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Pensions

The not-so-Great GASB

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THIS week's column (http://www.economist.com/news/finance-and-economics/21577088-muddle-headed-world-american-public-pension-accounting-money-burn) is on American public pensions (it may be an arcane subject but it's very important). One can make perfectly valid arguments that public sector workers deserve final salary pensions because of the nature of their work, or their lower pay (although the calculations are very complex, needing to take account of qualification levels etc) or because it is dishonest to remove a right from someone who has planned their career on the assumption their pension is secure. All that is fine, provided that the cost is properly accounted for to taxpayers, so that the bargain is clear and above aboard.

When you start a pension scheme, the cash position tends to look very good; workers are contributing and few retirees are claiming. But the real cost is the pension rights that are accrued each year. As the

baby boomers retire, and the elderly are living longer, the maths are shifting. For a long time, this shift was obscured by strong investment returns. But a decade of poor returns has brought the problem into sharp perspective.

Final salary pensions are a debt-like obligation, particularly in the public sector where the rights of pensioners are established in law (and even the constitution) in some states; there is an interesting case (http://www.bloomberg.com/news/2013-04-22/stockton-retirees-worry-pension-cuts-follow-health-losses.html) going on in Stockton, California, which may set the rights of creditors against those of pensioners. On corporate balance sheets, pension liabilities are discounted with a corporate bond yield. Falling bond yields have pushed up liabilities and widened deficits; hence many corporates have switched to defined contribution schemes. (Of course, the problem of low returns and falling rates dogs those schemes too, and are made worse by the low level of contributions that are made.)

This is NOT just a theoretical issue. If a company wants to offload its pension promise, or an individual wants to secure his pension by buying a fixed annuity, they find the cost has risen substantially.

But this doesn't show up in the public sector. It uses the expected rate of return to discount its liabilities; since the expected rate of return is higher (7.5-8% is standard) than bond yields, it makes the liabilities look smaller, and reduces the apparent cost to taxpayers. The rationale for this approach is that pension funds can afford to take a long-term view and benefit from the returns on risky assets; contributions can be smoothed over the long term, avoiding any sudden jumps in employer (taxpayer) payments.

However, this approach involves logical absurdities. Since equities are deemed to generate higher long-term returns than bonds, it means that $1000 of equities is worth more than $1000 of bonds under pension accounting. Yes, one might hope that equities will earn a risk premium over bonds over the long term, but the key word is *risk*. They might not. They haven't in Japan, for example, over the last 23 years. Indeed, at points in the last five years, it has been possible to find quite long time periods over which US equities haven't beaten Treasury bonds. Pension accounting treats the risk premium as guaranteed.

Some of those absurdities were highlighted in a Financial Analysts Journal piece (http://rnm.simon.rochester.edu/research/LIoGMfVPL.pdf) about the rules set by GASB (Governmental Accounting Standards Board) by Robert Novy-Marx, to which my column refers. This section really catches the eye.

> Under GASB, it is possible that a plan can improve its funding status by literally burning money. GASB recognizes that cash and bonds are valuable assets, but nevertheless penalizes a plan for holding these, by forcing it to recognize a larger liability. Destroying a dollar (i.e., reducing its bond holdings by a dollar while holding all other asset holdings fixed) reduces a plan's assets by exactly a dollar, but can reduce its GASB liability by more than a dollar. In this case, a plan can reduce its GASB recognized underfunding by destroying assets.

How so? Novy-Marx gives a worked example

> This can be illustrated with a simple example. Consider two pension plans, plans “A” and “B.” Plan A has a single member, a 35 year old worker with five years of service who plans to retire in thirty years with a projected salary of $105,000. The plan holds $10,000 of stocks that have an expected return of 10%. Plan B also has a single member, identical in all ways to that in plan A, holds the exact same stocks, but additionally owns $10,000 dollars worth of T-bills providing a risk-free yield of 4%. Common sense demands that plan B is better funded than plan A by exactly $10,000. Under GASB’s methodology, however, Plan A appears better funded than Plan B. To see this, suppose the workers are promised annual post retirement payments equal to 2% of their final salaries for each year of service. This implies annual payments recognized under the projected benefit obligation (PBO) of $10,500 per year (5 x 2% x $105,000/ year) starting in thirty years. If life annuities for 65 year old retirees make annual payments of 6% of the initial investment, then each employee’s currently recognized PBO liability can be satisfied with a payment in thirty years of $175,000 ($10,500 / 0.06). Plan A is, under GASB rules, fully funded. The present value of its thirty year liability of $175,000, discounted at the 10% expected return on its assets, is $10,000, the same as the value of its stock market holdings. Plan B, however, has an unfunded liability of $3,000 dollars under GASB. Its thirty year liability of $175,000 discounted at the plan's 7% expected return on assets (½ x 4% + ½ x 10%) is $23,000, $3,000 more than the value of its stocks and bonds. Despite the fact that plan B is identical to plan A in every respect except for the additional $10,000 it holds, GASB methodology holds that it is $3,000 less well funded. That is, GASB rules imply that a plan that must make a $175,000 payment in 30 years and owns $10,000 in stocks is better funded than a plan with the same liability and the same stock holdings but that additionally owns $10,000 in bonds. Plan B can thus improve its GASB funding status by $3,000 by burning its bonds.

In these days of spread-sheet errors, I thought I'd better check the calculations and they are fine. This seemed astonishing so I contacted GASB. Surely they had a reaction or rebuttal? I first contacted their press team on April 19, faxing over a copy of the article. On April 29, I finally received a response, linking to this FAQ factsheet (http://www.gasb.org/cs/ContentServer?site=GASB&c=Page&pagename=GASB%2FPage%2FGASBSectionPage&cid=1176160432178) ; as I quickly pointed out, this doesn't deal with the burning money point at all. So they sent me this second factsheet (http://www.gasb.org/cs/ContentServer?site=GASB&c=Page&pagename=GASB%2FPage%2FGASBSectionPage&cid=1176160426520) , which doesn't deal with the point either. No expert was offered to deliver a rebuttal, Their last effort was a quote from a spokesman that

> The GASB gave serious consideration to the views of Professor Novy-Marx when developing its new pension standards.

Hopeless. The only conclusion I can draw is that there is no answer to Novy-Marx's point and the accounting treatment for public pensions is based on a logical absurdity. As yesterday's note said, pity the taxpayer.