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Governmental Accounting Standards Board
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By email to director@gasb.org

Re: Accounting and Financial Reporting for Pensions, an amendment of GASB Statement No. 27

I appreciate the opportunity to comment on the Exposure Drafts of the amendments to GASB Statement Nos. 25 and 27. Any references made in this letter to those Exposure Drafts will cite the amendment of GASB Statement No. 27 (ED). I write in regard to the use of a discount rate based on the expected rate of return on invested assets (EROA) and the role of the Actuarial Standards Board (ASB) in limiting the subjectivity of the EROA selection.

I am a consulting actuary and, while I do not work with public pension plans and speak here only for myself, I write from at least three perspectives.

- A participant with GASB from 1996 to 2003 in the process that led to GASB Nos. 43/45 and a participant in writing actuarial standards of practice.
- A member of an American Academy of Actuaries (Academy) task force that examined the risks of public retirement benefit plans in 2009 and 2010.
- A current member of the Academy Board of Directors and chair of a task force examining risks to the Academy and the actuarial profession.

The ED states that all assumptions underlying measurements should be made in conformity with actuarial standards of practice issued by the ASB. In ED paragraph 191, the Board says it addressed concerns about subjectivity inherent in the selection of EROA by requiring conformity with actuarial standards of practice, as well as enhanced disclosures. In ED paragraph 164, the Board indicates it may not be able to attain its goal of reducing subjectivity in the selection of EROA. The Board is right to be concerned about the role of subjectivity and can take additional steps to limit that role.

The Exposure Drafts cite the Actuarial Standards of Practice as a possible governor over the subjectivity inherent in the selection of the EROA. I welcome that, but actuarial standards are limited in the distinctions they can make between assumptions for financial reporting purposes and for other studies. EROAs are, by their nature, subjective and based on individual expectations. If the Board would like limits placed on EROA subjectivity in public plan accounting, it is for the Board to determine those limits. Actuarial standards cannot solve a problem clearly within the GASB purview.

A two-tier standard for the discount rate melds practice from two different worlds – the current public plans practice of EROA and the widely accepted use of market rates in a larger financial world. Use of EROA discount rates in financial reports, however, will continue to be regarded skeptically by the larger world. In recent months, there is evidence that the audience for that skepticism is growing. Influential thought leaders are not persuaded that EROA is an appropriate discount rate. This spring the non-partisan CBO said, “the fair-value approach provides a more complete and transparent measure of the cost of pension obligations.” The OECD, examining the

international situation of public plans in a May 2011 Working Paper, favored market-related discount rates.

Popular media outlets are devoting more attention to discount rates and echoing the skepticism towards asset return assumptions for public plans. Here are two examples that crossed my path during my leisure time. In June, The PBS News Hour had a feature on pension assumptions and focused on the question of discount rates, leaning towards a move away from EROA. An article in The New Yorker of September 5 used words like “wishfulness” and “fairy dust . . .sprinkled nationwide” before noting, “two-thirds of the country’s largest public pension plans assume a return of eight per cent a year – when the compound growth rate of the stock market, in the past twenty years, has been about 6.5%.”

Such criticisms of public plan valuations, implicit or explicit, are likely to continue as long as a large gap exists between a public plan discount rate and the rates publicly available. The credibility of GASB, and governmental accounting in general, suffers. If the GASB standards are to sanction the selection of EROA as discount rates, they should be careful in stating the rationale for that decision and should more explicitly limit selection bias.

There is nothing in theory that would prevent selection of an EROA that is consistent with market rates. It could be part of a public plan’s policy to reduce subjectivity and to limit downside risk in EROA. (I feel public pension plan accounting should not use a discount rate with an equity return expectation component, due to the risk inherent in that expectation, but do not press the point in this letter.) Too much of the subjective judgment displayed in current public plan discount rates, however, relies on market return on assets reverting to former levels. As ED paragraph 164 notes, that is “inconsistent with the forward-looking nature of the expectation.” The GASB rules need to nudge the discount rate away from such reliance and to an objective level consistent with rates current at the valuation date (and events such as the announced policy of the Federal Reserve to keep interest rates low for the next few years).

Financial reporting aside, rationale exists for using EROA in some studies; actuaries can produce valuations discounted for future asset returns based on expectations, wishful or not. But while the actuarial profession has been moving to incorporate measures of risk in to its work and its standards and can reference prescribed accounting standards, they cannot be specific to financial reporting as a whole. If GASB standards are to limit subjectivity of specific assumptions, then the Board needs to send stronger signals than those in the ED.

By acknowledging that EROA contains elements of subjectivity, the Board has identified a potential failing of EROA. I personally appreciate that the board has explicitly linked the ASB (which, by the way, is not a subgroup of the Academy) as a mitigating factor in the subjectivity. But the Board needs to go further and indicate where objectivity is to be found. One useful and non-controversial indicator would be to simply include the mantra required in an investment prospectus – Past performance is no guarantee of future results. Past performance of equity returns is often given as an objective rationale for the selection of an EROA. GASB does well to note this inconsistency.

Footnote disclosure aids in warning of subjectivity, and such transparency may eventually reduce that subjectivity. I strongly agree with the disclosure of sensitivity analysis around the discount rate of a one percentage point increase and decrease. Other information that might be in footnote disclosures includes current and expected benefit cash flow levels and, when EROA is used, results with a discount rate at the municipal bond index rate.

The Exposure Draft amending GASB Statement 27 includes in the commentary in Paragraphs 188, 189 and 190 many of the reasons behind opposition to the use of EROA for financial reporting purposes. I am also sympathetic to the position of the Board member whose alternative view is shown in Paragraphs 287 to 290. In other parts of the Basis for Conclusions, the Board might use language that indicates more reservation about EROA.

From reading Paragraph 187, it appears some EROA supporters may believe that setting an investment goal is the same as achieving an investment goal. They may not be sufficiently aware of investment risk. The use of EROA can be consistent with policies of a plan or with management of the net position, but such consistency is irrelevant when an asset is needed to pay a pension benefit. The asset value will depend on the market price available, not previous plan expectations about that price.

Paragraph 181 asserts, "Assets can be invested with a long-term horizon and, therefore, can endure the short-term volatility of financial markets." This statement ignores the existence of long-term volatility, or worse, implies that volatility does not exist in the long term. While the consensus from many studies is that diversification in an asset portfolio can, to some extent when compared with a more concentrated portfolio, mitigate volatility for a particular time period, there is no such consensus that an equity portfolio can be constructed for the long-term that will meet a pre-selected rate of return.

Paragraph 182 speaks of incorporating "all reasonably anticipated future events" and noting that "if the potentially significant effect of investment earnings is not considered" then amounts "potentially would be misstated." I read Paragraph 182 in context as intending support for EROA, but as often as not, the "significant effect of investment earnings" will be to fall short of earnings expectations, in which case liabilities and expenses discounted at that expectation will be understated. In the long term, while the potential gain on an asset increases, so does the possibility of ruin.

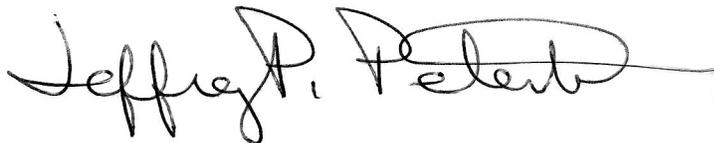
Paragraph 183 states "that the long-term investment rate of return should be used only to the extent that there is an expectation of resources being available in the pension plan" for investment. First, note that between Paragraph 181 and Paragraph 183 the word "expected" was dropped from "long-term expected rate of return." This presumably was an oversight, but calls to attention the tendency for advocates of the use of EROA to downplay a) the possibility that expectations won't be met and b) the regularity with which their expectations diverge from market consensus. Second, if the Board truly wants EROA to "be used only to the extent that there is an expectation" that sufficient resources will be available to cover the projected payment liability, then the Board should define that expectation.

In sum, the justifications for EROA set forth in these paragraphs ignore downside risk. Sanctioning an EROA discount rate not only results in a riskier investment portfolio leading to a lower pension liability, as noted in the Alternative View and by others, but also may be regarded as GASB endorsing more risk in investment strategy. I am not against equities in investment strategy or prudent risk in funding policy; but I do oppose financial reporting rules that may, intentionally or not, present a bias towards unnecessary or unacknowledged risk.

A second way, then, beyond disclosures, in which the Board can nudge expected rates of return away from subjective judgments and more towards the market consensus is by acknowledging downside risk in the language used to justify conclusions.

I commend the Board and staff for their efforts. Some Board members clearly find it necessary to include EROA among the discount rate choices, but recognize the credibility problem intrinsic in EROA subjectivity. If EROA closes the gap with market expectations, credibility will improve, although matching risks of assets and liabilities remains a problem for many, including me. I do believe the Board can move closer to attaining its goal of reducing subjectivity in the selection of EROA and hope that my suggestions are useful.

Sincerely,

A handwritten signature in black ink that reads "Jeffrey P. Petertil". The signature is written in a cursive style with a large, stylized initial "J" and a long, sweeping underline.

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