Policy Context on NPRI Pension Advocacy Paper

You may have seen or heard of the recent paper published by the Nevada Policy Research Institute (NPRI, author- Andrew Biggs) on the funding of Nevada PERS. NPRI argues that the liabilities of PERS should be valued using a "risk free" discount rate somewhere near current interest rates, instead of using the long term investment return assumption adopted by the Retirement Board based upon recommendation by the System's independent actuary. The paper further advocates a change in the System to a defined contribution plan.

It is important to note that Nevada PERS calculates its liabilities consistent with all Governmental Accounting Standards Board (GASB) requirements and Actuarial Standards of Practice. In short, Nevada PERS complies with the highest industry standards for actuarial calculation methodology, funding procedures and accounting disclosure. So while the paper acknowledges that PERS conforms to industry standards and is "… currently one of the better funded public sector pensions, due to sound management and consistent government contributions," the paper takes issue with these standards and proposes a different approach to measuring and managing public sector defined benefit pension liabilities.

This argument is not new to the discussion of public pension financing; in fact it has been actively debated for several years amongst pension administrators, economists, actuaries and accountants. Thus far, the theory has not been adopted in the governmental sector, for a variety of sound reasons, discussed below.

MVL vs. Current Actuarial Method

The "Market Value of Liabilities" (MVL) theory is an economics theory that reflects a pension plan's *settlement cost—the amount the plan would owe if it were terminated* and required to settle its liabilities with a so-called risk-free portfolio of bonds. Calculating the MVL involves three elements that currently are not part of the conventional method for determining public sector pension liabilities: 1) an investment return based on a portfolio of high quality bonds; 2) use of the accrued benefit (plan termination) obligation rather than a going-concern benefit obligation; and 3) marking assets to market, which precludes smoothing of assets (a tool used to make required contributions more stable and predictable). Opinions vary of what "risk-free" rate should be used to determine the MVL, ranging from the rate on 10-year US Treasury notes to a basket of fixed income securities that is higher than the US Treasury rate. NPRI used 4% as its benchmark in its position paper on this matter.

Calculation of the MVL results in the determination of liabilities accumulated by a plan only up to the measurement date (such as the date of the actuarial valuation), and does not consider the impact of future salary growth. By contrast, conventional public plan *actuarial valuation* methodology does consider future expected economic and demographic activity, including salary growth.

Current actuarial methods determine an actuarially required contribution (ARC), which represents the amount needed in the current year to fund the plan's normal cost and to amortize its unfunded liability over a period not to exceed 30 years. In Nevada, that amortization period is just over 24 years and is declining as the earliest (and largest) portion of the Unfunded Actuarial Accrued Liability (UAAL) will be retired in 23 years.

Barriers to MVL in the Government Sector

Because MVL is pinned to current market conditions, the calculation is extremely volatile, year-over-year. This is directly opposite to the desire for long-term predictable, stable costs in the government sector. In addition, in Nevada, PERS risk shares with our members (members pay 50% of the required contributions to fund their own retirement, including payment on the UAAL). MVL's "riskless" valuation rate does not recognize the member's exposure to market risk during their working career. In Nevada, employee and employer contributions adjust based upon a biennial calculation that takes into account market results for the period. When the contribution rate increases, employee contributions increase.

In addition to increasing the volatility of required contributions, replacing the current method of determining the ARC with one based on MVL results in significantly higher contributions due to the use of a lower investment return assumption. If PERS' actual investment return exceeds the risk-free rate used to calculate the MVL, the ARC would prospectively decline. This means that the current generation of members and employers would be overcharged, resulting in a loss of intergenerational equity. Consider this theory in light of the fact that Nevada PERS has generated an annualized investment return of 9.5% for 27 years, exceeding not only the long term investment assumption of 8%, but clearly exceeding the MVL assumed rate (in this case 4%), as well.

Much of this debate is fueled by the difficult market conditions of the last few years. The markets themselves have been extremely unpredictable in the short term. However, even in this most recent decade, Nevada PERS has exceeded the long term investment assumption of 8% in six out ten years. The last two years the System generated 11% and 21% returns respectively.

Conclusion

No one person, nor any individual theory, can accurately predict the future or control investment results associated with market conditions. At Nevada PERS, the System is managed taking into account short term volatility, but always with a focus on the very long term goal to match the assets and liabilities of the System over the 40 to 60 year time horizon necessary to fund retirement security for the members and beneficiaries of the System. All retirement investors, regardless of whether they are a large pension fund investor like Nevada PERS or an individual investor investing in a defined contribution account, must focus on the very long term goal of income security. Nevada PERS does so in an economically efficient, cost effective manner.

Public pension financing is a complex, multi-faceted topic that carries significant impact to employers, members, beneficiaries, indeed all taxpayers--including public employees. Almost 150,000 Nevadans are directly affected by the System, with perhaps another 500,000 indirectly affected by the contractual benefit that replaces both Social Security's poverty prevention promise and provides a pension allowance for public workers in Nevada. As such a vital and significant program, Nevada PERS adheres to the following principles in advising and informing this ongoing policy debate:

Guiding Principles of Sound Plan Design

- Participation of all relevant stakeholders, including government employers, employees, plan beneficiaries and retirees, and other taxpayers in discussions and processes pertaining to the design and financing arrangements of Nevada PERS
- Policy-driven decision-making based on objective and pertinent information that fairly reflects the long-term time horizon and economic effects of public pension financing, benefit adequacy and benefit distributions
- Tailored solutions, achieved by affected stakeholders working through the state and local legislative and regulatory processes
- Retention of core, indispensable elements of public pension design, namely mandatory participation, shared financing, benefit adequacy, pooled investment and longevity risks, and lifetime benefit payouts
- Removal of federal policy barriers to the preservation of these central retirement plan design features in the public sector and adoption of federal policies that encourage their inclusion in the private sector