



CERF

COUNTY EMPLOYEES'
RETIREMENT FUND

July 16, 2008

ASOP No. 27 Request for Comments
Actuarial Standards Board
1100 Seventeenth Street, N.W. 7th Floor
Washington, D.C. 20036-460

Governmental Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116

Subject: Financial Economics Concepts Applied to Public Sector Defined Benefit Pension Plans

Ladies and Gentlemen:

We are writing on behalf of the County Employees' Retirement Fund (CERF). We are CERF's Board of Directors.

Background

CERF provides a defined benefit pension plan for employees in all rural counties in the State of Missouri. CERF covers approximately 11,000 active plan participants, 2,800 current retirees and survivors receiving benefits, and approximately 1,500 terminated employees with deferred vested benefits.

We understand that the Actuarial Standards Board is considering changes to Standard of Practice Number 27. The Governmental Accounting Standards Board is considering the modification of GASB Statements 25 and 27. The efforts of your organizations intersect on the issue of financial economics applied to defined benefit pension plans. It is on this intersection that we are very concerned that you are about to make changes that would be disastrous to the thousands of well-funded and well-managed defined benefit plans in the public sector. In turn, such changes would eventually reduce or eliminate pensions for millions of hard-working, dedicated government employees.

Our Concerns

The impetus for these changes is coming from academics, with very little real-world experience with public pension plans and from the financial service industry with a vested stake in the outcome. The changes that they advocate will be subject not only to misunderstanding, but also to deliberate distortion, particularly by factions of the media. We have enclosed some of the reader responses to the recent Washington Post article. These responses demonstrate the level of hostility that has been unjustifiably stirred by the media. As a result, any "disclosure" that suggests higher liabilities than previously reported will be distorted, and will lead not to reform of public plans, but to their destruction.

Reasons Why ASOP 27 and GASB Statements Should Not be Changed

We have enclosed a list of technical reasons why changes from conventional actuarial approaches to financial economics does not make sense. We fully expect that those who advocate the financial economics principles will not find that our technical explanations reveal any irresistible logic that changes their minds. Therefore, we are presenting the following comments that are more of a practical nature.

By 1985, single-employer pension plans in the private sector, i.e., single-employer plans covered by the Pension Benefit Guaranty Corporation (PBGC), had grown in number to 112,208. Since this high point, the number has declined steadily to 28,784 in 2006. We believe that the situation is even worse because a large portion of the 28,784 are plans that have been frozen.

The decline began in the mid-1980's when ERISA funding and Financial Accounting Standards Board rules began turning pension plan obligations, which are inherently long-term in nature, into short-term obligations. To protect the PBGC, OBRA 87 introduced the concept of a deficit reduction contribution tied to short-term interest rates. In the name of better disclosure to stockholders, FAS 87 tied the discount rate to a "settlement rate." These measures introduced volatility into pension liabilities and costs that plan sponsors began to find unacceptable. Subsequent ERISA law changes and FASB changes have continued to make the situation worse and caused more and more plan terminations and plan freezes.

As a direct result, we saw the utter destruction of the private sector defined benefit plan system.

While the ERISA and FASB changes were not labeled "financial economics," they are intrinsically the same.

It boggles the mind that such concepts that have been proven to be so destructive could be applied to the public sector. With the exception of a small number of situations that the media

has sensationalized, pensions in the public sector are doing just fine under conventional actuarial approaches.

Certain people in the financial services industry are using financial economics to promote investing pension assets totally in bonds. They frequently use the catch phrase that \$1,000 invested in bonds has the same value as \$1,000 invested in stocks.

They seem to have lost track of the fact that the \$1,000 pays for different things. It's analogous to two people paying the same price for an automobile where one of the cars is an SUV and the other is a standard sedan. The purchases have the same price, but they are bought to serve different purposes.

With a portfolio of bonds, you are buying a steady, predictable return with lower volatility in value through time. With stocks, you are buying more volatility but you have a very high probability of significantly higher returns than bonds over a long period of time. Pension plans are inherently long-term and stocks are extremely well suited for these long-term needs. Yet people in the financial services industry who are pushing financial economics want to artificially turn the pension commitment into a short-term obligation.

The trade-off they want public plans to make is pristine accounting and ultra-safe investments in exchange for either a higher cost for employee pensions or for lower pensions.

Conclusion – The Emperor Has No Clothes

The financial economics view would extend private sector practices to the public sector with the simplistic logic “the obligations are the same.” We agree that the obligations are essentially the same. But financial economics proponents need to look in the mirror, and they will see the emperor without any clothes. Their measuring devices have destroyed the object that they were intended to measure.

Instead of considering whether to apply private sector approaches to the public sector, we encourage your organizations to instruct the private sector to examine what they can learn from the public sector.

Consider the following excerpt from one of the bitter comments on the Washington Post article:

....Any pension benefit (no matter how small) would be preferable to that which most of us in the private sector will receive: nothing....

Rather than lashing out at those fortunate enough to be in a public sector pension plan, this commentator should have been asking why his private sector employer is not able to provide a

pension. The factual answer is because of ever more destructive financial economics principles applied to private sector pension plans over the last 20+ years.

We implore the ASB and GASB to stay with what works. Please do not make the same mistakes that led to the destruction of private sector plans.

Sincerely,

A handwritten signature in black ink that reads "Wayne Scharnhorst". The signature is written in a cursive style with a large, prominent initial "W".

Wayne Scharnhorst, Chair
On Behalf of the Board of Directors
Of the County Employees' Retirement Fund

Examples of Unjustified Responses Stirred by Media Attacks on Public Sector Pension Plans

Response Number 1

Amazing how our politicians promise the moon and give away the store to Government workers, and those of us that bust our A\$\$'S in the real world have Social Security to look forward to, which wouldn't feed or house a dog.

Now after the promises to those Government unions to get their support and votes, now we're finding out they were empty promises never backed up by setting aside the funds to pay these pensions.

Oh well when the states and cities start going bankrupt those Government bee's will be in the same boat as those of us that aren't given taxpayer paid bliss in retirement.

Response Number 2

Most of these public servants are the parasites in our society. When you ring one of them, he's having his lunch- at all hours of the day- he's attending a meeting, he's on holidays, he's sick at home and all the other excuses they use for not be able to talk to the guy. After weeks of waiting, he's on the spot at last. When I pose the question, he doesn't know. He'll connect you to another person, etc.

It reminds of Kafka's the Trial!

Response Number 3

How much has been lost from these funds because of Sub-Prime; Swaps; Oil and Property Partnerships in the 80's and finally the dot.com fiasco of the 90's? Ask Wall Street Investment Bankers "How much into the trillions of dollars did you receive from these funds in exchange for the worthless investments you sold?" Now you wish to bill the public for this fraud?!

Response Number 4

Public pension funds should mirror the pensions of private industry. Its ridiculous that a fireman, policeman, etc can retire after 20 years and receive a pension that is indexed so each year it goes up. Medical insurance should be partially paid for rather than fully funded by the pension fund.

Most public safety officers I know retire after 20 years then go on to another career working until they reach 65 or 67 and then receive social security benefits.

Response Number 5

These public servants should do what they're supposed to do; serve the public it's as simple as that. If they don't understand this simple message, then give them a job at Wal-Mart.

Response Number 6

Regardless of who becomes President, the cancer that is government will continue to grow. Governments in the U.S. employ over 21 million people (not including the military) each of whose "work" is counted in our GDP figures. GDP is measured by dollars, not by actual work or product produced. Thus, the "product" of a government worker who does almost nothing for \$30,000 per year counts the same toward GDP as the labors of bricklayer, auto mechanic, or factory worker ... people who really work.

Response Number 7

The Pollyannish investment projections are one problem. But another monster problem is that ALL such pensions use outdated mortality tables, dramatically and systematically underestimating the life expectancy of retirees.

Given that the govt staffers and politicians in the decision-making process benefit from such generous pensions, they all turn a blind eye to the guaranteed future fiscal crisis guaranteed by such largess.

BTW, most pensions WILL pay off for govt employees - the taxpayers will pick up 100% of the shortfall, and all citizens will suffer from future reductions in govt services.

Bankruptcy and/or contracting out offer the only possible solutions.

Response Number 8

It would seem that the only things that America isn't short of are corrupt politicians and gullible idiots.

Response Number 9

Screw the selfish government employees (both local and federal). To paraphrase Barry Hussein Obama's spiritual mentor, "The chickens are coming home to roost".

These "public servants" do little to no work for most of their lives, contribute practically nothing to society, vacation and call in sick frequently, complain all of the time, maintain lifestyles that

most people in the private sector can only dream about and then expect the hard working people in society to take care of them.

Most people in the private sector have seen their wages stagnate, lost sleep over their jobs being eliminated or outsourced and observed benefits like a retirement/pension/healthcare disappear. Excuse me for not caring that someone who has contributed pretty much nothing in life might have to be concerned about the level of pension to which they are "entitled". Any pension benefit (no matter how small) would be preferable to that which most of us in the private sector will receive: nothing. A simple thank you to those of us who work so hard to support your dubious lifestyle perhaps would be nice.

Response Number 10

If the entire government, both Federal and State were held to the same accounting and reporting rules that the private sector was held to, we would know the truth about the fiscal shape of our government.

The politicians do not want us to know. That way they can continue to call increases "cuts" because it was not what was originally proposed by those who produce nothing, add nothing and merely tax the money you worked hard for and redistribute it. We only wish for the government to protect us from harming each other and our external enemies. The rest basically should be up to us to work out. I will concede we do need oversight in areas of the common good but not the government actually running the programs. The Accounting profession over the past few years has required all companies to disclose the Funded Status of their pension plans and retirement benefits on their balance sheets [FASB 158]. Prior to that the information was off Balance sheet and only disclosed in footnotes to the financial statements. In private accounting more disclosure is considered better. In government accounting less or no disclosure is considered better. Why is that?

I would recommend that all governments be held to the same accounting and reporting standards that companies who are regulated by the SEC are held to.

They should have annual audits by CPA firms to keep them honest. When there is a problem in the private sector new rules are proposed and implemented swiftly to prevent a recurrence. When there is a problem in government it is never fixed.

Technical Issues with Financial Economics Applied to Pension Plans
Paraphrased From the April 2008 Issue of "Insight," Gabriel, Roeder, Smith, & Company

1. Conventional approaches better reflect the underlying nature and dynamics of public pension plans. The financial economics (FE) approach is that pension cash flows have the same structure as bond cash flows. However, pension cash flows depend on factors not included in bond cash flows such as future service and salary increases.
2. The unit credit method advocated by FE does not incorporate future service or salary increases. A valuation approach that ignores these fundamental components 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 obligations.
3. Discounting the pension cash flows using bond yields ties the liabilities to external changes in the supply and demand for bonds, which are unrelated to the benefits promised under the plan. Small changes in the discount rate can cause large changes in reported plan liabilities, even when there are no changes in the benefits promised by the plan.
4. Conventional approaches provide better information about the contributions needed to fund the plan and the plan's true funded status. The FE approach could create the false impression that the plan is underfunded even when other accepted actuarial approaches show it is well-funded.
5. Conventional approaches are more likely to provide for stable contribution rates and more equitable allocation of costs between current and future taxpayers. If the FE approach were used to determine plan contributions, the contribution rates would be much higher than those determined using conventional actuarial methods. Current taxpayers would pay significantly more to fund the plan. If the contributions were invested in a diversified portfolio that earns significantly more than bond rates, the plan would become fully funded more rapidly and future generations of taxpayers would pay less than current taxpayers. This violates intergenerational equity.
6. Suddenly higher contribution rates under the FE approach would not necessarily motivate governments to make additional contributions. If the contributions were perceived to be artificially higher than actually needed to fund the plan, there would be a disincentive to contribute the full amount and a tendency to ignore the work of the actuary.
7. Conventional approaches are more likely to support better decisions related to public plan funding. Legislators, taxpayers, and members of the press will have difficulty distinguishing the different purposes behind reporting a "market value liability" versus a "funding liability." Instead of making financial reporting more transparent,

the FE approach would likely lead to confusion about the costs and sustainability of plans. This could result in poor policy decisions and potentially lead to the needless abandonment of public pension plans.

Refer back to 1986 when GASB issued Statement Number 5. There were two measures of a plan's financial status. However, in 1994 the GASB had to eliminate one of them, concluding "...the understandability and usefulness of financial reports are enhanced when the actuarially determined pension information is calculated... consistent with the funding methodology."