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Market valuation non sequiturs

Pressure to change how public plans measure liabilities

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Should public employee retirement systems be reporting the "market value" of their liabilities determined using a "risk-free" interest rate? According to a small but very vocal group of actuaries and so-called financial economists, they should.

In considering what is being proposed, I first asked myself if it is possible that proponents of reporting market value of liabilities, or MVL, do not understand the meaning of the terms market value and risk-free. I questioned this because what they are advocating does not appear to meet any reasonable description of market value, and the interest rate being proposed for determining that value is not free of risks. Given their training and experience, I had to conclude that they must have at least a fundamental understanding of these concepts and was surprised to learn how much traction they appear to be gaining with their non sequiturs.

Before pursuing this further, just a word of caution for anyone who might consider challenging MVL armed only with the position that what its proponents are proposing does not make sense for public plans — be prepared to hear that you simply don't have sufficient training in finance to understand their position or that you simply have not thought about it enough. The fact is that a number of very bright people who are well schooled in finance, who are not conflicted and who have thought about this a great deal have concluded that what is being proposed does not make any sense either.

In a rather cavalier manner, MVL proponents summarily dismiss distinctions between public plan sponsors and corporations that are critical in assessing the magnitude and duration of debt and how debt service should be addressed. I'd be astounded if they don't understand the public/private differences, and that line of reasoning led me down a different path. Specifically, when non sequiturs appear in the financial community, an explanation will often emerge by "following the money." In this case, honest answers to the following may provide some insight:

•Are the individuals who are volunteering substantial amounts of time to support and promote the MVL effort connected with investment banking?

•Does the proponent group include those who would benefit financially from plans shifting from stocks to bonds or a specific “market liability driven” investment model for public pension plans?

•Would the proposed change result in public plans appearing to be substantially less well funded than they are on the basis of reasonable going concern assumptions and methods? If so, would this increase the pressure for DB to DC conversions and put more money in the pockets of those in the financial services industry who service DC plans?

It does not require much investigating to come up with “yes” answers to these questions. However, one might also then say, “So what? They don't have real clout so what's the problem?” In my experience, when people have a product they can't sell on its own merit, sometimes they will attempt to persuade a standard-setting body (like the Governmental Accounting Standards Board) to embrace it, thus creating an artificial market (but a market all the same). Is that what's happening here? I don't know, but it seems plausible. (As an aside, it's also worth noting that an addition to disclosures, recommended by the pension practice council of the American Academy of Actuaries, would, if embraced by the GASB, produce a nifty little justification for a spike in fees for actuarial services regardless of whether it produces any information of value — how convenient!)

Public retirement system managers should discuss the MVL issue with their consulting actuary and position themselves to respond to proposed changes in public plan accounting literature distributed by the GASB. (Notably, on April 24, the GASB announced the addition of a project to its agenda to assess the effectiveness of existing standards for accounting and financial reporting for post-employment benefits, focusing on a review of existing pension standards in GASB Statements No. 25 and No. 27.)

As fiduciaries, those of us who represent the public retirement fund universe are obligated to administer our plans in the exclusive interest of plan participants. Contrary to the likely end result of what is being supported by the proponents of change, I find nothing in trust law to suggest that we should be administering our plans in the interest of Wall Street.

When I first learned about all of the activity in this space, I initially concluded that maybe the proponents of MVL just don't “get it” with regard to public plans. For example:

•they don't get infinite time horizons;

•they don't get contractual obligations for future benefit accruals;

•they don't get intergenerational equity; and

•they don't get the societal implications of terminating DB plans.

Upton Sinclair explained it succinctly in 1935 when he said, “It is difficult to get a man to understand something when his salary depends upon his not understanding it.” It is possible that the MVL proponents would say the same of those of us who are resisting their well-orchestrated initiative, but I can say with great confidence that my personal pocket will not be impacted by the outcome of this debate. I am skeptical about their ability to say the same. With the exception of a few people who have drunk the financial economics Kool-Aid who have no personal monetary interest in the end result, I suspect the things most of them do “get” include at least the following:

•private-sector DB business is drying up quickly;

•there is a lot of public-sector DB money on the table; and

•there has to be a way for them to get a share.

Shazam! With a little rationalization you can be on the yellow brick road. Remember, just follow the money.

A final thought

There are actuaries who acknowledge that contribution-rate volatility can also be mitigated by simply lengthening the smoothing period used in establishing the actuarial value of assets, such as has been done at the $245.4 billion California Public Employees' Retirement System. So, why has this not gained any traction? Some suggest it is because you don't need to host a seminar to explain it and you can't build a product around it — just follow the money.

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