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Committee on Ways and Means

Subcommittee on Oversight

Hearing on the Transparency and Funding of State and Local Pensions

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Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee. Thank you for the opportunity to present my views with respect to transparency and funding of state and local pension plans. My views are my own and do not represent any other persons or organizations.

I will address the disclosure of financial measurements of the assets, liabilities and costs of pension plans sponsored by state and local governments on behalf of their employees in the context of H.R. 567, the Public Employee Pension Transparency Act (PEPTA).

The disclosures at the heart of H.R. 567 are long overdue. The management of financial enterprises depends on good financial information. In the case of public pension plans, information is needed to support decisions about benefit levels, funding and investing. The most financially significant of these are decisions about levels of benefits. Pension benefits are the deferred portion of total compensation awarded today in return for services performed by public employees. The specification of benefits creates the deferred compensation and determines its cost.

Funding, i.e. cash contributed to the plan, as important as it is, does not alter the cost of benefits. It does, of course, determine whether cash is contributed sooner or later and thus which generation of taxpayers pays for the services performed by today's public employees.

Investing, as important as it is, does not alter the cost of benefits. Investing entails risks, the outcome of which, directly impacts future taxes and may, both directly and indirectly, affect future benefits. The assertion that investment does not impact costs is often disputed but can be illustrated by a simple analogy. If an automobile costs $30,000, it costs $30,000. If I invest my assets successfully, I may be better able to afford the automobile. But the automobile still costs $30,000.

Despite the preeminence of benefit levels, most financial reporting on public employee pension plans focuses on funding and investing. The liabilities reported in accordance with generally accepted accounting standards and in actuarial reports are not the economic liabilities incurred as the benefits are earned. The reported liabilities are rather a by-product of actuarial methods that have been designed to manage contribution flows rather than to measure and disclose the value of benefits being accrued.

H.R. 567 has the potential to put the horse before the cart. The *Current Liability*, defined in the bill, is a measure of the value of benefits independent of the funding and investment strategies of the plan. This is how it should be. First measure the benefits and <u>then</u> devise when and how to pay for them.

The heart of H.R. 567 reporting and disclosure is in **SECTION 3(b)** which adds **SECTION 4980J** to the Internal Revenue Code of 1986. **SECTION 4980J(a)** itemizes various disclosures, many of which commonly appear in the Comprehensive Annual Financial Reports (CAFRs) presently issued by most state and local pension plans. **SECTION 4980J(a)(1)(C)** which calls for extensive projections of future statistics would be expensive and potentially uninformative. **SECTION 4980J(a)(1)(G)** could be strengthened by requiring the disclosure of the amount paid for the plan year toward eliminating any unfunded current liability and the number of years in which annual payments of that same amount (in dollars, not as a percentage of payroll) would eliminate that unfunded current liability.

SECTION 4980J(b)(2) calls for the restatement of items (A), (C), (F) and (G) of subsection (a)(1).

- The restatement of item (A) is extremely valuable and, as discussed below, provides information critical to the assessment of the financial status of public pension plans by decision-makers and other interested parties.
- As with subsection (a)(1)(C), I believe that a restatement of item (C) will be more expensive than valuable.
- I suggest a new item – Current Cost – of benefits, discounted at Treasury rates, earned during the plan year. When compared with item (B) of subsection (1)(a), Current Cost will provide a critical measure indicative of funding progress. Additionally, Current Cost will directly determine the benefit cost component of the total compensation of public employees. I elaborate on this below.

H.R. 567 is a reporting and disclosure bill. Although it calls for enhanced reporting on the funded status of public pension plans, it makes clear in **SECTION 4** that it is not a funding bill at either the federal or local level.

SECTION 4980J(b)(3) specifies a discount rate basis which appears to have been borrowed from the Pension Protection Act (PPA) of 2006. It calls for averaging the Treasury yield curve over a 24-month period and for segmenting the result in three brackets. These adjustments to the actual yield curve were made in PPA because PPA is primarily a funding act. Such adjustments are not appropriate in a reporting and disclosure bill. I expand on this point below.

I Background

Governments are expected to focus on providing services and goods to taxpayers in an efficient, effective, economical, and sustainable manner. Citizens' taxes provide the resources that support those services and goods. Labor is the single largest cost, often exceeding all other costs combined.

Governments hire employees to provide necessary services to taxpayers and other residents. These employees are compensated by taxpayers in (at least) two ways: current cash compensation (salaries) and promises of future cash (pensions). Taxpayers, in order neither to burden nor to subsidize the taxpayers who will come after them, should generally expect to pay for today's services today – even though the deferred part of the employees' total compensation may not be received for decades.

Pension plans are the reservoirs that allow taxpayers to pay today for benefits employees receive after they retire. If the money set aside today is less than the value of the benefits earned, then future taxpayers will be paying for services received by today's taxpayers.

Employees of state and local governments such as teachers, civil servants, police, fire and sanitation workers are usually covered by defined benefit pension plans, commonly referred to in the U.S. as *public pension plans*. The financial positions of such plans are typically reported in documents called Comprehensive Annual Financial Reports (CAFRs). Public pension plan CAFRs usually include extensive data about plan assets, cash flows, expenses, investment policy and performance, etc. This information is helpful to watchdogs and other parties interested in monitoring the financial integrity of pools of assets that can run into the billions and hundreds of billions of dollars.

Information about plan liabilities, however, is much more sparse. A typical CAFR will disclose the actuarial methods and assumptions, plan provisions, data on participant ages, salaries and service, and *actuarial liabilities*. These actuarial liabilities are highly dependent upon the methods and assumptions chosen by the actuary, the trustees or administrators, or contained in local statutes and regulations. The actuarial assumptions, demographic and economic, and actuarial methods are typically consistent with Actuarial Standards of Practice. The economic assumptions (expected returns on invested assets, future inflation, and salary increases) are designed to facilitate a long-range budgeting process and are not intended to reflect current market conditions. The actuarial liabilities developed in accordance with these long range projections are not intended to approximate market values.

II What Decision-Makers Need to Know

Public pension plans directly affect the pocketbooks of public employees and the taxpayers whom they serve. The financial wellbeing of lenders, those who buy municipal securities, is also affected by the financial condition of these public plans. Various agents represent these principal groups: elected officials for taxpayers, union representatives for employees, rating agencies for lenders. Other agents also perform services related to these plans including plan trustees, investment managers, accountants and actuaries.

Decisions about plan benefits and operations are made by these agents. All these decisions depend highly upon the quality of information available to the agents. The information currently available, especially with respect to the value of benefit promises, is inadequate to support good decisions. At the very least, publicly available information should allow interested parties, principals and agents, to answer the following questions:

1) *What is the market value of benefits being earned by public employees this year? What does this tell us about their total compensation (salaries plus benefits)?*

2) *Will future taxpayers be paying for services provided to current and previous generations of taxpayers? Or might the opposite be true?*

3) *How does the funding level, and benefit security, of this plan compare to plans in other jurisdictions in the U.S.?*

H.R. 567 can go a long way towards helping decision makers answer these questions. But in order to do so it should shed the definition of interest rates under **SECTION 4980J(b)(3).** I suggest the following substitution for all of subsection (3) as follows:

> "(3) INTEREST RATES BASED ON U.S. TREASURY OBLIGATION YIELD CURVE RATE. – [1]

[1] Donald L. Kohn, in a speech to the National Conference on Public Employee Retirement Systems, New Orleans, May 20, 2008, said "public pension benefits are essentially bullet-proof promises to pay. … For all intents and purposes, accrued benefits have turned out to be riskless obligations. … The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate." http://www.federalreserve.gov/newsevents/speech/kohn20080520a.htm

"For benefits reasonably determined to be paid in any future month, the rate of interest will be determined by the Secretary for such month on the basis of the U.S. Treasury obligation yield curve for such month."[2]

Answering Question 3

How does the funding level, and benefit security, of this plan compare to plans in other jurisdictions in the U.S.?

With my suggested substitution of current Treasury rates for segmented two-year average Treasury rates, the restatement of the Current Liability in accordance with **SECTION 4980J(b)(2)** becomes the market value of liabilities (MVL) consistent with the use of the term "market value of liabilities" in a paper written by me and Gordon Latter.[3] It is also consistent with the use of the term "market value of the accumulated benefit obligation" (MVABO) as disclosed since 2003 in the CAFRs of each of the five New York City Retirement Systems.

SECTION 4980J(b)(2) also restates the plan assets as the market value of assets (MVA), the unfunded liabilities at market (MVL minus MVA), and the funded ratio (MVA divided by MVL). H.R. 567 uses the term "current liability" to describe the present value of all accrued benefits. The funded ratio provides a standardized number facilitating the comparison across jurisdictions, thus answering question 3.

Another measure that might be useful and comparable across jurisdictions would be the ratio of the unfunded liability to a pertinent local measure (e.g., gross local product, aggregate local income or property value, aggregate local t6ax revenues). Such ratios may be calculated by analysts even if H.R. 567 does not require such a computation.

Answering Question 2

Will future taxpayers be paying for services provided to current and previous generations of taxpayers? Or might the opposite be true?

The Current Liability, as restated by **SECTION 4980J(b)(2)** in conjunction with Treasury interest rates as provided by my simplified replacement for **SECTION 4980J(b)(3),** may be called the market value of liabilities and may be properly compared to the market value of assets in item (A) as restated under **SECTION 4980J(b)(2).** It is important to note that the definition of Current Liability does not include service after the end of the plan year, nor does it project future salary increases. As such it reflects all the benefits earned by plan employees and obligations of the plan to date – just as the market value of assets reflects all of the prior contributions to the plan to date.

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2 There are some situations in which it may be appropriate to use the yield curve of U.S. Treasury Inflation Protected Securities (TIPS). This is generally beyond the scope of this testimony.

3 The Case for Marking Public Pension Plan Liabilities to Market available in draft form here: http://www.pensionfinance.org/papers/TheCaseforMarkingPublicPensionPlanLiabilitiestoMarket.pdf later published in The Future of Public Employee Retirement Systems, Ed. Olivia Mitchell and Gary Anderson, The Pension Research Council at Wharton, Oxford Press 2009.

Because the MVA and the MVL (as defined by the Current Liability) reflect all past financial activities of the pension plan, Question 2 may be answered by reference to the unfunded liabilities. No unfunded (MVA equals MVL) implies that future generations of taxpayers will neither be burdened nor benefited by those who came before. Prior generations have paid for all of the public services they have consumed and future generations will pay for their own.

Based on recent data reported by various sources (and analyzed by Novy-Marx and Rauh among others), revealing massive unfunded liabilities (MVL much greater than MVA), it is very likely that future taxpayers are going to be severely burdened by pension obligations incurred in conjunction with public services that have already been rendered.

This has not always been the case. A similar analysis, had it been performed any time during the 1980's would have revealed significant pension plan surpluses (MVA greater than MVL) attributable to the high rates of interest available in the U.S. Treasury markets compared to relatively low rates used to value public pension plans at that time.

Answering Question 1

> *What is the market value of benefits being earned by public employees this year? What does this tell us about their total compensation (salaries plus benefits)?*

The Current Liability accurately measures the value of all the benefits earned by employees to date. Using Treasury rates, it is the appropriate liability to compare to the market value of assets. Similarly, what I would define as the Current Cost accurately measures the value of all the benefits earned in the year. A comparison of the following definitions makes this clear:

CURRENT LIABILITY.—The term 'current liability' of a plan for a plan year means the present value of all benefits accrued or earned under the plan as of the end of the plan year.

CURRENT COST.—The term 'current cost' of a plan for a plan year means the present value as of the end of the plan year of all benefits accrued or earned under the plan during the plan year.

The Current Cost of a pension constitutes the deferred pay component of total employee compensation.

III H.R. 567 – Precise Calculations Instead of Best Estimates

In several papers published in recent years, economists Robert Novy-Marx and Joshua Rauh have estimated the liabilities of major state pension plans using Treasury rates as the basis for their revaluation of liabilities disclosed by the plans themselves at rates averaging 8%. They estimate that underfunding of state plans approximates $3 trillion dollars while others, who have used the values disclosed by the plans, estimate underfunding at no more than $1 trillion.[4]

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[4] In April 2011, however, the PEW Center on the States updated its earlier compilations and noted that the funding gap had widened to $1.26 trillion at the end of fiscal 2009. Their study also notes it is

In 2008, Gordon Latter and I examined four large state plans, using Treasury discount rates. Our results are consistent with the work of Novy-Marx and Rauh. In our paper, however, we make the following observation:

> "Precise measurement of the [Current Liability] and the [Current Cost] can only be done by actuaries working with reliable plan data, appropriate computer software, and detailed descriptions of the benefits being earned."

Since 2003, New York City's Chief Actuary, Robert C. North, Jr. has disclosed the Current Liability at Treasury rates in the CAFRs for each of New York City's five Retirement Systems. For example, the 2007 CAFR for the New York City Employees' Retirement System[5] shows several measures of plan assets and liabilities. The most decision useful numbers shown are:

i) the market value of plan assets (MVA), and

ii) what Mr. North has called the Market Value of the Accumulated Benefit Obligation (MVABO); this is equivalent to what H.R. 567 calls the Current Liability at Treasury rates.

I am not aware of such disclosures by public pension plans in other jurisdictions in the U.S. This means that public employees, taxpayers and lenders cannot measure the economic value of pension obligations incurred to date nor can they determine total compensation costs. Additionally, they cannot detect intergenerational cost shifting nor can they accurately compare funding progress across jurisdictions.

H.R. 567 would serve us well by combining the low discount rates espoused by many commentators (e.g., Donald L. Kohn, Novy-Marx and Rauh) with the precise calculations that are best made by plan actuaries. If my suggestions with respect to i) eliminating item (C) of **SECTION 4980J(b)(2)** and ii) using the Treasury yield curve without 24-month averaging and segmented rates were incorporated into the bill, the cost of compliance would be modest in the first year and nearly negligible thereafter.

IV Conclusion

H.R. 567 calls for very valuable disclosures by public pension plans. These disclosures will make the funding status of public plans clear, economically realistic, and comparable across jurisdictions.

By addressing the three questions highlighted in my testimony, the disclosures of H.R. 567 will also improve the management of public pension plans. Until now, the agents responsible for plan management have been making important financial decisions (benefit levels, funding and investment strategies) without the information necessary to determine i) the value of benefits as a component of total compensation, ii) the efficacy

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based on actuarial assumptions where the discount rate is typically 8% and that using Treasury rates could increase the funding gap to $2.4 trillion.

http://www.pewcenteronthestates.org/uploadedFiles/Pew_pensions_retiree_benefits.pdf

5 See http://www.nycers.org/(4pdve4550se2te2d0dytvl45)/Pdf/cafr/2007/NYCERS_final.pdf pages 149-150.

of funding and investment strategies, iii) which generation of taxpayers are paying for services rendered, and iv) how plans in one jurisdiction compare to those in other jurisdictions. With the addition of Current Cost, as defined herein, H.R. 567 will support rational decision-making by agents on behalf of employees, taxpayers and lenders.

I suggest that item (C) of **SECTION 4980J(b)(2)** be eliminated because it will be expensive to satisfy and because the disclosures thereunder will be uninformative at best and may actually be misleading and counterproductive in the decision-making context.

I suggest the elimination of 24-month averaging and segmenting of Treasury rates. Unadjusted Treasury rates are more appropriate to the disclosure objectives of H.R. 567.

I suggest the addition of Current Cost as defined above in order to identify the value of benefits earned in the latest year as a component of total compensation.

H.R. 567 may stand as a landmark and a turning point in helping states and localities regain control of their obligations and the management of their resources.