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July 17, 2009

Submitted via Email to director@gasb.org

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To whom it may concern:

The National Conference on Public Employee Retirement System (NCPERS) is pleased to enter the following comment into the record for the Governmental Accounting Standards Board's Invitation to Comment (ITC) on Pension Accounting and Financial Reporting. NCPERS is the largest trade association for public sector pension funds, representing more than 500 public funds throughout the United States. We are a unique network of public trustees, administrators, public officials and investment professionals who collectively oversee nearly \$3 trillion in retirement funds on behalf of seven million retirees and 14 million active public servants.

The purpose of GASB's invitation is to learn stakeholders' views on pension accounting and financial disclosure. While many others in the public pension community will undoubtedly have much to say on the many aspects of public pensions and financial reporting that GASB seeks guidance on, we will restrict our comments mainly to the issue of what discount rate public pensions should use that was raised in Chapter 4 of the ITC.

NCPERS SUPPORTS USING THE CONVENTIONAL LONG-TERM EXPECTED RETURN ON PLAN INVESTMENTS

NCPERS supports maintaining GASB's current standard of basing the discount rate on the expected long-term rate of return on public pension investments. Our reasons for this position are based upon the purpose, structures, and life cycles of public plans.

Differences between Governmental Entities and Businesses

In 2006, the Governmental Accounting Standards Board released a white paper entitled *Why Governmental Accounting and Financial Reporting is—And Should Be—Different*. This white paper detailed the manner in which governments are fundamentally different from businesses. According to the report, governmental and business accounting standards are—and should be—different, including the standards related to pensions and other post employment benefits.

A government's primary purpose is to maintain or enhance the well-being of its citizens by providing public services financed through taxes; whereas a business's primary purpose is to benefit shareholders by creating wealth through voluntary transactions. The governmental accounting approaches supports allocating long term benefit costs to periods of service as a level of percent of payroll. This is different from business accounting, which places greater emphasis on the measurement of plan liabilities, since these affect the value of the business if and when it is sold, or if the plan is terminated.

For pensions, the governmental accounting approach supports allocating long-term benefit costs to periods of service as a level percent of payroll. This helps to smoothly spread the costs among different generations of taxpayers, promoting intergenerational equity. Level contributions also help governments to better plan and budget their contributions. This is different from business accounting, which places greater emphasis on the measurement of plan liabilities, since these affect the value of the business if and when it is sold, or if the plan is terminated.

Governmental entities, additionally, do not face the threat of dissolution or sale in the same fashion that private plans do, nor are governments expected to meet profit targets and report their earnings, which has demonstrably led to financial shenanigans in recent years, which in many cases has adversely affected private retirement programs.

Conventional approaches better reflect the underlying nature and dynamics of public pension plans

The underlying theoretical basis of the market value liability (MVL) approach is that pension cash flows have the same structure as bond cash flows. However, pension plan cash flows typically depend on factors not included in bond cash flows, such as future service accruals and salary increases.

A valuation approach that ignores fundamental characteristics of the retirement benefit will not reflect the underlying dynamics of the plan and will not provide an accurate or useful measure of the plan's liabilities and related contributions. Moreover, because the MVL does not include projected future salary and service in the contribution rate, plan contributions under the MVL will likely increase as salary and service increase.

In addition, discounting pension cash flows using bond yields ties the measurement of plan liabilities to changes in the supply and demand for bonds, which are unrelated to the benefits promised by the plan. Consequently, small changes in the discount rate could result in large changes in plan liabilities, even though there were no changes in the benefits promised by the plan.

Conventional approaches are more likely to provide for stable contribution rates

To help stabilize their contribution rates and funding, public plans use a variety of techniques. Most plans use the entry age actuarial cost method to calculate contribution rates intended to remain a level percentage of payroll over time. In addition, most plans smooth investment gains

and losses into the actuarial value of plan assets over a period of time, typically 3 to 5 years. Although these techniques do not guarantee that pension contributions and funding will remain level, they help mitigate short-term shocks and stabilize plan funding.

Using the MVL approach is likely to introduce more volatility into plan liabilities and contribution rates than under conventional approaches. While the discount rate used under conventional approaches does not vary much from year to year, the “risk free” discount rates can vary widely.

Since pension liabilities are inversely proportional to the discount rate, a decline in long-term government bond yields increases plan liabilities and contribution under the MVL approach. This was a problem for private-sector pension plans in early 2000s, when corporate plan liabilities grew rapidly as a result of discount rates pegged to declining bond yields. Since public plan liabilities are not discounted in this matter, they are not subject to similar pressures.

Some proponents of the MVL approach argue that it can be used to significantly reduce volatility in the plan’s funded ratio. However, in order to stabilize plan funding under the MVL approach, the plan would have to “immunize” the liabilities using matching securities of the same amount and duration or apply a “liability driven investment” (LDI) strategy. Theoretically, if this were done, changes in the value of plan liabilities due to changes in discount rate yields would be offset by related changes in the prices of the matching securities, thus stabilizing the funded ratio.

However, for this approach to work, the pension plan would have to be fully funded at the time the liabilities were immunized. If the plan was less than fully funded, this approach would lock-in the plan’s under funding or require even higher contributions. In addition, by investing largely in bonds, a pension plan would give up the potentially higher returns that are likely to be earned on equity investments. While higher equity returns are not guaranteed, there is substantial evidence to suggest that equity investments outperform bonds over the long term.

Conventional approaches are more likely to allocate pension costs equitably across current and future taxpayers

Proponents of the MVL approach argue that the current approach for funding public pension plans results in government contributions that are lower than necessary to fund the plan. As a result, future taxpayers will likely pay higher contributions to make up the difference, violating the principle of intergenerational equity.

If the MVL approach were used to determine plan contributions, the resulting contribution rates would immediately be significantly higher than those determined under conventional actuarial methods. Consequently, current taxpayers would pay significantly more to fund the plan than under conventional approaches. Moreover, if these contributions were invested in a diversified portfolio that earns significantly higher returns than the bond discount rate, the plan would become fully funded more rapidly than under current funding schedules. Therefore, at some

point, future taxpayers would likely pay less than current taxpayers. This too would violate intergenerational equity.

Conventional approaches are more likely to support better decisions related to public plan funding.

If the MVL approach were used to disclose public plan liabilities but not to establish contribution rates, it is likely that legislators, taxpayers and members of the press would have difficulty distinguishing the different purposes behind reporting a “market liability” and a “funding liability”. Instead of making financial reporting more transparent, the MVL approach would likely lead to confusion about the costs and sustainability of the plans. This could result in poor policy decisions and potentially lead to the needless abandonment of public pension plans.

NCPERS supports maintaining GASB’s current standard of basing the discount rate on the expected long-term rate of return on public pension investments. We hope our comments help move the debate in the right direction. Please contact us if we can be of additional assistance.



Pat McElligott
President

Sincerely,



Hank Kim, Esq.
Executive Director & Counsel