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# **New Developments in Public Plan Management**

**The Future of Public Employee  
Retirement Systems**

**Pension Research Council Symposium  
May 1-2, 2008**

**Discussion of Papers**

**Paul Angelo, FSA**

**The Segal Company**

**San Francisco**

**4045312**

## “New Developments” Papers

- Stephen T. McElhaney
  - Estimating State and Local Government Pension and Retiree Health Care Liabilities
- Jeremy Gold and Gordon Latter
  - Marking Public Pension Plan Liabilities to Market
- Parry Young
  - Public Pensions and State & Local Budgets: Can Contribution Rate Cyclicalities Be Better Managed?

## Two Ways to View the “Liability”

- Think of “Cost vs Benefit”
- Cost to the Sponsor/Taxpayer
  - Accumulated hurt on the taxpayer
  - “Actuarial Accrued Liability”, “Budget Liability”
- Value to the Member
  - Accumulated promise to the member
  - “Accumulated Benefit Obligation” (ABO), “Pension Wealth”
- “Obligation” vs. “Liability”

## Uses of Liability Measures

- Funding Requirements
  - Including GASB's "ARC"  
(annual required contribution)
- Investment Policy
  - "Liability Driven Investment" strategies
- Solvency/Benefit Security
  - "Settlement" or "termination" liability
- Other Disclosure
  - Comparative analyses

# McElhaney “Estimating Liabilities”

- “General Measurement Issues”
  - For broader audience, overview funding process
  - Project the stream of future payments
    - Agreement on demographic assumptions
  - Value stream by discounting to a value today
    - Introduces “discount rate” issue
  - Allocate value to each year of service (NC, AAL)
    - Introduces “various methods” issue
  - Contribution Policy (determines ARC)

## McElhaney “Estimating Liabilities”

- “Private Sector Management”
  - Distinguish expense from funding
  - For expensing, note FAS 87 also measures ABO
  - Add discussion of IRC minimum funding rules
    - Initially traditional methods and assumptions
    - OBRA 1987 added ABO (“current liability”)
    - PPA 2006 removed traditional methods

## McElhaney “Estimating Liabilities”

- “Public Sector Management”
  - Comment on role of GASB ARC vs funding
    - Closer relationship than for private sector, at least for pensions
- “Comments on Measurement Differences”
  - “Market related” measures (Ennis et al.) would change to market discount rate and ABO measure
  - Discuss need for and uses of “comparability”



## McElhaney “Estimating Liabilities”

- “Potential Changes for Public Sector Measures”
  - Are proposed changes “just” disclosure or also for ARC (and so perhaps even for funding)?
    - Currently, very limited non-ARC disclosures
  - Other possible disclosures
    - Expanded historical info on changes in methods, assumptions
    - Single method (EAN?) for disclosure only

## Gold/Latter “Marking Liabilities to Market”

- Focus on “Value to Member” liability measure
  - Method is value of accrued benefit (ABO)
    - Current service and salary
  - Discount rate is risk free return (MVABO)
  - Commonly called “Market Value Liability” (MVL)
    - Sometimes even “Economic Liability”

## Gold/Latter “Marking Liabilities to Market”

- Gold/Latter asserts that this is both “Value to Member” and “Cost to Sponsor/Taxpayer” (p. 7)
  - For entire system and for individual members
  - Both “to date” (MVABO) and “per period” (MV $\Delta$ AB)
  - MVABO is Accrued Liability, MV $\Delta$ AB is Normal Cost
- For private plans, this “identity” depends on corporate finance arguments (see “Pension Actuaries Guide to FE”)
  - Not established for public plans

## Gold/Latter: Scope of Application

- Disclosure of Market Value Liability (MVABO)
  - Gold/Latter: Recommends
- Funding based on risk-free discount rate
  - Avoid intergenerational risk transfer
  - Gold/Latter: compensation set aside today (p. 12)
- Investment based on MVL asset/liability models
  - Acknowledge bond-like nature of liabilities (LDI)
  - Gold/Latter: Silent!
- Investment only in bonds, not stocks
  - Avoid increasing taxpayers' equity risk exposure

## Impact of Market Discount Rate

- Introduces “liability-side” market volatility
  - Asset volatility is necessary and understood
  - Market discount rate means cost changes with market interest rates
    - Rates down, costs up, and vice versa (p.12)
  - Established for private plans since 1987
    - Settlement liability
    - Led to “perfect storm”
    - No empirical justification for public plans

## “Liability-side” market volatility

- Financial economics provides theoretical basis
  - Private sector: “Pension Actuaries Guide to FE”
  - “Transparency” and “Law of One Price”
  - “No intermediaries” appropriate for private sector
  - Need theory that includes independent plans
- Solution: Liability Driven Investing (LDI)
  - Leading edge of MVL proponents
  - More bond-like investments – plain or fancy
  - Gold/Latter: no investment issues raised

## MVL's "liability-side" market volatility

- If "disclosure only" (NYC), what does it measure?
- Suppose interest rates fall 1%, MVL up 10%
  - North ratio decreases 10 percentage points
- Has cost to taxpayers suddenly increased 10%?
- Has benefit security suddenly decreased 10%?
- Unless MVL is used for funding/investments, it is a misleading disclosure for public plans.
  - NYC as case study
- This is really about funding and investments

## Young: Managing Rate Cyclicity

- Review: Overview of funding process
  - Project the stream of future payments
    - Demographic assumptions
  - Value stream by discounting to a value today
    - Discount rate
  - Allocate value to each year of service
    - Various methods, determines NC, AAL
  - Contribution Policy (ARC)
    - Normal Cost adjusted for UAAL/Surplus



# Young: Managing Rate Cyclicity

- Rate Mechanics
  - Governance issue: contributions not enforceable
- Recent Record of Contribution Volatility
  - Note “partial” contribution holidays
    - Contribution less than Normal Cost
  - Note effect of mid-1990s POBs on surplus
  - Note pressure for benefit improvements
    - Discussed in a later section

## Young: Managing Rate Cyclicity

- Strategies: Asset Valuations and Employer Rates
  - CalPERS April 2005 Study and policy
    - 15 year asset smoothing
    - Also note 30 year gain/loss amortization
    - 30 year surplus amortization
      - Note prior policy was as short as 5 years
    - “As if” effect of new policies
      - Note connection to benefit improvements

## Young: Managing Rate Cyclicity

- Strategies: Liability Increases & Employer Rates
  - Connects surplus to benefit increases
    - Note CalPERS “Pension Inequities”
    - Surplus is not a funding source
  - Checks on Benefit Increases
    - Study long term costs
    - Voter approval
    - Note effect of contribution policy (amortization period)

## Young: Managing Rate Cyclicity

- Strategies: Decreasing Volatility w/ Rate Floors
  - Note effect of short surplus amortization periods
    - CalPERS: now uses 30 years
    - Also see California Public Employee Post-Employments Benefits Commission (Rec. # 7)
      - No “full” contribution holidays
      - Partial holidays only if based on 30 year surplus amortization



**QUESTIONS**