TRANSPARENCY AND FUNDING OF STATE AND LOCAL PENSION PLANS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

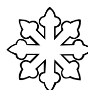
ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

MAY 5, 2011

Serial No. 112–OS3

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE

70–881 WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

SUBCOMMITTEE ON OVERSIGHT

CHARLES W. BOUSTANY, JR., Louisiana, *Chairman*

DIANE BLACK, Tennessee
JIM GERLACH, Pennsylvania
VERN BUCHANAN, Florida
AARON SCHOCK, Illinois
LYNN JENKINS, Kansas
KENNY MARCHANT, Texas

JOHN LEWIS, Georgia
XAVIER BECERRA, California
RON KIND, Wisconsin
JIM MCDERMOTT, Washington

Pursuant to clause 2(e)(4) of Rule XI of the Rules of the House, public hearing records of the Committee on Ways and Means are also published in electronic form. **The printed hearing record remains the official version.** Because electronic submissions are used to prepare both printed and electronic versions of the hearing record, the process of converting between various electronic formats may introduce unintentional errors or omissions. Such occurrences are inherent in the current publication process and should diminish as the process is further refined.

CONTENTS

Page

Advisory of April 28, 2011, announcing the hearing ... 2

WITNESSES

Honorable Walker Stapleton, Colorado State Treasury ... 6
Josh Barro, Walter B. Wriston Fellow, Manhattan Institute for Policy Research ... 11
Jeremy Gold, FSA, CERA, MAAA, Ph.D., Jeremy Gold Pensions ... 16
Robert Kurtter, Managing Director, U.S. Public Finance, Moody's Investors Service ... 26
Iris J. Lav, Senior Advisor, Center on Budget and Policy Priorities ... 37

SUBMISSIONS FOR THE RECORD

American Federation of State, County And Municipal Employees, statement ... 81
International Association of Fire Fighters, statement ... 83
Joint Group, statement ... 89
Labor Coalition, statement ... 95
Municipal Employees Retirement System, statement ... 96
National Education Association, statement ... 101
National Conference on Public Employee Retirement Systems, statement ... 104
Public Plans Community, statement ... 113
Service Employees International Union, statement ... 118
Securities Industry and Financial Markets Association, statement ... 122

TRANSPARENCY AND FUNDING OF STATE AND LOCAL PENSION PLANS

THURSDAY, MAY 5, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to call, at 9:30 a.m., in Room 1100, Longworth House Office Building, Hon. Charles Boustany [Chairman of the Subcommittee] presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
Thursday, April 28, 2011
OS–3

Boustany Announces a Hearing on the Transparency and Funding of State and Local Pension Plans

Congressman Charles W. Boustany, Jr., MD, (R–LA), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the transparency and funding of State and local defined benefit pension plans. **The hearing will take place on Thursday, May 5, 2011, in Room 1100 of the Longworth House Office Building, beginning at 9:30 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

Many have expressed increasing concern that State and local defined benefit pension plans (i.e., "public plans") have become dangerously underfunded. Based on the plans' own accounting measures, estimates suggest that as of 2009 they faced an aggregate shortfall of between $700 billion and $1.3 trillion. Many economists, however, have argued that these plans are improperly measuring their assets and liabilities in a way that significantly understates the true scope of the problem. Indeed, several recent studies have concluded that the plans may actually be underfunded by more than $3 trillion.

Growing concerns about the financial health of these public plans have led some public officials to suggest that a Federal bailout of these plans may be appropriate. The proposed FY 2012 State budget by Illinois Governor Pat Quinn (D–IL), for example, explicitly suggests that Illinois may seek a Federal guarantee of a new debt issuance to cover its unfunded pension plan liabilities.

In response to concerns about the financial health of these public plans—and about possible efforts by State and local governments to secure a Federal taxpayer bailout of such plans—Rep. Devin Nunes (R–CA), a Member of the Committee on Ways and Means, has introduced the "Public Employee Pension Transparency Act" (H.R. 567). This legislation is intended to enhance transparency in this area by encouraging public plans to disclose: (1) various plan funding data using their own actuarial assumptions, including a statement of those assumptions, and (2) the fair market value of plan assets and the value of plan liabilities using Treasury yields as the discount rate. While H.R. 567 would not impose any new standards on public plans with respect to actual funding requirements, State and local governments failing to make the disclosures proposed under the bill would lose their ability to issue debt that is tax-preferred under Federal income tax law. Additionally, H.R. 567 provides that the United States would not be liable for any obligation relating to funding shortfalls in State or local pension plans.

In announcing the hearing, Chairman Boustany said, **"Whether the underfunding of State and local pension plans is $700 billion or over $3 trillion, it is a serious concern for workers and retirees, for State and local govern-**

ments, and for taxpayers in general. The Subcommittee needs to understand how public plans are currently calculating their assets and liabilities, not just so we can get a clearer picture of how underfunded those plans really are, but also to determine whether there is adequate transparency in how these plans are reporting their shortfalls. Given that some have raised the specter of a Federal taxpayer bailout to cover the unfunded liabilities of these State and local plans, it is important for the Subcommittee to review this issue and to consider possible approaches to ensure that no such Federal taxpayer bailout is ever needed."

FOCUS OF THE HEARING:

The hearing will focus on the measurement and transparency of funding levels of State and local pension plans and will explore whether improvements to those plans' actuarial assumptions—and enhanced transparency in the reporting of the financial health of those plans—are warranted. Among the approaches to these issues that the Subcommittee will review is H.R. 567.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. Attach your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, May 19, 2011.** Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–3625 or (202) 225–5522.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://www.waysandmeans.house.gov/*.

Chairman BOUSTANY. Welcome to this morning's Oversight Subcommittee hearing on the Transparency and Funding Levels of State and Local Pension Plans. According to the Federal, State and local levels of government, our country faces a growing burden of public debt. Too often, governments have deferred difficult choices by pushing obligations off into the future without responsibly saving for the day when those obligations are due.

At the State and local levels, public employees are often promised defined benefit pension plans subsidized through the Tax Code that guarantee payments down the road. But the numbers suggest public employee pensions may be dangerously underfunded. This raises critical questions about the promises public employers make, how pension liabilities are calculated, and whether greater transparency is needed to protect the lives and livelihoods of the men and women to depend on these pensions as they plan for their futures. Millions of State and local government employees participate in defined benefit plans. These include many of our most valued public servants, firefighters, police officers, emergency personnel, nurses and teachers. But too often, State and local governments have not kept their end of the bargain and are failing to adequately fund employee pensions.

Though there is argument about how best to calculate pension assets and liabilities, it is clear that there is not enough money set aside to meet future obligations. Economists estimate the plans were underfunded by as much as $3.8 trillion in 2009. The corresponding increases in State and local pension contributions threaten to affect all Americans through higher State and local taxes and reduce services.

This hearing will consider how accounting standards differ for public and private pensions. There is growing consensus that accounting standards for public sector pensions encourage State and local governments to overpromise, underfund by taking on risky investments by discounting guaranteed future benefits against unrealistic rates of return. Unlike private pensions, which are required by law to use more realistic accounting standards, public plans are held to a lesser standard and suffer from lax accounting methods that can hide the magnitude of the problem. Public plans can discount future liabilities by making risky investments, a practice that imposes added risk on the taxpayers according to a new Congressional Budget Office report just released.

Of course, some argue that State and local affairs are generally not in the business of the Federal Government. But these plans are of increasing Federal concern because of our Tax Code which subsidizes retirement savings and gives preferential tax treatment to State and local debt. Furthermore, in our age of public and private bailouts, there can be little question to where State and local governments will turn when trillions in pension payments come due. And as if to underscore this threat, the recent proposed budget of the State of Illinois indicates that the Governor might seek Federal guarantees of future debt to cover pension liabilities.

Finally, we also will discuss H.R. 567, the Public Employee Pension Transparency Act, which was introduced by Congressman Devin Nunes, a Member of the full Committee. As a condition to receiving preferred treatment under Federal income tax law,

H.R. 567 requires public plans to disclose funding data and honest valuations of plan assets and liabilities. Respecting the rights of States and local governments, the bill does not try to tell States how to fund or pay pensions, it merely promotes transparency in their funding.

Whether the underfunding of State and local pension plans is hundreds of billions or several trillion dollars, it is a serious concern. With more retirees drawing pensions by the day, and some in government already raising the threat of a Federal bailout of these public plans, it is critical that the Subcommittee take this opportunity to review the issue and consider how better to protect workers and retirees as well as the Federal taxpayer.

Before I yield to the Ranking Member, Mr. Lewis, I ask unanimous consent that all Members' written statements be included in the record and the recently released CBO-issued brief entitled underfunding of State and local pension plans. Without objection, so ordered.

Now I will turn to Mr. Lewis for his opening statement.

Mr. LEWIS. Thank you, Chairman Boustany, for holding this hearing. Last month, this Subcommittee held a hearing to attack an organization that represents millions of seniors. At that hearing, I asked the chairman, "who is next? Who else is on your list?" Now, I have an answer.

This week is Teacher Appreciation Week 2011. Today, Republicans have set their sights on the teachers who educate our children, police officers who keep our communities safe, and first responders in moments of crisis. They paint teachers, firefighters, librarians and nurses as villains in their quest to widen the gap between the rich and the poor.

Our neighbors are not the villains. They are not the cause of the current economic situation. They are simple, hardworking Americans trying to retire with dignity and escape poverty as they age.

The Republicans have made many arguments to support today's attack. Republicans blame pension plans for State budget shortfalls. This is not true. States spend less than 4 percent of their budget on pension contributions. The Republicans claim that pension benefits are too high. This is not true. The average State pension benefit is modest; about $20,000 a year.

The Republicans also claim a Federal bailout may be needed. This is not true. The losses in the plan are related to the market and the recent recession. The Republicans claim that their solution would create transparency. It would not. It would create confusion and lead to unnecessary cuts in vital State services. Given the facts, I ask myself why are we here today? We both know that there is no immediate need for the Federal Government to take action. The committee has been looking at this issue since the 1970s.

I am also mindful that under the Committee rules of this Congress, this Subcommittee's jurisdiction is limited to oversight of existing laws. Our jurisdiction does not extend to select revenue measures. The subcommittee does report out legislation. Therefore, any consideration of House bill 567 would need to take place elsewhere under the regular order of the Committee.

Based on all of this, I believe today's hearing is simply a distraction from the Republican failure to create jobs. While the American

people continue to wait for jobs, the Republicans are playing a dangerous game with the welfare of women, seniors, and now teachers. It is time for the American people to take notice, stand up, and speak out. Today, I stand for America's middle class and State and local workers across the Nation. I thank the teachers for all that they do. And with that, Mr. Chairman, I yield back my time.

Chairman BOUSTANY. I thank the Ranking Member for his opening statement.

We will now turn to our panel of witnesses. I want to welcome the Honorable Walker Stapleton, Treasurer of the State of Colorado, welcome sir; Mr. Josh Barro, who is a fellow with the Manhattan Institute for Policy Research; Mr. Jeremy Gold, who provides pension finance consulting with Jeremy Gold Pensions; Mr. Robert Kurtter, managing director of the U.S. State and regional ratings of Moody's Investors Services; and Ms. Iris Lav, senior adviser for the Center on Budget and Policy Priorities.

I want to thank you all for being here today with us. You will each have 5 minutes to present your testimony here before the Subcommittee with your full written statement submitted for the record.

Mr. Stapleton, you can now begin.

STATEMENT OF HON. WALKER STAPLETON, TREASURER OF COLORADO

Mr. STAPLETON. Thank you, Mr. Chairman.

Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee on Oversight, thank you for the opportunity to testify this morning in support of the Public Employee Pension Transparency Act. My name is Walker Stapleton, and I am the treasurer of Colorado.

Before being elected treasurer last November, I spent my entire career in the private sector. I am fortunate to have both an MBA and a graduate degree in business economics. One of the most important duties I have as treasurer of Colorado is to serve as the only elected official on the board of our State's Public Employee Retirement Association or PERA. PERA has nearly 500,000 members including State workers, members of the State judicial branch, teachers in our public K–12 and higher education systems, local government workers and members of our State Patrol, among others.

Last year the Colorado legislature passed pension reform legislation which accomplished two main objectives: It lowered the cost of living adjustment from 3.5 percent to 2 percent, and it raised the eligible retirement age of members from 55 to 58 for educators and from 55 to 60 for everyone else. These are worthwhile reforms, but they unfortunately fell far short of the systematic improvements needed in Colorado's pension system to protect current and future retirees as well as Colorado's taxpayers.

Let me discuss the lingering and growing challenges facing PERA and the key factor that Colorado's pension reform legislation did not address. The system is operating with an unrealistic and unachievable rate of return which is now set at 8 percent. In Colorado's case, PERA currently maintains an unfunded liability of more than 21 billion based on this 8 percent expectation. Of course,

if this rate of return is lowered, the unfunded liability becomes far greater, and in my view, more realistic and transparent for PERA members and Colorado taxpayers alike. The question is whether States like Colorado should be in the business of guaranteeing market returns. If the answer to this question is no, as I believe it should be, then public pension plans like PERA need to start adopting rates of return in line with Treasury yields and stop the pervasive underfunding of plans. Overestimating a pension system's expected return is essentially gambling with the financial welfare of the next generation of Americans.

As you may know, Wilshire Associates, a nationally recognized financial consulting firm, recently completed a study of 126 public pension plans, including Colorado's. Wilshire found that not a single plan would meet an 8 percent return expectation over the next 10 years. In PERA's case, they have used an 8 percent rate of return to claim solvency over 30 years, meaning the only way they will achieve an average of 8 percent over the next two decades will either be to raise the rate of return even higher, which is fiscal fantasy, or to require members to contribute more for the benefits that they receive.

It is also worth noting that approximately 25 percent of PERA's portfolio of investments is currently invested in fixed income products, yielding in the neighborhood of 4 percent, which requires the rest of the portfolio to return closer to 10 percent in order to average an overall return of 8 percent. The only way to achieve this unrealistic return is to take outsized market risk, further exposing our public pension plans to more volatility.

If a default occurs, States, unlike private businesses, cannot declare bankruptcy and restructure, and taxpayers will be obligated to backfill resulting pension liabilities.

The Public Employee Pension Transparency Act makes a lot of sense. While it is not mandatory for States to adopt, it categorically states that the Federal Government will not bail out a State's public pension system.

This Act increases transparency standards for public pension systems. Unfortunately, the Government Accounting Standards Board, or GASB, refuses to require this minimum level of transparency from public pension plans in its accounting standards. The GASB currently does not and will not in the future require plans to disclose the sensitivity analysis of discount rates so that plan members, local government leaders and the public can assess for themselves what the underlying liabilities in these plans may be.

Greater transparency and better information is important for everyone, for the fiscal health of our States, for elected leaders to make decisions and for our taxpayers to use when it comes to evaluating the significant liabilities associated with public pension systems in this country.

I strongly support this legislation and am here today to urge every Member of this Committee to support the Public Employee Pension Transparency Act. Thank you.

[The prepared statement of Mr. Stapleton follows:]

Statement of the Hon. Walker Stapleton, Treasurer of Colorado

Subcommittee on Oversight

Committee on Ways and Means

May 5, 2011

Chairman Boustany, Ranking Member Lewis, and members of the Subcommittee on Oversight:

Thank you for the opportunity to testify this morning in support of the Public Employee Pension Transparency Act. My name is Walker Stapleton, and I am the Treasurer of Colorado. Before being elected Treasurer last November, I spent my entire career in the private sector. I am fortunate to have both an MBA and a graduate degree in Business Economics.

One of the most important duties I have as Treasurer of Colorado is to serve as the only elected official on the board of our state's Public Employee's Retirement Association (PERA). PERA has nearly 500,000 members, including state workers, members of the state judicial branch, teachers in our public K-12 and higher education systems, local government workers, and members of our State Patrol, among others.

Last year, the Colorado Legislature passed pension reform legislation which accomplished two main objectives:

- It lowered the Cost of Living Adjustment from 3.5 percent to 2 percent
- It raised the eligible retirement age of members from 55 to 58 for educators and from 55 to 60 for everyone else.

These are worthwhile reforms but they unfortunately fell far short of the systematic improvements needed in Colorado's pension system to protect current and future retirees as well as Colorado's taxpayers.

Let me discuss the lingering and growing challenges facing PERA and the key factor Colorado's pension reform legislation did not address.

The system is operating with an unrealistic and unachievable rate of return, which is now set at 8 percent.

In Colorado's case, PERA currently maintains an unfunded liability of more than $21 billion based on this 8 percent expectation. Of course, if this rate of return is lowered, the unfunded liability becomes far greater – and, in my view, more realistic and transparent for PERA members and Colorado taxpayers alike.

The question is whether states like Colorado should be in the business of guaranteeing market returns. If the answer to this question is "NO," as I believe it should be, then public pension plans like PERA need to start adopting rates of return in line with Treasury Yields and stop the pervasive underfunding of plans. Overestimating a pension system's expected return is essentially gambling with the financial welfare of the next generation of Americans.

As you may know, Wilshire Associates, a nationally recognized financial consulting firm recently completed a study of 126 public pension plans, including Colorado's. Wilshire found that not a single plan would meet an 8 percent return expectation over the next 10 years. In PERA's case, they have used an 8 percent return to claim solvency over 30 years, meaning the only way they will achieve an average

of 8 percent over the next two decades will either be to raise the rate of return even higher, which is a fiscal fantasy, or to require members to contribute more for the benefits that they receive.

It is also worth noting that approximately 25 percent of PERA's portfolio is currently invested in fixed-income products, yielding in the neighborhood of 4 percent, which requires the rest of the portfolio to return closer to 10 percent in order to average an overall return of 8 percent. The only way to achieve this unrealistic return is to take outsized market risk, further exposing our public pension plans to more volatility. If a default occurs, states, unlike private businesses, cannot declare bankruptcy and restructure, and taxpayers will be obligated to backfill resulting pension liabilities.

The Public Employee Pension Transparency Act makes a lot of sense. While it is not mandatory for states to adopt, it categorically states that the federal government will not bail out a state's public pension system. This act increases transparency standards for public pension systems. Unfortunately, the Government Accounting Standards Board (GASB) refuses to require this minimum level of transparency from public pension plans in its accounting standards. The GASB currently does not and will not in the future require plans to disclose a sensitivity analysis of discount rates so that plan members, local government leaders, and the public can assess for themselves what the underlying liabilities in these plans may be.

Greater transparency and better information is important for the fiscal health of our states – and for our taxpayers – to use when it comes to evaluating the significant liabilities associated with public pension systems in this country.

I strongly support this legislation, and am here today to urge every member of the Committee to support the Public Employee Pension Transparency Act.

Thank You.

Chairman BOUSTANY. Mr. Barro, you may proceed with your testimony.

STATEMENT OF JOSH BARRO, WALTER B. WRISTON FELLOW, MANHATTAN INSTITUTE FOR POLICY RESEARCH

Mr. BARRO. Good morning. Thank you, Chairman Boustany and Ranking Member Lewis for having me here today to talk about this important issue.

If you are trying to evaluate the pension plan serving a State and local government, there are some simple questions you might want to ask about it, such as how much do the pensions we provide cost? How much do we owe to active workers and retirees? And over the next few years, how much more cash are we going to have to come up with to make our required contributions into the pension fund?

But if you pick up the comprehensive annual financial report of most State and local pension funds in the United States, you will either find no answers to these questions or you will find incorrect answers to them.

The recession has been driving pension contributions skyward in States and localities all around the country. And many State and local governments are currently feeling the need to reform their pension systems. Indeed, 18 States enacted some sort of pension reform law in 2010. But because of this lack of useful financial information, many States have made underwhelming pension reforms, and a lot of them are even coming back to do a second round of reform having just done reform within the last 18 months.

As a couple of examples of the pressure that localities are feeling, Newark, New Jersey, made $37 million in pension payments in 2009. They had to make $62 million for 2010. San Francisco will make $357 million in payments this year, and their city treasurer expects that that will rise to $800 million within 2 years.

So how can the financial disclosures around pension funds be improved so that State and local law makers have better ability to make good choices about pensions? H.R. 567 would make several improvements to the way that pension funds make their disclosures, and there are some additional disclosures that these funds should also be encouraged to make.

The most important change relates to the valuation of pension liabilities using a practice called fair valuation of liabilities, or market valuation, as would be encouraged by H.R. 567. As the CBO said in a report just yesterday, fair valuation provides a more complete and transparent measure of the costs of pension obligations. Using a fair valuation method will help States and municipalities and their taxpayers and bondholders better understand where they stand with regard to pension liabilities.

States and cities also don't know what their future outlook looks like for the year-to-year cost of pension obligations. Even though pension funds the way they smooth their asset returns means that we can expect pension contribution rates to keep rising through about 2014, because of stock market losses in 2008 and 2009, most pension funds are not releasing projections of how those costs will move, so municipalities and States can't do effective budget plan-

ning because they don't know how big those cost explosions are going to be.

H.R. 567 will require a 20-year projection of cash flows which will give States and localities better clarity about what their future costs will look like.

There are some additional transparency measures that States and localities would be wise to adopt. One, again, relates to asset smoothing, that process of gradually recognizing unusual gains and losses. Over the last decade, many States and localities, their pension funds have made opportunistic changes in the way they perform smoothing, either increasing or decreasing the length of the smoothing period to artificially inflate the appearance of financial solvency in their funds.

In one case, New Jersey, such a shift was actually used to justify a 9 percent increase across the board in pension benefits that appeared affordable just because of this accounting trick. States should be encouraged to adopt a standardized smoothing practice so they do not have the option to game that system.

Finally, public pension plans do not disclose what is called a normal cost of the pension benefits that they are awarding in a given year. That is to say, what is the present cost of all the promises we made to active workers this year in exchange for their labor? This is a standard feature of private sector pension disclosures. But you can't figure out when you look at a public employee pension, and it is not the same amount as the cash contribution that is being made into a pension fund. For this reason, it is extremely difficult to do comparisons of the value of public and private sector compensation packages. We don't really have a good sense now of what the pension benefits that public employees are getting are worth.

So why should Congress involve itself in this which is a State and local issue? States don't understand how big a hole they have dug for themselves. And in certain States such as Illinois where the funding ratio of public plans has fallen to 38 percent, even under the current GASB standards which are too aggressive in terms of valuing the liabilities, the risk is that eventually you will have clamor for a Federal bailout of insolvent State and local pension funds that appear to be on the brink of being unable to make payments to the State and local employees. It is better to avoid that situation now by giving State and local leaders the clarity they need to fix their own pension problems so that Washington does not have to later.

Chairman BOUSTANY. Thank you, Mr. Barro.

[The prepared statement of Mr. Barro follows:]

"Improving Public Pension Transparency"
May 5, 2011
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Testimony by Josh Barro
Walter B. Wriston Fellow
Manhattan Institute for Policy Research

Chairman Boustany, Ranking Member Lewis, and members of the Subcommittee, good morning. Thank you for inviting me to testify today on this important topic.

Over the last 18 months, alarm bells have started going off in state capitols and city halls around the country about the unsustainable costs of public employee pensions. State and local officials understand the huge crush that rising pension costs are imposing on their budgets: as one example, the city of San Francisco expects its annual pension contribution to rise from $357 million in the current year to $800 million in two years.

State lawmakers are responding by passing pension reform laws. In 2010 alone, 18 states passed some sort of law to reform its public employee pension system. But as lawmakers make important decisions about the future of employee retirement benefits, they are hampered by the lack of transparency in pension funds' financial reporting.

Reviewing a public pension fund's Comprehensive Annual Financial Report does not necessarily make it possible to answer basic questions, such as: how much do we owe? How much do the pension benefits we provide cost? And how can we expect pension contributions to change over the next several years? Without the answers to these questions, lawmakers do not know what kind of pension reform their jurisdictions need—and relatedly, many recent pension reforms have been underwhelming.

Overly expensive and insufficiently funded pension plans are a state and local problem. But Congress can play a valuable role by requiring greater financial transparency by state and local pension funds. The federal government has particular reason to act because of the specter that states with unacknowledged and unresolved pension troubles may someday look to Washington for bailouts.

There are a few key areas in which the federal government should encourage better reporting. Some of these transparency ideas are included in HR 567.

- **Discount rate.** Retirement plans use a "discount rate" to convert pension or OPEB liabilities due far in the future into a present value. Government Accounting Standards Board (GASB) guidance leads plans to use discount rates that are unreasonably high. Such rates allow them to understate their true liabilities and claim to be better funded than they really are. Plans should additionally report their liabilities discounted at a lower rate that

corresponds to the low risk borne by pensioners that they won't be paid. Doing this would result in plans' reporting a higher (and more accurate) present-value liability and a lower ratio of assets to liabilities (the "funding ratio").

- **Smoothing**. Most retirement plans do not recognize unusual gains or losses on assets immediately. Instead, they recognize them over a period of years—most often, five. Unfortunately, some plans have been changing their smoothing periods opportunistically: shortening them to recognize sharp gains quickly, or lengthening them to delay recognition of losses. Doing this allows funds to overstate the value of the assets they hold and thus make their unfunded liabilities seem smaller than they actually are. Jurisdictions in which plans have taken such steps include New Jersey in the wake of the dot-com stock bubble; and more recently Arizona, Los Angeles, South Carolina and West Virginia. Plans should instead use a standardized smoothing period of no more and no less than five years at all times. They should also continue to separately report the market value of their assets as of particular dates and disclose the funding ratio on both a smoothed and an un-smoothed basis.
- **Projections**. When a pension plan's financial position deteriorates, actuaries direct the plan's sponsors (i.e., state and local governments) to contribute more money. But because of asset smoothing, it takes several years before a protracted decline in stock prices is fully recognized, forcing sponsors to deal with the shortfall by increasing their contribution rates. Pension fund managers know that stock-market losses, especially the steep ones of recent memory, are very likely to drive required employer contributions higher in the coming years, as past losses are gradually recognized. However, because most plans do not issue public projections of contribution rates, legislators do not necessarily have fair warning of these impending increases. Therefore, pension plans should annually issue five-year projections of employer contribution rates, so that lawmakers can plan to accommodate rising pension costs in future budgets—or enact pension reforms to lower costs.
- **Normal Cost.** The factors that obscure the aggregate cost of pension plans also obscure the cost per employee. Employer contributions are the basis for current measures (such as those published by the U.S. Bureau of Labor Statistics) of these costs, but they do not represent the full cost, which is the present value of the pension credit that employees receive for providing service in the current year. Public pension plans should report the market value of this ongoing cost, as private firms already do. This figure is the true "cost" of offering pension benefits, whether it is met with cash in the current year or by incurring a liability that will be covered in the future. The unavailability of accurate measures of the present value of pension and retiree health care benefits paid to public workers has been a key problem in answering questions about whether or not public employees are overpaid compared to similarly-situated private sector workers.

If pension plans adopt disclosure practices as outlined above, state and local lawmakers will be easily able to answer the questions I laid out earlier in my testimony. This will empower them to take steps to lower the cost of public employee pension benefits (if appropriate) and prepare to make room in upcoming years' budgets for rising costs (if necessary). It will also provide better information to bondholders seeking to evaluate states' creditworthiness.

It is up to state and local governments to decide how to structure employee retirement benefits and how generous they should be. Greater transparency will not require states and localities to make any substantive changes to retirement benefits. However, governments should not make pension policy in the dark. It is likely that greater transparency will lead states to enact more aggressive pension reforms by showing how burdensome pension costs are and will become in the next several years.

Thank you again. I am happy to take questions and comments.

Further reading:
Josh Barro, "Unmasking Hidden Costs: Best Practices for Pension Transparency." Manhattan Institute, February 2011.
Josh Barro, "Good Pension Policy Requires Transparency." *The Hill*, February 10, 2011.
Josh Barro, "Dodging the Pension Disaster." *National Affairs,* Spring 2011.

Chairman BOUSTANY. Mr. Gold, you may proceed.

STATEMENT OF JEREMY GOLD, FSA, CERA, MAAA, PH.D., JEREMY GOLD PENSIONS

Mr. GOLD. Good morning, Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee. Thank you for this opportunity to present my views with respect to transparency and funding of State and local pension plans. My views are my own and do not represent any other persons or organizations. I am an independent consulting actuary specializing in the financial aspects of pension plans. I will address the disclosure of the assets, liabilities and costs of public pension plans in the context of H.R. 567.

The disclosures at the heart of H.R. 567 are long overdue, and I welcome this bill. H.R. 567 is conceptually right.

I will suggest three changes that will keep it right in concept and make it more useful and efficient in practice.

The bill calls for two financial measures that are so fundamental that they must be made available to every decisionmaker and every interested party, the market value of plan assets and the current liabilities.

H.R. 567 requires that the current liability be determined by discounting future cash flows using rates of interest derived from U.S. Treasury securities. In my written testimony, I quote former Federal Reserve vice chair Donald Kohn, who has explained why bulletproof promises should be discounted at rates derived from bulletproof securities.

My first recommendation—H.R. 567 calls for averaging Treasury rates over 24 months and for segmenting rates for three different future periods. These ideas have been borrowed from private pension funding law where they are used to reduce contribution volatility. H.R. 567, however, is not a funding bill. It is a disclosure bill. Good disclosure should use the Treasury spot rates at one point in time. We cannot spend averaged dollars, nor can we make good decisions based on liabilities that have been averaged. H.R. 567 calls for the fair value of assets at one point in time. The proper comparison liability must be based on spot rates at one point in time.

The comparison of assets at market and liabilities at spot rates answers two questions that cannot be answered accurately in the pre-H.R. 567 world. First question—will future generation of taxpayers be paying for services provided to earlier generations? Second question—how does this plan's funding compare to plans in other jurisdictions?

My second recommendation: H.R. 567 calls for extensive projections of future statistics that would be expensive and potentially uninformative. The subsections calling for these projections should be stricken. Eliminating the projection along with the rate averaging and segmenting should reduce compliance costs to a level that I would call modest in the first year and nearly negligible in subsequent years.

My third recommendation: The bill should add a new item which will be very valuable and easy to calculate. Mr. Barro just referred to it. I call it the current cost. It is the portion of the current liability that has been accrued in the latest fiscal year. Current cost asks a third question that cannot be answered in the pre-H.R. 567

world: What is the market value of benefits earned by public employees this year? Current costs will make it possible to fairly compare compensation from jurisdiction to jurisdiction and between private and public sector employees.

In summary, I recommend that we use spot Treasury rates, not averaged, not segmented. I suggest the elimination of the 20-year projection requirement, and I suggest the inclusion of a defined current cost computed on the same basis as the current liability. I thank you.

Chairman BOUSTANY. Thank you, Mr. Gold.

[The prepared statement of Mr. Gold follows:]

Statement before the United States House of Representatives

Committee on Ways and Means

Subcommittee on Oversight

Hearing on the Transparency and Funding of State and Local Pensions

Jeremy Gold, FSA, CERA, MAAA, PhD

Jeremy Gold Pensions

May 5, 2011

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee. Thank you for the opportunity to present my views with respect to transparency and funding of state and local pension plans. My views are my own and do not represent any other persons or organizations.

I will address the disclosure of financial measurements of the assets, liabilities and costs of pension plans sponsored by state and local governments on behalf of their employees in the context of H.R. 567, the Public Employee Pension Transparency Act (PEPTA).

The disclosures at the heart of H.R. 567 are long overdue. The management of financial enterprises depends on good financial information. In the case of public pension plans, information is needed to support decisions about benefit levels, funding and investing. The most financially significant of these are decisions about levels of benefits. Pension benefits are the deferred portion of total compensation awarded today in return for services performed by public employees. The specification of benefits creates the deferred compensation and determines its cost.

Funding, i.e. cash contributed to the plan, as important as it is, does not alter the cost of benefits. It does, of course, determine whether cash is contributed sooner or later and thus which generation of taxpayers pays for the services performed by today's public employees.

Investing, as important as it is, does not alter the cost of benefits. Investing entails risks, the outcome of which, directly impacts future taxes and may, both directly and indirectly, affect future benefits. The assertion that investment does not impact costs is often disputed but can be illustrated by a simple analogy. If an automobile costs $30,000, it costs $30,000. If I invest my assets successfully, I may be better able to afford the automobile. But the automobile still costs $30,000.

Despite the preeminence of benefit levels, most financial reporting on public employee pension plans focuses on funding and investing. The liabilities reported in accordance with generally accepted accounting standards and in actuarial reports are not the economic liabilities incurred as the benefits are earned. The reported liabilities are rather a by-product of actuarial methods that have been designed to manage contribution flows rather than to measure and disclose the value of benefits being accrued.

H.R. 567 has the potential to put the horse before the cart. The *Current Liability*, defined in the bill, is a measure of the value of benefits independent of the funding and investment strategies of the plan. This is how it should be. First measure the benefits and then devise when and how to pay for them.

The heart of H.R. 567 reporting and disclosure is in **SECTION 3(b)** which adds **SECTION 4980J** to the Internal Revenue Code of 1986. **SECTION 4980J(a)** itemizes various disclosures, many of which commonly appear in the Comprehensive Annual Financial Reports (CAFRs) presently issued by most state and local pension plans. **SECTION 4980J(a)(1)(C)** which calls for extensive projections of future statistics would be expensive and potentially uninformative. **SECTION 4980J(a)(1)(G)** could be strengthened by requiring the disclosure of the amount paid for the plan year toward eliminating any unfunded current liability and the number of years in which annual payments of that same amount (in dollars, not as a percentage of payroll) would eliminate that unfunded current liability.

SECTION 4980J(b)(2) calls for the restatement of items (A), (C), (F) and (G) of subsection (a)(1).

- The restatement of item (A) is extremely valuable and, as discussed below, provides information critical to the assessment of the financial status of public pension plans by decision-makers and other interested parties.
- As with subsection (a)(1)(C), I believe that a restatement of item (C) will be more expensive than valuable.
- I suggest a new item – Current Cost – of benefits, discounted at Treasury rates, earned during the plan year. When compared with item (B) of subsection (1)(a), Current Cost will provide a critical measure indicative of funding progress. Additionally, Current Cost will directly determine the benefit cost component of the total compensation of public employees. I elaborate on this below.

H.R. 567 is a reporting and disclosure bill. Although it calls for enhanced reporting on the funded status of public pension plans, it makes clear in **SECTION 4** that it is not a funding bill at either the federal or local level.

SECTION 4980J(b)(3) specifies a discount rate basis which appears to have been borrowed from the Pension Protection Act (PPA) of 2006. It calls for averaging the Treasury yield curve over a 24-month period and for segmenting the result in three brackets. These adjustments to the actual yield curve were made in PPA because PPA is primarily a funding act. Such adjustments are not appropriate in a reporting and disclosure bill. I expand on this point below.

I Background

Governments are expected to focus on providing services and goods to taxpayers in an efficient, effective, economical, and sustainable manner. Citizens' taxes provide the resources that support those services and goods. Labor is the single largest cost, often exceeding all other costs combined.

Governments hire employees to provide necessary services to taxpayers and other residents. These employees are compensated by taxpayers in (at least) two ways: current cash compensation (salaries) and promises of future cash (pensions). Taxpayers, in order neither to burden nor to subsidize the taxpayers who will come after them, should generally expect to pay for today's services today – even though the deferred part of the employees' total compensation may not be received for decades.

Pension plans are the reservoirs that allow taxpayers to pay today for benefits employees receive after they retire. If the money set aside today is less than the value of the benefits earned, then future taxpayers will be paying for services received by today's taxpayers.

Employees of state and local governments such as teachers, civil servants, police, fire and sanitation workers are usually covered by defined benefit pension plans, commonly referred to in the U.S. as *public pension plans*. The financial positions of such plans are typically reported in documents called Comprehensive Annual Financial Reports (CAFRs). Public pension plan CAFRs usually include extensive data about plan assets, cash flows, expenses, investment policy and performance, etc. This information is helpful

to watchdogs and other parties interested in monitoring the financial integrity of pools of assets that can run into the billions and hundreds of billions of dollars.

Information about plan liabilities, however, is much more sparse. A typical CAFR will disclose the actuarial methods and assumptions, plan provisions, data on participant ages, salaries and service, and *actuarial liabilities*. These actuarial liabilities are highly dependent upon the methods and assumptions chosen by the actuary, the trustees or administrators, or contained in local statutes and regulations. The actuarial assumptions, demographic and economic, and actuarial methods are typically consistent with Actuarial Standards of Practice. The economic assumptions (expected returns on invested assets, future inflation, and salary increases) are designed to facilitate a long-range budgeting process and are not intended to reflect current market conditions. The actuarial liabilities developed in accordance with these long range projections are not intended to approximate market values.

II What Decision-Makers Need to Know

Public pension plans directly affect the pocketbooks of public employees and the taxpayers whom they serve. The financial wellbeing of lenders, those who buy municipal securities, is also affected by the financial condition of these public plans. Various agents represent these principal groups: elected officials for taxpayers, union representatives for employees, rating agencies for lenders. Other agents also perform services related to these plans including plan trustees, investment managers, accountants and actuaries.

Decisions about plan benefits and operations are made by these agents. All these decisions depend highly upon the quality of information available to the agents. The information currently available, especially with respect to the value of benefit promises, is inadequate to support good decisions. At the very least, publicly available information should allow interested parties, principals and agents, to answer the following questions:

1) *What is the market value of benefits being earned by public employees this year? What does this tell us about their total compensation (salaries plus benefits)?*
2) *Will future taxpayers be paying for services provided to current and previous generations of taxpayers? Or might the opposite be true?*
3) *How does the funding level, and benefit security, of this plan compare to plans in other jurisdictions in the U.S.?*

H.R. 567 can go a long way towards helping decision makers answer these questions. But in order to do so it should shed the definition of interest rates under **SECTION 4980J(b)(3).** I suggest the following substitution for all of subsection (3) as follows:

"(3) INTEREST RATES BASED ON U.S. TREASURY OBLIGATION YIELD CURVE RATE. –[1]

---

[1] Donald L. Kohn, in a speech to the National Conference on Public Employee Retirement Systems, New Orleans, May 20, 2008, said "public pension benefits are essentially bullet-proof promises to pay. … For all intents and purposes, accrued benefits have turned out to be riskless obligations. … The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate." http://www.federalreserve.gov/newsevents/speech/kohn20080520a.htm

"For benefits reasonably determined to be paid in any future month, the rate of interest will be determined by the Secretary for such month on the basis of the U.S. Treasury obligation yield curve for such month."[2]

Answering Question 3

How does the funding level, and benefit security, of this plan compare to plans in other jurisdictions in the U.S.?

With my suggested substitution of current Treasury rates for segmented two-year average Treasury rates, the restatement of the Current Liability in accordance with **SECTION 4980J(b)(2)** becomes the market value of liabilities (MVL) consistent with the use of the term "market value of liabilities" in a paper written by me and Gordon Latter.[3] It is also consistent with the use of the term "market value of the accumulated benefit obligation" (MVABO) as disclosed since 2003 in the CAFRs of each of the five New York City Retirement Systems.

SECTION 4980J(b)(2) also restates the plan assets as the market value of assets (MVA), the unfunded liabilities at market (MVL minus MVA), and the funded ratio (MVA divided by MVL). H.R. 567 uses the term "current liability" to describe the present value of all accrued benefits. The funded ratio provides a standardized number facilitating the comparison across jurisdictions, thus answering question 3.

Another measure that might be useful and comparable across jurisdictions would be the ratio of the unfunded liability to a pertinent local measure (e.g., gross local product, aggregate local income or property value, aggregate local t6ax revenues). Such ratios may be calculated by analysts even if H.R. 567 does not require such a computation.

Answering Question 2

Will future taxpayers be paying for services provided to current and previous generations of taxpayers? Or might the opposite be true?

The Current Liability, as restated by **SECTION 4980J(b)(2)** in conjunction with Treasury interest rates as provided by my simplified replacement for **SECTION 4980J(b)(3)**, may be called the market value of liabilities and may be properly compared to the market value of assets in item (A) as restated under **SECTION 4980J(b)(2)**. It is important to note that the definition of Current Liability does not include service after the end of the plan year, nor does it project future salary increases. As such it reflects all the benefits earned by plan employees and obligations of the plan to date – just as the market value of assets reflects all of the prior contributions to the plan to date.

---

[2] There are some situations in which it may be appropriate to use the yield curve of U.S. Treasury Inflation Protected Securities (TIPS). This is generally beyond the scope of this testimony.

[3] The Case for Marking Public Pension Plan Liabilities to Market available in draft form here: http://www.pensionfinance.org/papers/TheCaseforMarkingPublicPensionPlanLiabilitiestoMarket.pdf later published in The Future of Public Employee Retirement Systems, Ed. Olivia Mitchell and Gary Anderson, The Pension Research Council at Wharton, Oxford Press 2009.

Because the MVA and the MVL (as defined by the Current Liability) reflect all past financial activities of the pension plan, Question 2 may be answered by reference to the unfunded liabilities. No unfunded (MVA equals MVL) implies that future generations of taxpayers will neither be burdened nor benefited by those who came before. Prior generations have paid for all of the public services they have consumed and future generations will pay for their own.

Based on recent data reported by various sources (and analyzed by Novy-Marx and Rauh among others), revealing massive unfunded liabilities (MVL much greater than MVA), it is very likely that future taxpayers are going to be severely burdened by pension obligations incurred in conjunction with public services that have already been rendered.

This has not always been the case. A similar analysis, had it been performed any time during the 1980's would have revealed significant pension plan surpluses (MVA greater than MVL) attributable to the high rates of interest available in the U.S. Treasury markets compared to relatively low rates used to value public pension plans at that time.

Answering Question 1

> *What is the market value of benefits being earned by public employees this year?*
> *What does this tell us about their total compensation (salaries plus benefits)?*

The Current Liability accurately measures the value of all the benefits earned by employees to date. Using Treasury rates, it is the appropriate liability to compare to the market value of assets. Similarly, what I would define as the Current Cost accurately measures the value of all the benefits earned in the year. A comparison of the following definitions makes this clear:

CURRENT LIABILITY.—The term 'current liability' of a plan for a plan year means the present value of all benefits accrued or earned under the plan as of the end of the plan year.

CURRENT COST.—The term 'current cost' of a plan for a plan year means the present value as of the end of the plan year of all benefits accrued or earned under the plan during the plan year.

The Current Cost of a pension constitutes the deferred pay component of total employee compensation.

III H.R. 567 – Precise Calculations Instead of Best Estimates

In several papers published in recent years, economists Robert Novy-Marx and Joshua Rauh have estimated the liabilities of major state pension plans using Treasury rates as the basis for their revaluation of liabilities disclosed by the plans themselves at rates averaging 8%. They estimate that underfunding of state plans approximates $3 trillion dollars while others, who have used the values disclosed by the plans, estimate underfunding at no more than $1 trillion.[4]

---

[4] In April 2011, however, the PEW Center on the States updated its earlier compilations and noted that the funding gap had widened to $1.26 trillion at the end of fiscal 2009. Their study also notes it is

In 2008, Gordon Latter and I examined four large state plans, using Treasury discount rates. Our results are consistent with the work of Novy-Marx and Rauh. In our paper, however, we make the following observation:

> "Precise measurement of the [Current Liability] and the [Current Cost] can only be done by actuaries working with reliable plan data, appropriate computer software, and detailed descriptions of the benefits being earned."

Since 2003, New York City's Chief Actuary, Robert C. North, Jr. has disclosed the Current Liability at Treasury rates in the CAFRs for each of New York City's five Retirement Systems. For example, the 2007 CAFR for the New York City Employees' Retirement System[5] shows several measures of plan assets and liabilities. The most decision useful numbers shown are:

i) the market value of plan assets (MVA), and

ii) what Mr. North has called the Market Value of the Accumulated Benefit Obligation (MVABO); this is equivalent to what H.R. 567 calls the Current Liability at Treasury rates.

I am not aware of such disclosures by public pension plans in other jurisdictions in the U.S. This means that public employees, taxpayers and lenders cannot measure the economic value of pension obligations incurred to date nor can they determine total compensation costs. Additionally, they cannot detect intergenerational cost shifting nor can they accurately compare funding progress across jurisdictions.

H.R. 567 would serve us well by combining the low discount rates espoused by many commentators (e.g., Donald L. Kohn, Novy-Marx and Rauh) with the precise calculations that are best made by plan actuaries. If my suggestions with respect to i) eliminating item (C) of **SECTION 4980J(b)(2)** and ii) using the Treasury yield curve without 24-month averaging and segmented rates were incorporated into the bill, the cost of compliance would be modest in the first year and nearly negligible thereafter.

IV Conclusion

H.R. 567 calls for very valuable disclosures by public pension plans. These disclosures will make the funding status of public plans clear, economically realistic, and comparable across jurisdictions.

By addressing the three questions highlighted in my testimony, the disclosures of H.R. 567 will also improve the management of public pension plans. Until now, the agents responsible for plan management have been making important financial decisions (benefit levels, funding and investment strategies) without the information necessary to determine i) the value of benefits as a component of total compensation, ii) the efficacy

---

based on actuarial assumptions where the discount rate is typically 8% and that using Treasury rates could increase the funding gap to $2.4 trillion.

http://www.pewcenteronthestates.org/uploadedFiles/Pew_pensions_retiree_benefits.pdf

[5] See http://www.nycers.org/(4pdve4550se2te2d0dvtvl45)/Pdf/cafr/2007/NYCERS_final.pdf pages 149-150.

of funding and investment strategies, iii) which generation of taxpayers are paying for services rendered, and iv) how plans in one jurisdiction compare to those in other jurisdictions. With the addition of Current Cost, as defined herein, H.R. 567 will support rational decision-making by agents on behalf of employees, taxpayers and lenders.

I suggest that item (C) of **SECTION 4980J(b)(2)** be eliminated because it will be expensive to satisfy and because the disclosures thereunder will be uninformative at best and may actually be misleading and counterproductive in the decision-making context.

I suggest the elimination of 24-month averaging and segmenting of Treasury rates. Unadjusted Treasury rates are more appropriate to the disclosure objectives of H.R. 567.

I suggest the addition of Current Cost as defined above in order to identify the value of benefits earned in the latest year as a component of total compensation.

H.R. 567 may stand as a landmark and a turning point in helping states and localities regain control of their obligations and the management of their resources.

Chairman BOUSTANY. Mr. Kurtter, you may proceed.

STATEMENT OF ROBERT KURTTER, MANAGING DIRECTOR, U.S. PUBLIC FINANCE, MOODY'S INVESTORS SERVICE

Mr. KURTTER. Thank you. Good morning.

Mr. Chairman, Congressman Lewis, Members of the Subcommittee, my name is Robert Kurtter. I am a managing director in U.S. Public Financial Group at Moody's Investors Service. Thank you for inviting Moody's to participate in today's hearing.

My comments will focus on our views of the potential credit impact of transparency initiatives like H.R. 567 and the Governmental Accounting Standards Board project on pension disclosure. While Moody's does not rate pension plans themselves, we monitor proposals like these and the related developments because our assessment of government pension plans is one of the many factors in our credit analysis of government-issued bonds. Moody's comments on policy initiatives, however, should not be taken as an endorsement or criticism of any such initiative or the conduct of any particular issuer.

In recent years, we have observed increases in the unfunded pension liabilities of State and local governments. This growth has occurred for several reasons. First, during peaks of the stock market in 2001 and 2007, some State and local governments enhanced benefits and/or reduced employer contributions. Second, the recent economic downturn significantly diminished the value of pension plan assets. Third, adoption of early retirement incentive programs shifted costs from payroll to retirement systems. And fourth, demographic factors, including an aging work force and the increasing life expectancy of beneficiaries are adding to liabilities.

State and local governments have needed to increase their pension contributions at a time when declining revenues are also requiring them to impose budget cuts. These developments have prompted a discussion about whether the existing disclosure standards of our government pension plans remain appropriate and also about whether and to what extent government pension plans are underfunded.

In addition to the proposed legislation, the GASB is considering changes to its financial reporting rules for public sector pension plans. As I described in my written testimony, if the GASB changes were adopted, as proposed, employers subject to its disclosure requirements could calculate their funding requirements as they do now, but they would have to use different methods to calculate certain elements of the pension expense they disclose in their financial reports.

Moody's believes H.R. 567 would increase public access to State and local government pension plan data. Additionally, both the bill and the GASB proposal would increase comparability of that data. At the same time, they could also increase the amount and complexity of the information disclosed. If these or other initiatives help investors and government issuers have more informed discussions about the credit risks associated with these obligations, we believe these proposals could create incentives for issuers to address their unfunded pension liabilities.

Governments have many options to improve the funded status of public plans. These include increasing government or employee contributions or adjusting benefits. Depending on the specific measures taken, these actions could be positive, neutral or negative for bond holders. Though as noted earlier, any changes in the funded status of the pension plan would be one of the many factors that we would consider in our credit analysis.

Of course, the decisions that governments make about their pension plans affect much more than their credit profile as bond issuers.

Our opinions do not speak to the wider implications for an issuer or its stakeholders of any actions it takes. Also, as a credit rating agency, Moody's does not take a position on whether or how a State or local government should address a pension funding shortfall. Our role is limited to providing opinions and research about issuers' likely ability and willingness to pay their bonds in full and on a timely basis.

Thank you again for inviting me to testify on this important matter. I look forward to answering your questions.

Chairman BOUSTANY. Thank you, Mr. Kurtter.

[The prepared statement of Mr. Kurtter follows:]

Testimony of Robert Kurtter
Managing Director, U.S. Public Finance
Moody's Investors Service

Before the
United States House of Representatives
Committee on Ways and Means
Subcommittee on Oversight

Hearing on the Transparency and Funding of State and Local Pensions

I. Introduction

Good morning Mr. Chairman, Congressman Lewis and members of the Subcommittee. My name is Robert Kurtter, and I am a Managing Director in the U.S. Public Finance Group at Moody's Investors Service ("**Moody's**"). Thank you for inviting Moody's to participate in today's hearing.

In my testimony, I will explain our views on the potential impact of transparency initiatives like H.R. 567 – the Public Employee Pension Transparency Act. We monitor developments like these because our assessment of government employers' pension plan assets and liabilities is one of many factors in our credit analysis of government-issued bonds.

We believe that H.R. 567 would increase access to, and comparability of, state and local government pension plan data. At the same time, H.R. 567 and other initiatives could increase the amount and complexity of the information disclosed. To the extent this or other initiatives help investors and government issuers have more informed discussions about the credit risks associated with these obligations, we believe they will create incentives for issuers to reduce unfunded pension liabilities. Depending on the specific measures taken, these actions could affect a government bond issuer's credit profile.

Of course, the decisions that governments make about their pension plans affect much more than their credit profile as bond issuers. Our role, however, is limited to providing opinions and research about issuers' likely ability and willingness to pay their bonds in full on a timely basis. For example, we do not take a position on whether or how a state or government should address a pension funding shortfall. Likewise, any commentary on policy initiatives that could affect issuer behavior should not be construed as an endorsement or criticism of any such initiative.

II. Transparency Initiatives Relating to Public Sector Pension Data

A. Overview of Recent Developments

For employers, pensions are a type of deferred compensation that leads to a long-term obligation to pay benefits in the future. In recent years, we have observed increases in state and local governments' unfunded pension liabilities. This growth has occurred for several reasons. First, at the prior peak of the stock market, some state and local governments enhanced benefits and/or reduced employer contributions. Second, the economic downturn significantly diminished the value of pension plans' assets. Third, adoption of early retirement incentive programs shifted costs from payroll to retirement systems. Fourth, demographic factors, including an aging workforce and the increasing life expectancy of beneficiaries, are adding to liabilities. These increasing liabilities have resulted in a situation where state and local governments have needed to increase their pension contributions at a time when declining revenues are also requiring them to impose budget cuts.

These developments have drawn the public's attention to some other issues relating to pension finance. For example, the Governmental Accounting Standards Board ("**GASB**") specifies that

government employers should use a discount rate for their pension obligations[1] that is the same as the employer's long-term expected future rate of return on the pension plan's invested assets. Given various investing strategies and asset mixes, different governments use different assumed rates of return, typically ranging from about 7.25-8.5%. Currently, there is widespread discussion about whether the existing disclosure standards about government pension plans remain appropriate and also about whether and to what extent government pension plans are underfunded. H.R. 567 and the GASB project discussed below are among the initiatives contributing to this discussion.[2]

Even as this discussion continues, some state and local governments already have reduced or announced planned reductions in the rates they use to calculate the present value of their future benefit payment obligations. These include pension plans in Alaska, California, Colorado, Illinois, Indiana, New York, Pennsylvania, Rhode Island, Virginia, the District of Columbia and San Francisco. Generally, these reductions have been in the range of 0.25 to 0.75 percentage points.

B. H.R. 567

H.R. 567, if enacted in its present form, would provide for the following, among other things. First, while a pension plan would still be permitted to prepare its funding report and financial statements in accordance with the GASB's standards, it would have to prepare and file supplemental financial schedules containing information prescribed by H.R. 567. For example, it would have to include information about the plan's funding status, funding and contribution projections for the next twenty years, and the plan's investment returns for the current and preceding five years. Most of this information already is reported in plan financial statements. H.R. 567, however, would set uniform calculation methods for certain disclosures made in the supplemental schedules. For example, H.R. 567 would require pension plans to calculate the value of their assets using a method based on the current fair market value of those assets. This is different from the current actuarial method, which uses a smoothed rate of return that averages investment performance over a period of years to reduce the impact of market volatility. Currently, private sector pension plans generally use this fair market value approach.

H.R. 567 also would require plans to calculate the unfunded, actuarial accrued liability ("**UAAL**") using a discount rate derived from a three-segment, modified yield curve based on Treasury rates. This approach would result in most state and local governments using lower discount rates to report their obligations in the supplemental schedules than they currently use to calculate and disclose their UAAL in their financial statements. This would result in reported pension liabilities increasing substantially.

Second, a central repository for pension data would be created. Each state and local government pension plan would have to file financial information about its pensions, including the new schedules prescribed by H.R. 567, with the Secretary of Treasury, which would make those reports available on a publicly accessible website.

---

1 To estimate the value in today's dollars of future pension plan liabilities, an employer uses an interest rate to discount those liabilities to their present value. The lower the discount rate, the higher the estimate of the pension plan's obligation to pay future benefits.

2 We also are aware of an initiative by the National Association of Bond Lawyers to provide guidance to counsel for public sector issuers about how to prepare disclosures about defined benefit pension plans.

C. The GASB Initiative

The GASB also is considering changes to its financial reporting rules for public sector pension plans. In June 2010, it issued a request for comment in the form of Preliminary Views (a "PV") on pension accounting and financial reporting by public sector employers. The GASB is considering the comments it received on the PV and is expected to publish another consultation paper in the form of an exposure draft in June 2011.

If the PV is adopted as proposed, employers subject to the GASB's disclosure requirements would be able to continue calculating their funding requirements as they do now, but they would have to use different methods to calculate the pension expense they disclose in their financial reports. In particular, the GASB is considering, among other things, whether or not to require public sector employers to: (1) recognize on their financial statements the unfunded portion of their pension obligations; (2) recognize faster any expenses caused by plan amendments, as well as certain actuarial gains and losses; and (3) use a lower discount rate for the portion of any plans that are expected to be unfunded.

With respect to item (3), the GASB has suggested that a reasonable long-term expected rate of return on the plan's investments could continue to be the basis for discounting projected benefit payments to their present value, but only to the extent that the current and expected future plan net assets are sufficient to cover the future benefit payments. Benefit payments that are expected to occur beyond the point at which expected plan benefits are projected to be exhausted would be discounted to their present values using a high quality municipal bond index rate.[3]

D. Potential Impact of Initiatives on Amount of, Access to and Comparability of Pension Information

Moody's believes that these initiatives, if adopted, would increase the amount of, access to and comparability of pension plan information, but they also could increase the complexity of the information disclosed. More specifically:

- Creating a publicly accessible, internet-based central repository for financial information about state and local government pension plans, as called for in H.R. 567, would make it easier for the public to obtain the relevant information. Likewise, requiring state and local governments to report certain information in a prescribed format in supplemental schedules, even if they already report such information elsewhere in their financial statements, could make it easier for the public to locate the relevant information.
- Prescribing uniform calculation methods for certain key metrics would facilitate comparability of information across state and local government pension plans. For example, H.R. 567 would require all of these employers to calculate the present value of their pension obligations using the same, modified yield curve based on Treasury rates of return. The GASB PV would require

[3] This rate would change as the rate of return on the high quality municipal bond index fund changed. If this calculation method were in use now, we estimate that the prescribed discount rate likely would be somewhat lower than the long-term expected rate of return currently used by government pension plans but somewhat higher than a discount rate derived from a modified yield rate curve based on Treasury rates.

all public sector employers subject to its rules to use the same discount rate, based on a rate derived from an index of high quality municipal bonds, to calculate the present value of the unfunded portion of their pension obligations. While the discount rate is only one of a number of assumptions used in calculating pension liabilities, changes in this assumption would have a significant impact on the size of the reported obligation. Therefore, standardizing this assumption would enhance comparability even if other assumptions are not standardized.

- At the same time, requiring an employer to make multiple disclosures, using different calculation methods and in different places, about the same set of assets and liabilities could increase the complexity of disclosures and the time required to analyze the information. Some users of that information are likely to find that the resulting diversity of perspectives enhances their understanding. Others, however, might find the information more time-consuming to analyze and harder to understand.

E. Moody's Views on the Credit Implications of These Initiatives

If either or both of these initiatives result in a better informed dialogue about the credit risk of pension obligations, we believe this dialogue will create incentives for issuers to take actions to address unfunded pension liabilities. Governments have many options to increase the funded status of plans, including increasing government or employee contributions or adjusting benefits. Any changes in the funded status of a pension plan would be one of many factors that we would consider in our credit analysis. Depending on the specific measures taken, these actions could be positive, neutral or negative for bondholders.

As a credit rating agency, Moody's does not take a position on *whether* or *how* a state or local government should address a pension funding shortfall. Moreover, we do not rate the pension plans themselves. Rather, our opinions focus only on the potential implications for the creditworthiness of issuers' bonds and not on the wider implications for an issuer and its stakeholders of any actions that it takes. Finally, while we may comment on the credit implications for bondholders of various developments, including regulatory initiatives, that could affect the behavior of issuers, such commentary should not be construed as an endorsement or criticism of any such initiative or the conduct of any particular issuer.

***

Thank you again for inviting me to testify on this important matter, and I look forward to answering your questions.

ANNEX

To assist the Subcommittee in its deliberations, in this Annex I provide an overview of the key factors we consider in our credit analysis of issuers of state and local government bonds, including how we take pension liabilities into account, and our outlook on these sectors, including the assumptions that underpin our views.[1]

1. WHAT MOODY'S CREDIT RATINGS ADDRESS – AND WHAT THEY DO NOT

There has been a lot of attention paid recently to the debt levels of states and local governments. The term "debt" can refer to many things. When Moody's uses the word "debt", we are referring specifically to "bond debt". We are not referring to any other obligations of the government, such as utility payments, salaries due to employees or pension liabilities. Our opinions speak only to the likelihood that a government-issued bond is likely to be paid in full on a timely basis, according to the contractual terms of that bond. This is what bond investors want to know. Therefore, when we use the term "default", we are referring specifically to the failure to make payments to bondholders. We do not rate and are not referring to the default on any other type of obligation to any other person or entity.

Similarly, the term "credit risk" can mean different things to different people. When Moody's uses the term "credit risk", we are referring to the risk that an issuer will not pay the obligations due on its bonds when those obligations come due. As I explain below, we take into account all of an issuer's major financial obligations as part of our analysis so that we can assess both the issuer's ability and its willingness to meet its bond payment obligations.

We intend for our opinions to promote dialogue and debate among market participants about the relative credit risk of bonds issued in different regions and by different types of issuers. If people choose to consider our opinions, we expect them to use those opinions to supplement, and not replace, their own credit analysis, a task that is made easier by increased transparency and comparability of the information that issuers provide to us and the market generally.

2. KEY FACTORS IN OUR ANALYSIS OF STATE AND LOCAL GOVERNMENT BONDS

A. Overview

Set out below is an overview of the key factors we consider in our credit analysis of the U.S. public finance sector. By way of example, I will describe our analytical approach to the states. We focus on four broad factors:

1. *Economy*: We look at the breadth and diversity of the affected economy, including growth trends and comparative economic position to other, similar issuers.
2. *Finances*: We analyze information contained in financial statements as well as current budget information and compare this information to sector statistics for comparable issuers.

[1] There are a significant number of unrated, U.S. public finance bonds. Therefore, my comments should not be generalized to the entire universe of public finance bonds because, historically, unrated issuers and bonds have demonstrated greater levels of credit risk and may continue to have quite different risk characteristics in the future.

3. *Debt Ratios*: Debt ratios are calculated to adjust for size (debt per capita) and wealth (e.g., debt to personal income) and compared to sector medians.
4. *Governance/Management*: We assess the type of governance, including legal powers to manage finances and any legal constraints on taxing, borrowing or spending.

All of these factors are important to our assessment of the state's degree of financial flexibility to meet the specific obligations it faces with respect to its bonds. We also look at each factor's impact on the other factors. Importantly, our focus is not *how* the state or local government achieves – or does not achieve – financial flexibility. Rather, we look to *whether* financial flexibility exists, and to what degree it exists.

B. State and Local Governments' Pension Liabilities

State and local governments' pension liabilities have long been part of our analysis and are factored into our opinions. We recognize that growing, unfunded pension obligations are creating challenges that these issuers must address, and we are monitoring the situation closely. We have taken, and will continue to take, rating actions where we believe an issuer's credit profile warrants it.

From an analytical perspective, pensions are a type of long-term debt obligation, and therefore they are incorporated into our debt ratio analysis. Ongoing contributions to the pension fund also represent a current budget cost, which we consider in our analysis of an issuer's finances. And finally, our governance analysis incorporates the way a government sponsor responds to developments regarding its pension obligations. How state and local governments manage their pension plans, however, is just one of many factors that we consider in our credit analysis of these issuers' bonds.

3. MOODY'S OUTLOOK FOR STATE AND LOCAL GOVERNMENTS

A. Credit Pressures and Credit Strengths

There is unprecedented financial strain on the U.S. public finance sector and this is reflected in the negative outlooks we have on all major sub-sectors in this market. For state and local governments, we hold this view for various reasons, including:

- A recovering but still fragile overall economy;
- Increased liabilities, such as pension and healthcare costs;
- Lingering fiscal pressures, which have required severe budget cuts, use of reserves, and other nonrecurring solutions to solve budget gaps; and
- Strained revenue sources because of persistent high unemployment and sagging real estate prices, along with attendant drags on taxes.

Despite these credit pressures, from the perspective of bondholders, bonds issued by the state and local governments continue to reflect a variety of credit strengths, including the following:

- Governments exist in perpetuity.
- State economies and those of some large cities are broad-based and diverse.
- State and local governments have strong incentives to pay bond debt. General obligation bonds are backed by the issuer's full faith and credit pledge, which an investor can take to court to

enforce. State and local governments also are motivated to treat other bond debt the same way so that they can continue accessing the markets to finance initiatives such as the construction of schools, roads and hospitals. For the same reasons, in the extremely unlikely event of a state default on general obligation bonds or related debt, we expect that investors' rate of recovery on their bonds would be very high.

- Bond debt, on its own or combined with unfunded pension liabilities, represents a relatively small proportion of state and local governments' total liabilities compared to other sectors, such as corporates. For example, debt owed to bondholders generally accounts for only 5-8% of state budgets and annual bond debt costs remain a relatively small share of expenditures. This means that governments have less incentive to default on these payments because non-payment would do little to solve major budget gaps.
- Federal monetary policies benefit state and local economies.
- State and local governments have a variety of powerful fiscal management tools at their disposal, including balanced budget requirements, authority to raise revenues, the ability to cut expenditures without reducing revenues (although large-scale state employee layoffs might depress economic growth), and, for states, the ability to cut or delay aid to local governments.

B. Widespread Defaults Not Expected

While states are facing a revenue and spending problem, Moody's does not see debt in the form of obligations to bondholders as the source of credit strain for most states. Annual bond debt costs remain a relatively small share of expenditures. In addition, most states do not face refinancing or material rollover risks. We could see a few more states turn to deficit financings to fund operating expenses, or restructurings to produce budget savings in 2011, but we expect those states to be the exception rather than the rule. For these reasons and because of the strong incentives states have to pay their bond debt, we do not expect any states to default on their bond obligations in the next twelve to eighteen months.

In the Moody's-rated local government sector, we expect a relatively small increase in defaults from historically low levels, but we do not expect a wave of defaults. One reason for the expected increase in bond defaults is that the states can reduce or delay their aid to local governments or cut programs so that local governments have to step in and fill the resulting funding gap. This is likely to exacerbate problems at the local government level. But we also expect that the majority of individual local governments will make the tough choices and painful budget cuts needed to continue making timely payments on their bonds. As a credit rating agency, we do not have views on which choices these issuers should make. Rather, we focus on whether the choices they make increase or decrease the likelihood that they will meet the contractual obligations under their bonds.

While we do not expect a wave of actual bond defaults by rated state and local governments, there have been situations in the past, for example in Harrisburg, Pennsylvania, where the risk of bond default seemed imminent but was averted. We expect there will likely continue to be selective instances of severe credit stress.

C. Assumptions

Moody's views on credit risk are predictions about the future and, as such, they are based on certain assumptions, or expectations, about what is likely (but not guaranteed) to happen. I have set out below a number of the assumptions we have incorporated into our outlook for the next twelve to eighteen months. We expect that:

- State and local governments will honor their contractual obligations to make bond payments because there are such strong incentives for them to do so.
- State and local governments will be able to continue accessing financial markets on roughly the same terms that are available to them now.
- State and local governments will continue to have sufficient budget flexibility, e.g., to cut costs and/or increase revenues, to meet the contractual obligations associated with their bonds.
- Bankruptcy laws will not change.
- The economic recovery will not be derailed by, for example, an oil price shock.

We recognize that a number of the assumptions above currently are the subject of debate. We constantly monitor the environment in which state and local governments operate, seeking information that is relevant to these assumptions. If at any time during our ongoing analysis, we were to begin seeing shifts that might call into question the appropriateness of these assumptions, we would re-consider those assumptions and, if we believe the facts and circumstances warranted it, revise and communicate our views to the market.

Chairman BOUSTANY. Ms. Lav, you may now proceed.

STATEMENT OF IRIS J. LAV, SENIOR ADVISOR, CENTER ON BUDGET AND POLICY PRIORITIES

Ms. LAV. Thank you. Mr. Chairman, Congressman Lewis and Members of the Subcommittee, I appreciate the invitation to appear before you today. I will make six related points and I will then elaborate on the problems that I see with H.R. 567.

First, as was mentioned, most State and local employees receive modest pension benefits, averaging less than $23,000 a year. Second, most States can address underfunding in their pension plans with relatively modest measures, such as increases in contributions from employers and employees and some sensible and moderate changes in benefits. Only a few States, those with pensions that are grossly underfunded and a history of failing to make required contributions, would have to make more extensive changes.

Third, pension funds, according to the Federal Reserve data, have already recouped two-thirds of their recession market losses. But smoothing and data lags have led recent studies to portray the situation as worse than it is.

Fourth, the use of a so-called riskless rate, as we are discussing, to discount liabilities makes underfunding appear much greater than what pension funds report. But, the somewhat academic debate over whether or not to discount liabilities using a riskless rate is quite distinct from the actuarial finding of how much States and localities have to deposit in their pension funds to meet their future obligations. States and localities should use a realistic measure of future investment returns to set their deposit levels.

Fifth, H.R. 567 I view in many ways as a solution in search of a problem, one that would override the careful process that the Governmental Accounting Standards Board has nearly completed. The Board's proposed new rules would standardize State pension fund reporting and make it more transparent.

Sixth, and finally, moving State and local employees from defined benefit to defined contribution plans, which some sponsors of H.R. 567 have said they would like to see, would not address the funding problem that public pension systems now face. On the contrary, it would raise annual costs in many instances. Some States that were considering such a conversion have backed away after concluding that they would face higher costs.

I will now elaborate on the problems with H.R. 567. For the past 4 years, GASB has been conducting extensive research and consultation and holding hearings with well over 100 stakeholders in order to develop new pension financial reporting standards.

The draft GASB standard makes clear that the liability amount that results from the riskless rate does not properly reflect State and local government pension liabilities. Instead, GASB has carefully crafted rules that reflect market expectations and applies a lower discount rate only to the least well-funded plans in order to reflect the greater risk to their solvency.

Congress should not replace GASB standards and the financial market discipline that induces State and local governments to comply with those standards with H.R. 567's unnecessary Federal intrusion into the issue. Unlike the GASB process, H.R. 567 would

likely increase public confusion between liabilities based on a riskless rate and actual liabilities. That could spook bond markets and lead States and localities to cut spending for education and other key areas or raise taxes more than necessary. It also would create an entire new Federal bureaucratic structure to regulate something that market forces should manage.

Most States with significant pension underfunding are moving to address it. And they are doing so in a variety of ways. They are increasing employee contributions. Eleven States did that last year, and 16 States made changes that will reduce benefits for future employees. Some 12 States have raised their retirement ages. Other States have made changes that will require consistent employer contributions. States should be able to gradually solve their underfunding problems with the steps they are already taking, with modest increases in employer and employee contributions, with a greater recovery in the markets, and by adhering to the new rules that GASB will promulgate. The Federal Government does not need to intervene in this issue. In fact, that would do more harm than good. Thank you.

Chairman BOUSTANY. Thank you, Ms. Lav.

[The prepared statement of Ms. Lav follows:]

TESTIMONY OF IRIS J. LAV
Senior Advisor, Center on Budget and Policy Priorities

Before the House Ways and Means Committee
Subcommittee on Oversight
Hearing on the Transparency and Funding of State and Local Pensions
May 5, 2011

Mr. Chairman, Mr. Lewis, and members of the committee, I appreciate the invitation to appear before you today. I would like to make six related points in my testimony:

1. Most state and local employees receive modest pension benefits, for which both they and their employers contribute annually during their working years.
2. The underfunding problems of most state pension systems can be addressed with relatively modest increases in state and local contributions from employers and employees, along with a set of sensible, moderate changes in benefits. In a handful of states with gross underfunding and a history of failure to make required contributions, more extensive changes are likely to be necessary, but those states are not typical.
3. Some of what has been widely published recently about current underfunding is related to market losses during the recent recession. Pension funds have already recouped two-thirds of those losses, but the asset averaging procedure (or "smoothing") used by the pension funds does not yet fully recognize the extent to which assets have bounced back.
4. Underfunding would appear to be much greater than pension funds report if pension fund liabilities were discounted at a "riskless rate." The debate over whether or not to discount liabilities using a "riskless rate," however, is distinct from the actuarial determination of the amount of funding that states and localities have to deposit into their pension funds to meet future obligations.
5. H.R. 567 is in many ways a "solution" in search of a problem — one that would override a careful process already well underway by the Government Accounting Standards Board to standardize state pension fund reporting and make it more transparent. In contrast to the GASB process, H.R. 567 would be likely to increase public confusion, could spook bond markets, and could lead states and localities to cut spending for education and other key areas — or raise taxes — more than necessary. It also would create a new federal bureaucracy to regulate something that should be "regulated" by market forces.
6. Moving state and local employees from defined benefit to defined contribution plans — an objective that some of the sponsors of H.R. 567 have said they would like to accomplish — would not address the funding problems public pension systems currently face. On the contrary, it generally would *raise* annual costs by making it harder for a state to pay down the existing liabilities for employees still in the defined benefit plan, because that plan would include fewer employees and fewer contributions going forward, while requiring additional contributions for the employees in the defined contribution plan.

What are State and Local Pensions?

Pension benefits are part of the compensation of most state and local employees. Each year, in addition to pay and other benefits, employees earn deferred compensation. Among state and local

workers, 84 percent are covered by defined benefit plans, as compared to 47 percent of employees in private sector firms with more than 500 employees.

Despite various newspaper headlines and talk show claims, public sector pensions are not particularly large. The average state and local public pension benefit is $22,653 a year, according to the Census bureau. It also is important to note that not all state and local sector workers have access to Social Security. For 27 percent of state and local employees, their pension is in lieu of Social Security. This includes more than 40 percent of all teachers and a majority of all public safety workers. Since these workers are missing one leg of the desirable three-legged stool of income to replace a reasonable portion of earnings during retirement — the three legs being Social Security, pensions, and private savings — their pensions are somewhat larger and push up the average.

Currently, employer contributions to state and local pension funds equal, on average, 3.8 percent of state and local budgets. This contribution is part of state and local operating budgets, while pension benefits themselves are paid from the accrued assets in the trust funds. Employer contributions accounted for 27 percent of the revenues to pension trust funds, employee contributions accounted for 13 percent, and investment earnings accounted for 60 percent in the period from 1982 to 2009.

Funding Status of State and Local Pensions

Pension funds in many states are underfunded, and some seriously so. This is a problem that needs to be addressed over time in most states, through some sensible measures, which I discuss below. More extensive changes are likely to be needed only in those states that failed in recent years to make the required contributions or that retroactively improved benefits without providing funding to cover the costs of those benefit improvements. These more troubled states include Illinois and New Jersey, as well as Colorado, Kansas, Kentucky, and Rhode Island.

There is an ongoing debate over just how seriously underfunded state and local pension funds currently are, as well as over whether they are sustainable over the next number of decades. This debate, which primarily centers on how the current value of future liabilities should be measured, has heated up as pension funds lost substantial assets in the recent recession (as well as in the 2001 recession) and therefore are currently reporting less than full funding.

Using conventional assumptions that follow the rules set forth by the Governmental Accounting Standards Board, the unfunded liability of state and local pension funds is approximately $700 billion. Using alternative assumptions based on discounting liabilities by what is known as the "riskless rate" – described below – the unfunded liability is more than $3 trillion.

Unfunded liability is calculated as the current value of future liabilities minus the value of assets on hand. It is worth looking at both sides of that equation.

Assets

About two-thirds of the $900 billion in assets that pension funds lost during the recent recession has now been recouped. Funding declined from $3.2 trillion in 2007 to $2.3 trillion in 2008, but assets had rebounded to close to $3 trillion at the end of 2010. Most pension funds, however, use a

procedure called "smoothing," which phases in gains and losses in assets over a period such as five years to limit the volatility of their asset measure. Thus, 2008 losses will continue to be reflected in the smoothed measure of assets for a few more years, after which the growth of assets will become more evident.

The confusion over the amount of assets held by pension trust funds may lead to some over-concern about the funding status of the funds. For example, a report released last week by the Pew Center for the Study of States reported on funding status at the end of fiscal year 2009 (June 30, 2009 in most states and localities) and found that funding had dropped substantially from the previous year. But assets were much lower in the second quarter of 2009 than in the most recent data for the fourth quarter of 2010. Both the smoothing and the lag in reporting means that the well publicized results of the Pew study are significantly affected by the temporary dip in assets during the recession, and will likely change substantially as the assets in the funds regain ground and as the bad years work out of the smoothing formula.

Liabilities

The issues relating to the measurement of liabilities are more complicated.

Economists generally support use of the riskless rate in valuing state and local pension liabilities because the constitutions and laws of most states prevent major changes in pension promises to current employees or retirees; they argue that definite promises should be valued as if invested in financial instruments with a guaranteed rate of return, like Treasury bonds. State and local pension funds, however, historically have invested in a diversified market basket of private securities and received average rates of return much higher than the riskless rate – 8 percent on average over the past two decades. (A "riskless rate" would be about 4 percent or possibly less.) It also should be noted that most economists are *not* arguing that state and local pension funds should change their investment practices, liquidate their equity portfolios, and invest solely in bonds.

A key point to understand is that the issues of: 1) how states and localities should *value* their pension liabilities; and 2) how much they should *contribute* to their pension funds each year to meet their pension obligations are two separate issues, although they obviously are related. The estimate of more than $3 trillion in unfunded liabilities that results from use of the "riskless rate" does *not* mean states and localities should have to contribute that amount to their pension funds, since the pension funds very likely will earn higher rates of return over time than the Treasury bond rate — and that, in turn, means states can achieve pension fund balances adequate to meet future obligations without adding the full $3 trillion to the funds.

Implications for Budgets

Work done by the Center for Retirement Research at Boston College (CRR) finds, using GASB assumptions, that state and local contributions to pension funds would have to rise from 3.8 percent of state and local budgets to 5.0 percent of state and local budgets over the next 30 years to bring the pension funds to full funding. This assumes that no other changes are made in benefits or employee contributions to lower costs.

By contrast, CRR finds that contributions would have to rise to 9 percent of state and local budgets to fully fund pensions if a discount rate of 5 percent were assumed. Since many proponents of the riskless rate are suggesting using the rate for Treasury Bonds, and the yield on 30-year Treasury Bonds currently is below 5 percent, more than 9 percent of budgets would have to be devoted to pension contributions if the riskless rate became the basis for those contributions (again assuming that all else is held constant).

Implications of H.R. 567

In February, 2011 Congressmen Devin Nunes, Darrell Issa and Paul Ryan introduced legislation (H.R. 567) to require states and local governments to report their pension liabilities to the federal government using the "riskless rate" — defined as an interest rate tied to the Treasury bond rate — as the discount rate to determine their pension liabilities. Any state or local government not complying with this requirement would face a penalty of great severity — it would lose the ability to issue tax exempt bonds, which states and localities rely upon to finance infrastructure construction and related purposes.

In a number of ways, I think this bill is a "solution" in search of a problem. Most people would agree that there is a need to standardize state and local pension reporting and make it more transparent — and that process already is underway. Extensive work has been done on these matters by GASB, which is an expert, non-political board appointed by the independent foundation that oversees both private and public accounting standards in the country. The GASB board is composed of accountants and financial analysts, many of whom have served as state or local auditors or comptrollers; the board enjoys substantial respect in financial markets. GASB's work on new pension standards is now nearing completion, and it is on track to issue the new standards for state and local government reporting on the financial status of their pension funds late this year or next year.

The Nunes bill would effectively short-circuit and override the GASB process by issuing a federal edict on how pension funds are to report liabilities. It would be unsound policy to substitute heavy-handed and unnecessary federal intrusion for the GASB standards and the financial market discipline that induces state and local governments to comply with those standards.

There are a number of other, related problems with the Nunes proposal, as well, including:

- It could sow public confusion, as it would likely lead the public and many policymakers to believe that the amounts that states and localities need to deposit in their pension plans each year are substantially larger than the amounts actually needed. Misunderstanding of the level of contributions required could lead to excessive cuts in *other* parts of state budgets (such as education) and/or greater-than-needed tax increases in order to free up more room in state budgets for the greatly increased pension contributions; it also could generate pressure to end defined-benefit pension plans.
- The legislation could unnecessarily spook the bond markets, leading to higher borrowing costs for states and localities.
- A new federal bureaucracy would have to be created to gather, process, and verify the

information for the nation's 2,550 state and local pension plans and to apply and enforce any federal penalties that would have to be applied under the legislation. The new bureaucracy would be created at a time when the federal government is trying to cut costs.

These important problems are discussed below in more detail.[1]

Short-circuiting and conflicting with GASB

For the past four years, the Governmental Accounting Standards Board — which sets standards for financial accounting for governments, just as the Financial Accounting Standards Board (FASB) does for private sector businesses — has been conducting extensive research and consultation with well over 100 stakeholders, including public hearings, to develop new pension financial reporting standards. The standards are expected to be promulgated next year. While GASB has no authority to *require* states and localities to follow its standards, bond raters and financial analysts generally look askance at governmental entities that do not comport with the standards. Thus, GASB standards typically become the *de facto* financial accounting rules for state and local governments, because of the discipline of the financial markets.

The new GASB standards have been issued in draft form. Assuming that the final standards will be similar to the most recent GASB draft, the new standards will provide for many fewer choices of methods and move state and local governments to issue annual statements of the financial position of their pension funds that are comparable to one another. Unlike the Nunes bill, the forthcoming GASB standard addresses a wide array of areas of pension financial reporting, including the liability accrual basis as well as other areas, in its effort to achieve accuracy and much greater uniformity.

In addition, while the Nunes bill requires use of the interest rate for Treasury bonds to determine the funding status of pension funds, the draft GASB standard explains that the liability amount that results from using the "riskless rate" to calculate fund liabilities does *not* reflect the amount that state and local governments need to deposit in their pension funds. The GASB draft said use of the riskless rate for determining state and local contribution levels would not be "…consistent with the view … that the present value of projected benefit payments should reflect an expectation of the employer's projected sacrifice of resources, reduced by the expected return on investments."

To estimate the amount of pension fund assets actually expected to be available to finance pension payments, the draft GASB standard calls for use of the actual expected rate of return, because it better reflects the level of contributions that will be needed. The GASB draft does require use of a lower interest rate for projecting benefit payments expected to have to be made after the projected point at which a plan's assets are expected to be depleted. For the portion of future liabilities for which current assets or expected contributions and associated earnings cannot be identified, the GASB draft standard uses an interest rate derived from an index rate for state and local governmental bonds of high quality.

Accordingly, the *overall* rate that the GASB draft would use to estimate the level of contributions that state and local governments need to make to their pension funds would be based on a *blend* of the expected rate of return on a fund's existing and expected assets *and* the rate of return on high-

[1] For a fuller description of the problems with this approach, see Iris J. Lav, *Proposed Public Employee Pension Reporting Requirements Are Unnecessary*, Center on Budget and Policy Priorities, March 14, 2011.

quality municipal bonds (which would be applied to the additional funding that will be needed). The precise blend would depend on various factors related to the funding status of the pension fund, but it is clear that less well-funded plans would be required to use a lower discount rate to reflect the greater risk to their ability to pay benefits.

A large amount of analysis and thought has gone into the development of the new GASB standards. The process of developing these standards has been one into which stakeholders and interested parties have had an opportunity to provide input and analysis, and the GASB Board has spent considerable time scrutinizing these submissions and various other analyses. When the final standard is issued, it is likely to have strong compliance.

Adding to Public Confusion

Given the complexities of determining the appropriate discount rate and understanding its meaning, there is risk that a federal rule that *mandates* valuation on the basis of the "riskless" rate would sow confusion between the unfunded liability valuation and the amounts necessary for state and local government to contribute to the plans. The public is unlikely to be able to distinguish between the valuation required under the legislation and the required annual contribution levels, especially if the large unfunded liability numbers derived under the legislation's reporting requirements are widely publicized. This may lead some policymakers to conclude that the levels of required contributions are unaffordable and the pension plans no longer viable when that is not the case.

More specifically, if states and localities are pressured to increase their annual pension contributions to meet the much larger contribution amounts that would be required if the "riskless" discount rate were used mechanically to calculate the contribution levels, any of several deleterious effects could result. States could end up cutting education or other priority investments in order to free up room in their budgets for pension contribution levels that exceed the amounts needed to cover future pension liabilities. Or, states could raise taxes more than is needed. Moreover, the overfunding of pension plans that ultimately would result could lead to demands for increased pension benefits that would not represent a sound use of resources.

Alternatively, if states and localities are pressured to raise their pension contributions to the levels that would be needed if pension funds actually invested solely in bonds, that could induce more states to abandon defined benefit pension plans altogether. That appears to be one of the goals of some of the bill's sponsors. Commenting on an identical bill introduced in the last Congress, a *Wall Street Journal* editorial said, "Their bill would encourage governments to switch to defined-contribution plans by revealing the true magnitude of their unfunded liabilities."[7]

To be sure, many states and localities do need to increase the amount of funding they deposit in their pension funds to address their unfunded liabilities. But they do not need the massive increases

---

[7] "Public Pension Hygiene Act," *Wall Street Journal*, January 22, 2011. Rep. Nunes also told a group of California government officials, "So what this will only set up, what the folks in the private sector have figured out a long time ago, was that you have to get away from the defined benefit plan (pensions) and somehow get to a defined contribution (401(k)-style plan)"; see Ed Mendel, "Pension Debt Bill: New Drive Toward 401(k)s," *Calpensions*, posted February 21, 2011. http://calpensions.com/2011/02/21/pension-debt-bill-new-drive-toward-401ks/

in contributions that would be required if pension funds were to invest solely in bonds and to receive the bond rate of return.

Potential for Spooking Bond Markets

Spooking bond markets could be another consequence of the confusion created by the Nunes bill. State and local bond markets have been volatile recently. In particular, an appearance on the television show *60 Minutes* by a financial analyst predicting 50 to 100 significant bond defaults this year — a claim that later was shown not to be supported by solid analysis and that is extremely unlikely to be borne out — is thought to have played a significant role in causing some investors to lose confidence in municipal bonds at the end of 2010 and beginning of 2011, resulting in a sizeable sell-off of those securities. States and municipalities have had to offer higher interest rates to sell their bonds because of this loss of confidence, a situation that is only now slowly turning around.

The potential of large and confusing unfunded liability numbers appearing on a federal government website could have a similar affect on the bond market, especially since those numbers would not represent the amounts that states and localities actually need to contribute to their pension funds to cover their obligations. Not every financial analyst, bond trader, or mutual fund investor understands the complexity of state and local pension financing and thus would know how to interpret these data. The legislation and the data it requires hold the potential to frighten potential investors unnecessarily and thereby result in higher interest costs for states and localities.

Creating a New Bureaucracy

Each of the 2,550 distinct state and local pension plans in the country provides information about its plan. The federal government does not collect or compile this information.

As a result, instituting the Nunes bill would necessitate creating a new bureaucratic entity within the Treasury Department to maintain information on active state and local pension plans, collect relevant reports from state and local governments, assure the timeliness of those reports, check them for accuracy and for compliance with the terms of the legislation and the implementing regulations, communicate with states and localities regarding any discrepancies, and enforce the penalties (described below) on states and localities that are out of compliance. This new bureaucracy would be created at a time when virtually everyone is looking for a way to cut federal government expenditures.

It is financial analysts and the securities markets that can effectively enforce discipline on the pension reporting of states and localities. Once the new GASB standards are in place, the strong market incentives for compliance with those standards will assure that the reported financial status of pension plans is comparable across plans. This is a clear example of a situation in which the operation and discipline of markets is preferable to the imposition of federal regulations.

A Common Sense Strategy for Improving Pension Funding

States' options to reduce the costs of their pension plans as a way to bring assets and liabilities into balance are somewhat constrained because key provisions of current pension promises to current employees are legally guaranteed in most states. Moreover, changes to public employees' compensation will affect the ability of states and localities to attract and retain workers. Currently, the pay of public-sector workers is below that of their private-sector counterparts: "Apples-to-apples" studies find that state and local workers are paid 4 to 11 percent less than private-sector workers with similar education, job tenure, and other characteristics.[3] Benefits, including pensions, make up some of that difference. States that slash benefits deeply for new workers (and current workers in states where that's allowed) run the risk of dissuading the best young workers from entering careers in education, health care, public safety, and other areas that are important for a state's long-term economic future.

Nevertheless, many states and localities have been taking a variety of actions over the past few years to improve the funding status of their pension funds. Some 11 states last year increased employee contributions toward their future pension costs, and 16 states made changes that will reduce benefits for future employees such as changing the formula used to set pension levels. (Several states fall in both categories.) In addition, a number of states reduced or eliminated cost-of-living increases in pension payments, primarily for future employees. Other states have made changes that will facilitate more consistent and adequate funding for pensions, such as requiring at least a minimum contribution every year. Most states in which there is significant underfunding are well aware of the problem and are moving to address it in a variety of ways.

These types of actions are among the steps that states and localities can take, within the current legal, fiscal, and economic framework, without throwing their budgets out of whack or harming their economies. I believe states and localities should:

- Act now to craft a plan to restore pension trust funds to solvency gradually. The long-term nature of the problem means that most state and local governments can fashion a plan that defers placing significant additional pressure on strained state budgets for a few years until state revenues have recovered from the economic downturn.

- Move carefully to change, as necessary, their methods for determining needed state and local contributions. Requiring much larger contributions now, while state budgets are still in crisis, would mean that states and localities would have to take even more resources away from other important areas like education (or raise taxes more) at a time when they are already cutting important services and investments deeply.

- Immediately change pension rules to reduce the potential for uncommon but damaging abuses

---

[3] See, for example, analysis of Current Population Survey data in Keith A. Bender and John S. Heywood, *Out of Balance? Comparing Public and Private Sector Compensation over 20 Years*, Center for State & Local Government Excellence (CSLGE), National Institute on Retirement Security, April 2010, page 7, http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7B03E820E8-F0F9-472F-98E2-F0AE1166D116%7D.PDF; and John Schmitt, *The Wage Penalty for State and Local Government Employees*. Center for Economic and Policy Research (CEPR), March 2010, http://www.cepr.net/documents/publications/wage-penalty-2010-05.pdf.

such as "double-dipping" (where, for example, a person claims a public pension while continuing to draw a government salary) and "spiking" (where employees artificially inflate their final year's earnings in order to boost their pensions).

- Gradually address under-funded pensions with a balanced combination of adequate contributions to pension funds by governments and employees (in the states where employees are not already contributing adequately) and restructuring of benefits as appropriate. For example, many states and localities are following the lead of the Social Security system and raising the age when an employee qualifies for a full pension to reflect the fact that people are staying healthier longer and living longer than in the past. For example, last year alone, 12 states upped their retirement ages including Illinois (to 67), Pennsylvania and Vermont (to 65), and Virginia (to match Social Security's full retirement age). In almost all states and localities, police, firefighters, and employees in other physically demanding jobs are allowed to retire with full pensions at a younger age than other employees.

- Continue to offer defined-benefit plans, since to do otherwise would actually make it harder for states to restore fund balance, as explained below.

Defined Benefit v. Defined Contribution Plans

The issue of whether states should close their defined benefit plans and switch over to offering defined contribution plans has received considerable discussion and deserves attention. There are a number of reasons why these conversions do not make sense from either a fiscal or retirement security perspective.

First, closing a defined-benefit plan to new hires has no effect on a state's current unfunded liability, so it does not address the major funding problem most public pension systems currently face. On the contrary, it can *raise* annual costs by making it harder for a state to pay down those existing liabilities, because the plan will include fewer employees and fewer contributions going forward. (This would become particularly problematic if GASB adopts proposed rules that would significantly reduce allowed amortization periods.)

In addition, a defined-contribution plan is a more expensive way to provide a given level of retirement income to employees because it lacks the benefits of improved investment returns that result from a pension trust fund's pooled investments, professional money managers, and shared administrative costs.

One advantage of defined contribution plans often cited by proponents is that they reduce risk for the employer, who faces no future liability once the contributions are made. This reduction in risk, however, is a major disadvantage from the point of view of individual employees who now face the risks of inadequate retirement income or outliving their retirement savings.

Another argument for defined-contribution plans is that younger employees are less likely to remain in one job for many years and are attracted by the portability of individual retirement accounts. This desire for flexibility, however, may not be enough to offset the shift in risk from the employer to the employee, as well as other problems with defined-contribution plans. In addition, the experience of states that offer employers a choice between defined benefit and defined

contribution plans shows that, when given a choice, most public employees prefer defined benefit plans.

Some states have tried to get the best of both the defined-contribution and defined-benefits approaches by creating a hybrid that provides a reduced defined-benefit plan in addition to a defined-contribution plan. Michigan (in its teachers'plan) and Utah recently adopted this approach, and other states are considering it. (Utah gives employees the option to go completely to a defined-contribution plan.) This reduces the risk for employees somewhat. Another way to mitigate some of the risk of defined contribution plans is to include provisions like automatic enrollment, matching employer contributions and access to investment managers. None of these provisions, however, give employees participating in a defined contribution plan the same level of retirement security as those in a defined benefit plan.

States and local governments considering defined-contribution or hybrid plans solely for the purpose of saving money would be well advised to look carefully at the experience of other states. For example, Utah's employer contribution under its new plan (10 percent of payroll) is higher than the contributions that a number of states typically make to their defined-benefit plans. In addition, Nevada decided against putting new hires in a defined-contribution plan when projections showed that the state's total pension costs would increase, since the state would have to increase its contributions to offset the loss of these new employees to the state's defined-benefit plan.[4] Similarly, Kentucky found that conversion to a defined-contribution plan would increase the state's costs for close to 20 years.[5]

Conclusion

There is no need for the federal government to take actions that could result in undesirable changes in state and local pension plans. Proposed federal requirements would undercut the GASB process to set standards on which financial markets rely, and is unnecessary because market discipline will enforce the new GASB standards. In addition to being unnecessary, the requirements would have a number of undesirable effects including sowing public confusion and thereby forcing states and localities to make larger than necessary reductions in vital services or increases in taxes, potentially spooking bond markets and raising the cost of borrowing for states and localities, and requiring creation of an entirely new federal bureaucracy at a time when additional federal spending can least be afforded.

A combination of the recovery of market losses sustained during the recession, modest increases in employer (and in some cases) employee contributions, and moderate restructuring of benefits should be able to restore the vast majority of state and local pension plans to full solvency.

[4] The Segal Company, *Public Employees' Retirement System of the State of Nevada: analysis and Comparison of Defined Benefit and Defined Contribution Plans*, 2010.

[5] "Actuarial Analysis of Senate Bill 2 GA", Letter to Mr. William A. Theilen, COO, Kentucky Retirement Systems, revised February 25, 2011.

Chairman BOUSTANY. We will now begin questioning, and I will begin here with Mr. Barro.

Some States and local governments have actually borrowed money in order to make contributions to their pension funds. And in these cases, the government borrows money in hopes that the pension fund earns investment returns greater than the interest rates so that they can remain solvent and meet their liabilities. This might work well if the investments actually earn a great deal on returns. But what happens if the investment actually loses money? Is this really constituting buying stocks on margin in effect?

Mr. BARRO. That is really exactly what it is. One of the great champions of this was Governor Rod Blagojevich of Illinois who pushed forward a $10 billion pension obligation bond issuance in, it was either 2003 or 2004. And yes, this practice is purely a creature of the use of discount rates roughly in the range of 8 percent; the idea is the government can borrow around 5 percent, invest, earn an 8 percent return and they are just getting free arbitrage there. Now, of course, the problem with is that the equity investments are risky and the payments that you have to make to the bondholders are fixed.

And so, yes, if the market performs poorly, it is exactly like buying stock on margin and losing. You shouldn't be under the illusion that because the State issues pension obligation bonds and uses them to buy assets to put in a pension fund that it has somehow improved its overall fiscal solvency.

The other thing I would note is that it creates avenues for other chicanery, which we saw in Illinois where the State issued 10 billion in bonds but only used about 7.3 billion of the issuance to shore up the pension funds. The rest was used to service debt on the bonds and to close gaps in a couple of years of State budgets. So it is just another way for the government to make its books more complicated, hide borrowing and further actually worsen a State's fiscal situation.

Chairman BOUSTANY. Thank you, Mr. Barro.

Mr. Gold, do you want to comment on that?

Mr. GOLD. I think you have it right. I think Mr. Barro has it right. It is borrowing to invest in risky assets. I began writing about this when I did my dissertation in 1999. And all I have seen since then is greater and greater issuance. Illinois is one of the poster children, but a number of other States have ventured down that risky route.

Chairman BOUSTANY. Thank you.

A new report released yesterday by the Congressional Budget Office said, and I quote, "By accounting for different risk associated with investment returns and benefit payments, the fair value approach provides a more complete transparent measure of the cost of pension obligations than the actuarial standards that are currently in use."

So for the panel I would like each of you to address this. Do you think that CBO is correct? Or are current standards more accurate? Why don't we start with Mr. Stapleton.

Mr. STAPLETON. Thank you, Mr. Chairman. One of the many reasons why I am a strong supporter of this particular piece of leg-

islation is that, in my view, the Government Accounting Standard Board has not done its job in maintaining uniform standards that are in line with the financial accounting standards boards which govern private sector companies. You can look at any number of things, including not fair value assessing what the liabilities are. You can look at amortization rates. They allow the amortization period to be far greater under GASB rules than under FASB rules allowing for a smoothing of write-offs over a much longer period of time.

In the private sector, plan liabilities are valued separately. Under GASB plan liabilities, the expected rate of return equals the actual rate of return. In the private sector, liabilities are valued using corporate high yielding bonds which come out around 6 percent.

And the issue of the sensitivity analysis, I was with Mr. Attmore, the Chairman of the Government Accounting Standards Board a number of week ago. I asked him from a disclosure standpoint, will you simply provide a sensitivity analysis so that people, State leaders and public policy makers can judge for themselves what these liabilities may be? And he said no.

And so I view this as simply transparency of information, of people being able to reach their own conclusions, whether it be State leaders or public policy makers. Thank you.

Chairman BOUSTANY. Thank you.

Mr. Barro.

Mr. BARRO. Yes. I would just say briefly that I think CBO was absolutely right in its characterization of the appropriateness of the fair value method for valuing liabilities. And frankly, I think it is a reflection of the near unanimity on this question in the financial economics community. It is often portrayed as a debate. But the main parties that you see defending the 8 percent discount rate practice are pension fund managers and actuaries. I think that there isn't a good financial economics argument for the use of a discount rate associated with risky investments to value a liability that is not risky.

Chairman BOUSTANY. Mr. Gold.

Mr. GOLD. In my comments, I made a distinction between a funding law such as the PPA of 2006 and a disclosure bill or proposals coming out of GASB. There is a history which is built into actuarial methods for guiding funding over long periods of time, and from that history, developed many of the practices which found their way into ERISA, found their way into accounting and so on.

Financial economics is exactly the—well, financial economics addresses the difference between an engineering approach to developing contributions, which at some future date will be adequate if things work out, and valuing promises made today. And the financial economics, or fair value approach, is far superior for accounting purposes.

Chairman BOUSTANY. Thank you.

Mr. Kurtter.

Mr. KURTTER. Yes, thank you. We do believe that pension fund unfunded liabilities may be overstated because earning rate assumptions don't reflect current market conditions, that directionally those rates are too high. GASB is considering initiatives to

lower those rates, and several States and pension plans have already taken actions to begin lowering those rates.

We don't have an opinion about what the right rate is other than to note that directionally these are moving toward more realistic number. We look at pension funding on a case-by-case basis for each credit involved, and that this is really only one factor that we look at in our overall credit assessments.

Chairman BOUSTANY. Thank you.

Ms. Lav.

Ms. LAV. I would not say that 8 percent is the exact right number right now. As Mr. Kurtter said, a number of pension funds are bringing that down, and one needs to figure out what the right number is. But CBO's preferred method is using municipal bond rate, adjusted for its tax exemption, and as they note in a footnote, there are a number of anomalies to that idea. This is for disclosure. I should back up and say they say that that does not mean that that should be the way that funds contribute.

As I said, those are two different things. But even using municipal bond rate for disclosure has its problems. For example, the bond rate is higher in the States with the weakest fiscal system. So you have a situation with a higher rate, you have lower pension liabilities disclosed if you have the worst fiscal system because your bond rate, the interest you have to pay is higher. That doesn't make any sense. Also, if you compare with corporate bonds, which have interest rates in the 6, 6½-percent range, they use their bond rates to discount liabilities. But everybody knows that corporate bonds are more risky than municipal bonds. So they get to use a higher discount rate and show lower liabilities because their bonds are more risky than State and local bonds? So there is some basic fundamental problems with these conceptions that don't necessarily make sense in the actual world.

Chairman BOUSTANY. Thank you.

Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman. I want to thank each of you for being here this morning. This question is for the entire panel. My time is limited, so I ask each witness to answer either yes or no to the following question.

Do you support closing public pension plans?

Mr. STAPLETON. No.

Mr. BARRO. It depends on the State, but in most cases yes.

Mr. GOLD. I am sorry. I missed a word. I am not very good at hearing. Do I support what?

Mr. LEWIS. Closing.

Mr. GOLD. No, I do not.

Mr. KURTTER. Moody's does not have an opinion on that matter.

Ms. LAV. No, I do not.

Mr. LEWIS. Do you have a personal opinion or are you speaking for Moody's.

Mr. KURTTER. I am speaking for Moody's.

Ms. LAV. No.

Mr. LEWIS. Let me just ask, does closing public pension plans save money? Ms. Lav?

Ms. LAV. No.

Mr. LEWIS. Why not?

Ms. LAV. If you have unfunded liabilities that exist from past service or from market losses, you still have to pay off those unfunded liabilities. And if on top of that you are creating a defined contribution plan, you haven't lost those liabilities. You still have to pay them off, and you have to put money into a defined contribution plan. And in fact, a defined contribution plan for any given level of retirement security you want to provide for your employees, which is important for attracting quality employees, then you have to put more money in a defined contribution plan like a 401(k) kind of plan because then you don't have the benefits of pooled investment and professional management.

Mr. LEWIS. Ms. Lav, I would like to understand more about the people who benefit from public pension plans.

Ms. LAV. Sure.

Mr. LEWIS. What type of State and local workers are eligible for public pension plans?

Ms. LAV. Most State and local workers benefit, so we are talking about first responders, we are talking about correction officers, we are talking about teachers, we are talking about social workers and nurses and bus drivers, schoolbus drivers, a whole range of State and local workers.

Mr. LEWIS. To continue, how much, on average, do these retirees receive in pension benefits?

Ms. LAV. Across States, the Census reports that they receive an average of about $23,000 a year.

Mr. LEWIS. Could you tell us whether all State and local workers participate in Social Security?

Ms. LAV. No. All State and local workers do not participate in Social Security.

Mr. LEWIS. What are the exceptions?

Ms. LAV. The exceptions are quite a number of teachers, about 40 percent of teachers and a majority of public safety workers like police and fire, and then there are some States, a few States, where most of the workers don't participate. So those workers need more from their pensions because they don't also have Social Security.

Mr. LEWIS. Could you tell the Members of the Committee what is the purpose behind providing workers with pension benefits? What is the intent?

Ms. LAV. Well, first of all, studies that do what we call apples-to-apples comparisons find that public workers particularly at middle and higher income, or middle and skilled areas, are paid less than their private sector counterparts. So pensions are part of their compensation.

But in general, it is important that people have retirement security. And this is part of how State and local governments attract quality workers to do the work. And so they provide deferred compensation as well as current compensation. It is a choice that has been made, an important one.

Mr. LEWIS. Thank you. I thank all members of the panel. Mr. Chairman I yield back.

Chairman BOUSTANY. I thank the Ranking Member.

Mr. Buchanan, you are recognized 5 minutes.

Mr. BUCHANAN. Thank you, Mr. Chairman, for doing this most important hearing. I also want to thank our colleague, Congressman Nunes, because I think it is very critical. I just think back, we were being in business for a lot of years we had profit sharing plans and 401(k)s that we have now. But I look back on the last 10 years and if you take a look at S&P, for example, they are flat-lined.

So my point is, I am looking at these, I was thinking in 2008 I was sitting around with a bunch of people having dinner at Christmas just before that news, maybe 15, a lot of them were investors and everything, and the market, everybody lost a third of their net worth then.

So when we talk about someone put a number together at 8 percent or 4 percent or 12 percent, in these uncertain times, you can come up with any number you want. I always refer back to the rule of 72 that if you have an 8 percent number, it doubles in 9 years. But the bottom line, these are different times. So it just seems like we have to reassess where we are at. We need more transparency so that it doesn't lead everybody into bankruptcy.

So I will start with you, Ms. Lav. What do you think a number should be today when you are looking to put together what you might have to pay out in the next 10 or 20 years, what number? Because if you look at the bond rate, maybe there has been some appreciation, but if I look at interest rates today, it is almost free money if you are going to go into Treasuries, and the equity markets have been zero for 10 years on average, but historically for a lot of years, they were 10 percent.

But where do you even begin to get a number that makes any sense? That is why I am concerned as more people retire, someone mentioned 8 percent, do we need to be dealing with 1 percent? What makes sense going forward for the workers?

Ms. LAV. I am not going to put a specific number on it. I haven't done that research. That is not what I do.

But I do know it is not—it is very unlikely to be 4 percent. You know, I think that it would be somewhat irresponsible for States and localities just to invest in Treasury bonds. I think that would not make any sense. That would not——

Mr. BUCHANAN. But you understand the S&P, in the last 10 years, went down, has been down, it has been flat-lined at zero and it went down 38 percent in 2008. How do you get to a number of 4, 6, 7 percent with any confidence going forward?

Ms. LAV. Well, I mean pension returns have not been, the returns to pension funds have not been zero.

Mr. BUCHANAN. What have they been in the last 10 years?

Ms. LAV. In the past couple years, they were in the double digits, they were down in the recession——

Mr. BUCHANAN. Do you know what the returns have been in these pension funds on average? Take them across the board. What is the average for the last 10 years? Do you have any idea? I don't even know that number, but I know my overall returns have not been good.

Ms. LAV. I think CBO had a number, it was in the neighborhood of 3 percent or something like that. But this was through two back-to-back recessions. I certainly don't think you necessarily want to

plan for the future of having two recessions, one of them the largest since the Great Depression within 10 years, I don't think that that is a realistic way to plan either, to assume that that is going to happen.

Mr. BUCHANAN. These are different times today. I am an optimist, but at the same token, the reality of it is a lot of people are reassessing where they are at. I can't tell you—I represent Florida—how much retirees that were hoping to retire based on a 6, 8, 4 percent number. They are not seeing those returns, so now they are working longer and those kinds of things.

Mr. NUNES. Would the gentleman yield?

Mr. BUCHANAN. Yes.

Mr. NUNES. Mr. Buchanan, I want to thank you for your kind words on the bill. I want to make sure, I know the bogeyman is out here and people are talking about 4 percent or 3 percent and the detractors to this bill that are against transparency continue to use that rate of return as if that rate of return was meant that the Federal Government is now going to say this is what the return is going to be.

The purpose in drafting the legislation had nothing—when we looked at that rate, was to do nothing other than to protect the workers from the employers, meaning the government. Because really, when we look at that discount rate of today, which would be around 4 percent, it is not to do anything but compare oranges to oranges or apples to apples, so that you can compare a plan in Fresno, California, to a plan in Florida. And that was the purpose of this discount rate. That is why we put this in there just to have a conservative rate so you would be able to compare these plans across State lines and from entity to entity.

Mr. BUCHANAN. I thank the gentleman. But I guess my point in saying all this is I was trying to work toward the uncertainty that we have faced in the last 10 years. And we need more transparency. And I appreciate your effort.

Thank you.

I yield back.

Chairman BOUSTANY. I thank the gentleman. Ms. Jenkins, you are now recognized for 5 minutes.

Ms. JENKINS. Thank you, Mr. Chair.

And I want to thank you all for being here today.

I find it a bit ironic that Congress, which doesn't have the political will to take action to fix Social Security is here today talking about our grave concern with our State and local government pension plans.

So I am not sure that any of us have much credibility on this issue. But I have great respect for the panel in particular as a former president of the National Association of State Treasurers, a State treasurer myself, and a board member on our public employee retirement system in Kansas; I really have the utmost respect for State treasurers. So I would like to address some questions to Treasurer Stapleton.

Some have commented that this bill, H.R. 567, is unnecessary because the Government Accounting Standards Board, GASB, already provides standards for State and local pension plans. I would just like your response to that.

Mr. STAPLETON. This is not the case. GASB standards, in my opinion, have basically permitted plans not only to adopt their own rates of return, but basically act like the wild West when it comes to assuming plan returns. That is why there are no credible levels of comparison between plans.

I spoke earlier about differences in amortization length. Obviously, the longer the amortization period, the less you have to write off in a given amount of time. Under the Financial Accounting Standards Board, which governs the private sector it is a much shorter length of time to write off plan assets.

I have been very disappointed with the oversight of the Government Accounting Standards Board and their refusal to transparently invest in information that will allow public policymakers to make informed decisions. I see this bill as a nonpartisan bill, as a bill to increase information, whether 4 percent is the right rate of return, I can guarantee you that 8 percent is not the right rate of return. If you go into the insurance market and try to get a private contract or somebody to guarantee you a rate of return, you will never find somebody that will guarantee you an 8 percent rate of return.

States have increasingly tried to regulate the insurance industries, and when they have done that, they have required plans to have more assets than liabilities. And so if GASB had done its job or would do its job and require the same standards that are applicable in the private sector, we wouldn't need to be here today. But it is refusing to do that. And so plan members are not getting a uniform level of information to assess liabilities. And public policy makers need this information for State governments to responsibly respond to these liabilities because the fact of the matter is that plans are not taking the advice of their own actuaries.

Just look at what happened which was chronicled in The Wall Street Journal with Calpers a few weeks ago. They told the board to lower the rate of return, then they started getting letters in from school districts, from local governments around the State that said, we cannot afford for you to lower the rate of return. And they said, we are going to discount the professional advice of our actuaries and create in effect a deferred liability for future generations. And we cannot allow that to happen.

Ms. JENKINS. Excellent. Thank you. The bill, the Public Employee Pension Transparency Act, is not mandatory, but does condition the continued ability to issue tax exempt bonds upon filing certain information about State and local pension plans to the Internal Revenue Service. As a State elected official, do you think that is fair?

Mr. STAPLETON. Absolutely. This does not force compliance. There is a carrot, which is tax exempt bond financing. But even if States comply, after they comply and issue this information back to the plan holders and back to their States, they still don't have to adopt the rate of return. It is just a way to get greater information.

And as I said earlier, I asked Mr. Attmore at the Government Accounting Standards Board what is the problem with providing a sensitivity analysis of different discount rates? Let's look at 8 percent, let's look at 6, let's look at 4 percent, but let's make sure that

public policy makers at the State level have a wide range of information from which to reach conclusions. And he said no, in the coming standards, that they will not provide that information.

Ms. JENKINS. And finally in your testimony, you said overestimating a pension system's expected return is essentially gambling with the financial welfare of the next generation of Americans. Can you explain what this gamble places at stake for the next generation? And is it fair to say that this gamble could also impact the current generation through decreased services, increased taxes?

Mr. STAPLETON. One of the things that opponents of this legislation and of transparency with public pension plans in general like to point out is they try and make apples to oranges comparisons with private sector plans. They will say, well, look at the underfunding in private pension systems. The problem is that structurally you are talking about two different things.

First of all, as I mentioned earlier, private plans have a different valuation assessment for what their liabilities are. They peg it to high-yielding corporate bonds at 6 percent. That does not happen in public pension plans where the expected rate of return equals the actual rate of return. But structurally, unless I am an investor in a private company with a lucrative defined benefit plan, I don't really care, because I am not going to be on the hook.

But in the public pension system, all taxpayers at the State level are on the hook if the plans become insolvent because the State of Colorado is not going to let the Jefferson County School District go insolvent without finding a way for funding. And we are bankrupt, like a lot of States. And the only people that can actually make up the difference are the taxpayers. And that is why it is important that we have this level of transparency so that everybody can know where we stand and can take public policy actions to remedy what I believe is a very serious problem.

Ms. JENKINS. Thank you, Treasurer.

I yield back.

Mr. BOUSTANY. Thank you.

Mr. Kind, you are now recognized for 5 minutes.

Mr. KIND. Great. Thank you, Mr. Chairman.

I thank the panelists for your testimony here today. As a Democratic representative from the great State of Wisconsin, I have to admit we kind of received our fair share of attention in the last couple of months in the media, both at home and nationally.

This may seem a little heretical to my Democratic colleagues up here on the dais, but I commend Governor Scott Walker and what he did. I think what he proposed in the State of Wisconsin was incredibly bold and courageous in recognizing the deep fiscal hole that we were in and coming forward with the bold proposals that he did.

And quite frankly, the fact that hundreds of thousands of people showed up in subfreezing weather, braving bitter wind chills, blowing snow, bitter winds in their face in both the square in Madison and virtually every city throughout the State of Wisconsin, I have to believe they wouldn't have done that if they had all the facts, if they knew the real fiscal crisis that our State was facing and how boldly the Governor was really trying to address these issues.

Because if they had known that the State public pension fund was only funded at 99.8 percent and that that 2 percent—.2 percent shortfall was creating a deep fiscal hole for our State, I cannot believe that they would have been out there for weeks and months on end protesting what the Governor was trying to do with the State public pension system. I mean, they wouldn't have been so selfish and so self-centered in the demonstrations that they were conducting throughout the State of Wisconsin.

No, I think not.

I think those individuals, those workers, those families knew exactly what they were doing when they were out there protesting what the Governor and the Republican legislature was trying to jam down their throats. This had nothing to do with the budget crisis that the State of Wisconsin was facing.

In fact, Governor Walker was just here in this town a few weeks ago and admitted in testimony before Congress that his assault on worker rights had absolutely nothing to do with the budget situation that we face in the State of Wisconsin.

In fact, they stripped that portion out of the bill and therefore admitted before the entire world that it had nothing to do with the budget implication.

But nevertheless, the public employees knew that they had to be a part of the solution, and they were willing to contribute more to their State public pension system. They were willing to contribute more to their health care system.

In fact, Governor Walker got every concession that he was asking for from those public employees, but that wasn't good enough. He had to go after those worker's rights and strip that away, basically telling them, you no longer have a seat at the table, and your voice isn't going to matter anymore, and we are going to jam these decisions down upon you.

So it was not surprising seeing hundreds of thousands of people going out and braving that cold weather and that bitter wind chill day after day protesting what Governor Walker was doing to the State of Wisconsin. If we want to have a serious conversation about the fiscal hole we are facing at the State and Federal and local level, let us talk about the real cause of what is driving these budget deficits, which is rising health care costs.

Now, my Republican colleagues have a proposal on how to deal with it and that is going to the workers of the country, to seniors, to disabled people, the children and saying, you contribute more to your health care plans, and that is it.

They are not proposing anything to deal with rising health care costs. And that is just going to shift the burden more and more on working-class families throughout the Nation.

Or there is another approach that we can take and that is through the health care reform measure that we passed that will reform the way health care is delivered in this country and ultimately how we pay for it. So it is based on the value and no longer the volume of care that is given. And surprise, surprise, this has been a bipartisan agreement for many, many years. Some of the most prominent names in the Republican party from Newt Gingrich, to Bill Frist, to my former Governor and former Secretary at HHS, Tommy Thompson, Mark McClellan, they have all been say-

ing we have to go to a value- or outcome-based reimbursement system in the health care system, or it will bankrupt us. That is what is driving the fiscal crisis at the State and at the local level. That is the largest and fastest growing area of spending at the Federal level. That is what we should be focused on, instead of some one-size-fits-all Washington approach to the State public pension system, 99.8 percent funded in the State of Wisconsin, and yet look at all the attention that we garnered as a State over the last couple of months.

Mr. Chairman, I would like with unanimous consent to submit for the record a letter dated May 4, 2011, to me from the Secretary of the Department of Employee Trust Fund, Dave Stella, from the State of Wisconsin.

Mr. BOUSTANY. Without objection.

[The information follows:]

STATE OF WISCONSIN
Department of Employee Trust Funds
David A. Stella
SECRETARY

801 W Badger Road
PO Box 7931
Madison WI 53707-7931

1-877-533-5020 (toll free)
Fax (608) 267-4549
http://etf.wi.gov

May 4, 2011

The Honorable Ron Kind
United States House of Representatives
Washington, DC 20515

Delivered Electronically

Dear Congressman Kind:

On behalf of the Wisconsin Retirement System (WRS) and its nearly 570,000 members whose retirement security we provide and protect, I am writing to urge your active opposition to HR 567 legislation that imposes one-size-fits-all Federal reporting mandates regarding our pension costs. The Subcommittee on Oversight of the Committee on Ways and Means has scheduled a hearing on the legislation on Thursday, May 5, 2011.

Rather than creating transparency, HR 567, the "Public Employee Pension Transparency Act," would needlessly create turmoil in the municipal bond market and would confuse bondholders, taxpayers and retirees by erroneously claiming our pension trust will soon be exhausted. The legislation reflects a lack of understanding not only regarding the financing of state and local pensions, but also the strong accounting rules and strict legal constraints already in place that require open and transparent governmental financial reporting and processes.

Public plans are established, operated, and overseen in a very transparent manner. Wisconsin's plan is no exception. The terms of public plans typically are set through the legislative process, the plans are overseen by a board of fiduciaries acting in open meetings, and the finances of the plans are regularly disclosed and audited in extensive and detailed publicly available reports prepared in accordance with well-established government accounting standards. Thus, contrary to what the proponents of the legislation suggest, the issue is not a current lack of transparency and disclosure – it is simply an effort to justify a Federal take-over of areas that are the financial and regulatory responsibility of State and local governments.

The WRS has several unique features including risk sharing between members and employers and modest benefit levels, which, when combined with the funding discipline of the State and local units of government across Wisconsin and the professional

management of the assets of the System by the State of Wisconsin Investment Board, makes it one of the best funded plans in the country. The funding strength of the WRS is documented in the latest PEW Center on the States report that was released in April 2011. I have attached a brief fact sheet about the WRS that you may find useful.

HR 567 directly conflicts with existing governmental accounting standards and usurps the role of the Governmental Accounting Standards Board, which is currently in the middle of a multi-year review process of its existing rules in this very same area. Furthermore, the academic study on which this legislation is based is highly suspect. Attached is a critique, along with links to supporting data and reports, of the study's faulty assumptions and recommendations that essentially create a problem in order to solve it.

I hope that we have an opportunity to personally discuss this proposed legislation in the near future.

Sincerely,

David A. Stella, Secretary
Wisconsin Department of Employee Trust Funds
(608) 266-0301

Attachments

Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts

October 2010

As state and local governments lead efforts to address the unprecedented fiscal challenges created by stagnant economies, in the face of aging populations and workforces, the accuracy and integrity of information is more vital than ever. Authors of a new paper, *The Crisis in Local Government Pensions in the United States*, would be more constructive, as well as provide more accurate municipal pension information, if their assumptions were based on historical experience and their methodology appropriate for the government sector. Robert Novy-Marx and Joshua Rauh – who also earlier this year authored, *Are State Public Pensions Sustainable?* – again vastly underestimate projected future contributions to public pension plans and expected investment returns to draw dramatic and improbable conclusions regarding the solvency of these plans.[1] Both papers are based on pension fund assets values as of 2009, prior to the recent improvement in financial markets. Further, their method used to determine future pension liabilities of states and localities is not recognized by governmental accounting standards. The authors additionally ignore changes already underway at the state and local levels to restore long-term pension sustainability, and they make recommendations that would only serve to worsen the financial condition of these plans.

Assumptions of Future Behavior Are Not Supported by Past Practice

The reports' findings are premised on two key suppositions: 1) state and local governments will contribute nothing to amortize past pension liabilities, and 2) funds will generate rates of return commensurate with highly conservative, "risk-free" all-bond portfolios, rather than the diversified portfolios actually in use. These two assumptions are inconsistent with plans' actual experience, as most governments have a history of paying their pension contributions. In fact, according to the Public Fund Survey, from FY 01 to FY 09, on average, pension plan sponsors paid 91 percent of their required contributions. Regarding investment returns, the standard assumption is that pension fund portfolios will earn a real (after inflation) return of 4.5 percent annually, based on the mix of assets they typically hold, and more reasonable given the current ratio of stock prices to trend earnings.[2] Further, analysis shows that public pension funds' actual long-term investment returns still exceed this assumption, even after incorporating losses from the 2008 market collapse.[3]

Projections Are Based on Asset Values Near Their Market Low Point

The authors base their financial analysis on pension asset values as of June 30, 2009, at the end of a 12-month period when the S&P 500 had a return of -26.2%, and prior to much of the market increase that took place the following year. Pension fund asset values have been growing since March 2009, and for the year ended June 30, 2010, median public pension fund investment returns were 12.8 percent, well above plans' typical assumed investment return of eight percent. In addition, historical investment experience over 20-, 25- and 30-year time periods, a more appropriate measure of the long-term investment horizon of public funds, also exceed this assumed rate of return.[4]

The Method Used to Value Future Liabilities Is Inconsistent With Accounting Standards

Another factor driving the authors' findings is the method used to value future pension liabilities, which is not compliant with public sector accounting standards. In fact, the Governmental Accounting Standards Board, which has been reviewing these standards over the past three years, recently affirmed its support for the use of a long-term expected rate of return, rather than the use of current interest rates. In its Preliminary Views, published last June, GASB specifically "considered but rejected" an interest rate-based method for valuing future liabilities (the approach used in the Norvy-Marx-Rauh paper), stating instead that, "The rate used should be a reasonable estimate of the rate at which plan net assets are expected to grow, over a term commensurate with the accounting measurements for which the rate is used, as a result of investment earnings."

[1] Based on original analysis prepared by Paul Zorn and Mita Drazilov at Gabriel, Roeder, Smith & Company, Paul Angelo at The Segal Company, and Keith Brainard at NASRA.

[2] "More Scare Stories About State Pensions at the NYT," Dean Baker, Center for Economic and Policy Research, June 30, 2010.

[3] "NASRA Issue Brief: Public Pension Plan Investment Return Assumptions," National Association of State Retirement Administrators, March 2010.

[4] "Investment Return Assumption for Public Funds: The Historical Record," Callan Investments Institute Research, June 2010.

Analysis Does Not Account for Recent State/Local Pension Changes

More state and local governments have enacted significant modifications to their retirement plans in 2010 than in any other year in recent history.[5] Since 2006, nearly two-thirds of the states have made changes to benefit levels, contribution rate structures, or both[6] and many more local governments also have made adjustments. Ignoring these alterations results in a gross mischaracterization of the current situation and disregards the measured approach that can be and has been taken to *realistically* and responsibly close pension funding gaps.

The Authors' Recommendations Do More Harm Than Good

In response to their dire projections, the authors have suggested that state and local governments should no longer offer pensions to new hires, recommending instead that such employees be covered with Social Security and a 401(k) plan, and that states and cities should issue debt – possibly at a federally subsidized rate – to pay off the added cost of closing pension plans. These recommendations ignore the significant cost and disruption that would be imposed by such changes:

- Mandatory Social Security Adds Billions in Expenses. Conservative estimates of the added expense of mandating newly hired public workers into Social Security are over **$44 billion in the first five years alone,**[7] which would worsen the financial condition of the sponsoring governments and their pension systems.
- Putting New Hires Into a 401(k) Increases Costs. Recent studies have shown that closing pensions to new hires can have several serious, unintended consequences, including increasing administrative costs associated with running two plans, forgoing or undermining economic efficiencies of traditional pension plans, accelerating pension costs for employees in the closed plan, worsening retirement insecurity, and potentially damaging employer recruitment and retention efforts. [8] Moreover, although 401(k)-type plans are a useful means of supplementing pension benefits, they are inherently not as effective or efficient as a primary source of retirement income. By pooling mortality and investment risks, traditional pensions reduce participants' risk of outliving retirement assets and can provide the same benefit at nearly half the cost of a defined contribution plan.[9] Unlike a traditional pension plan, a 401(k) does not include provisions for disability and death benefits, which are especially important for employees in hazardous occupations such as firefighters and police officers, who face higher risks in the line of duty. Without a pension, these benefits would have to be provided through commercial insurance, likely at significantly higher costs to the employer.
- Issuing Debt and/or Asking for Federal Involvement Adds Risk. Proposing that state and local governments should issue debt to fund their pension benefits adds risk to the funding equation. Such debt would become a liability for the sponsoring government. If the markets fall after the funds are invested, the government now has two sets of liabilities: the outstanding debt and the pension liability. Even with a federal subsidy – which is unlikely given current federal government budget constraints and which raises additional challenges – this is a risky approach.[10, 11]

In the wake of the Great Recession, states and cities are examining and adjusting pension benefit levels and financing structures to restore reserves and long-term sustainability. Hyperbole and distortion, as presented in the referenced academic papers, are not helpful to these efforts or to the long-term fiscal health of state and local governments and their retirement systems.

Contact:

Keith Brainard, NASRA Research Director keithb@nasra.org 512-868-2774

Jeannine Markoe-Raymond, NASRA Director of Federal Relations jeannine@nasra.org 202-624-1417

---

[5] "Pensions and Retirement Plan Enactments in 2010 State Legislatures," Ronald K. Snell, National Conference of State Legislatures, October 10, 2010.

[6] "Pensions and Retirement Plan Enactments in 2010 State Legislatures," Ron Snell, National Conference of State Legislatures, May 17, 2010.

[7] "The Cost Impact of Mandating Social Security for State and Local Governments," Cathie Eitelberg, Alexander Sussman, F.S.A., and Leslie Thompson, Revised 2005.

[8] "Look Before You Leap: The Unintended Consequences of Pension Freezes," Ilana Boivie and Beth Almeida, National Institute on Retirement Security, October 2008.

[9] "A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans," Beth Almeida, William B. Fornia, FSA, National Institute on Retirement Security, August 2008.

[10] "Evaluating the Use of Pension Obligation Bonds," *Government Finance Officers Association Advisory* (1997 and 2005).

[11] "Issue Brief: Pension Obligation Bonds: Financial Crisis Exposes Risks," Alicia H. Munnell, Thad Calabrese, Ashby Monk, and Jean-Pierre Aubry; Center for State and Local Government Excellence, January 2010.

Welcome to the Department of Employee Trust Funds

The Department of Employee Trust Funds (ETF) is a non-cabinet state agency that administers various fringe benefit programs for state and local governments in Wisconsin. ETF is 100% funded from the segregated Public Employee Trust Fund (Trust) and no general purpose funding is used in its operation. ETF is overseen by an independent board and its trust funds are held on behalf of ETF benefit program participants.

Wisconsin Retirement System

The Wisconsin Retirement System (WRS) is ETF's largest program, providing retirement benefits for more than 565,000 current and former state and local government employees. As of December 31, 2010, WRS assets were valued at $79.1 billion, making it the ninth largest public pension system in the United States and the 30th largest in the world. The system is 99.8% funded on an actuarial basis and is often referred to as a national leader among public sector pension plans due to its benefit and financial structure, among other things.

Other ETF administered programs include health insurance, life insurance, long-term and short-term disability, employee reimbursement accounts, commuter benefits, long-term care insurance, deferred compensation and the accumulated sick leave conversion credits.

Economic Impact

About 90% of WRS retirees live in Wisconsin and as a result much of their spending is done with businesses within Wisconsin. This spending reverberates throughout the local and state economies, as one person's spending becomes another person's income, creating a multiplier effect. The result being nearly $4.5 billion added annually to Wisconsin's economy from WRS pension payments, according to a national study.

Who is Covered in the WRS

- Teachers (including Milwaukee)
- Local government employees, except city of Milwaukee and Milwaukee County
- State government employees (including the UW System)

Important Figures

1,469: Number of WRS participating employers (1,410 local and 59 state).

73%: Percentage of WRS active employees who work for local governments.

More than 66%: Amount of WRS benefits paid by investment returns.

$3.7 billion: Total annual annuities paid to annuitants for an average annual annuity amount of $24,488.

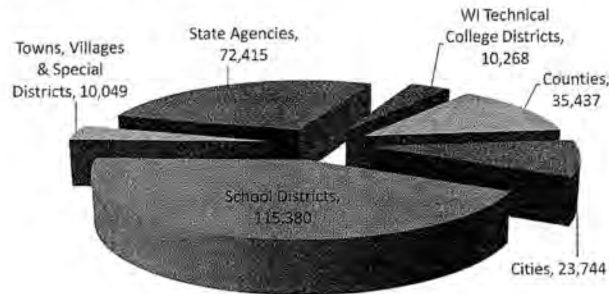
Over 150,000: Annuitant population, which is expected to double to over 300,000 in the next 10 to 15 years, with "baby boom" generation retirements.

ET-8907 (Created 2/1/11)

WRS Participation

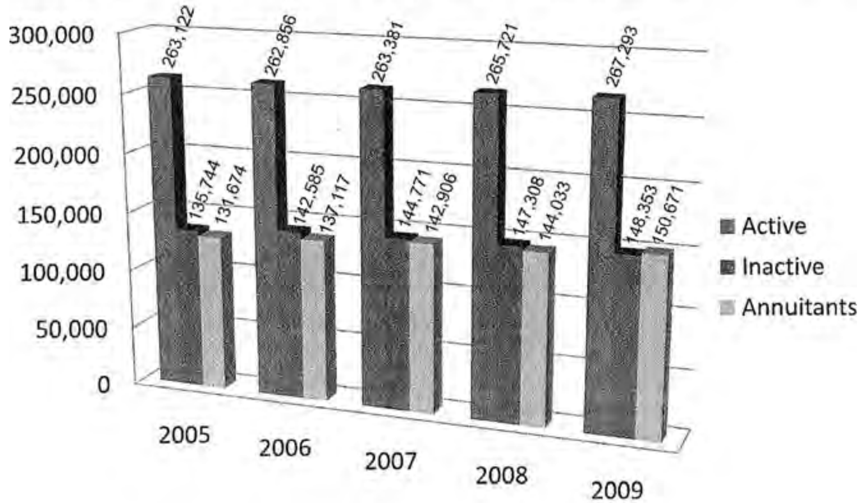
Participants By Employer Type

The following graph shows a breakdown of WRS participation by employer type. School districts represent the highest number of participants with 115,380, followed by 72,415 state agency participants, 35,437 county participants, 23,744 city participants, 10,268 Wisconsin technical college district participants and 10,049 town, village and special district participants.



WRS Participants

The following graph shows the number of WRS participants from 2005 to 2009. Participant numbers of all groups increased yearly, with the exception of an active participant decrease between 2005 and 2006.



Mr. KIND. In the letter, he adamantly opposes H.R. 567.

And, in fact, in the last paragraph—and I quote him—he says, "thus, contrary to what the proponents of the legislation suggest, the issue is not a current lack of transparency and disclosure; it is simply an effort to justify a Federal takeover of areas that are the financial and regulatory responsibility of State and local governments."

For the party that claims to be the party of less government in Washington and more responsibility at the State, proposing this one-size-fits-all approach with this Federal legislation is contrary to even I think your principles. And our own Secretary back in the State of Wisconsin is opposed to this legislation. So I think we could spend a lot more time on the issues that are really driving these budget deficits rather than some type of Washington one-size-fits-all approach.

Mr. BOUSTANY. The gentleman's time has expired. We just had a vote called. There are two votes. One is a 15 and one is a 5. I think what we will do now is go to Mrs. Black for questioning, and then we will recess afterward.

Mrs. BLACK. Thank you, Mr. Chairman.

Under the current government accounting standard for rules, public plans can discount their pension obligations based on expected rates of return on pension assets, as has already been talked about in some detail. By putting their value into the stock market, private equity and other risky investments, State and local plans can decrease the current actuarial value of their liability.

Now, GASB rules are contradictory to basic finance theory that I think has already been said here by a number of our panelists in the practice of financial markets where discount rates are based on characteristics of liability, not asset. And Congress actually had banned this type of accounting for single employer private pensions, but yet we are still using it in the government.

Do you believe that GASB rules encourage State and local governments to take on inappropriate risks with these planned assets? And also, added to that, do you believe that H.R. 567 would have an effect on this practice? And you can start with Mr. Stapleton, if we can, and just go down the panel.

Mr. STAPLETON. Thank you, Mrs. Black.

Yes, I do believe that the lack of uniform standards required by the Government Accounting Standards Board has allowed State plans to very dangerously adopt overrealistic rates of return. Even if you look at an actuarial analysis, which is called a Monte Carlo analysis, that is often provided to States, they talk about the probability of achieving different rates of return.

In Colorado's case, there is almost a 30 percent chance that we will not achieve an 8 percent rate of return. If I told you and other Members of this Committee that there was a 30 percent chance that they would be in a life-threatening car accident on the way to work today, I think I would have a lot of people biking. Yet essentially that is the risk that we are taking day in and day out with the State's tax money, assuming these rates of returns.

Mrs. BLACK. Mr. Barro.

Mr. BARRO. I would agree with that, and I think we see that in the political resistance to plans that are lowering assumed rates

of return. In New York, we just had a reduction in the rate of return assumed for the State employee retirement system and yet, just coincidentally, the plan happened to at the same time adjust other actuarial assumptions with regard to longevity and such that happened to largely offset the effects of the reduction and the rate of return.

So I think there is significant resistance to reduced rates of return. And in order to not lower the rate, you have to invest in an aggressive manner. The other thing I had noticed is that the defense of this aggressive investment is essentially that the government can be indifferent to variability and risk in asset returns. Because the government is going to be around forever, it has this superior ability to take on risk. And the implications of that are really kind of perverse.

Pension funds happen to be vehicles through which we make promises to public employees and through which we invest in assets. But these are fundamentally unlinked activities, and there is no reason that a government couldn't just create essentially a sovereign wealth fund by issuing bonds and using the proceeds to invest in equities. If the government really has a superior ability to take on risk, we should be doing a lot more of that. They should issue as many bonds as they can, use them to buy up as much stock as they can and use that as a cheap source of financing for government activities.

Now, obviously, that makes no sense because it would involve governments taking on tremendous and inappropriate investment risks. But that is exactly what they do through public employee pension plans.

Mrs. BLACK. Thank you.

Mr. Gold.

Mr. GOLD. The best financial theory, brought to our attention by famous economist Fischer Black indicates that pension plans should not be investing in risky assets but should be investing in bonds. I have written that liability measurement using the "expected return on assets" rather than a bond "reference portfolio" does enable, at the very least, and encourage, perhaps, risky investing which financial theory would not support.

Mrs. BLACK. Mr. Kurtter.

Mr. KURTTER. Yes. We think that the preliminary review's report of GASB, their project to review pension and accounting standards for public-sector pensions, this bill, the many reports that have been issued on this subject recently help to increase transparency and improve the quality of the debate between issuers and investors, thereby improving the amount and the quality of information in the market. To the extent that transparency is improved, comparability is improved, we think this helps to create incentives to issuers to help address funding shortfalls and improves the overall quality of information available to investors.

Mrs. BLACK. Ms. Lav.

Ms. LAV. The fact is that over the last 20 or 25 years, the funds have earned close to 9 percent. Over the last 10 years, they have earned 5 percent. I didn't have that number in front of me before. And over the last about 25 years, 60 percent of the revenue to these funds has come from investing. It has been investment in-

come. So it does appear that the funds have invested prudently. They have made very good returns. And I think having them invested entirely in bonds would be wrong for the taxpayers of the State who are missing out on the potential of these returns to finance the pensions.

Mrs. BLACK. Thank you.

Mr. BOUSTANY. The gentleman's time has expired.

We will now go to Mr. Marchant for 5 minutes.

Mr. MARCHANT. Thank you, Mr. Chairman.

Ms. Lav, who in your opinion is the biggest loser if a pension fund goes broke or is severely underfunded?

Ms. LAV. Well, ultimately, the pension funds are in essence backed up by the full faith and credit of the State. So, in the very unlikely situation that a major pension fund would not be able to pay benefits, presumably they would pay it from current tax dollars. That is how they paid—prior to the seventies, all State and local pensions just about were paid on a pay-as-you-go basis. There were not these forward-funded pension funds. And then they started investing and prefunding their pension funds around 1980, and they built up this $3 trillion fund in the pensions.

And pensions are not in danger of not being able to pay their benefits. That is just not the case in most situations. I mean, if you want to look at the most extreme, even Illinois will be able to pay its pensions.

Mr. MARCHANT. So you don't feel like there is any benefit to an additional amount of transparency for the employees that are going to benefit from the pension system?

Ms. LAV. Transparency is a word that is used in a lot of different ways. And when what is called transparency puts up a construct that is different from how much States and localities have to invest in order to make their pension funds whole and to pay their obligations, then you have confusion rather than transparency, in my opinion, because you have two different numbers and people don't know what to think about it. And if they look at an inflated and a very large liability, then some other things are going to happen. People are going to try and raise taxes to fill it. People are going to cut other programs, or they are going to say, oh, we can't keep this pension fund; we are going to have to go to a defined contribution or something else, because of the liability. It is confusion.

Mr. MARCHANT. So your theory is that transparency increases confusion?

Ms. LAV. No, not necessarily any transparency. I am saying that I don't think that what we are talking about here is good transparency.

I think that what GASB is proposing in its new rules is good transparency. It has a much more realistic view of the funding level and the liabilities of pension funds.

Mr. MARCHANT. In my previous career in the State legislature, I served on the Texas Pension Review Board. And it was not a review board that took very seriously its responsibility for years until we got a Governor that decided that maybe we ought to meet and maybe we ought to actually do our job. And our job was simply to just publish the same kind of information that is in this bill. And we found that we got the most resistance from the public entities

that administrated these plans, and we got the most enthusiasm and the most inquiries from the actual employees that once they were able to look at the disclosure and the comparisons of the Dallas Police and Fire Pension Fund versus the El Paso Police and Fire Pension Fund, that is when we began to—our main input came from the employees.

And we found that the increased transparency benefited really the employees because they then began to demand an accountability from the pension funds that they were depending on for their retirement.

I think your first answer was very telling in that, in your opinion, the ultimate loser is not the employee but the State or the entity. And I think that, at some point, the employee needs to be more worried about the content and the investment policies and the transparency of their pension planning and cannot always rely on the State or the county or the city or the school district in bailing a system out.

Ms. LAV. That would be a very rare situation. I think the GASB rules will create the kinds of transparency and comparability that you are talking about, which I think is good and important and——

Mr. MARCHANT. We found that GASB was a reactive entity and not a proactive entity.

Ms. LAV. Well, it has——

Mr. MARCHANT. That was our experience.

Mr. BOUSTANY. The gentleman's time has expired. The committee will stand in recess until we complete the round of votes on the floor. I anticipate it will be about 20 minutes.

[Recess.]

Mr. BOUSTANY. The Committee will resume business.

At this time, Mr. Becerra is recognized for questioning.

Mr. BECERRA. Thank you, Mr. Chairman.

And thank you all for your testimony today. I appreciate that very much.

One of the things that I am sensing is that there is a disconnect between what we are doing here in Washington, including this conversation here, and what the American public is feeling. In a recent survey of the public—and let me go ahead and cite it, the National Institute on Retirement Security's survey, that survey found that the vast majority of Americans believe that the disappearance of pensions has made it harder for them to achieve the American dream. Some 75 percent of Americans believe that. And it sounds like more and more politicians are talking about eroding or eliminating the opportunities for Americans to have these pension plans. Sometimes the public conveys to us that they don't believe that we are listening or that we understand how difficult it is for them to prepare for retirement. Some 80 percent of Americans responded to the survey saying that precise point. And they responded by a percentage of 81 percent saying that they think that we should make it a higher priority to ensure more Americans, not less, that more Americans can have a secure retirement. And so as we hear this discussion about public pensions and we take a look at the real facts, I wonder if the American public is actually not way ahead of us in talking about this. Because if the public believes that we don't get it, they might be right because my under-

standing is that the average pension in America for most public employees is somewhere in the low $20,000s. Not $80,000, not $150,000.

Now, they may be confusing that with the big parachutes and buyout plans that they heard about during this Wall Street scandal where executives were getting billions of dollars or millions of dollars in buyout moneys, even though their companies were failing. But these are public employees who put in many, many years, most of them more than a decade or two, to be able to collect some $20,000 to $25,000 a year in retirement.

At the same time, my understanding is that for most States, the cost of having these pensions for their public employees translates to less than 4 percent of their State budget. Now, I know my State is having a tough time. I know any number of States have been having a hard time. But I daresay that eliminating the pensions that have been paid into by employees over decades and getting rid of the opportunities for American workers to lead out their lives in retirement and dignity is not what folks would expect of us. I have to believe that the teachers who have been paying into the system who have been working for so many years, the firefighters, the police officers, the public employees throughout America who have been working for less money than their private sector counterparts, because pay scales in the public sector are a little lower, but they get a little bit stronger and better protected pension benefits; I have to believe that those American workers are saying, you are not listening to us; well, we want some help, but please don't target our pensions at a time when we want the most safety.

So I have a question to ask. Is it the case that there is any State that has said to us, we need to have a Federal bailout of our pension system? I know Illinois was mentioned.

Ms. Lav, you may have already commented on this I was told. But has Illinois requested a bailout from the Federal Government for its pension program?

Ms. LAV. No, it has not. In a 472-page budget, there was one phrase, not even a sentence, which says; "significant long-term improvements will come only from the additional pension reforms, refinancing the liability and seeking a Federal guarantee of the debt, or increasing the annual required contributions."

So there was that one phrase in which a Federal guarantee was mentioned. But a couple of weeks later, The Wall Street Journal asked Governor Quinn, and there is an article which says he said, no, no, we are not planning on doing that.

Mr. BECERRA. Let me ask a quick question. Is there anyone that challenges the figure that the average pension benefit for public employees throughout America is around $23,000, $24,000 a year?

Ms. LAV. That comes from the U.S. Census.

Mr. BECERRA. So no one would question it.

Ms. LAV. No.

Mr. BECERRA. Does anyone question that the average cost for a State throughout the country or the 50 States is somewhere around 4 percent or less of their State budgets?

Ms. LAV. Right. The most recent data shows 3.8 percent.

Mr. BARRO. I would challenge that idea.

Mr. BECERRA. Okay. Mr. Barro.

Mr. BARRO. That is a measure of the actual cash payments made by governments. That is not the cost of pension benefits that are being provided.

Mr. BECERRA. Doesn't that go to the question of what we are talking about in terms of a State's budget? A State is budgeting for a fiscal year, not for 20 years from now.

Mr. BARRO. Well, that is part of the problem.

Mr. BECERRA. If I could finish my point. And so while I think where you are heading is that we want to make sure that these pension plans are solvent for years to come just the way we want Social Security to be solvent, we wouldn't use today's money that is contributed for a program we need today to pay for a program that has to go long term. And so what we have to do is deal with the long-term costs of the pension program through—and I know my time is expired, if I could just finish this point—we want to deal with the long-term costs of the program through long-term solutions, not short-term solutions. So the short-term solution of fixing a State budget should not be foisted on a long-term program that has been funded for decades and is supposed to last for decades to try to solve a short-term State budget, which is caused principally by the downfall, the economic recession and so forth.

So it could be in a few years we are doing very well, and that means that pensions will be doing very well. So what we want to do is budget long term for pensions, not have a short-term sight and deal with State budgets through our pension programs for our workers.

Mr. Chairman, thank you for allowing me the additional time.

Mr. BOUSTANY. The gentleman's time has expired.

Mr. McDermott, you are recognized for 5 minutes.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

This morning we are gathered once again to watch the Republicans attack the middle class and watch them ignore the problem of jobs in this country.

Although there is a twist this morning because this is a Subcommittee that has no jurisdiction whatsoever on pending legislation. They had to find a Committee that would have the hearing because other Subcommittee chairmen would not attack unions, so they brought it into this Committee.

Now, we are sitting here while they cynically abuse the Committee process to beat up on the working people of this country. If the public wonders why our politics are polarized, it is because of all of the incremental steps of abuse. This morning is another example.

Let us be clear: The Republicans hate defined benefit pensions, whether it is Social Security at the Federal level or it is a public pension at the State level. They want rid of them all.

That is what Wisconsin was about, and it is what this whole exercise here today is. Now, instead of focusing on jobs, they are going after their political enemies, once again, the regular whipping boys, the unions. Let us drag the unions out here and kick the living daylights out of them when, in fact, they are not the problem.

Unions built this country. They built the highways, the ports, the schools. They created fairness, the 8-hour work day, safe working conditions, health care, pensions. They are not the robber barons in this society. And union workers are under attack because they haven't gotten poor enough. They are under attack because they haven't given up, as they showed in Wisconsin.

After two decades, the eighties and then the 2000s, where the Republican policies led to huge deficits, transferring most of the wealth to the top 5 percent in this country, you would think they would be satisfied, but they aren't. Here we are, back to the same old stand, attacking the pensions of policemen and firefighters and teachers and sanitation workers. Now, it is good that we found who the enemies are in this society; the police, the firefighters and the teachers and the sanitation workers. Let's take away their pensions. Let's destroy the system we have developed in this country.

There is no problem with most State pensions. The State of Washington is 99 percent financed. Wisconsin is 99 percent financed. If you look at all the records that come from all of the agencies, the Pew Foundation and others, and it is very clear that these pensions are not in trouble in most places. There are some States, but for the Federal Government to leap in to fix New Jersey or Illinois or whatever and make Washington go through that process is an abrogation of State rights, and there is no sense in doing it.

Some of the witnesses here have said things about public officials at the local level, which I think you ought to take back, because some of them have been very responsible. In my State, we have a functioning system that is well financed.

Now, the CBO put a report out and the chairman kindly put it into the record.

And, Ms. Lav, I would like you to comment on this line in this: It says, "by indicating a larger amount of underfunding, adopting a fair-value approach and reporting pension financing could indicate a need for significant increase in funding which would further strain State budgets, despite the fact that on average a much smaller increase in funding might turn out to be significant to cover pension plan funding."

It sounds to me like what they are trying to do with this bill is jack up the pressure on States; therefore, they will dump the pension plans. Is that a fair reading of what this bill is about?

Ms. LAV. Well, I think that is a pretty fair reading. I think that some of the sponsors have said that, as is indicated in my written testimony.

I think that what it will do is create this idea that there is just this massive underfunding, and people will demagogue that. You would have it all in one place. You have a so-called transparent—maybe it is on a Web site and everything, and with these very large liabilities, and people are going to demagogue and say, oh, my God, we can't afford this, and it is going to create pressure either to eliminate the plans or pressure to cut other spending or pressure for higher taxes. And given the volatility of the bond markets and people that invest in State and local mutual funds that—mutual funds for State and local bonds——

Mr. MCDERMOTT. Let me stop you there, because you brought up the bonds, the bond market.

Mr. Chairman, I would ask unanimous consent to put into the record the Huffington Post article called "Credit Rating Agency Analyst Covering AIG, Lehman Brothers Never Disciplined." I think we ought to have a hearing on that.

I yield back the balance of my time.

Mr. BOUSTANY. Without objection, that report will be put in the record.

[The information follows:]

Shahien Nasiripour
shahien@huffingtonpost.com | HuffPost Reporting

Credit Rating Agency Analysts Covering AIG, Lehman Brothers Never Disciplined

First Posted: 09-30-09 06:08 PM | Updated: 11-30-09 05:12 AM

Analysts at the three biggest credit rating agencies who gave positive, investment-grade ratings to AIG and Lehman Brothers up until their collapse have not been fired or disciplined, the heads of the agencies admitted at a Congressional hearing today.

Moody's, Standard & Poor's, and Fitch Ratings all maintained at least A ratings on AIG and Lehman Brothers up until mid-September of last year. Lehman Brothers declared bankruptcy Sept. 15; the federal government provided AIG with its first of four multibillion-dollar bailouts the next day.

Under questioning by Rep. Jackie Speier (D-Calif.), Raymond W. McDaniel, Jr. of Moody's, Deven Sharma of S&P, and Stephen Joynt of Fitch said the analysts in charge of ratings for the now-disgraced firms are still employed.

McDaniel defended Moody's ratings of Lehman Brothers by pointing to the government-engineered rescue of Bear Stearns in March of 2008, arguing that it played an important role in Moody's analysts maintaining an A rating on the now-bankrupt firm. Joynt said his analysts have since done "a lot of thoughtful soul-searching."

The big three rating agencies have come under fire since the 2007 collapse in the subprime home mortgage market for issuing rosy ratings on a plethora of securities that are now considered to be junk. The Obama administration and Congress are exploring various reform proposals.

At the hearing today, the exchange between Speier and the agency chiefs was particularly contentious.

"You had rated AIG and Lehman Brothers as AAA, AA minutes before they were collapsing. After they did fail, did you take any action against those analysts who had rated them?" Speier asked. "Did you fire them? Did you suspend them? Did you take any actions against those who had put that kind of a remarkable grade on products that were junk?"

McDaniel answered first. "No, we did not fire any of the analysts involved in either AIG or Lehman," he replied. "An important part of our analysis was based on a review of governmental support that had been applied to Bear Stearns earlier in the year.

"Frankly, an important part of our analysis was that a line had been drawn under the number five firm in the market [Bear], and that likely number four would be supported as well. Additionally..."

Speier then interrupted him.

"But that's not analysis," the first-term Congresswoman shot back. "That's an opinion. I can have that kind of an opinion, and I'm not an analyst. How could you possibly make that kind of a decision based on an opinion when you have millions of people relying on that?"

"Our opinion applies to whether we believe an instrument will pay or will not pay," McDaniel responded.

"That was a political determination that you made, Mr. McDaniel," Speier retorted.

S&P's Sharma said his analysts also were not fired. Joynt of Fitch said the same. He said that Fitch analysts in charge of Lehman Brothers and AIG were "disappointed" and "surprised."

In an interview with the Huffington Post after the exchange, Speier said she was "flabbergasted" by the responses.

"It just makes the case over and over again of the lack of accountability in the financial services industry," she said. "It's heads they win, tails the public loses."

The analysts "should have been disciplined, and they should have gone back and looked at their modeling, which was flawed to begin with. We don't need your political opinions [off which] to base a rating of a security," she added.

"For all the talk of all this being such a deliberative, scientific process...to have this decision was remarkable to me."

Mr. BOUSTANY. I would remind the gentleman that it is a little unseemly to impugn motives of Members of the Committee and other Members of the House. The purpose of this hearing is simply to explore the issue of transparency and whether or not the accounting methods being used accurately depict liabilities.

So, with that, the chair now recognizes Mr. Nunes.

Mr. NUNES. Thank you, Mr. Chairman.

I also would like to remind the Committee here that when the public employee transparency bill was introduced in the House, it was the House Parliamentarian that referred the bill to the Committee.

Also, it amazes me that now CBO is part of the vast right wing conspiracy to take out public employee unions. I have a quote here that I would like to read from another far right winger. Some of you may recognize the name of Mayor Willie Brown, the Mayor of San Francisco. He was also the California assembly speaker for many years. I guess he is now a right winger because I am going to read this, and he must be against unions. But here is his quote: "The deal used to be that civil servants were paid less than private-sector workers in exchange for an understanding that they had job security for life. But we politicians, pushed by our friends in labor, gradually expanded pay and benefits to private-sector levels while keeping job protections and layering on incredibly generous retirement packages that pay ex-workers almost as much as current workers. Talking about this politically is politically unpopular and potentially even career suicide for most office holders. But at some point, someone is going to have to get honest about the fact that 80 percent of the State, county and city budget deficits are due to employee costs. Either we do something about it at the ballot box or a judge will do something about it in bankruptcy court. And If you think I am kidding, just look at the city of Vallejo."

So when the bill was put together, it was put together to protect the employees. And Ms. Lav, it amazes me that you don't believe that transparency is good for the employees. Why is it that you want to hide the numbers from the public employees?

Ms. LAV. I think transparency is very good.

Mr. NUNES. You said earlier that it would create confusion.

Ms. LAV. Well, because I am saying that I am not defining forcing this estimation of liabilities at a riskless rate as transparency because I think it is more in the category of something that is not relevant particularly to the level of contributions that State and local employees should be making to their plans. And what should be disclosed to people is how much it is that this State and this locality have to put into their plans to reach full funding over the next couple of decades as we recover from these back-to-back recessions.

And that is the amount that I think you should be transparent about so people have an idea, so employees have an idea, so the public has an idea, so the investing public and everybody else has an idea what has to be put into those accounts.

Mr. NUNES. The bill allows for basically two basic things. One is for the pension plan to show how they feel they are going to meet the needs. The other is this discount rate that you seem to

be fixated on and that the left seems to be fixated on. And for some reason, you can't get off this fixation about 3 percent, 4 percent, 5 percent. The truth of why the rate was picked is what I said earlier to Mr. Buchanan, is so that you would have a conservative ability to compare public employee pensions across the line. And I will also say that it amazes me how this has now turned into a union-Wisconsin vast conspiracy bill here when I think half of the public employee pensions are actually for non-union employees. So, I think hopefully we can just really raise the rhetoric level down a little bit here. This is a good government bill. It is trying to create transparency so that public policymakers can make better decisions.

And with that note, Mr. Stapleton, could you just kind of comment on—I know you didn't get a chance to respond to some of the Members on the Democrat side and some of their accusations, so I would like to give you an opportunity to respond.

Mr. STAPLETON. Thank you, Congressman Nunes.

I would simply say that everybody benefits in my opinion from greater information. I think that a risk-free rate of return is absolutely as justifiable, if not more justifiable, than assuming an 8-percent rate of return.

In Colorado, we had the market returns compounding—the market compounding at nearly 18 percent over the last 20 years. And as a result, our plan was only fully funded once. To assume that we are going to have that type of run-up again over the next 20 years is a complete fallacy. Also, the notion that everybody is contributing the same amount is a fallacy.

Using Colorado as an example, Congressman, we have government workers, who according to this year's budget, have been asked to contribute a mandatory of 12.5 percent of their paychecks into the pension system. The problem in Colorado is that government workers only represent 15 percent of the membership in the pension system. Everybody else, all 85 percent of other members, schoolteachers, higher education, local government workers, they only have to contribute 8 percent, and they get the same benefits. So if we are talking about fairness here, let's have everybody contribute the same amount. Let's have everybody retire at the same age; not some get to retire at 60, others get to retire at 58. There is no uniformity, and Colorado is not alone. Many States don't have uniformity in contribution levels or retirement ages. So this is about economic fairness.

Mr. BOUSTANY. The gentleman's time has expired.

Mr. NUNES. Mr. Chairman, I would like to just thank all of the panel for being here today and for their contribution. I know they spent a lot of time on these public employee pensions, and I appreciate the panel's time today.

And I appreciate your time, Mr. Chairman, for holding this hearing.

Mr. BOUSTANY. I thank the gentleman. Let me just remind Members on both sides that we want to try to keep from impugning motives and stick to really what the heart of the subject is. And it was really dealing with the transparency, the accounting methods and ultimately, are these pension plans fair to the workers at the end of the day? So we will continue to work on this issue. And

I want to thank the panelists for joining us today. You all have been very helpful. Please be advised that Members may have written questions that they will submit to you. And those questions and answers will be made a part of the official record.

With that, this hearing is now adjourned.

[Whereupon, at 11:27 a.m., the Subcommittee was adjourned]

[Questions for the Record follow:]

Questions from Representative John Lewis

Question 1: An observation was made during the hearing that retirees who were expecting a 6 or 8 percent return on their retirement investments were sorely disappointed in their ability to retire on account of the recession and the drop in asset values. Could you please explain the advantage that a defined benefit plan offers to participants in contrast to a defined contribution plan in terms of retirement asset volatility and any one participant's expected retirement date?

Answer 1: In a defined contribution plan, the employee bears the entire risk for his or her retirement security. There are at least two kinds of risk that employees bear. 1) During his or her working lifetime, he bears the risk that he will make the right kinds of investments to grow the account to a sufficient size to allow a decent income in retirement. This can be extremely difficult for an unsophisticated investor. 2) In addition, there is a risk of the timing of retirement. Many holders of defined contribution plans want to "annuitize" their accounts at the time of retirement so that they will receive a steady stream of retirement income over their remaining life. The monthly annuity they would receive, however, is highly dependent on the amount in the account at the time of retirement, so an employee who retires during a down market such as in the recent recession is unlikely to have sufficient income from his or her defined contribution plan.

By contrast, a defined benefit plan pools the risk of all the employees in the plan. It utilizes professionals to invest its assets and generally experiences lower investment fees, so money invested is likely to grow at a more rapid rate. In addition, a pension fund has a long time horizon. An employee who retires during a down market can still get his or her full pension, because the plan can recoup investment losses at a later time. No individual employee suffers because of the timing of his or her retirement.

Question 2: You were asked during the hearing whether H.R. 567 was good for employees and you responded that, while transparency is good, the disclosure required under H.R. 567 would not result in transparency. Could you please provide more detail on this point?

Answer 2: The term "transparency" implies that the public will be provided with useful information to help them understand the issue that is the object of the transparency. The term "transparent" means "readily understood." As I have testified, I believe that H.R. 567 would sow confusion rather than clarify the funding status of state and local pensions. The calculation of liabilities based on using Treasury Bond yields that is required by the legislation would likely lead the public and many policymakers to believe that the amounts that states and localities need to deposit in their pension plans each year are substantially larger than the amounts actually needed. Thus the data that would be provided under this legislation would not help make pension funding more understandable, but in fact would obfuscate the issue to some degree.

Questions from Representative Ron Kind

Question 1: Could you please provide information on the historical investment returns of public pension plans over the long term (for example, 30 or 25 years) and the returns of such plans over the short-term (for example the last 10 and 5 years and the last year)?

Answer 1: Over the 25 years ending 12/31/2010, the average annual investment return has been 8.8 percent. Over the past 10 years, it has been 5% and over the past 5 years it has been 4.5%. The last year, 2010, it was 13.1 percent.

Although there were substantial losses during the last two recessions, which pulled down the growth rate for the past 10 years and the past 5 years, strong growth in recent years has allowed pension funds already to recoup about two-thirds of the $900 billion in asset losses they experienced during this most recent recession.

Question 2: A recent CBO issues brief on public pension plan funding was introduced into the record at the hearing and one of the concerns noted in the brief regarding the use of a riskless rate to discount plan liabilities is the volatility of the plan liabilities from year to year. You make the same observation in your written testimony — for example, what sort of fluctuations would have occurred in the past if the riskless rate had been used?

Answer 2: Between 1980 and 1985, the yield on 30-year Treasury Bonds — a proxy for the riskless rate — exceeded 10%, peaking at 13.45% in 1981. The yield then hovered between 7% and 9% for the next 7 years, and between 5% and 7% through 2002. Between 1977 and 2002, the yield averaged 8.4%, as compared with a yield close to 4% today.

There was some substantial year-to-year volatility: a 2 percentage point increase from 1979 to 1980, and a 3 percentage point drop from 1985 to 1986, for example. The latter could have required a sudden increase in contributions. Rates have changed less dramatically recently, but the 1990s were characterized by year-to-year drops and increases in the one-half to one percentage point range. Yields were 4.91% in 2006, but less than 4% today. And each percentage point difference in the discount rate may have a substantial effect on required contributions, averaging something like one percent of state and local budgets.

It is worth noting that the period with the high yields was also the period in which state and local governments were transitioning from pay-as-you-go to pre-funded pension plans, a transition that began in the 1970s. If plans had at that time estimated their liabilities using Treasury bonds as the benchmark for their discount rate, they would have been required to deposit only small amounts into their pension funds, and funding arguably would not have grown to reach full funding in 2000.

Testimony by another witness at the hearing, Jeremy Gold, illustrates the lack of connection between the Treasury rate and the funding needs of a pension plan.

Gold wrote: "Based on recent data reported by various sources (and analyzed by Novy-Marx and Rauh among others), revealing massive unfunded liabilities…, it is very likely that future taxpayers are going to be severely burdened by pension obligations incurred in conjunction with public services that have already been rendered. This has not always been the case. A similar analysis, had it been performed any time during the 1980's would have revealed significant pension plan surpluses… attributable to the high rates of interest available in the U.S. Treasury markets compared to relatively low rates used to value public pension plans at that time."

In other words, if the same amount of assets and promises as exists in today's pension had been analyzed using 1980s interest rates, the results would show overfunding rather than today's unfunded liabilities.

[Submissions for the Record follow:]

Statement for the Record
of the American Federation of State, County And Municipal Employees (AFSCME)
for the
Hearing on the Transparency and Funding of State and Local Pensions
before the
Subcommittee on Oversight
Committee on Ways And Means

U.S. House of Representatives

May 5, 2011

Mr. Chairman and members of the Subcommittee, on behalf of the 1.6 million members of the American Federation of State, County and Municipal Employees (AFSCME), please include the following statement for the record on the hearing held on May 5, 2011 on the transparency and funding of state and local pensions. In particular, AFSCME would like to state its strong opposition to H.R. 567, the Public Employee Pension Transparency Act. This legislation is an unnecessary response to exaggerated problems, and it would harm state and local government employees and lead to reduced retirement security.

Pensions play an important role in the operations of state and local governments, yet retirement systems remain a small part of state and local government budgets and are not a major cause of state and local fiscal problems. In fact, according to the Boston College Center for Retirement Research, public pension expenditures account for less than 4% of state non-capital spending. Moreover, pension benefits are paid out of a trust that public employees contribute to, not out of general operating revenues, and the employee contribution rate typically amounts to 5-10% of wages and, in recent years, these rates have been raised in many states.

It is true that state and local fiscal conditions remain difficult as revenues have fallen and as Recovery Act assistance winds down, but pension obligations are not the cause. The poor national economy has been the largest contributor to the poor fiscal conditions in state and local governments, not pension costs. Starting in December 2007, the U.S. economy suffered the longest and deepest recession since World War II. More than eight million jobs have been lost, housing and retails sales declined, and sub-prime mortgage foreclosure problems resulted in slashed property values and diminished business profits, all of which contributed to state and local budgetary problems. The result was a precipitous decline in revenue. Moreover, the stock market plunge also caused huge losses in savings and retirement earnings across the board, but especially for pension earnings. Rather than overspending, state and local government budgetary problems have been primarily caused by national fiscal and economic challenges.

Unfortunately, these economic conditions provided the opportunity for opponents of defined benefit plans to attack public pensions and falsely accuse them of being the primary cause of state and local fiscal problems. They are attempting to bolster the case by grossly overestimating the liabilities of public pension plans. But, the facts tell a far different story. Most state and local government employee retirement systems have substantial assets to weather the current economic downturn and to meet current and future obligations.

The great majority of public pension funds are not in crisis. They are operating as they were designed to operate and where problems exist – they are being addressed. To deal with specific funding problems, more than half the states made significant changes to their pension plans in recent years. While some plans may be underfunded, this can be addressed by long-term solutions on a case-by-case basis.

While every investor was affected by the 2008 financial market collapse, most state and local government retirement systems have a strong track record in managing their assets and a much greater time period to recover from economic downturns than do other retirement plans. The public sector pension model is a proven vehicle for preserving a secure retirement for American workers.

Public pension plans collectively pre-funded about 80% of their future pension obligations – even after considering the steep losses in 2008 and earlier this decade. In April, 2011, the National Association of State Retirement Administrators (NASRA) reported for the period ending December 31, 2010, the median annualized public pension fund investment return over the last 20 years is 8.7% and over the last 25 years, it is 8.8%. NASRA also reported that aggregate state and local government retirement system assets are now 25% higher than on June 30, 2009. Thus, public pension investments have rebounded from recessionary declines and many are now gaining double-digit returns.

Public employee pensions are an irreplaceable source of security for public employees. Yet, average public pension benefits are far from lavish. The average retirement benefit for public employees, including firefighters and teachers, is $22,600, and for AFSCME retirees it averages $19,000. AFSCME members typically contribute towards the cost of their pension. While government employers have in some instances failed to regularly contribute to their employees' plans, public workers have contributed year in and year out.

Many of the problems that do exist relate primarily to employer underfunding and recent investment losses. Where there are significant problems, most notably in the states of New Jersey and Illinois, the primary cause is employer underfunding and recent investment losses that similarly affected defined contributions plans. For example, Governor Chris Christie of New Jersey failed to make the state's estimated pension contribution amounting to $3.1 billion in 2010 and has not committed to make this year's payment.

The so-called Public Employee Pension Transparency Act (PEPTA) is inappropriate and unnecessary. AFSCME opposes PEPTA, introduced by Reps. Devin Nunes (R-CA), Darrell Issa (R-CA) and Paul Ryan (R-WI), because it imposes a new unnecessary federal mandate requiring state and local public pension plans to use an extremely low rate of return to calculate estimated future investment gains which would have the effect of drastically inflating their reported financial liabilities. H.R. 567 would also sow unnecessary confusion because these new federal requirements would conflict with the accounting standards dictated by the Governmental Accounting Standards Board (GASB).

H.R. 567 in reality does nothing to increase transparency. Extensive public pension reporting already takes place at the state and local level where these pension plans are organized and operated. State and local plans already report all of their financial data in Comprehensive Annual Financial Reports (CAFR) which are audited and publicly available. And, as previously noted, state and local government retirement systems are also already required to adhere to the strict accounting standards set by the GASB which is an independent standard-setting body. In short, PEPTA is not needed.

H.R. 567 is an ideologically motivated attempt to reduce the retirement benefits of public sector workers, including law enforcement officers, firefighters, teachers, social workers and nurses. It is also an unwarranted intrusion into the historical and proper domain of the states. As such, AFSCME is strongly opposed to H.R. 567 and urges its rejection.

INTERNATIONAL ASSOCIATION OF FIRE FIGHTERS

Statement of

Harold A. Schaitberger
General President
International Association of Fire Fighters

Hearing on "Transparency and Funding of State and Local Pension Plans"

Before the

The House Ways and Means
Subcommittee on Oversight

May 5, 2011

Introduction

Chairman Boustany, Ranking Member Lewis, and all the distinguished members of the House Ways and Means Subcommittee on Oversight, I welcome the opportunity to provide this statement for today's hearing on "Transparency and Funding of State and Local Pension Plans." As the General President of the International Association of Fire Fighters (IAFF), I speak today on behalf of the nearly 300,000 men and women who risk their lives to provide fire rescue and emergency medical services protection to over 85 percent of our nation's population.

In addition to having the honor of representing these courageous Americans, I also speak as someone who has spent the better part of his professional life focusing on retirement security issues for first responders and other public employees. After serving as a Lieutenant in the Fairfax County Fire Department, I served as a public member of the County pension board. Upon my arrival in Washington, DC, I served as Counsel to both the National Conference on Public Employee Retirement Systems and the National Association of Government Deferred Compensation Administrators. And as President of the IAFF, I have greatly expanded our organization's emphasis on retirement issues, creating a new Pension Department. In total, I have spent four decades championing public pension transparency and accountability.

Fire fighters know firsthand the true meaning of the word "sacrifice." Indeed, we were again reminded of the ultimate sacrifice that 343 of our brothers made on September 11 when we learned of the demise of Osama Bin Laden. Although the death of this murderer can help bring closure to the surviving widows and children of the 9/11 victims, it gives me no great comfort to know that the next disaster, the next fire, the next attack, could force our brothers and sisters to once again make that ultimate sacrifice.

For the IAFF, shared sacrifice does not end there. Our members are sharing in the sacrifice that far too many Americans are making at their kitchen tables when confronted with difficult choices over their budgets. In state capitols and city halls all across our great country, our members are making voluntary budget concessions to help balance state and municipal budgets. We make these hard choices because we know that to fully recover from the worst recession since the Great Depression, all Americans must carry this great load. "A house divided cannot stand," said Lincoln, and as fire fighters, we know the wisdom of this phrase all too well.

But there are limits to what the IAFF can endure. When politicians attack our pension plans, they attack our pension safety-net, which has evolved to meet the specific needs of fire fighters. That is why this hearing and the underlying legislation, H.R. 567, the "Public Employee Pension Transparency Act," give the IAFF great alarm.

H.R. 567 should really be renamed the Public Employee Pension **Elimination** Act because that is what the bill will ultimately do. Reporting a pension's financial status based on the "riskless rate" would dramatically exaggerate the plan's unfunded liabilities. This would give the false impression that pension plans are going bankrupt and lead to calls to eliminate defined benefit

pension plans altogether in favor of 401(k)-style defined contribution plans. In the end, fire fighters would be left without the critical safety-net that makes our current pension system irreplaceable.

Is There A Public Pension Crisis?

This distinguished subcommittee is not the first in the 112th Congress to explore the issue of public pension plans. Both the House Oversight and Government Reform Committee and the House Judiciary Committee have held hearings with prominent scholars that explored public pensions and their impact on state budgets. Most recently, the American Action Forum hosted a Capitol Hill briefing that explored the question, "Are Employee Pensions the Cause of the Financial Crisis in the States?" that featured prominent conservative scholars from the American Enterprise Institute, the Heartland Institute, and the Manhattan Institute.

At every instance, conservative and liberal scholars alike all agreed that public pensions are not to blame for the current fiscal crisis in the states. That's because only 3% of state expenditures are related to paying employee pensions. The budget deficits facing states throughout the nation are the result of decreased revenue and increases in spending on health care and education. Pensions have nothing to do with the shortfalls, and pension reforms will not solve the problem.

It is also misleading to say that public pension plans are in a liquidity crisis that requires immediate federal intervention, or worse, a bailout. The highly-respected Center for Retirement Research at Boston College issued a report in March 2011 that examined this issue. They concluded, "Most state and local plans had made great strides in improving their funding discipline and management in recent decades, so they had a relatively solid foundation in place before the two financial crises hit. For that reason, even after the worst market crash in decades, state and local plans do not face an immediate liquidity crisis."[1]

It cannot be stressed enough that the vast majority of public pension plans are on sound financial footing with an overall funded status of 77.4%.[2] While the downturn in the stock market has posed challenges, most plans will be able to recoup their losses. Those plans that need to make changes are already doing so. In the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures, or both; many local governments have made similar reforms.

It is true some public pensions, such as plans in Illinois and New Jersey, are seriously underfunded, but they are the exceptions, not the rule. The reason they are dangerously underfunded is because the state refused to make their required annual contributions during good times and now are paying the price. In no way should these few bad apples be considered the norm.

---

[1] Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, and Laura Quinby. "Can State and Local Pensions Muddle Through?" Center for Retirement Research at Boston College, March 2011, 3.
[2] 2011 NCPERS Public Fund Study Preliminary Results, 2.

Of course, the tried and true does not make for good news. That's why titles like "The Public Pension Time Bomb" and the "Trillion Dollar Gap" make for good headlines. It's easy to examine public pension plans during the worst economic recession since the Great Depression and conclude that public pensions will need a federal bailout.

But that's like going to Texas, which is enduring a severe drought, and concluding that the state will soon become one giant desert. Such limited snapshots in time fail to incorporate decades of past performance and the historic circumstances of the present moment. Clearly, it will rain again in Texas, just as investment assets in public pension plans will rebound.

According to a recent survey by the National Conference on Public Employee Retirement Systems, investment returns (and not taxpayer dollars) constitute about 66 percent of fund revenue; the rest is made up by employee (10%) and employer (24%) contributions. As the markets improve, so too will the funding levels of public pension plans.

Given time, along with targeted reforms to benefit and contribution levels for plans requiring it, public pension plans will be able to pay their obligations. No plan is anticipating the need for a federal bailout, and the unprecedented federal intrusion into state and local governments that H.R. 567 embodies is simply unwarranted.

The Public Employee Pension Elimination Act

The IAFF is strongly opposed to H.R. 567. Contrary to what its supporters have said, the bill is not a benign attempt to shed sunlight on the books of public pension plans. If that were all it truly did, the IAFF would be ardent supporters. Fire fighters clearly benefit by having access to information about our pension plans, and the IAFF has been the nation's leading proponent of public pension transparency over the past several decades. These efforts have led to the reporting and disclosure requirements in place in every state that ensure that information about our pension funds is publicly and readily available.

Moreover, the Government Accounting Standards Board (GASB) is in the process of updating their new standards on how public pension plans report their finances. As you may know, GASB is a private, non-governmental organization that establishes accounting principles for State and local governments. While GASB's recommendations don't carry the force of law, the financial markets closely follow GASB and will penalize those plans that don't adhere to GASB's standards. The new rules GASB is expected to announce this year will be written by financial experts who are far better equipped than politicians to decide the most appropriate rates that plans should report. H.R. 567 would impose an unnecessary and duplicative reporting requirement.

H.R. 567, however, is not about providing better transparency. It's about providing bad numbers that will make public pensions look bankrupt. At its heart is an attempt to force public pension plans to value the discount rate at a "riskless" rate of return that would be equal to the Treasury

bond rate of about 4%. The problem is the "riskless rate" isn't grounded in reality. The simple fact is public pension plans don't invest solely in Treasury bonds. They have a diversified portfolio of investments that include stocks and bonds that historically have produced a much higher rate of return than Treasury bonds.

Requiring reporting of the unfunded liabilities based on the riskless rate is simply a naked attempt to scare the public into believing that public pension plans are going bankrupt. The point is to create the political will to convert them into defined contribution plans to the benefit of Wall Street.

Overall, defined benefit plans are superior to defined contribution plans in many ways. Defined benefit plans have much greater return on investments than defined contribution plans and have lower administrative costs. Defined benefit plans also weather the ups and downs of the stock market better than defined contribution plans, and do not penalize workers who reach retirement age during a market downturn.

Fire fighters and their families would be especially hard hit if our defined benefit plans were dismantled. As a matter of public policy, state and local governments have determined to provide earlier retirement ages for public safety officers than other occupations. Many jurisdictions have mandatory retirement ages which require a person to leave their job at a certain age.

We have helped structure defined benefit pension plans that allow for the earlier retirement ages of fire fighters and law enforcement officers. Defined contribution plans, which are dependent solely on the amount of money contributed rather than a benefit formula, undermine the policy goal of having a younger, more physically fit, public safety workforce. We do not believe it is wise public policy to force a fire fighter to remain on the job after they are no longer capable of performing their duties solely because a market downturn robbed their DC plan of the funds they needed to retire.

Our DB plans also address the high rates of disability in public safety occupations. Working with our employers, we have designed our pensions to protect the retirement security of those who lose their ability to earn a living because they placed themselves in harm's way to protect their neighbors. 401(k)-style defined contribution plans provide no such protections and jeopardize the financial security of those who serve in dangerous occupations.

Finally, I want to touch on the myth of the overly generous pension. While DB plans have proven to be essential for the retirement security for our members, their pensions are by no means lavish. While there have been a few widely reported cases of people unfairly gaming the system, the typical pension received by a fire fighter who works a full career is less than $35,000 a year. Moreover, most fire fighters are not covered by Social Security, so this modest benefit may be all they have to live on.

The image of lavish pensions being paid to retirees living high on the hog is both false and deeply offensive to the men and women who put their lives on the line to earn their retirement.

Conclusion

For several generations, defined benefit plans have provided the nation's fire fighters with a fair retirement in exchange for risking their lives to keep the public safe. Attempts to undermine these plans and force fire fighters into DC plans so that Wall Street can reap larger profits are unacceptable. For this reason, we strongly oppose HR 567.

But if you don't want to take my word for it, then I would implore you to heed the advice of a prominent conservative public policy advocate. Eli Lehrer, Vice President of the conservative Heartland Institute, recently wrote a defense of public pensions in the *Weekly Standard*. I will reserve the last word for Mr. Lehrer:

> Given that pension systems are not all that expensive, very difficult to change, and in better shape than some assume, there's a strong practical case for directing budget cutting attention elsewhere. State and local governments also have a strong comparative advantage relative to private industry in offering pension benefits: State governments never go out of business and can count on rising gross revenues so long as their populations grow … In principle, therefore, state governments are much better positioned to offer pensions than the typical private corporation and can offer them more cost effectively. Since many of the most common government jobs—firefighter, police officer, corrections officer, regulatory overseer—have no direct private sector analog, the lifetime-with-one employer career path scorned by many in the private sector makes a lot of sense for government employees.[3]

[3] Eli Lehrer, "Pensions Aren't the Problem," *The Weekly Standard*, March 28, 2011, http://www.weeklystandard.com/articles/pensions-aren-t-problem_554833.html

Statement for the Record
at a Hearing Before the
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

May 5, 2011

Transparency and Funding of State and Local Pension Plans

Submitted on Behalf of the

National Association of Counties
National League of Cities
United States Conference of Mayors
International City/County Management Association
National Association of State Auditors Comptrollers and Treasurers
International Public Management Association for Human Resources
National Council on Teacher Retirement
National Association of State Retirement Administrators

On behalf of the national organizations listed above, representing state and local governments, officials and public retirement systems, we submit the following comments for the public record.

In response to the recent unparalleled financial market decline that impacted all investors, state and local governments have been reviewing the long-term sustainability of their retirement systems. These governments, their plans and their employees (who share in the financing of their pension), working through state and local legislative and regulatory structures, have made an unprecedented number of changes to benefit levels, financing structures, or both, and more continue to do so. Given the differing plan designs, financial conditions and fiscal frameworks across the nation, a diverse range of solutions will be required for each, and one-size-fits all federal mandates will only serve to hinder rather than help state and local recovery efforts.

State and local governments have rigorous accountability requirements set in statute and through regulation, and follow stringent accounting standards in accordance with Generally Accepted Accounting Principles (GAAP). Similar to how financial reporting requirements for federal agencies are set by the Federal Accounting Standards Advisory Board (FASAB), reporting for state and local governments and their pension plans are adopted by the Governmental Accounting Standards Board (GASB). Both FASAB and GASB were established recognizing fundamental differences between governments and businesses, which require unique accounting and financial reporting standards essential for public accountability and for an efficient and effective functioning of government.

State and local government retirement systems follow GAAP standards established by GASB and are currently required to report all of their financial data in Comprehensive Annual Financial Reports (CAFRs), which are audited, publicly available and can be easily accessed by anyone. The CAFR contains considerable information about the pension fund's liabilities, asset values, assumptions, rates of return, annual required contributions, as well as other pertinent information. State and local retirement systems are also subject to open records statutes, Freedom of Information Acts, open meeting and sunshine laws, and other public accountability requirements.

Federal proposals such as H.R. 567 would levy a whole new and conflicting Federal reporting regime on top of these existing state and local structures. In addition, they would paint a misleading picture of public finance and impose costly measures far more conservative than Federal law requires even of corporations. Further, the legislation threatens the current tax exempt status of state and local government bonds if any of the numerous and complex calculations imposed are deemed insufficient by Federal agencies.

Thus, our organizations wrote to all members of Congress earlier this year to register our strong opposition to H.R. 567, noting this legislation creates a dangerous precedent with regard to federal taxation and regulation of state and local governments. In addition, the proposal represents a fundamental lack of understanding regarding the operations and funding of public pensions and the strong accounting rules and strict legal constraints already in place requiring open and transparent governmental financial reporting and processes.

GASB is an independent standard-setting body that regularly reviews the reporting requirements of states and localities. H.R. 567 inappropriately preempts a formal, multi-year project in which GASB has been examining its current accounting and reporting standards for state and local government pensions, and in which proposed new disclosure requirements are expected shortly.

Further, this legislation ignores the extensive efforts made at the state and local levels to close short-term budget deficits as well as address longer-term obligations such as pensions. Inaccurate and misleading descriptions of the state of public finance and pensions are unhelpful and Federal intrusion into areas that are the fiscal responsibility of state and local governments are unwarranted. At a time when Congress and the Administration are both discussing the need to remove regulatory barriers, it makes little sense to impose disruptive and costly federal mandates that interfere with state and local government recovery efforts already underway, do not allow states and localities to adopt tailored solutions to meet their unique long-term needs, and set a dangerous precedent with regard to Federal taxation of state and local government bonds.

We welcome the opportunity to work with the Committee as you further examine these important issues. We have attached a fact sheet on public pensions for your review, as well as a summary of what H.R. 567 does and does not accomplish. If you have any questions or would like additional information, please do not hesitate to contact our organizations' legislative representatives:

Deseree Gardner, National Association of Counties, (202) 942-4204
Neil Bomberg, National League of Cities, (202) 626-3042
Larry Jones, United States Conference of Mayors, (202) 293-7330
Elizabeth Kellar, International City/County Management Association, (202) 962-3611
Cornelia Chebinou, National Association of State Auditors Comptrollers and Treasurers, (202) 624-5451
Barrie Tabin Berger, Government Finance Officers Association, (202) 393-8467
Tina Chiapetta, International Public Management Association for Human Resources, (703) 549-7100
Leigh Snell, National Council on Teacher Retirement, (540) 333-1015
Jeannine Markoe Raymond, National Association of State Retirement Administrators, (202) 624-1417

Attachments (2)

The Public Employee Pension Transparency Act
("PEPTA" HR 567/S 347)

State and local governments have rigorous accountability requirements set in statute and through regulation, and follow stringent accounting standards in accordance with Generally Accepted Accounting Principles. HR 567 and S 347 would nevertheless levy a whole new and conflicting Federal reporting regime on top of these existing state and local structures, paint a misleading picture of public finance, and impose costly measures far more conservative than Federal law requires even of corporations. Further, the legislation threatens the current tax exempt status of state and local government bonds if any of the numerous and complex calculations imposed are deemed insufficient by Federal agencies.

What the bill does:

- ***Creates a worrisome precedent regarding federal regulation of state and local governments and taxation of their bonds***
  - Mandates a costly and complex layer of Federal reporting on top of existing state and local accounting and reporting.
  - Gives Federal regulators sweeping powers to impose duplicative requirements on State and local governments already struggling to comply with existing Federal paperwork burdens.
  - Jeopardizes state and local financing of infrastructure and other critical needs by stripping the tax exempt status on bonds issued by state and local governments if new regulations are not met to the regulators' satisfaction.
  - Creates confusion as to which entities are required to report information to the Federal government and penalizes state and local governments that issue municipal bonds for simple, unintended reporting errors.
  - Threatens far-reaching and unintended consequences for the municipal bond market and the economy as a whole.

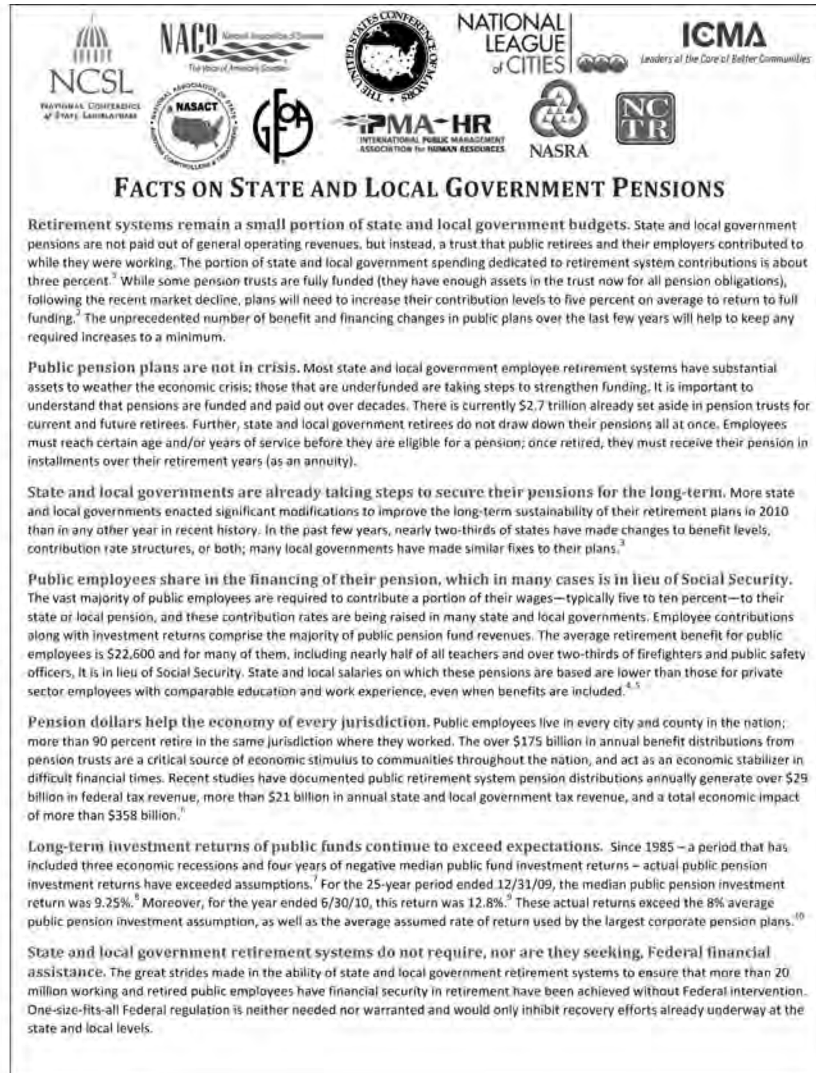
- ***Falsely depicts the true condition of state and local governments and their retirement systems***
  - Requires state and local governments to report as though they are invested only in U.S. Treasuries, not the diversified portfolios actually in use. This would create a false picture of the true condition of public pension plans and mislead taxpayers, alarm retirees, frighten investors and confuse policymakers.
  - In 2006, Congress rejected similar public reporting requirements for corporate pension plans because the private sector argued, just as the public sector is now, that such reporting significantly increased costs and volatility, and was irrelevant. The U.S. Chamber of Commerce testified that "these calculations are among the most burdensome and costly procedures a plan can ever endure," "would not provide relevant information in the majority of cases," and "this information would unduly alarm plan participants."
  - Creates the false impression that one state's pension system can be directly compared with that of another state by ignoring important differences in the sovereign entities and political subdivisions that sponsor these programs, as well as the unique demographic make-up, cost-of-living, inflation factors, mortality rates, and fiscal condition of each.

What the bill does NOT do:

- ***Does NOT lower taxpayer costs***
  - The Federal government does not guarantee state and local government employees' pensions, and no public pension plan is asking for Federal financial assistance. This is a red herring.
  - At a time when both Congress and the Administration want to remove regulatory barriers, this bill would impose complicated, costly Federal mandates that will only interfere with state and local recovery efforts.

- ***Does NOT increase transparency and understanding regarding state and local government retirement systems***
  - PEPTA is not about transparency. Public pension reporting is already transparent.
  - State and local government retirement systems are currently required to report all of their financial data in Comprehensive Annual Financial Reports (CAFR), which are audited, publicly available and can be easily accessed by anyone. The CAFR contains considerable information about the pension fund's liabilities, asset values, assumptions, rates of return, annual required contributions, as well as other pertinent information.

- ***Does NOT improve public pension accountability***
  - State and local government retirement systems are already required to adhere to strict accounting standards set by the Governmental Accounting Standards Board (GASB). This independent standard-setting body regularly reviews the reporting requirements of states and localities.
  - PEPTA inappropriately preempts a formal, multi-year project in which GASB has been examining its current accounting and reporting standards for state and local government pensions and is expected to issue proposed new disclosure requirements in mid-2011.
  - In 2010, an unprecedented number of states made changes to their pension benefits, contribution requirements, or both, and many more states are expected to follow suit in 2011 – all done without the need for Federal intervention.
  - One-size-fits-all Federal mandates that interfere with state and local government recovery efforts already underway, do not allow states and localities to adopt tailored solutions to meet their unique long-term needs, and set a dangerous precedent with regard to Federal taxation of state and local government bonds, simply make poor public policy.



Facts on State and Local Government Pensions

Retirement systems remain a small portion of state and local government budgets. State and local government pensions are not paid out of general operating revenues, but instead, a trust that public retirees and their employers contributed to while they were working. The portion of state and local government spending dedicated to retirement system contributions is about three percent.[1] While some pension trusts are fully funded (they have enough assets in the trust now for all pension obligations), following the recent market decline, plans will need to increase their contribution levels to five percent on average to return to full funding.[2] The unprecedented number of benefit and financing changes in public plans over the last few years will help to keep any required increases to a minimum.

Public pension plans are not in crisis. Most state and local government employee retirement systems have substantial assets to weather the economic crisis; those that are underfunded are taking steps to strengthen funding. It is important to understand that pensions are funded and paid out over decades. There is currently $2.7 trillion already set aside in pension trusts for current and future retirees. Further, state and local government retirees do not draw down their pensions all at once. Employees must reach certain age and/or years of service before they are eligible for a pension; once retired, they must receive their pension in installments over their retirement years (as an annuity).

State and local governments are already taking steps to secure their pensions for the long-term. More state and local governments enacted significant modifications to improve the long-term sustainability of their retirement plans in 2010 than in any other year in recent history. In the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures, or both; many local governments have made similar fixes to their plans.[3]

Public employees share in the financing of their pension, which in many cases is in lieu of Social Security. The vast majority of public employees are required to contribute a portion of their wages—typically five to ten percent—to their state or local pension, and these contribution rates are being raised in many state and local governments. Employee contributions along with investment returns comprise the majority of public pension fund revenues. The average retirement benefit for public employees is $22,600 and for many of them, including nearly half of all teachers and over two-thirds of firefighters and public safety officers, it is in lieu of Social Security. State and local salaries on which these pensions are based are lower than those for private sector employees with comparable education and work experience, even when benefits are included.[4,5]

Pension dollars help the economy of every jurisdiction. Public employees live in every city and county in the nation; more than 90 percent retire in the same jurisdiction where they worked. The over $175 billion in annual benefit distributions from pension trusts are a critical source of economic stimulus to communities throughout the nation, and act as an economic stabilizer in difficult financial times. Recent studies have documented public retirement system pension distributions annually generate over $29 billion in federal tax revenue, more than $21 billion in annual state and local government tax revenue, and a total economic impact of more than $358 billion.[6]

Long-term investment returns of public funds continue to exceed expectations. Since 1985 – a period that has included three economic recessions and four years of negative median public fund investment returns – actual public pension investment returns have exceeded assumptions.[7] For the 25-year period ended 12/31/09, the median public pension investment return was 9.25%.[8] Moreover, for the year ended 6/30/10, this return was 12.8%.[9] These actual returns exceed the 8% average public pension investment assumption, as well as the average assumed rate of return used by the largest corporate pension plans.[10]

State and local government retirement systems do not require, nor are they seeking, Federal financial assistance. The great strides made in the ability of state and local government retirement systems to ensure that more than 20 million working and retired public employees have financial security in retirement have been achieved without Federal intervention. One-size-fits-all Federal regulation is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels.

ENDNOTES

[1] NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems

[2] The Funding of State and Local Pensions, Center for State and Local Government Excellence

[3] Pensions and Retirement Plan Enactments in 2010 State Legislatures, National Conference of State Legislatures

[4] The Wage Penalty for State and Local Government Employees, Center for Economic and Policy Research

[5] Out of Balance? Comparing Public and Private Sector Compensation Over 20 Years, Center for State and Local Government Excellence/National Institute on Retirement Security

[6] Pensionomics: Measuring the Economic Impact of State and Local Pension Plans, National Institute on Retirement Security

[7] Investment Return Assumption for Public Funds: The Historical Record, Callan Investments Institute Research

[8] NASRA Issue Brief: Public Pension Plan Investment Return Assumptions

[9] The Public Fund Survey

[10] Milliman 2010 Pension Funding Study

OTHER RESOURCES:

The Impact of Public Pensions on State and Local Budgets, Center for Retirement Research at Boston College

Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts, National Association of State Retirement Administrators

Frequently Asked Questions About Pensions, National Institute for Retirement Security

Research Brief on America's Cities, National League of Cities

NATIONAL CONFERENCE OF STATE LEGISLATURES (WWW.NCSL.ORG)
NATIONAL ASSOCIATION OF COUNTIES (WWW.NACO.ORG)
UNITED STATES CONFERENCE OF MAYORS (WWW.USCM.ORG)
NATIONAL LEAGUE OF CITIES (WWW.NLC.ORG)
INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION (WWW.ICMA.ORG)
NATIONAL ASSOCIATION OF STATE AUDITORS COMPTROLLERS & TREASURERS (WWW.NASACT.ORG)
GOVERNMENT FINANCE OFFICERS ASSOCIATION (WWW.GFOA.ORG)
INTNERNATIONAL PERSONNEL MANAGEMENT ASSOCIATION FOR HUMAN RESOURCES (WWW.IPMA-HR.ORG)
NATIONAL COUNCIL ON TEACHER RETIREMENT (WWW.NCTR.ORG)
NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS (WWW.NASRA.ORG)

May 16, 2011

The Honorable Charles W. Boustany, Chairman
Ways and Means Subcommittee on Oversight
1136 Longworth House Office Building
Washington, DC 20515-6350

The Honorable John R. Lewis, Ranking Minority Member
Ways and Means Subcommittee on Oversight
1139E Longworth House Office Building
Washington, DC 20515-6350

Dear Chairman Boustany and Ranking Member Lewis:

We, the undersigned public employee unions, wish to correct for the record a statement made by Representative Devin Nunes (R-CA) during the Oversight Subcommittee's May 5th hearing on the transparency and funding of State and local defined benefit pension plans. In an exchange with witness Iris J. Lav, Representative Nunes stated that his legislation (H.R 567, the Public Employee Pension Transparency Act) was put together to protect public employees, expressing the view that public employees would benefit from the new federal intrusion into how state and local governments report the financial status of its public employee pension plans.

On behalf of the approximately 8 million public employees our organizations collectively represent, we wish to assure the committee that we neither requested nor would welcome the burdensome and misguided new federal mandates that the legislation would impose. Our organizations strongly support pension plan transparency, and have worked for decades to improve reporting and disclosure requirements. Rather than providing meaningful measures, H.R. 567 could create a distorted picture of plan funding. The bill will not provide transparency as stated. Instead, it will create different measures than plans currently use--creating confusion among decision-makers and potentially leading states and local governments to abandon defined benefit public pension plans. Such a result would unquestionably be detrimental to the men and women employed by states and localities.

Organizations representing public employees are united in our opposition to this legislation, and we take strong exception to any claim that the legislation would benefit them.

Sincerely,

American Federation of State, County and Municipal Employees
American Federation of Teachers
Fraternal Order of Police
International Association of Fire Fighters
National Education Association
Service Employees International Union

Municipal Employees' Retirement System

TO: Committee on Ways and Means / Subcommittee on Oversight

FROM: Municipal Employees Retirement System of Michigan

DATE: May 16, 2011

RE: Written Comments: Transparency and Funding of State and Local Pension Plans and HR 567

HISTORY OF MERS

The Municipal Employee Retirement System (MERS of Michigan) was established by the Michigan legislature in 1945 as the state pension pool system for municipalities. MERS operated under the direction of the Department of Management and Budget until 1996 when the system was removed by the legislature from direct state control. MERS has since operated under its statute as a public nonprofit governmental pension plan, an instrumentality of all the participating municipalities and courts of Michigan.

MERS membership is, and always has been voluntary. MERS offers defined benefit, defined contribution, and hybrid pension plans. Currently of the approximately 890 municipalities in Michigan offering pension benefits, 760 belong to MERS, representing over 2100 separate pension plans. The remaining 130 non-MERS municipalities manage their pension plans individually.

Recent studies indicate that over 91% of the 27,150 MERS plan retirees continue to live in Michigan and those retirees contribute over $451 million annually to Michigan's economy.

All told, there are over 250,000 public sector retirees living in Michigan, and those retirees support 57,300 jobs in Michigan.

FINANCIAL DATA

MERS combines the use of both in house investment management and outside contracted money managers. Currently about 15% of the defined benefit assets and 100% of the defined contribution pension investments are managed in house by MERS. As of April 1, 2011, total assets under investment were at $6.578 billion.

As of December 31, 2009, the average pension benefit in the MERS system was $16,991 a year, or $1416 each month, and it should be noted that National Association of State Retirement Administrators data indicates that nationwide, 28% of municipal employees and 70% of police and fire employees work in positions not covered by Social Security.

For every dollar of pension assets in the MERS defined benefit system, 64 cents comes from investment returns, 26 cents comes from the municipality and 10 cents comes from the employee. As the market downturn from 2008 works its way off the books, in response to robust investment returns in 2009 and 2010 (17.1% and 14.43% respectively) as the economy continues its recovery, assets are likely to further increase, as will the amount of required employee contributions. Additionally, pension system reforms will result in decreasing employer

liabilities thus lowering their required contributions. Collectively, these reforms should decrease the amount of municipal dollars that will be required to fund a defined benefit system in the coming years.

US public pension fund assets comprise about 6% of the total worldwide economy. The 1000 largest public pension systems in the U.S. hold investments of $6.6 trillion, of that, $4.7 trillion are defined benefit plan assets while the remaining $1.9 trillion are in defined contribution.

FINANCIAL ISSUES

There has been much said about the funding sources and funding levels of public pension plans, and based on its experiences MERS has a difficult time understanding how many of the conclusions that are being asserted could have been reached. MERS also questions the general concept that municipalities would be best served by simply closing out existing defined benefit pension programs and placing all new hires into defined contribution plans. Our data and our experience in offering defined benefit, defined contribution and hybrid pension plans along with many other pension-related programs, indicates that in many cases, this is simply not accurate.

In a number of committee meetings, testimony has been given claiming the following:

"Employer contributions are not being made, resulting in serious underfunding situations for public pension funds."

The fact is that at the present time, only four of MERS 760 municipalities are past due in making their required pension contributions (representing about six-tenths of one percent of the total annual required employer contributions). The lowest funding level among the four municipalities is 83%. Historically, delinquent contributions have been almost nonexistent and when late payments do occur, they are typically the result of time lags in the municipality receiving funds due to them (such as a hospital awaiting Medicaid and Medicare payments from the state and federal government). Of the four entities that are currently past due, one is a hospital and one is a community that is in the process of having a Financial Manager appointed by the state. The extremely low rate of delinquent employer contributions is largely due to the mandate of the Michigan Constitution of 1963, Article 9, Section 24, requiring that local governments must prefund annual pension accruals (and make contributions on unfunded liabilities).

"No future employee contributions are likely to be made."

In Michigan, the average employee contribution to municipal defined benefit pension plans is just under 5% of the cost of the plan. Proposed legislation suggested by Governor Snyder would increase the employee contribution towards funding the cost of pension obligations (and 20% for health care, if health care benefits are offered to employees). Even without such legislation, many local government plans have already negotiated increases in the amount of required employee pension (or health care) contributions.

"The investment rate of return is well below what is required to fund public pension plans."

The market return on investment at MERS for 2009 was 17.1%, for 2010 it was 14.43% and the unaudited return on investments for the first quarter of 2011 is 4.33%. The investment return

average for the past 25 years at MERS is 9.52%. The assumed rate of investment return has been 8% since 1981.

"Public pensions are using assumptions that mask serious problems that will result in the financial collapse of public pension systems."

MERS has used what is known as the entry age / normal costs actuarial funding method since 1993. This method requires that a municipality contribute the amount required to advance fund the pension benefits of an employee at the acceptable amount of normal cost for the expected term of their employment at the municipality. Using this method, a municipality is assured that they are regularly making a pension contribution that will cover the pension cost of that employee from the first day on the job until their final day of employment. MERS also uses the practice of "smoothing" investment returns above or below the assumed 8% return over a ten year period. This is done to avoid huge fluctuations in the contribution rates for municipalities from year to year. Smoothing results in more level employer contributions making it easier to budget pension obligations, but results in a municipality paying more than they would pay under a market value system (when returns are less than 8%) and less (when returns exceed 8%). The end result is the same, smoothing simply lessens the annual volatility in the required employer contributions that would result from a straight market value approach.

"Overly rich pension benefits have resulted in huge unfunded liabilities and many states face serious financial problems as a result."

There is no doubt that current financial situations have forced state and local units of government to take serious measures to reduce their short and long-term costs so that employer contributions may be lessened (or abated). As a result, municipalities have reformed pension plans and are seeking additional reforms to further reduce the cost of providing pension and health care benefits.

That said, as mentioned earlier, only four MERS municipalities are past due in making their defined benefit pension contributions. MERS assists municipalities in implementing reforms to limit or reduce both current and future costs, and continues to work with the legislature and Governor Snyder on statewide reforms to all public pension systems in Michigan.

An honest investigation into the states that currently suffer serious financial situations in their pension plans will disclose that this situation is often the result of actions taken by the legislative and executive bodies in those states that have diverted funds that were required or earmarked as employer pension contributions, to other programs. As a general rule, the states that have made their required pension payments enjoy fairly healthy pension systems. In Michigan, the pension systems remain fairly well funded despite the fact that the states' economy has been in a depression for the past ten years, and past governors and legislatures have twice covered shortfalls in the general operating budget by having the pensions use trust funds to cover expenses that were otherwise funded by the general fund. The actuarial funding requirement of the Michigan Constitution of 1963, Article 9, Section 24, has for almost 60 years enforced pension funding discipline on the state and local governments.

PENSION REFORMS IN MICHIGAN

Michigan Governor Rick Snyder and the current legislature have taken drastic measures to reform the structure of the public pension system in Michigan. A handful of these reforms have

been signed into law, many are being considered by the legislature at the present time, and a number will be introduced in the coming months.

MERS has been allowed to play an active role in the development of these reforms, despite the fact that we are not totally supportive of every detail of many of these reforms; we are, in general, agreeable to the reforms and supportive of the efforts to make structural, long term reforms and improvements to the public pension systems.

An example of some of the reform measures include:

Reforms to the Emergency Manager Statute

Far-reaching legislation enacted in March 2011 greatly expands the powers of state appointed Emergency Managers for local units of government and school districts that are in serious financial distress. Among the most important of these newly expanded powers is allowing the Emergency Manager, under specific circumstances to strike any or all provisions of a collective bargaining agreement, remove any or all appointed or elected local officials, including pension board members, and with the approval of the state treasurer, take sole control of the pension system. The Emergency Manager would also have the power to appoint new members to boards including pension boards. When the municipality or school district is returned back to local control, there must be a two year, non-amendable budget in place and collective bargaining agreements in place cannot be changed for five years. The Emergency Manager also has the power to place a pension plan into MERS if the plan is currently independent.

Reforms to State / Local Revenue Sharing Agreements

Governor Snyder has proposed tying future state revenue sharing payments to municipalities based on firm municipal proposals for consolidation of services and pension reform. In order to receive future revenue sharing payments, a municipality must establish a pension plan structure that limits the employer cost at 10% of payroll or below, requires that final average compensation amounts be calculated on at least three consecutive years of employment and limits all one time pensionable payments to 240 hours, and requires that at least 20% of the cost of employee health care coverage be paid by the employee. This language is contained in the 2011 – 2012 General Government Budget that will be approved by the legislature in the next few weeks.

Pension Cost Containment

MERS has drafted legislation that should be introduced in the next few weeks that would put cost containment and anti-pension spiking language into statute that will apply to all local governmental pension plans in Michigan. At the present time, similar limitations exist in the MERS pension systems, but do not apply to the other municipal pension systems in the state.

The proposed amendments would not allow the enhancement of existing benefits or the approval of new benefits unless a pension system is at least 80% funded (using the entry age / normal cost actuarial funding method) **before and after** the proposed benefit change. Where the proposed change reduces actuarial liabilities, the 80% funding requirement does not apply (as the change will correspondingly increase the funding level). In addition, the proposed legislation would require that all pension benefits be calculated on a final average compensation that was calculated on at least three continuous years salary, and limit the amount of unused vacation time, sick time, overtime or other one time payments to a combined total of 240 hours.

MERS expects that these proposals will be approved by the legislature either as stand-alone legislation or as part of a single pension reform bill that is being drafted by the Department of Treasury.

COMMENTS ON HR 567

MERS strongly opposes HR 567 for a number of reasons. In general, we feel that this is an area that always has been, and should continue to be, a state and local responsibility. The federal government, in our opinion, has one role in this matter, and that role is to tell the states and local units of government that the federal taxpayers will not pay for any bailouts, loans or any other form of financial assistance due to pension problems. Beyond that, the federal government should leave it to each state and local unit to address its own problems. There is not a state in the union that has suffered the financial distress that has occurred in Michigan over the past ten years, but despite that, Michigan has been and is taking measures to address this matter. If Michigan can achieve this, there is no reason that every other state in the union cannot do the same in its own backyard.

The bill is also flawed in a number of areas. The requirement that the financial data be based upon market value is clearly designed to reach a desired, preconceived outcome. Basing financial data strictly on market value is an unrealistic requirement that will render any data received as unrealistic. Furthermore, the annual actuarial valuations for each MERS municipality's separate pension plan(s) has for many years reported the market value of assets. Under HR 567's disclosure requirement, most (if not all) governmental pension plans in the country would appear to be underfunded. Requiring the use of so called riskless rates of return will also result in unrealistic data. Requiring MERS to figure their investment rate of return at Treasury bill rates of 4% makes no sense when MERS actual rate of return is 17.01% in 2009, 14.43% in 2010 and 4.33% so far in 2011. It doesn't even make sense when you compare our 25 year return rate of 9.52%, unless, of course, the requirement is aimed at proving a distorted, preconceived conclusion.

MERS cannot understand why the bill has not, to our knowledge, been scored. It is difficult to believe that the US Department of Treasury is going to review and analyze hundreds of thousands of reports at no cost to the federal government. MERS alone has 760 municipal pension plans (containing 2100 separate plans) that would be required to file the report, so the number nationwide would likely be many thousands.

It is also difficult to understand how the federal government would strip the tax exemption from local municipal bonds. In Michigan, it is currently almost impossible to get bidders for municipal bond offerings. Already unattractive to investors, municipal bonds will become completely impossible to sell if the tax exempt designation would be at risk because the municipality failed to file a report that will be filled with nearly useless data.

It is not the intent of MERS to diminish the issue of underfunded pension plans where they exist. States and local governments need to immediately begin to focus on reforms that will be necessary to assure that their plans remain sustainable. MERS has been and is committed to this objective for our members. HR 567, and more importantly, the mind set of those who support the bill are, in our opinion headed completely in the wrong direction.

Great Public Schools for Every Student

Statement of the National Education Association

To the

Subcommittee on Oversight
Committee on Ways and Means

Hearing on
"Transparency and Funding of State and Local Pension Plans"

May 5, 2011

The National Education Association, representing 3.2 million public educators working in classrooms across the country, respectfully submits this statement for the record in conjunction with the above-referenced hearing. We thank the Subcommittee for the opportunity to provide these comments.

NEA strongly believes that all working Americans – public and private sector employees alike – deserve a secure retirement. Part of the American dream is to be able to retire with dignity and security after a lifetime of hard work. Yet, increasingly, more Americans are facing unattractive choices – having to work indefinitely (if they can find a job and are physically able), living in poverty, or being forced to look for assistance from family or government. Without adequate retirement income, older Americans will lack the resources that allow them to live independently, afford health care, and contribute to the economy.

We are deeply concerned by rhetoric and actions being taken at the state level that place the blame for state budget crises on public employees and public sector pensions. We believe the focus on pensions as a solution for budget shortfalls is misplaced, and will only undermine the secure retirement earned by public employees and further jeopardize economic recovery.

Pension Plans Not in Crisis

Public pension plans are not in crisis. Participants do not all retire on the same day and draw down their pensions. On the contrary, pensions are funded and paid out over decades.[1] Pension liabilities are being misused by opponents of public pension plans to confuse the long-term nature of pension obligations with short-term debt obligations. They have created the misguided impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown.

The truth, however, is that public employee retirement systems have substantial assets. There is currently $2.7 trillion already set aside in pension trusts for current and future retirees[2]. Boston College

---

[1] *Facts You Should Know, State and Local Bankruptcy* Municipal Bonds, State and Local Pensions, ICMA, National Governors Association, National Conference of State Legislatures, Council of State Governments, National Association of Counties, National League of Cities, U.S. Conference of Mayors, National Association of State Budget Officers, National Association of State Auditors, Comptrollers and Treasurers, Government Finance Officers Association, and National Association of State Retirement Administrators. February 2011.

[2] Ibid.

researchers project that public pension funds are sustainable and have sufficient assets to pay benefits now and into the future.[3]

The recent Pew Center report, "The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs," may cause unnecessary alarm because the data do not reflect current market conditions. The Pew report is based on the 2008 and 2009 period, following the stock market crash, and the condition of anyone's portfolio during that period would be dismal. Like all investors, public employee pension plans were hit by the downturn in the stock market, but they are durable and efficient and over time, they can recover their losses. Most state and local government employee retirement systems have substantial assets; those that are underfunded are taking steps to strengthen funding.

In contrast to the Pew report, new research by the National Conference on Public Employee Retirement Systems (NCPERS) paints a much different, much more accurate, and far more positive picture. Based on the most recently reported data, public funds had an average one-year return of 13.5 percent. Funds participating in the study reported a 20-year average of 8.2 percent. The NCPES report also found that, "although media coverage has focused on a handful of troubled funds, most funds are managed responsibly and maintain strong funding levels. On average, funds are 75.7 percent funded and continue to work toward full funding.[4]

More state and local governments enacted significant modifications to improve the long-term sustainability of their retirement plans in 2010 than in any other year in recent history. It is not the fault of public employees that some states did not make adequate pension contributions in the past or that Wall Street practices caused the recession and the loss of jobs and billions of dollars in investments. Nevertheless, in the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures, or both, and many local governments have made similar fixes to their plans.[5] Only a year after suffering record investment losses, many of the nation's largest public pension plans are reporting double-digit percentage gains for the budget year that ended in June 2010.

It is important to note that the majority of public employee pension benefits are funded by returns on fund investments—about 75 percent. Although the amount contributed by employers to fund benefits often varies from year to year, the average amount is currently about 9.5 percent, while employees contribute about 6 percent of their salary. Public employees share in the financing of their pension, which in many cases is in lieu of Social Security. The vast majority of public employees are required to contribute a portion of their wages—typically five to ten percent—to their state or local pension, and these contribution rates are being raised in many state and local governments.[6]

Economic Contributions of Public Employee Pensions

Public employee pension checks represent a vital, continuous source of spending in every state, city, and community across America. Some 7.3 million retired Americans receive a monthly pension check, which translates into enormous economic benefits. Spending by retirees provides stability to national, state, and local economies, especially during tough economic times.

Pension dollars help the economy of every jurisdiction. Public employees live in every city and county in the nation; more than 90 percent retire in the same jurisdiction where they worked. The over $175

---

[3] Can State And Local Pensions Muddle Through?, *Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, and Laura Quinby, Center for Retirement Research at Boston College, March 2011*

[4] 2011 NCPERS Public Fund Study, Preliminary Results, April 2011. Study conducted by National Conference on Public Employee Retirement Systems and Cobalt Community Research

[5] *Pensions and Retirement Plan Enactments in 2010 State Legislatures*, National Conference of State Legislatures

[6] *The Wage Penalty for State and Local Government Employees*, Center for Economic and Policy Research; *Out of Balance? Comparing Public and Private Sector Compensation Over 20 Years*, Center for State and Local Government Excellence/National Institute on Retirement Security

billion in annual benefit distributions from pension trusts are a critical source of economic stimulus to communities throughout the nation, and act as an economic stabilizer in difficult financial times. For example, expenditures made from state & local pension benefits for fiscal year 2005-2006:

- Had a total economic impact of more than **$358 billion;**
- Supported more than **2.5 million American jobs** that paid more than **$92 billion** in total compensation to American workers;
- Supported more than **$57 billion** in annual federal, state, local tax revenue;
- Had large multiplier effects. Each taxpayer dollar invested in state and local pensions supported **$11.45** in total economic activity, while each dollar paid out in benefits supported **$2.36** in economic activity;
- Had the largest impact on the manufacturing, health care, finance, retail trade, and accommodation and food service sectors.[7]

Great Public Schools and Retirement Security

Protecting the economic future of public school employees is not only the right thing to do, it is the smart thing to do - it ensures a high quality workforce and a healthy economy. But, in order to retain the most accomplished individuals in our classrooms, we need to take care of them now and in the future. This country demands a lot from its teachers and others who work in public schools and rightly so. Education professionals enter and stay in the profession, not for the money, but because they are dedicated to helping their students learn and prepare for the future. They don't expect to be wealthy, but they do expect and deserve a decent retirement.

Defined benefit plans are a proven tool for retaining accomplished public sector professionals. They provide public sector workers with a more secure and predictable pension than other types of retirement plans. Yet, plan benefits for education employees are modest. The pension of a full career education employee replaces only a portion of the salary earned while working, and educators' salaries are so low that their pension provides only a modest living in retirement. The average retirement benefit for public employees is $22,600 and for many of them, including nearly half of all teachers and over two-thirds of firefighters and public safety officers, it is in lieu of Social Security. State and local salaries on which these pensions are based are lower than those for private sector employees with comparable education and work experience, even when benefits are included.

The Public Employees Pension Transparency Act

NEA opposes the Public Employees Pension Transparency Act (PEPTA), which would require sponsors of state and local government employee pension plans to report funding information annually to the Secretary of the Treasury. Governments failing to do this would lose their ability to issue tax-exempt debt until they comply. The bill would use different measures for the required reporting than those used to fund plans. The measures are also different from what the Governmental Accounting Standards Board (GASB) requires.

Rather than providing meaningful measures, PEPTA could create a distorted picture of plan funding. The bill will not provide transparency as stated. Instead, it will create different measures than plans currently use – creating confusion among decision-makers and potentially leading states to abandon public pension plans.

Conclusion

The real key to viable employee pension plans is to ensure that our economy continues to recuperate in a healthy and responsible way. Instead of looking at taking away retirement security from public employees and demanding unneeded action to change their benefits, we should protect them while working to restore retirement security for all American workers.

---

[7] *Pensionomics:* Measuring the Economic Impact of State and Local Pension Plans, National Institute on Retirement Security

National Conference on
Public Employee Retirement Systems — *The Voice for Public Pensions*

OFFICERS

Pat McElligott, *President*

Mel Aaronson, *First Vice President*

Daniel Fortuna, *Second Vice President*

Tina Fazendine, *Secretary*

Richard Wachsman, *Treasurer*

EXECUTIVE BOARD

Stacy Birdwell, *Shreveport, LA*

Larry Curran, *Boston, MA*

Kelly L. Fox, *Olympia, WA*

Dan Givens, *Miami, FL*

Kathy Harrell, *Cincinnati, OH*

Kenneth Hauser, *Chicago, IL*

Will Lundy, *Little Rock, AR*

John R. Niemiec, *Fairfax, VA*

Will Pryor, *Los Angeles, CA*

John Reilly, *Philadelphia, PA*

Mona Romain, *New York, NY*

Carol G. Stukes, *Philadelphia, PA*

Richard Tettamant, *Dallas, TX*

Carolyn Widener, *Venice, CA*

Emmit J. Kufahl, *Past President*

Hank H. Kim, Esq., *Executive Director & Counsel*

On the Record Statement
Regarding the Funding and Transparency
of State and Local Pension Plans

by Hank Kim, Esq.
Executive Director and Counsel
National Conference on Public Employee Retirement Systems (NCPERS)
Before the Committee of Ways and Means Subcommittee on Oversight
Submitted May 5, 2011

Introduction

Thank you for allowing my organization, the National Conference on Public Employee Retirement Systems (NCPERS), to submit this on-the-record testimony for your review. The growing national debate over public pension funds has raised a wide range of concerns. Some of those concerns are justified, but many are not. In many instances, the current debate has generated much more heat than light. It is our hope that our testimony will shed much-needed light on the status of public pension plans and provide the subcommittee with up-to-date data on the health and sustainability of those plans. Given the contentious political climate that has put public pension plans under attack, it is crucial that policymakers at all levels of government are operating with full and accurate information and that they are evaluating that information in the proper context.

NCPERS is the largest trade association for public sector pension funds, representing more than 500 funds throughout the United States and Canada. It is a unique non-profit network of public trustees, administrators, public officials and investment professionals who collectively manage nearly $3 trillion in pension assets. Founded in 1941, NCPERS is the principal trade association working to promote and protect pensions by focusing on advocacy, research and education for the benefit of pubic sector pension stakeholders. Further, NCPERS promotes retirement security for *all* workers through access to defined benefit pension plans.

In addition to serving as Executive Director and Counsel for NCPERS, I currently serve as a Trustee on the Fairfax County Uniform Retirement System, $1 billion public employee retirement system providing pension coverage for the Fire & Rescue Department, Sheriff's Department, and certain other sworn employees of Fairfax, Virginia. I also served on the Morningstar Pension Endowments and Foundations Steering Committee and City of Virginia Beach Mayor's Committee on Employee Pensions. Before joining NCPERS I served for six years as a government representative for an international public sector union, working on benefits, appropriations, homeland security and health care issues. I helped draft and lobby for passage of the Staffing for Adequate Fire and Emergency Response

(SAFER) Act. I have served on several Federal Advisory Committee Act (FACA) committees and working groups. I began my career in the office of former Sen. Bill Bradley of New Jersey, where I worked on the Newborns' and Mothers' Health Protection Act.

The Health and Sustainability of Public Pension Plans

First and foremost, we would like to assure you that the vast majority of public pension plans are healthy, sustainable and more than adequately funded. There are a few, extremely well-publicized exceptions, but they are just that – exceptions, not the rule. And the few plans that are in trouble are in trouble for the same reason – failure by the government entities sponsoring them to live up to their legal and fiduciary responsibilities to regularly and adequately fund their plans.

Illinois is currently in the news for being in last place among the states when it comes to funding its pension systems. Illinois' repeated and prolonged failure to contribute what it owes stands in stark contrast to its employees' faithful contributions, paycheck after paycheck. The story of the tiny town of Prichard, Alabama has also been chronicled far and wide. Town officials failed to fund its plan, defied state law by cutting off all benefits to its 150 retirees nearly two years ago and has sought (unsuccessfully so far) bankruptcy protection to get out from under their obligation. At least 18 of Prichard's pensioners have died while waiting for the pension checks they were promised in return for their years of public service.

But as I said, these are the exceptions, not the rule. This spring, NCPERS and Cobalt Community Research conducted perhaps the most comprehensive study addressing retirement issues for state and local pension plans. In all, 216 public pension funds covering nearly 7.6 million active and retired public employees and with assets exceeding $900 billion were surveyed. The vast majority – 83 percent – were local pension funds, while 17 percent were state pension funds.

What we found was that public pension plans are experiencing a robust recovery from the Great Recession that adversely impacted all institutional investors. They report earning above-average returns. And they are more than adequately funded to meet their obligations.

Some recent studies of public pension funds paint an unrealistically bleak picture because they rely in the main on 2009 data – data from a low point in the Great Recession. NCPERS survey relies on up-to-date data and demonstrates convincingly that a lot has changed for the better over the past 18 months.

The NCPERS/Cobalt Community Research Survey's key findings

Despite weak short-term investment experience in 2008 and 2009, the long-term investment discipline of fund managers has produced an average one-year return of 13.5 percent, based on

the most recently reported data. Funds participating in the study reported a 20-year average return of 8.2 percent.
Investment returns are the single most significant source of plan funding, comprising about 66 percent of fund revenue. Individual plan members are a significant source of plan funding, contributing 10 percent of plan revenue. Employer contributions comprise only 24 percent of plan revenue.

Although media coverage has focused on a handful of troubled funds, the vast majority of plans are managed responsibly and maintain strong funding levels. On average, public pension plans are 75.7 percent funded and continue to work toward full funding. According to its February 2011 report *Enhancing the Analysis of U.S. State and Local Government Pension Obligations*, Fitch Ratings considers a funded ratio of 70 percent or above to be adequate.

The NCPERS/Cobalt Community Research study presents a far more accurate – and far less distressing – picture of the actual status of public pension plans today. And our findings do not stand alone. Reviews by the Economic Policy Institute as well as by the National Association of State Retirement Administrators and the National Council on Teacher Retirement have produced similar findings.

Public Pension Plans Adapting to New Economic Realities

Public pension plans are not relying solely on strong investment returns to ensure their sustainability. Plans are already undertaking a wide range of structural changes to adapt responsibly to current economic realities and to guarantee their long-term health.

In 2010, more changes were enacted by state and local governments across the country than in any year in recent history. More modifications are in the works – to benefits, plan design, operational practices, oversight practices and more. This continuing restructuring should guarantee not only that public pensions remain the most efficient means of delivering retirement benefits, but also the least costly – at least to states and localities that have kept up with their required contributions to those plans. Jurisdictions that have shown less funding discipline may face greater challenges.

NCPERS and Cobalt Community Research are currently conducting a comprehensive review of the changes public pension fund have made or plan to make in the near future. The full report will be completed in late Spring 2011 and will be shared with members of the subcommittee.

America's Retirement Crisis

While budget and revenue shortfalls have prompted officials at all levels of government to take a close look at public pensions systems, we believe that their focus is too narrow. The fact is

that while the vast majority of public pension plans are healthy and sustainable, they provide retirement benefits to only a fraction of American workers.

The U.S. is facing an overall retirement crisis. Our ability as a nation to sustain our economy at a time when a record number of workers are entering their retirement years should be an important part of our national debate. Retirement security for *all* Americans – whether the work in the public or private sector – must become a national priority.

The truth is that for more than 100 years, public pension plans have been the most economically efficient means of delivering retirement benefits. Another inescapable truth is that until the 1980s – when defined contribution plans like the 401(k) were introduced – defined benefit pensions were common in the private sector. Workers knew that with their pensions, Social Security and their own savings, they could retire with dignity.

Today, there's a $6.6 trillion deficit between what 401k account holders should have and what they actually have. And the 80 million baby-boomers who are nearing retirement may not have enough time left in the workforce to earn back what they have lost in retirement assets.

It is our hope that as they look at the functioning of state and local pension funds, members of Congress and other policymakers will see that public pension plans provide ample evidence of how effective retirement systems can and do work – and that they provide a strong model for addressing America's retirement crisis and providing retirement security for all.

NCPERS stands ready to assist federal and state policymakers with facts, research, and expertise as they delve into policy discussions on retirement security. We invite this committee to contact us should you need additional information.

# # #

2011 NCPERS Public Fund Study

Preliminary Results
April 2011

Study conducted by
National Conference on Public Employee Retirement Systems
and Cobalt Community Research

© 2011 Cobalt Community Research

2011 NCPERS Public Fund Study Preliminary Results

Compiled by Cobalt Community Research

This study reviews funds' current fiscal condition and steps they are taking to ensure fiscal and operational integrity

Executive Summary

In March and April 2011, the National Conference on Public Employee Retirement Systems (NCPERS) began a study to collect the most recently available data on member funds' fiscal condition and steps they are taking to ensure fiscal and operational integrity.

NCPERS is the largest trade association for public sector pension funds, representing more than 500 funds throughout the United States and Canada. It is a unique non-profit network of public trustees, administrators, public officials and investment professionals who collectively manage nearly $3 trillion in pension assets. Founded in 1941, NCPERS has been the principal trade association working to promote and protect pensions by focusing on advocacy, research and education for the benefit of public sector pension stakeholders.

The 2011 NCPERS Public Fund Study includes responses from 216 member funds with a total number active and retired memberships surpassing 7,599,000 and assets exceeding $900 billion. It is the most comprehensive study addressing retirement issues for this segment of the public sector.

Key Findings

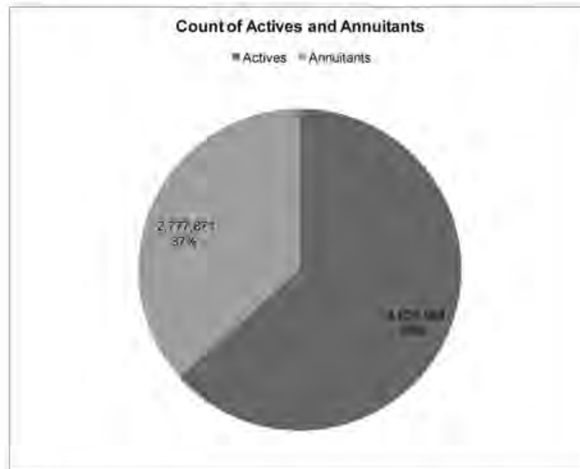
1. Despite weak short-term investment experience in 2008 and 2009, the long-term investment discipline of fund managers has produced an average 1-year return of 13.5 percent based on most recently reported data. Funds participating in the study reported a 20-year average of 8.2 percent. The average return that respondents use to calculate assets is 7.7 percent with an assumed rate of inflation of 3.5 percent.
2. Investment returns are the single most significant source of plan funding, comprising about 66 percent of fund revenue. Members are a significant source of plan funding and contributed 10 percent of plan revenue. Employer contributions comprise only 24 percent of plan revenue.
3. Although media coverage has focused on a handful of troubled funds, most funds are managed responsibly and maintain strong funding levels. On average, funds are 75.7 percent funded and continue to work toward full funding. According to its February 2011 report *Enhancing the Analysis of U.S. State and Local Government Pension Obligations*, Fitch Ratings considers a funded ratio of 70 percent or above to be adequate. As with a home mortgage, funding levels are designed to slowly be funded over many years. The average amortization period for respondents is 25.8 years.

About Cobalt Community Research

Cobalt Community Research is a nonprofit research coalition created to help governments, local schools and other nonprofit organizations measure, benchmark, and manage their efforts through high-quality affordable surveys, focus groups and facilitated meetings. Cobalt is headquartered in Lansing, Michigan.

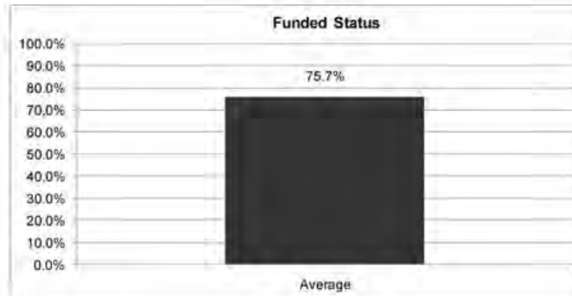
2011 NCPERS Public Fund Study: Preliminary Results

For the 2011 study, 216 respondents provided feedback to NCPERS using the most recent data they have available. Approximately 83 percent of respondents represented local government pension funds and 17 percent represented statewide retirement systems. The graph below shows the number of active members and retiree/beneficiaries represented by these funds. This totals more than 7,599,000 covered lives.

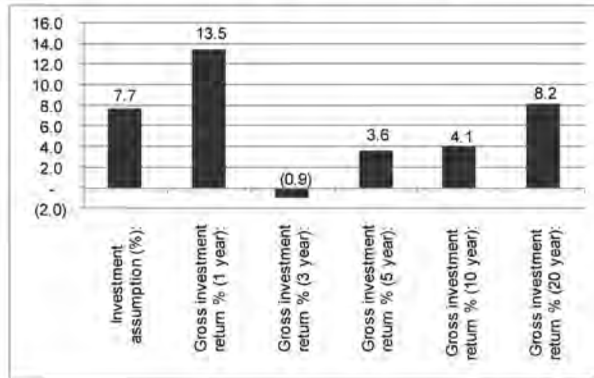


Funding Level and Returns

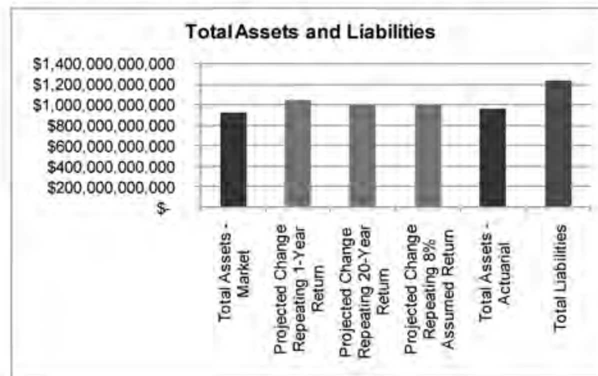
On average, the funded level of responding funds is a solid 75.7 percent. When comparing the total actuarial assets of all respondents to the total liabilities, there is an overall funded status of 77.4 percent. Pension funds are designed to pay off liabilities over a period of time to ensure long-term stability and to make annual budgeting easier through more predictable contribution levels. For responding funds, that period of time averages to 25.8 years.



Funding level is affected by the average investment returns a fund experiences over a set number of years. For respondents, the average number of years used in the calculation is 5 years. This is done to keep employer contribution rates more stable, as annual market return fluctuations would create significant volatility in the budgeting process. With the market declines in 2008 and 2009, the market and actuarial value of fund assets has declined; however, both 1-year and 20-year returns reported by participating funds points to continuing long-term improvement in funded status. The graph below shows average returns for responding funds.



The following graph shows the market value and actuarial value of assets (dark blue columns). The red column shows actuarial liability that pension plans are designed to meet over time. The light blue columns project the improvement in market assets in one year using three scenarios: repeat of the 1-year return (13.5 percent), returns that equal the reported 20-year return (8.2 percent), and returns that equal the average reported actuarially assumed rate of return (7.7 percent). Essentially, this graph shows that despite short-term market declines, funds will continue to make progress toward funding liabilities.



Sources of Funding

Income used to fund pension programs generally comes from three sources: member contributions, employer contributions and investment returns. The chart below shows the proportion of funding provided through each of these sources. By far, investment returns are the most significant source (66 percent). Member contributions make up 10 percent of fund income. Employer contributions equal about 24 percent. These findings are consistent with other credible industry studies. Both this study and other industry studies show that annual fund expenditures and economic impact significantly exceed the annual contributions made by the employers.

Next Steps

This preliminary data represents only a portion of findings in the 2011 study. Other areas to be reviewed include changes funds have made or plan to make in the following areas:

- Benefit changes
- Design changes
- Operational practices
- Communication and member engagement practices
- Oversight practices.

The full report will be completed in late Spring 2011.

3880 Salem Lake Drive, Suite H
Long Grove, IL 60047-5292
p: 847/719-6500
f: 847/719-6506

May 17, 2011

Committee on Ways and Means
Hearing on Transparency and Funding of State and Local Pension Plans

To: Committee on Ways and Means – Hearing on Transparency and Funding of State and Local Pension Plans

The attached comments were developed through the coordinated efforts of members of the Conference of Consulting Actuaries' (CCA) Public Plans Community and are being submitted to the Committee on Ways and Means by the Steering Committee of the CCA Public Plans Community. However, these comments do not necessarily reflect the views of the CCA Board, the CCA's other members, or any employers of CCA members, and should not be construed as being endorsed by any of the aforementioned parties.

The CCA Public Plans Community (PPC) represents a broad cross section of public-sector actuaries whose extensive experience with public plans provides the framework for our response. The PPC includes over 50 leading actuaries whose firms are responsible for the actuarial services provided to the majority of public-sector retirement systems. The following comments reflect a substantial consensus among the actuaries who provide valuation and consulting services to public pension plans.

We are grateful to the Committee on Ways and Means for holding Hearings on Transparency and Funding of State and Local Pension Plans and inviting public-sector actuaries and others to comment on these important issues. We are available to present our comments to the committee if desired. We are also grateful to the Committee on Ways and Means for their hard work in striving to understand these complicated and interconnected issues.

Paul Angelo, FSA, FCA, MAAA, EA (By Direction)
Chair of the Public Plans Steering Committee on behalf of the
Public Plans Steering Committee

Board of Directors

Adam J. Reese
President

Donald E. Fuerst
President-Elect

S. Aquil Ahmed
Vice President
Patricia A. Rotello
Vice President
Carol R. Sears
Vice President
Dale H. Yamamoto
Vice President

Nadine H. Orloff
Secretary
Tamara R. Shelton
Treasurer
Lawrence J. Sher
Immediate Past President
Lance J. Weiss
Penultimate President

John J. Bauer
Lawrence A. Johansen
Barbara J. Lautzenheiser
John H. Lowell
Stephen T. McElhaney
Phillip A. Merdinger
Gerard C. Mingione
Marn Rivelle

Bruce D. Schobel
John J. Schubert
John T. Stokesbury
Thomas A. Swain

Rita K. DeGraaf
Executive Director

Steering Committee of the Conference of Consulting Actuaries Public Plans Community[1]

CCA PPC Comments on PEPTA

We are writing as the Steering Committee of the Conference of Consulting Actuaries (CCA) Public Plans Community to present significant concerns over the Public Employee Pension Transparency Act (PEPTA). The CCA is a professional organization representing credentialed actuaries, including those who work with private- and public-sector retirement plans. The Public Plans Community (PPC) represents a broad cross-section of public-sector actuaries whose extensive experience with public plans provides the framework for our response. The PPC includes over 50 leading actuaries whose firms are responsible for the actuarial services provided to the majority of public-sector retirement systems. The following comments reflect a substantial consensus among the actuaries who provide valuation and consulting services to public plans.

In February 2011, PEPTA was introduced in the U.S. House of Representatives (H.R. 567) and the U.S. Senate (S. 347). While the intent of these bills is to provide more meaningful measures of state and local government pension plan funding, we do not believe the bills would serve this purpose. On the contrary, key measures required by PEPTA would produce a distorted picture of public pension funding and create substantial confusion about the proper actions needed to address current public pension funding issues.

Our key concern is that PEPTA introduces a new methodology that is inappropriate for measuring the contributions, liabilities, and funded status of public plans. The established approach currently used by public plans focuses on the cost of the benefits to taxpayers, and so measures pension liabilities and costs in a way that includes the effect of both past and future salaries and service. This approach then measures the liabilities using the expected long-term rate of return on plan investments, since those investment returns are a component in determining the net cost of the benefits to taxpayers.

By contrast, the PEPTA approach is what some call a "Market Value of Liability" (MVL) approach. This approach differs from the more established approach in two ways. First, it measures public pension liabilities and funded status based the plan's "current liabilities" using benefits based only on salary and service to date, and ignores the effect of future salary and benefit accruals. Second, it discounts these liabilities using a yield curve based on U.S. Treasury securities, rather than what the investments are actually expected to earn.

In effect, the PEPTA/MVL approach measures the hypothetical price at which the benefits accrued to date might be settled in financial markets, as if there were such a market for public pensions. Of course, public retirement benefits are neither tradable nor transferable, so there is no real market value for them. So while this approach might have theoretical applications either for plan terminations or for purchasing annuities to provide such benefits in insurance markets, it is not an appropriate disclosure measure for ongoing governmental plans. This conclusion is further developed below.

Key Concerns

1) The PEPTA/MVL approach does not reflect the ongoing cost of the pension plan to taxpayers and employees but instead would only reflect a hypothetical market price at which the accrued benefits might be sold. To properly fund

---

[1] These comments were developed through the coordinated efforts of the Conference of Consulting Actuaries' (CCA) Public Plans Steering Committee and are being submitted to the Committee on Ways and Means by the Steering Committee of the CCA Public Plans Community. However, these comments do not necessarily reflect the views of the CCA Board, the CCA's other members, or any employers of CCA members, and should not be construed as being endorsed by any of the aforementioned parties.

their plans, decision-makers must know the long-term ongoing contributions which, when combined with current assets and future investment earnings, are sufficient to pay the benefits promised to current and future retirees. These contributions represent the true cost of the plan to taxpayers. This is why actuarial valuations for public plans use well-established actuarial methods that measure liabilities using benefits based on both past and future salary and service. It is also why the liabilities are measured using the expected rate of return on plan assets.

In order to reflect the long-term costs of the ongoing plan, the plan's liabilities and costs must anticipate future conditions related to investment returns, salary increases, and inflation, among other assumptions. This is an appropriate approach for state and local governments which, by their nature, are long-term ongoing entities, and must plan for the actual cost of future payments, net of future investment returns. The PEPTA/MVL approach tries to determine a hypothetical market price of the pension promises made to date. While this might be useful if the plan were terminating, it does not provide relevant information about the ongoing cost for an ongoing plan, and so is a misleading measure of plan liabilities.

2) The PEPTA/MVL approach would not be useful for measuring the plan's funded status. The simplest way to see this is to note that, as indicated in PEPTA itself, the MVL measure is not a basis for determining funding requirements, and so cannot measure how well a plan is meeting its funding requirements. In more specific terms, use of U.S. Treasury bond yields as a discount rate would produce a distorted measure of the plan's funded status. When bond yields are high (e.g., during periods of high inflation expectations), discounting pension liabilities using U.S. Treasury bond yields would understate the liabilities and so make the plan appear better funded than under established long-term valuation methods. However, this does not mean the pension plans are any healthier than shown in their actuarial reports. Similarly, when bond yields are low (e.g., during periods of low inflation expectations), discounting using U.S. Treasury yields would overstate the liabilities. But this does not mean the plan is any worse off than it was when yields were higher. Using U.S. Treasury bond yields also introduces spurious volatility into a pension plan's financial statements that has little to do with the adequacy of plan funding. Consequently, this approach misrepresents the plan's long-term financial health.

3) The PEPTA/MVL approach would not improve the transparency of plan reporting. We recognize the need for meaningful measures with regard to public pension funding. Such measures are essential for determining how much should be contributed to the plan, or whether the plan is making progress toward full funding. However, as we discussed above, the PEPTA/MVL approach would not provide meaningful measures, and in fact would produce misleading results regarding the funded status of public plans. Rather than improving transparency, it would create confusion about the proper actions needed to address the plans' actual funding issues.

It should also be noted that the PEPTA/MVL approach is not, itself, transparent. To understand what the MVL measure really means, one would have to understand the differences between the well-established long-term actuarial approaches and the MVL approach, and how these differences should be interpreted in evaluating the plan's funded status. One would also have to know how changes in U.S. Treasury bond yields have impacted the measures, and be able to separate out the effect of the changes in Treasury yields from the effect of any changes related to the plan itself. In short, the PEPTA/MVL approach does much more to cloud the issues surrounding public pension funding than it does to make them transparent.

Finally one aspect of transparency that PEPTA hopes to address is to provide a consistent measure of liabilities that would be comparable for all plans. While we appreciate the desire for comparability, the PEPTA/MVL approach does not achieve such comparability in any meaningful way. In particular, since the MVL is not related to plan funding, it cannot be used to determine how well funded one plan is compared to another. A better approach is currently being developed by the Governmental Accounting Standards Board (GASB). The GASB has tentatively decided to have all plans report their liabilities based on a single actuarial cost method, which is a widely used level cost method that reflects future salaries and service.

4) The PEPTA/MVL approach focuses on a theoretical "value" of the benefits rather than on the actual cost to the taxpayers. Proponents of the MVL approach argue that it measures the true value of the benefit that the member has accrued. However, what it really measures is the theoretical amount an individual plan member would have to pay, in the absence of the pension plan, to reproduce the benefit by purchasing annuities or other low risk investments in the individual markets. But this ignores the purpose of the pension plan. Through the pension plan, taxpayers can provide retirement security to public employees more efficiently (at a lower actual cost) than by just buying annuities. Consequently, for public plans, the only meaningful measure of plan liabilities is one based on the expected actual cost to the taxpayer, net of investment return, rather than the theoretical value of the benefit to the member. This is also why comparing the MVL to plan assets is a misleading comparison. For public pension plans, plan assets need to be sufficient to pay the cost of the future benefits, net of future investment returns. They do not need to be sufficient to pay the hypothetical costs individual members would have to pay to obtain those same benefits on their own in the financial markets.

Governments provide many benefits to citizens more economically than if the citizenry were to purchase these benefits on their own (defense, highways, schools, etc.). There is no requirement that the government calculate the value of these benefits as if purchased individually outside the government. Similarly, no such measure is necessary or even meaningful for public pensions.

Other Concerns

In addition to our concerns that PEPTA would result in distorted measures of public pension funding, we have other concerns.

5) PEPTA circumvents state and local government authority and undermines the Governmental Accounting Standards Board (GASB) in the setting of accounting and financial reporting standards for state and local governments. The GASB is the nationally recognized rulemaking body for state and local government accounting and financial reporting standards. It establishes and revises its standards through a process of open deliberations and input from all interested parties, and is currently reviewing the accounting and reporting standards for state and local government pensions. Not only has the GASB put considerable effort and research into their proposed changes of public pension accounting standards, but they specifically considered and rejected both the accrued benefit measure and the yield curve discount rate that PEPTA would impose. For the U.S. Congress to ignore the GASB's decisions would substitute a federal reporting requirement in place of standards developed through an informed process of discussion and consultation by the nation's recognized rulemaking body for state and local governments. Moreover, given state and local governments' widespread adherence to the GASB standards, any federal oversight is arguably redundant, and contrary federal oversight (such as PEPTA) would be confusing and misleading.

6) At a time when governments are under enormous fiscal pressure, PEPTA would require unnecessarily higher expenditures on the part of the federal, state, and local governments. To comply with PEPTA, every state and local government would need to have additional actuarial valuations and projections done to conform to the Act's requirements. This amounts to an unfunded mandate imposed on state and local governments to produce measurements that are neither meaningful nor useful. This is particularly problematic for sponsors of cost-sharing multiple employer plans. These are public plans that share pension costs across all participating employers, and consequently have one actuarial valuation done for the plan as a whole and not for individual employers. Also, in order for the federal government to collect and audit the annual reports to ensure they comply with PEPTA's provisions, the U.S. Treasury would have to divert current resources or hire additional employees for this purpose.

Conclusion

Clearly, recent economic conditions have put significant fiscal pressure on state and local governments. Some of this pressure stems from higher pension contributions, mostly due to sharp investment declines in 2008-2009. As a result, many state and local governments are reviewing their pension plan designs to reduce benefit costs. In addition, many organizations such as the GASB, the Actuarial Standards Board, the Conference of Consulting Actuaries, the American Academy of Actuaries, and others are looking for ways to better communicate the risks related to the cost of public pension plans.

However, for this process to be effective, the measures of public plan contributions, liabilities, and funded status must be meaningful. To be meaningful, they have to reflect the actual cost dynamics of the plan, which must relate to the way the plan is funded. Established actuarial approaches used to fund public pension plans reflect the long-term costs to taxpayers of the ongoing pension plans. In contrast, the PEPTA/MVL measures reflect the hypothetical market price of pension liabilities for which there is no functioning market. Rather than providing transparency, the PEPTA/MVL approach would provide a volatile and distorted picture of public pension funding by focusing on the theoretical value of the benefit to the member instead of its cost to the taxpayer. This would create substantial confusion about the proper actions needed to address current funding issues.

Statement of Mary Kay Henry
International President

Service Employees International Union (SEIU)
1800 Massachusetts Avenue, NW
Washington, DC 20036
Telephone: 202-730-7382
FAX: 202-350-6617

to the

Subcommittee on Oversight
Committee on Ways and Means

Hearing on
"Transparency and Funding of State and Local Pension Plans"

On behalf of the more than 2.1 million members of the Service Employees International Union, I am pleased to submit the following written testimony to be included in the public record for the House Ways and Means Subcommittee on Oversight hearing on "Transparency and Funding of State and Local Pension Plans."

Nurses, school employees, child protection and social service workers, librarians, higher education workers, highway workers, court clerks, and other essential state and local public employees are our neighbors, colleagues, and taxpayers in communities across our country. When they retire, their average pension is $1,888 per month, or $22,653 annually, after years of service. Many public employees do not receive Social Security, making their public pension plan their only source of retirement security after years of hard work and dedicated service to their communities.

Public employees make contributions to their retirement plans every pay check, with the rest of the payments to pension plans coming from investment earnings and state and local employer contributions. Stable and secure public pension plans are essential to the well-being of millions of hardworking Americans and retirees. Therefore, SEIU opposes H.R. 567, the *Public Employee Pension Transparency Act* (PEPTA), which was discussed by the Subcommittee on Oversight at its hearing. This legislation has little to do with enhancing pension plan transparency and more to do with undermining the ability of state and local governments to manage what otherwise are very reasonably funded public pension systems. H.R 567 is a threat to public pension plan solvency; if enacted, would be an unnecessary federal intervention into state and local fiscal accounting responsibilities; and would undermine retirement security for millions of workers across the country, providing very little useful information to taxpayers or bondholders.

This written testimony further explains our reasons for opposing H.R. 567.

First, we oppose federal regulation of how state and local government pension systems are funded. If PEPTA were to become law, it would likely be the first time the federal government has taken on the responsibility of regulating the funding of state and local pension funds. Indeed, there is no need for federal intervention. Consider the following:

- City and state governments are already making unprecedented changes to benefits and contribution requirements to improve pension system funding levels. In the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures or both; many local governments have made similar fixes to their plans.[1]
- State and local government retirement systems are already transparent. They are already required to report all financial data in audited, publicly available comprehensive annual financial reports.
- Pension costs are manageable and benefit levels are reasonable. The portion of state and local government spending dedicated to retirement system contributions is only about 3 percent.[2] Part of the reason that pension costs are affordable is that public employees contribute a significant portion of their annual salaries toward their future benefits—typically 5 percent to 10 percent—to their state or local pension, and these contribution rates are being raised in many state and local governments. According to the Census Bureau, the average annual state and

[1] NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems.
[2] NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems.

local pension benefit is $22,653.[3] Indeed, public defined benefit plans are vital for providing a secure retirement to millions of public employees, many of whom do not receive Social Security benefits.

While the bill makes a point of prohibiting any future federal bailout of state or local pension funds, despite the fact that no state or local pension fund has ever requested any type of federal bailout, the bill could actually increase the possibility of a future federal bailout by laying the groundwork for federal oversight of local and state pension funds. H.R. 567 would create a precedent for a federal role in overseeing these pension funds where no such precedent currently exists.

Second, there is no basis for requiring pension funds to use a "risk-free" rate for discounting the value of future liabilities. Pension systems generally use the expected value of returns on their investments to discount the value of future liabilities. The logic of using expected values, rather than the risk-free rate, stems from two related facts. First, state and local governments are better able to bear risk than individual investors or even private sector pension systems. If the market experiences a downturn, state and local pension funds can easily cover their pension obligations from the current funding flows combined with the sale of non-equity assets. Moreover, city and state governments do not have on-going risk concerns as exist with corporations.

Experience has shown that since 1985, actual investment returns have exceeded average assumptions. For the 25-year period ended 2009, the median public pension investment return was 9.25 percent.[4] Moreover, for the year ended June 2010, this return was 12.8 percent.[5]

It is worth noting that in 2006, Congress rejected this requirement for corporate pension plans because, just as the private sector argued, the requirements would increase cost and volatility, and would lead to the transmission of irrelevant information.

It is also important to note there are a host of undesirable consequences of requiring public funds to use a risk-free rate to value future liabilities, including unnecessarily forcing current taxpayers to bear a much larger share of the cost of funding retirement systems and introducing considerable volatility to the annual pension contribution levels that, from a budgetary standpoint, creates unmanageable uncertainty.

Third, the Government Accounting Standards Board—an independent, nonpolitical board of experts—already establishes strict accounting standards to which all state and local pension funds must adhere. The board is expected to propose new disclosure requirements this summer.

Fourth, it is absolutely inappropriate and certainly a dangerous precedent to strip city and state governments of their ability to issue tax-exempt bonds for what would amount to a violation of a reporting requirement. First, the punishment should fit the crime in tax policy as in criminal justice, and preventing governments from having access to the lowest cost of capital in order to enforce a reporting requirement is a violation of that fundamental policy tenet. Second, the composite effect of H.R. 567 will likely be higher borrowing rates for cities and states that will ultimately shrink the total

[3] Cited in Testimony of Iris J. Lav, Senior Advisor, Center on Budget and Policy Priorities, Before the House Ways and Means Committee Subcommittee on Oversight, Hearing ON Transparency and Funding of State and Local Pensions, May 5, 2011.

[4] NASRA Issue Brief: Public Pension Plan Investment Return Assumptions.

[5] The Public Fund Survey.

amount of spending on job-creating capital projects. Worse, jeopardizing state and local government access to tax-exempt borrowing for something as minor as violating a reporting requirement would undoubtedly undermine state and local economies.

Most importantly, the real impact of H.R. 567, if it were to become law, would be to undermine the retirement security for millions of workers. By inflating the real cost of providing defined retirement benefits to public employees—mostly teachers, firefighters and public safety workers—support for these otherwise superior systems for delivering retirement benefits would undoubtedly wane. We believe the result of this legislative overreach if enacted would spell the beginning of the end of defined benefit pension plans in the public sector. We suspect the authors of this legislation may have that outcome in mind, as they try to make the public sector mimic more closely the private sector, where federal regulation has hastened the virtual demise of defined benefit pensions. Public sector defined benefit pension funds serve the unique needs of public employers and employees alike, which differ in significant ways from those of the private sector, and we firmly believe PEPTA would be detrimental to the interests of all stakeholders in the public employee retirement system, including taxpayers and municipal bond investors, as well as employees and employers.

Invested in America

United States House of Representatives
Committee on Ways and Means
Subcommittee on Oversight

Hearing on the Transparency and Funding of State and Local Pension Plans

May 5, 2011

Statement for the Record

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to provide comments on the transparency and funding of state and local pension plans. The condition of state and local pension plans is an important issue for participants in the $2.9 trillion municipal bond market, and we commend Chairman Boustany for calling this hearing.

Our comments focus on issues raised by legislation pending in the House, H.R. 567, the Public Employee Pension Transparency Act of 2011. H.R. 567 would prohibit the federal government or the Federal Reserve from bailing out any state or local pension plan that was unable to meet its obligations. The bill would also require that pension plans make certain disclosures to the Treasury Department regarding funding status and other factors and mandate that the plans determine their funding status based on discount rates determined by yields on Treasury securities, either as the principal reporting method or in supplemental reports. Public employee pension plans would also have to report their liabilities using a uniform accounting standard. Those governments affiliated with plans that do not file the reports or are found not to be in compliance would not be able to issue tax-exempt bonds or tax-credit bonds during the period the plan was deemed by Treasury to be out of compliance.

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

Washington | New York

1101 New York Avenue, 8th Floor | Washington, DC 20005-4269 | P: 202.962.7300 | F: 202.962.7305
www.sifma.org | www.investedinamerica.org

SIFMA supports the provision in H.R. 567 that would prohibit federal bail-outs of state and local pension plans. We note that we are not aware of any state or local pension plan seeking federal financial assistance. Indeed, the tide seems to be turning for some state and local pension plans. Late last month, the National Association of State Retirement Administrators and the National Council on Teacher Retirement reported that state and local pension assets at the end of 2010 were 35 percent higher than their 2009 lows and that long-term investment returns for many plans exceeds projected assumptions, even accounting for weak returns brought about by the financial crisis and recession. Nevertheless, we feel a prohibition on federal bail-outs send an appropriate message to state and local pension managers.

We also support the goal of H.R. 567 to promote more and better disclosure by state and local pension plans. However, we do not support using the tax code as the means to implement that policy.

SIFMA is a strong supporter of informational transparency by issuers of public securities. Financial disclosure is a cornerstone of our securities markets, and SIFMA supports reasonable policies that promote timely and sound disclosure practices. While SIFMA supports better transparency and disclosure in all markets, we believe that rescinding the ability of state and local government entities to issue tax-exempt bonds is not the appropriate means to engender better pension liability disclosure, and the Treasury Department is not the appropriate agency to enforce such requirements.

Information disclosure by issuers of securities is generally regulated by the Securities and Exchange Commission ("SEC"), not the Treasury Department. Two provisions of federal securities law limit the ability of the SEC to regulate the disclosure practices of state and local governments. First is the inclusion of municipal bonds as "exempt securities" (Section 3(a) of the Securities Act of 1933) over which the SEC has limited authority regarding issuer disclosure. Second is the so-called Tower Amendment (Section 15B(d) of the Securities Exchange Act of 1934), which prohibits the SEC and the Municipal Securities Rulemaking Board ("MSRB") from requiring states or localities to make any information filing prior to issuing securities. The Tower Amendment also prohibits the MSRB from requiring municipal securities issuers to file disclosure statements generally.

Despite the limitations in the authority of the SEC and MSRB regarding issuer disclosure, regulators have taken numerous steps in recent decades to improve the quantity and quality of information available to municipal bond investors. Regulators have used their authority under the anti-fraud provisions of the securities laws (Section 10(b) of the Securities Exchange Act of 1934) and their authority over securities dealers to effectively mandate and enforce municipal

issuer disclosure. Primary market disclosure in the municipal market is typically required to be submitted to the MSRB by the broker-dealer; and broker-dealers are required to bind issuers contractually to produce and submit continuing disclosure to the MSRB. We are not advocating any changes to federal securities laws regarding pension disclosure by states and localities. We also do not believe that effectively imposing such requirements through the federal tax code would be appropriate.

Further, municipal industry participants and regulators are already taking measures to improve pension disclosure practices. The SEC has sharpened its focus on state and local government pension liability disclosure and has taken several high-profile enforcement actions in recent years against state and local governments deemed to have made incomplete or misleading disclosures regarding their pension plans. The National Association of Bond Lawyers is spearheading a pension-disclosure project to bring participants together to promote more and better information disclosure, with the goal of completing the project by year-end. The Governmental Accounting Standards Board ("GASB")—the principal accounting standards body for state and local governments and agencies—has also undertaken a major project to review pension disclosure and accounting practices and plans to release updated guidance in the future. We believe the GASB initiative in particular holds significant promise with regard to improving pension disclosures. A large number of states and localities are required to adhere to GASB standards regarding their accounting and disclosure practices, and we believe Congress should allow GASB's efforts to take hold before moving legislation with regard to state and local pension disclosure.

SIFMA looks forward to working with the Subcommittee and other interested members of Congress on this important issue and can provide further information if needed. Thank you for your time and consideration.

○