states that require ARC (as we have known it) to be paid under law. But what about the myriad pension funds and employers who determine their contribution rates every year or two on a discretionary basis? What about state legislatures that ignore their own laws, or budget whatever they wish regardless of actuarial projections and recommendations? In 2008 you spent considerable time deliberating similar distinctions when developing the (restricted, committed, assigned) fund balance classification standards and criteria, but it appears you have spent none so far on this comparable issue. I will try to provide a starting point for that review, below.

As you know, the actuarially calculated employer cost (ACEC) under the proposed model will be volatile over business and market cycles and is thus unlikely to be used regularly and consistently for funding purposes in many jurisdictions, so it is not clear what employer
contribution rate will be used to perform the calculation. It is completely unrealistic to believe that all or even most public employers will actually fund the ACEC rate every year, as the investment scenario of 2008-9 has clearly demonstrated.

To substantiate the “expectations” for an attester, will governing officials simply declare their funding policy in a public document and then use that? Let’s focus on that “lick and a promise” scenario. Whether intentional or not, some governmental employers will inevitably establish a funding policy that theoretically “beats the clock” against the Depletion scenario on paper, and then make subsequent contributions at a lower rate regardless of the policy. This happens regularly enough to present a genuine problem under the contemplated standards. Many formal financial policies are aspirational statements and are not binding on future governing bodies, as we have seen repeatedly in the history of public finance. That history is replete with pension contribution holidays and insufficient budgetary appropriations. What shall attesters and auditors do in such scenarios, which are inevitable in a world of political decision-making? The ED was completely silent about these inevitable issues of policy vs practice and form vs substance.

After all the attention you’ve given to "substance in practice" for ad hoc COLAs, your standard for making these projections of expected resources will likely invite much more widespread abuse through a procedure that blissfully ignores the historical and actual funding practices of the plan and the employer. You have opened a can of worms.

Now let’s look downfield to your concurrent OPEB project, where the aggregate national liabilities are double those of pension funds. How will this model apply to OPEB plans which have no history of actuarial funding, but whose employers earnestly endeavor to “ramp up” their employer contributions over a period of time to eventually achieve improved funding? How will users of financial statements know what is embedded in the actuarial assumptions? Will an employer’s hopeful promise to fund all or most of the full ACEC in the future, completely devoid of substantiated past practice, be sufficient to avoid or minimize blending the discount rate of a plan that is presently unfunded and simply paying as it goes? The resulting difference in reportable OPEB liabilities could be massive for some employers. Who will be required to attest to the sustainability of those promises and the veracity and reliability of the estimated "future resources"? Your proposed model could unnecessarily invite professional liability lawsuits and regulatory enforcement actions by failing to provide clear standards.

To capsulize my concern, you don’t have to design dozens of additional controls, tests, caveats, qualifications, disclaimers and implementation guidelines if you abandon or at least subordinate this problem-ridden depletion model and adopt the Forrest Gump alternative or something else that is equally simple and decision-neutral.

Alternative discount rate calculations. From the sole standpoint of precluding abuses, there is one condition under which you could reasonably permit plans and employers to discount all liabilities under the ED’s blending model (which is tantamount to the current standard for these cases). Employers that actually do contribute the full ACEC under your new standards will have no opportunity for the manipulations described above, and such parties could be permitted to elect the optional discount rate using your proposed model. Such employers have demonstrated that expectations of future resources (as you describe) are actually fulfilled in practice at a level that should satisfy an attester. I believe it is reasonable for the
board to permit this application of the depletion model – but as an alternative rather than
the general method. The problem is what to do with them in a year when they fall out of
bed.

So to prove that I'm not dogmatic about this, I will now articulate a way to use your
depletion model in a more generalized way as an alternative to the (suggested primary) Forrest
Gump method of discount rate calculations. This could represent the middle ground. It
requires three modifications of your current model:

First, for those who wish to use the depletion method, you should require plans and their
actuaries to exclude from the depletion calculation (at the end of the descriptions now
contained in ED paragraphs 23 and 54) all projected UAAL contributions expected from
employers in years beyond the average service lives of current employees over a closed
amortization period. (For example, the last five years of amortized UAAL in a 17-year open
amortization schedule would be disregarded in a plan with average service lives of 12 years,
and in the following year the final 6 years would be disregarded.) This carve-out would
permit use of the depletion method for employers making substantial but incomplete UAAL
amortization contributions at levels less than GAAP. Such employers could not manipulate
their amortization schedules to game the system to dodge the blended rate.

Second, for this alternative calculation you should also require such entities to limit their
expected composite return on investments to the published national average for plans of
their size (NASRA produces such data regularly), which would curtail abusive assumptions
as an artifice to avoid blended rates.

Third, you should further require that this alternative calculation may presumptively include
only those employer contributions that are enforcably required by law. Otherwise, future
UAAL-amortization contributions which are subject to employer discretion should be limited to the
lowest rate of actual contributions in the current and recently preceding years. This
provision would also virtuously inform employers that a discretionary reduction in their
contributions will immediately flow through the discount rate into their balance sheet as an
increase in pension liability.

Because these three “ring fence” controls are necessary to prevent gaming, you can hopefully
now see the deficiencies in the ED’s blending model as it stands now.

I am not thrilled that these alternative uses of the depletion model would still include
“expected future resources” from UAAL-amortization contributions in the calculation.
However, this may be the best possible compromise, if you have irreversibly fallen in love
with this “expected resources” idea and now require remedial patches to qualify and quantify
such expectations. The depletion model is therefore best adopted as an alternative and not
the primary approach, for all the reasons explained above. In whatever way you may choose
to employ the depletion model in your final standard, you should adopt the three
preconditions outlined above. Those will curb the most egregious foreseeable abuses of this
model.

Reportedly you are embarking on field testing. I encourage you to field test your current
model against (1) my suggested alternative and remedial revisions to that model and also (2)
Forrest Gump's version, and see the results for yourself. Once you complete your research
and decide what precisely is your complete standard for blending the discount rates, please consider issuing an additional (perhaps 30-day) Invitation to Comment on this one narrow technical issue before adopting final standards. You certainly don’t need to re-open the entire discount rate debate, but this one technical aspect of the blending paradigm is worth re-exposing to ensure that you’ve got it right so that GASB can issue the most durable solution in the final standards. You will avoid surprises, “standards shock” and headaches down the road when the final pronouncement is issued.

I apologize for the lengthy discussion of this one narrow but central topic. Hopefully this extensive early comment will help frame a thoughtful professional debate and Board deliberation before you finalize your standards.

Fortunately, my three remaining suggestions are much more concise and less controversial.

**The municipal bond index.** With the major methodological caveat above, I am fully supportive of your conclusion that the blended rate should employ the government’s cost of capital. As you know from my prior testimony on your Preliminary Views, I believe that the correct rate (in theory) should be the taxable municipal bond rate, not the tax-exempt bond rate. The simple reason is that public employers cannot actually borrow at a tax-exempt rate to increase the funding ratio of a pension plan. So the tax-exempt index is a fictitious reference point in practice.

However, I have also done a substantial amount of research and -- after consultation with my professional peers in the muni bond market -- cannot present to you a reliable and relevant index for taxable bonds. Therefore, I suggest to you instead that employers (and their plans, obviously) should be allowed to use the statement-date yield on 20-year U.S Treasury bonds *if that rate is a closer approximation of the employers’ cost of capital for the purpose of funding pension obligations.*

Financial markets fluctuate. Yield curves and inter-market spreads change over economic and business cycles. Presently, tax-exempt municipal bonds carry yields above U.S. Treasury obligations of similar maturity, in many sections of the yield curve. This may not always be true – usually the reverse is true because of municipal debt’s tax exemption -- so the continuous use of the tax-exempt yield could become especially punitive when muni yields normalize. Allowing the use of a U.S. government bond yield as an alternative *if it better fits your intended objective* is a simple solution to this complex problem. (Ironically, it would also allow the financial economists who dispute the risk-based rate in your blending model to claim “partial victory” in principle because this would essentially be the “risk free” rate – when that rate better approximates the taxable muni bond market level.)

Treasury bond yields should normally trade at rates lower than high-grade taxable municipal bonds of equal duration because of credit and market depth. Therefore, the T-bond yield is less advantageous to employers and plans than would be a taxable muni bond index. This alternative is therefore a reasonable, pragmatic compromise. I don't think you need to require restatement when the alternative is effective, which should be industry-wide rather than an individual plan election in order to promote comparability. You should verify this with empirical data, but I suspect its use as an alternative during those periods when it’s a superior proxy for prevailing taxable muni borrowing costs will actually reduce volatility in discount rates and therefore promote more consistent funding and reporting.
As a technical matter, I have chosen the 20-year bond and not the 30-year bond because history has shown that there are times in market and business cycles when supply and demand for the long bond are distorted and the long bond trades at lower yields. This happens commonly when pension funds seek long-duration assets to match long-term liabilities at advantageous yields. Thus, the 20-year bond is a preferable benchmark, and its duration is actually closer to the average remaining service lives of current employees, which makes it a superior maturity in my view.

I realize this could put you (or some designated organization) into the business of issuing implementation guidance periodically when the optional treasury rate is to be employed industry-wide, but I don’t think that is terribly problematic. The practitioner community can track your decisions and it is unlikely that this will flip-flop too frequently. You can easily verify that with some historical research and I would be happy to connect you with a data source.

**Disclosure of selected actuarial projections.** As I have previously commented, your disclosure requirements are well balanced (and reasonable) and my only suggestion here is that you should include in the RSI a forward-looking projection of the employers’ contributions (including ACEC and current funding policy plus the latest actual practice if different) and the resulting plan net positions. As you know, the national association of bond lawyers is proposing a similar 10-year schedule for debt disclosures. My professional work has shown me that policymakers will benefit more from a 15-year schedule, as this will better present the difference and value of proper amortization of unfunded liabilities over the remaining service lives of employees – and whether the employer is “kicking the can” of unfunded liabilities to the next generation of taxpayers by excessively extending the amortization. Ten years is too short a period for these projections to be as informative as 15 years, average remaining service lives exceed 10 years in many plans. I believe that NABL would happily follow your lead if you adopt 15 years as the disclosure period for such projections.

You have already asserted in the Basis and shown by your example in Illustration 1 that the data are readily available to support this presentation.

For bond investors, labor negotiators and arbitrators, policy-makers and the public, this information would be of great explanatory value. The cost-benefit of this supplemental information is clearly in favor of mandatory display, and is likely to be more valuable to decision-making and investment analysis than your proposed disclosure of asset allocations and expected real rates of return by asset class, to pick just one point of comparison.

**Glossary.** Finally, as a purely housekeeping matter, you should ask staff to comb carefully through the drafts of your final standard to be sure that essential terms are defined clearly, especially those which are new or unfamiliar terms to generalist readers. Likewise I suggest you do some telephonic focus group work on the Plain Language Supplement with reporters, generalists and policy-makers. The complaint I’m hearing now from the “pension press” is that several important concepts have now become as “clear as mud” to them (direct quotes). Just a heads-up that you probably need to do some more work on the popular communications front.
In conclusion, I strongly support your entire initiative, and you are already 90% perfect in my view. You can do even better yet, of course, and I'm happy to help you achieve a more perfect product. Hopefully you can appreciate that I have given these three issues considerable thought, and my comments are intended as constructive suggestions. Feel free to contact me if you have questions.

Cordially,

Girard Miller CFA

c: GFOA and NASRA; selected colleagues

ADDENDUM

September 26, 2011

In the weeks since my original comments were submitted, I have encountered significant confusion in the field over the the proposed treatment of previously accumulated unfunded liabilities in transition. Although your various pronouncements have emphasized inter-period equity considerations, this is not reflected clearly in the exposure draft with respect to the manner in which the amortization of accumulated unfunded liabilities will be be treated as pension expenses. As you would expect, my view is that the attribution method should also focus on the average remaining service lives of current employees, and I had anticipated that you would take a similar view which was not reflected in the ED. Given the outstanding pension UAALs estimated at $700-800 billion measured conventionally using expected rates of return, and OPEB liabilities twice or thrice that level, this is clearly the most important immediate cost driver in your work; yet it received little mention in the ED.

GASB-based accounting and financial reporting will become completely irrelevant if the result of this transition is to simply restate the employers’ liabilities without principles-based expense recognition that addresses the massive immediate inter-period and intergenerational issues that your standards now seem to ignore.

One possible solution would be to require amortization of initial unfunded liabilities over closed periods that do not exceed 20 years unless the employees’ projected average remaining service lives exceed that. This would enable the industry to migrate to average remaining service lives during this decade, without creating such widespread “sticker shock” that the standards lose all connection with funding practices.
Outline of Comments for October 13 Hearing

Pension Accounting and Financial Reporting

Girard Miller

1. Blended discount rate: defects in the proposed model and suggested remedies

2. Municipal bond index and 20-year Treasury bond yield alternative when more appropriate

3. Forward-looking disclosures in RSI: 15 year projections

4. Transition for outstanding UAAL amortization: 20 year closed
While realizing this is the 11th hour and the 59th minute in GASB deliberations on pension accounting, I have revisited the board's proposed discount rate blending convention in light of recently published findings by the Maastrict-Yale researchers whose empirical data suggest that GASB's prevailing accounting standards permitting use of expected returns to determine the discount rate have resulted in distorted economic behaviors and riskier investment management decision-making. Although the blended discount rate concept seeks to address some of these concerns, the practical result of the depletion method is that many plans will avoid use of the municipal borrowing rate in this calculation by structuring their expected contribution flows in such a way as to outrun the liabilities. I have already heard public pension actuaries propose slight modifications of their amortization policies (such as closing 30 year amortization) to achieve this result. In light of these new research findings which have become available only recently, and after all the board's scheduled opportunities for public input, I have given further thought to the blending convention and devised a supplemental provision to shield the board from potential criticism that the new standards will simply perpetuate the distortions revealed in the newly reported research.

Before you close the books on the ballot draft, I would encourage the board to consider a slight one-sentence modification of the blending convention to provide that:

Accrued liabilities funded by resources expected to be provided in periods later than the remaining average service lives of active participants should be discounted at the municipal borrowing rate in the computation of the blended rate unless the depletion date occurs earlier.

This provision allows future resources provided to meet unfunded liabilities within the working lives of participants to be discounted at the expected rate of investment income, whereas liabilities to be funded by resources contributed subsequently should be discounted at the municipal borrowing rate (recognizing that they represent an unfunded intergenerational burden).

This formulation offers the following advantages for financial reporting preparers and users:

1. The depletion convention remains a central concept in the discount-rate blending convention, except where the plan's funding policy defers future contributions beyond the average remaining service lives and thereby fails to achieve intergenerational equity. Expected investment returns will continue to be the prevailing factor in the blended discount rate computation for plans that fund accrued liabilities over average service lives.

2. When funding policy stretches the amortization of unfunded liabilities beyond the average remaining service lives, the disparity between accounting ACEC and plan-funding ARC will become apparent, which provides actionably decision-useful financial information to: trustees in setting funding policy, public employers (plan sponsors) concerned about alignment of budgetary costs with accounting costs, debt issuers concerned about intergenerational equity and competing claims on future resources needed for debt repayment, financial analysts and investors concerned about deferred costs, and taxpayer groups concerned about intergenerational equity. This signal (provided by the blended rate)
to the financial community and concerned stakeholders will be far more useful and less stigmatizing than the depletion-date method alone.

3. This standard will also be more helpful as a primary criterion for OPEB accounting, given the widespread historical failure of most government employers to fund their OPEB plans actuarially or even establish a GASB-qualified trust. As you undertake your OPEB accounting project, you will achieve far greater consistency in the application and results of the blending convention with this approach applied to both pension and OPEB plans.

As to implementation, I would recommend a delayed implementation of this specific standard, to permit the pension plans an opportunity to adjust their funding, asset allocation and amortization policies in coming years, as many will undoubtedly be doing, perhaps using 2016 for the effective date of this single-sentence provision. This would be far less confusing to all concerned and minimize inter-period comparability problems as pension plans adjust to the anticipated separation of funding policies from accounting policies. That date will also align more closely with what you may establish for implementation of a parallel provision under prospective revisions of OPEB accounting and financial reporting standards. Delayed implementation would also provide an opportunity for item-specific re-exposure without delaying the entire project.

Thanks very much for the opportunity to revisit this important subject and share these last-minute thoughts in light of newly published evidence that warrants reconsideration of previous conclusions. Be assured that I will strongly support the Board’s ultimate decisions because the improvements you have already announced are fundamentally sound and beneficial to the entire public finance community.

Cordially

Girard Miller CFA