



TO: Clients of Pension Consulting Alliance, Inc. (PCA) and EFI Actuaries, Inc. (EFI)

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FROM: PCA and EFI

## Proposed Financial Economics Applications to Plan Liabilities Raise Concerns

**T**he debate on how to measure and account for public pension plan liabilities is heating up. Proponents of having public funds move to a financial economics-based (i.e., Treasury yield curve-based) liability discount model state that doing so virtually eliminates inter-generational inequities that might otherwise arise under the conventional actuarial-based model. They also point out that transparency improves because of the application of a standard discounting approach that would apply to all plans.<sup>1</sup>

There are numerous simplifying assumptions typically used to make this case: for example, (i) the distribution of risky returns is symmetrical, (ii) current active participants are completely risk averse with respect to bearing pension costs, (iii) there are no cost-of-living adjustments associated with future retirement benefits, (iv) the only liability measured is the accrued liability (which does not factor in the impact of future wage increases and thus represents a value the plan sponsor would be required to pay if the plan was terminated today), (v) all excess risky returns are spent by plan sponsors, rather than reserved, (vi) municipalities and states are completely riskless entities from an investment perspective, and (vii) the political environment and other practicalities can be ignored.

Opponents of the proposed financial economic modeling approach strongly disagree with its application to the public plan pension system.<sup>2</sup> Their view is (i) that a financial economic model would, in fact, provide inaccurate information, (ii) plan sponsors would be compelled to develop investment strategies that limit long-run investment return potential, (iii) financial economic models would actually create confusion rather than provide the relevant transparency, and (iv) that there is a profit motive lurking behind promotion of the financial economics mantra.

Finally, taking these factors into account, opponents also argue that more defined benefit plans would be forced to terminate, resulting in a shift to defined contribution plans and annuity-based products. This scenario has played out in the corporate plan arena, resulting in the development and promotion of numerous investment “solutions.” Since these recent trends within the corporate community are in their infancy, significant questions remain about whether they will actually add value. What is highly probable is that the resultant product line of retirement solutions will be more expensive to the end



user (i.e., the beneficiary). What is also certain is that, despite the popularity of the defined contribution plan framework as an investment solution and social engineering tool, implementation of defined contribution plans has been (i) costly in terms of management costs and underperformance and (ii) ineffective at providing anything close to a substitute for the defined benefit framework. In summary, broad acceptance of recent “innovative solutions” has not produced the desired outcomes.

In fact, two of the largest pension funds in the world (ABP and CalPERS) have essentially rejected the financial economics-based approaches to strategic investment allocation. ABP indicated that liability-driven investing (or LDI) is problematic because of the difficulty of accurately matching the risk structures of assets with the risk structures of liabilities.<sup>3</sup> CalPERS instead instituted a contribution rate stabilization plan in 2005 that significantly reduced the need for financial economics models.<sup>4</sup> The CalPERS approach (i) incorporates additional smoothing techniques to the Plan balance sheet and (ii) establishes “rainy day” reserves that receive priority funding before the granting of additional benefits. These techniques are designed to place less stress on the broad array of contributing employers that support and fund the Plan.

**PCA/EFI agrees that moving toward a financial economics-based approach is an inappropriate “solution” for public plan sponsors.** First, there is no crisis in funding public funds: The average public pension plan has a funding ratio of nearly 90%.<sup>5</sup> Furthermore, the administrative and investments staffs of most public funds are thoroughly competent and professional. Moreover, as highlighted above, plan sponsors have the capability to apply a spectrum of approaches to resolve existing or potential funding challenges without having to rely upon untested nationally-binding funding-method standards based on too many simplifying assumptions and having a highly uncertain potential outcome. Interestingly, there *is* one area of broad consensus: As public funds reach and exceed full funding in future years, benefit granting discipline and benefit funding discipline must improve.



## ENDNOTES

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<sup>1</sup> See: Ennis, Richard M., "What Ails Public Pensions?," *Financial Analysts Journal*, Nov/Dec 2007; Bader, Lawrence N. and Gold, Jeremy, "The Case Against Stock in Public Pension Funds," *Financial Analysts Journal*, Jan/Feb 2007.

<sup>2</sup> See: Findlay, Gary W., "Market valuation non sequiters," *Pensions & Investments*, June 23, 2008; comment letter to the Actuarial Standards Board (co-signed by approximately 50 state funds), National Association of State Retirement Administrators (NASRA), July 31, 2008.

<sup>3</sup> See: "ABP rejects LDI for new plan," *Global Pensions*, June 11, 2007.

<sup>4</sup> See: Macht, Pat, "CalPERS Diversified Investments Help Offset Stock Market Losses for Fiscal Year; Funding Levels Remain Very Strong," *CalPERS Press Release*, July 18, 2008; Hall, Darren, Macht, Pat, "CalPERS Committee Recommends Rate Stabilization Policy – Pension Fund to Explore Rainy Day Reserve Accounts for Employers," *CalPERS Press Release*, April 19, 2005.

<sup>5</sup> See: "State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Future Funding Costs," United States Governmental Accounting Office (GAO), Report to the Committee on Finance, U.S. Senate, September 2007; "Promises with a Price," The Pew Center on the States, December 2007; Bonafede, Julia, Foresti, Steven, Browning, Alexander, "2008 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation," Wilshire Consulting, March 3, 2008.