



## **BILL 19-77 PENSION PROTECTION AND SUSTAINABILITY ACT**

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Chairperson Cheh and members of the D.C. City Council, thank you for the opportunity to present testimony today prepared jointly with Andrew G. Biggs, resident scholar at AEI regarding pension accounting reforms being considered for the District of Columbia's teachers and police pensions systems.

The goal of any accounting system is to give an accurate view of a program's financial health so that policy makers and the public may place these plans on the surest foundation, to ensure that benefits promised to retirees are adequately funded. If left unaddressed, the District's pension system runs the risk of basing funding and policy decisions on distorted numbers. We believe Washington, D.C. can be a leader in public-pension accounting reform and provide an example for municipal plans across the country—some of which are in dire condition—of how such reforms can serve to guarantee a stable pension system for municipal workers.

### THE VALUATION OF PUBLIC-SECTOR PENSION LIABILITIES

The bill under consideration seeks to require more information, an experience study, and quadrennial actuarial audit of the District's two main pension plans, the Teachers Retirement Fund (TRF) and the Police Officers and Firefighters Retirement Fund (POFRF). We believe, however, the first step to improving pension accounting in public plans is to value public-sector pension liabilities according to methods recommended by financial economists and practiced by private-sector plans. That is, plan actuaries should also calculate what is known as the Market Value of the Liability (MVL) in order to determine the funded status and funding needs of the plan.

As recent news around the country has demonstrated, public pension plans in state and local governments have taken significant investment losses and many sponsoring governments have had difficulty in meeting their annual contributions. Behind this news, however, has been a simmering technical debate regarding public-pension accounting rules. Economists almost universally believe that pension financing has been weakened by accounting practices that encourage public-sector pensions to promise too much, fund too little, and take excessive risk with their investments. While these practices have affected every municipal pension, the District's plans are an at least a partial exception: they are well funded compared to state and local plans around the country and they take among the least risk with their investments. Thus, Washington, D.C.'s government is well-positioned to be a leader in accounting reform.

The debate centers over how pension plans should value their liabilities, which of course are the benefits they will pay to retired public employees in the years and decades ahead. How a plan values its liabilities influences how much it sets aside to fund them each year and how those funds are invested.

Under current practices, set by the Governmental Accounting Standards Board (GASB), future benefits liabilities are discounted to the present based on the interest rate assumed for the plan's investments.<sup>1</sup> On average states have assumed an annual return of 8 percent while the District assumes a 7 percent rate of return, recently lowered from 7.5 percent to reflect the recent downturn and lessened likelihood of high returns in the near term.

Economists are nearly unanimous, however, in believing that this approach is both technically wrong and, from a policy perspective, dangerous. According to economic theory as well as the practice of financial markets, the discount rate used to value a liability should reflect the relative risk of the liability, not of any assets set aside to fund the liability.<sup>2</sup> As the vice chair of the Federal Reserve Board put it, "While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: the only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate."<sup>3</sup> Likewise, a recent article in the respected *American Economic Review* states that "Finance theory is unambiguous that the discount rate used to value future pension obligations should reflect the riskiness of the liabilities."<sup>4</sup>

Since public-pension benefits are guaranteed by governments, most economists recommend that pensions liabilities be discounted using the lower interest rates paid on Treasury bonds, currently around 4 percent. Doing so would increase pensions' measured liabilities and the contributions that must be made to fund them.

Why should this seemingly arcane debate between economists and actuaries have any relevance for policy makers? The reason is these accounting rules play an important role in shaping how we view policy issues and whether and how to address them. For instance, the District's pension portfolio has a lower expected return—and thus lower risk—than most other public pension plans. According to the current accounting rules, the District could create literally billions of dollars in value at the stroke of a pen merely by taking more risk.<sup>5</sup> If the District pull all of its assets into stocks, it could discount its liabilities using a higher interest rate, which would make the plan appear better funded—at least on paper—and allow the District to make smaller annual contributions. Of course, economists would rightly point out that this gain is *only* on paper. When a government takes a more aggressive funding strategy, it is also running a larger risk of large investment losses and the need for contribution increases in bad times. This risk is not reflected at all in current GASB accounting rules.

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<sup>1</sup> Actuarial practice is based on guidance provided by two government accounting standards Government Accounting Standards Board (GASB) 25 and Actuarial Standards of Practice (ASOP) 27.

<sup>2</sup> For a discussion see, Eileen Norcross and Andrew Biggs, "The Crisis in Public Sector Pensions: A Blueprint for Reform in the States," Mercatus Center Working Paper, No. 10-31, June 2010.  
<http://mercatus.org/sites/default/files/publication/WP1031-%20NJ%20Pensions.pdf>

<sup>3</sup> Kohn, Donald L., "Statement at the National Conference on Public Employee Retirement Systems Annual Conference." New Orleans, Louisiana, May 20, 2008.  
<http://www.federalreserve.gov/newsevents/speech/kohn20080520a.htm>

<sup>4</sup> Brown, Jeffrey R. and Wilcox, David W., "Discounting State and Local Pension Liabilities," *American Economic Review*, vol. 99, May 2009.

<sup>5</sup> Alicia Munnell, Rickard W. Kopcke, Jean-Pierre Aubry and Laura Quinby, "Valuing Liabilities in State and Local Plans," Center for Retirement Research at Boston College, Number 11, June 2010.

These perverse incentives have led public plans to shift their portfolios towards equities and other high-risk investments.<sup>6</sup> In 1990, 40 percent of public-sector pension assets were held in equities, rising to 70 percent in 2006, roughly 10 percent higher than the allocation of pension assets to equities in private pension systems.<sup>7</sup> More recently, pensions have moved heavily into so-called “alternate investments,” which include hedge funds, private equity, and other such assets. Since currently accounting rules pay no mind to risk, there seems to be no reason not to take it—until, as in recent years, markets decline and taxpayers and public employees are left to make up the investment losses.

Some will argue that government is somehow different from the private sector, in that government will presumably be around forever. But this ignores the fact that public pensions don’t have forever to honor their obligations: benefits must be paid, month in and month out, regardless of how the market performs. Moreover, most pension liabilities don’t occur decades in the future. Rather, the majority of a plan’s obligations are payable over the next 15 years,<sup>8</sup> and no investor can guarantee achieving high returns over this period. Thus there is a significant probability that a “fully funded” plan would be unable to meet its obligations even if the plan accurately projected average market returns.

Under current accounting rules, the TRF and POFRF both have high funding levels, 108 percent and 99.8 percent respectively assuming a 7 percent discount rate. This places the plans among the best funded in the country. However, when using the risk-free rate to match the safety of a government guaranteed pension (the 15-year yield on Treasury bonds, currently at 4 percent), these funding levels drop to 71 percent and 65 percent respectively. Using private-pension standards put forward by the Department of Labor, these funding ratios would classify the District’s pensions as “endangered.”

TABLE 1: FUNDED STATUS OF THE DISTRICT OF COLUMBIA’S RETIREMENT SYSTEMS UNDER CURRENT 7 PERCENT DISCOUNT RATE AND USING THE RISK-FREE RATE

	Actuarial Value of Assets (AVA)	Actuarial Value of Liabilities (AVL)	Unfunded Actuarial Liability (UAL)	Funded Ratio 7% discount rate	Market Value of Liability (MVL)	Market Value of Unfunded Liability	Funded Ratio using 4% risk-free rate
TRF	\$1,447,600	\$1,338,000	\$109,600	108%	\$2,049,806	\$(602,206)	71%
POFRF	\$2,932,100	\$2,938,800	\$(6,700)	99.8%	\$4,502,218	\$(1,570,119)	65%

Note: All dollar values in thousands.

Source: Authors’ calculations, based on District of Columbia Retirement Board, *Comprehensive Annual Financial Report (CAFR) for FY 2009*.

<sup>6</sup> Before the 1980s, most systems held their assets mainly in fixed-income securities, investment choices were restricted by legal lists. In the 1980s legal lists were replaced by the “prudent person” rule. This allowed pension plans to hold larger percentages of equities and capture the higher returns being generated in a booming market, See, Olivia S. Mitchell, David McCarthy, Stanley C. Wisniewski and Paul Zorn, “Developments in State and Local Pension Plans,” Chapter 2 in *Pension and the Public Sector*, eds. Olivia S. Mitchell and Edwin C. Husted, University of Pennsylvania Press, Philadelphia 2001, p.14.

<sup>7</sup> Andrew G. Biggs, “The Market Value of Public Pension Deficits,” *Retirement Policy Outlook*, No. 1, American Enterprise Institute for Public Policy Research, April 2010, p. 2.

<sup>8</sup> M. Barton Waring, “Liability-relative investing,” *Journal of Portfolio Management*, 30 (4), 2008. Waring finds that the mid-point of a public pension’s stream of benefit payments is around 15 years in the future. Thus, a lump-sum payment 15 years hence can be treated as an approximation of the annual benefit liabilities owed by a plan.

Because the flawed discount-rate assumption understates true pension liabilities, it has led to the systematic underfunding of pension plans. Even where plans are making their full contributions under current rules, in truth they are contributing too little. Moreover, because accounting rules encourage plans to invest in risky assets whose values may rise significantly in good times, many systems have increased benefits and deferred contributions when asset returns are high only to find themselves underfunded when returns are low.

## RECOMMENDATIONS

Our recommendations are two-fold: make public pension accounting accurate and transparent. Accurate accounting means valuation of liabilities that reflect the government guaranteed that benefits will be paid, regardless of how well plan assets may perform. Discounting plan liabilities using an interest rate that reflects this guarantee will increase their value and make the District's plans appear less well-funded. Nevertheless, because the District's pensions are better funded than most and because they rely on risky investments less than other state and local plans, the District's pension-funding health advantage over other states and localities actually would *grow* under market valuation.

Transparent accounting means providing more information rather than less. To our knowledge, no public plan currently releases information on the risk of their investments, even if such information is commonly used by investment managers.<sup>9</sup> Releasing such information would set a standard for openness and transparency. Likewise, few pension plans release projections of annual pension costs in future years, even if these annual costs are far more important in practice than the present values of summed assets and liabilities that plans current publish. Finally, plan reports should include more information on the data and methods used to project the plan's finances. The effects of plan underfunding can only be mitigated when states and the public are presented with a complete picture of the tradeoffs that are going to be necessary to ensure plan funding.

## CONCLUSION

With accurate pension accounting, state and local governments can make better choices about how to structure and fund their pension plans. Both voters and public employees must be made aware of the sacrifices that will be necessary to pay what is owed, while at the same time undertaking retirement reform for state and local workers. Under current pension accounting rules, governments can make the appearance of reforms by fudging the numbers or taking more investment risk, which only puts off the hard decisions for the future. The crisis in pension systems in New Jersey, Illinois, Pittsburgh, Philadelphia, New York City, Boston, and Chicago as well as other states and municipalities has been driven by inaccurate accounting that encouraged these governments to underfund their benefits.

For reform to take root one government must be a leader and it is likely that the leadership will come from a system that is relatively well-funded and well-managed. The District's pensions are amongst the best funded and managed in the country, putting Washington, D.C. in the position to promote reform. It would serve to also demonstrate to elected officials nationally who often level criticism at the District that the government of Washington, D.C. is a national leader on this important issue affecting scores of municipal governments and all state governments.

Thank you for the opportunity to testify today. I look forward to answering your questions.

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<sup>9</sup> The most common measure of risk is the standard deviation of annual investment returns.