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Mr. Thomas J. Cavanaugh and Dr. Brent A. Banister
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200 Main Street, Suite 201H
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Subject: "GASB Won't Let Me" – A False Objection to Public Pension Reform

Dear Mr. Cavanaugh and Dr. Banister,

Thank you for your letter of May 11, regarding my paper, [*"GASB Won't Let Me" - A False Objection to Public Pension Reform*](#), issued by the Laura and John Arnold Foundation. As you know, my paper included material from two actuarial statements by Cavanaugh MacDonald: one in **Kansas** and one in **Kentucky**. Both statements address the implications for amortization payments of closing a DB plan and replacing it with another plan for new entrants.

Specifically, there are two points at issue:

- (1) the role of GASB (or lack thereof) in funding policy, specifically for amortization; and
- (2) the actuarial soundness of maintaining the amortization payment schedule (not accelerating it) when based on total payroll rather than members-only payroll of the closed plan.

Your firm's **Kansas** statement, of April 22, 2011, was a model of clarity and accuracy in both respects. It clearly stated that GASB governs financial reporting but not funding policy. It also clearly explained that if amortization payments were based on total payroll, there was no compelling actuarial reason to accelerate payments upon closing the DB plan. The statement was quite valuable for educating the public, where confusion has been sown. That is why I highlighted it with extensive excerpts, as "a particularly clear statement of the case" (p. 15).

Your **Kentucky** statement, of February 25, 2011 (and earlier versions) was very different. It explicitly and repeatedly stated that GASB requires an acceleration of amortization payments upon closing the DB plan. It was diametrically opposed to the Kansas statement and helped perpetuate public misperceptions. That is why I highlighted your statement as "an excellent example of the confusion about GASB's role" (p. 16). It also failed to inform the public about the potential use of total payroll as an actuarially sound method of avoiding acceleration, unlike your Kansas statement, although I did not make that point in my paper.

Your letter of May 11 takes exception to my presentation of your Kentucky statement. But the public record – what is at issue here – is unambiguous. As you acknowledge, my quotations from your work are "absolutely accurate." Moreover, I quote the relevant passages of your statement in full, so that the reader may have the context. Your letter of May 11 does not claim I have omitted relevant passages from your public statement. Nonetheless, you claim there are "inconsistencies and shortcomings in the conclusions" I draw about your work (paragraph 1).

I find no basis in your letter to support this charge. Indeed, your letter not only affirms the inconsistency between your Kansas and Kentucky statements, it illustrates an even more disturbing problem: the **inconsistency between your public and private statements**.

In the remainder of this letter, I will review your Kansas and Kentucky statements, what I wrote about them, and your May 11 letter (references will be identified by paragraph number).

Does GASB's ARC Determine Funding Policy?

Section 3 of my paper, "Does GASB's ARC Determine Funding Policy?" provides extensive quotations from your Kansas and Kentucky statements. One question specifically posed to Cavanaugh MacDonald for the Kansas legislature, regarding closure of the DB plan, was "What GASB Requirements Apply and How Do They Impact KPERS' Funding?" (KPERS, p. 42) I reproduced from your **Kansas** statement the following passages that respond to this question:

GASB 25 provides guidance for the preparation of governmental pension plan financial statements. It contains procedures regarding the calculation of pension costs to be recognized in different time periods. *This is strictly related to accounting for pension benefits, and does not represent a requirement to fund the plan under the standard.* It does, however, provide one frame of reference with respect to the funding of the UAL. The key measurement in GASB 25 is the Annual Required Contribution (ARC). The Standard sets out rules regarding the amortization of the unfunded actuarial liability for the Annual Required Contribution (ARC). In general, the standard provides that the UAL may be amortized as a level dollar amount or as a level percent of payroll. However, it states that if the level percentage of payroll method is used, projected decreases in the payroll should be reflected if no new members are permitted to enter the plan. Therefore, *for GASB reporting purposes*, the ARC would have to be amortized as a level dollar amount or over a decreasing payroll stream, if the percent of payroll method is used. [emphases added] (KPERS, p. 52)

and

It is important to note that the rules in place under GASB 25 apply to the accounting of pension benefits and are not required to be used to fund the plan. Therefore, absent a requirement in state law or city ordinance, a retirement system does not have to contribute the amount of the ARC. However, the ARC must be calculated in accordance with GASB 25 and used in exhibits in the financial statements of the system and employer. To the extent the actual cash contributions are less than the amount determined

under GASB 25, it is reflected and disclosed in the GASB 25 exhibits. This is the same situation that has occurred with respect to the KPERS contribution for the last 16 years, i.e. the full ARC has not been contributed. [emphasis added] (KPERS, p. 54)

To drive home the significance of the point, I noted (p 16) that when analyzing costs of closing Kansas' DB plan and converting to DC, you maintained the level percent of payroll method with growing payroll (4.0 percent assumed). Thus, in evaluating a prospective closure of Kansas' DB, you found no transition costs based on the GASB accounting rule.

Your letter of May 11 reiterates the point:

...we agree with your basic conclusion that GASB accounting rules should not drive pension reform decisions. You clearly brought that out in the paper with the quotes from our Kansas work (paragraph 2).

In the remainder of your letter's paragraph 2, you offer some sympathetic understanding for those who reached the opposite, incorrect conclusion. That is very charitable, but in no way justifies a claim that my paper carries "inconsistencies."

You also downplay the significance of the erroneous view in paragraph 2, by noting this "is a moot issue," since GASB now intends to drop the ARC, as my paper discusses. However, just last week, the false view of GASB's role was still advanced in Michigan's legislature, to block pension reform (see *Wall Street Journal*, June 13, 2012, "[Michigan's GOP Pension Scrap](#)"). False ideas – even moot ones – can die hard when they serve entrenched interests, if not assertively debunked in public by those upon whom the public relies for independent expertise.

Even after the GASB revision is announced, it will be important to understand how such false views take hold, since there will surely be others that pension experts will need to correct. It is in this context that I presented your **Kentucky** statements as an example of how such false views get propagated:

...as contemplated by the Bill, the contribution necessary to amortize the unfunded accrued liability (UAL) of the various KRS funds will not change but rather will continue in the future until the UAL is completely funded. In fact it is likely the UAL contributions will have to be calculated on a level dollar basis once the KRS funds are closed to new members *in order to meet the current GASB requirements for closed plans*. This will result in an increase in required contributions in the early years after the legislation becomes effective when compared with the results using level percent of pay UAL financing as is now being done. [emphasis added] (KRS, February 21, 2011, p. 2)

and

For KERS and SPRS, passage of this legislation will likely require a shift from level percent of payroll financing of the UAL to level dollar financing in order to meet current GASB requirements. While not impacting the overall cost for employers such a change does generate a higher cost early in the amortization period and a lower cost later, as is

evidenced by the projection results. *This change would also have been required for CERS had the Senate Committee Amendment not mandated the use of level percent of payroll financing for the CERS funds regardless of the GASB requirements.* [emphasis added] (KRS, February 25, 2011, p. 16)

These two passages from your Kentucky statements unambiguously state in two places (and in other places that I did not reprint) that GASB rules require certain contributions. This was incorrect (even before GASB's stated intent to drop the ARC), and it was inconsistent with your Kansas statement. Unlike your Kansas evaluation, for Kentucky you calculated transition costs, based on the GASB accounting rule. You seem to take issue with me pointing all this out in my paper, citing "several mitigating issues" (paragraph 3).

The only exception in which your Kentucky statement could be true was indicated in the qualifying clause in your Kansas statement, "Therefore, *absent a requirement in state law or city ordinance*, a retirement system does not have to contribute the amount of the ARC." I also discuss this exception in my paper, with particular reference to the case of Rhode Island, where some GASB standards are explicitly cited in statute.

However, this did not apply to Kentucky. Your May 11 letter cites Kentucky statute's reference to an "actuarially required contribution" (61.565(5)) as the first "mitigating issue." But as you acknowledge, the term is "undefined in statute" (paragraphs 3 and 5) and is used "ambiguously" (paragraph 5). GASB is not cited in statute. Moreover, the term used in 61.565(5) is not the same as GASB's ARC -- GASB's acronym refers to "annual" (not "actuarial") required contribution. As discussed below, there are perfectly sound "actuarial" methods for amortization that do not follow GASB's rule for closed plans. So I am puzzled by your citation of 61.565(5) as a "mitigating issue" on your assertion of GASB's "requirements" in Kentucky.

You state in paragraph 5 that 61.565(5) "was interpreted by many to mean the GASB ARC." I do not see how this justifies your Kentucky statement. An interpretation by "many" of an undefined term in an ambiguous statute is not a "*GASB requirement*," contrary to the language you used repeatedly in your Kentucky statements. The public relies on public actuaries for their own expertise, not for statements that simply mirror one interpretation held by others.

Moreover, you acknowledge (paragraph 3) that Kentucky statute (61.565(1)) does explicitly "require" (paragraph 5) the use of level percent of payroll. Unlike 61.565(5), there is no ambiguity here about the amortization method. And yet, your Kentucky statement claims, to the contrary, that for closed plans GASB requires a shift from level percent to level dollar. Thus, as I stated in my paper, "Cavanaugh opined that GASB ... trumped statute." It is hard to see what basis you have for objecting to this characterization of your Kentucky statement.

In paragraph 5 you provide a non-statutory explanation for your statement: "we suggested using level dollar amortization because the rate would be lower than level percent of a declining payroll." Of course, it is true that level dollar contributions are initially lower than level percent of a *declining* payroll. But this statement contrasts with your public statements in two respects.

First, the public statement did not say that Cavanaugh Macdonald "*suggested*" level dollar; it said that level dollar was used "*in order to meet the current GASB requirements for closed plans*" (and similar language repeated elsewhere in your Kentucky statements).

In addition, the assertion that level dollar served to lower (your emphasis) the amortization rate contrasts with your public statement: "This will result in an increase [my emphasis] in required contributions in the early years ... when compared with the results using level percent of pay ..."

As we both know, the effect of switching from level percent to level dollar depends on what payroll is being used for level percent: members-only (declining) or total payroll (not declining). **This issue is critical.** It is not explicitly discussed in your Kentucky statement, but your point there that level dollar increases contributions over level percent seems to imply total payroll base. Your letter of May 11 states otherwise, so let us turn to that issue.

Member and Total Payroll

The choice between member and total payroll in the calculation of amortization is discussed in Section 4 of my paper, "Should GASB's Rule on the ARC for 'Closed Plans' Determine Funding Policy?" I favorably cite and quote your **Kansas** statement (p. 21):

If the UAL payment is calculated using the total payroll of members in both the DB and DC plans, the dollar amount of the payroll is the same as if the DB plan were still open. As a result, the UAL is amortized at approximately the same rate of pay as would occur if the DB plan had not been closed to new hires. (KPERs, p. 50)

Your Kansas statement goes on to state "the financing of the UAL can still be accomplished in a manner similar to an open plan." In other words, there is no reason to accelerate amortization if total payroll is used: level percent can be maintained with *positive growth*. It is important for states to know this option is open to them (notwithstanding that GASB's ARC is based on member payroll). Your Kansas statement performed a valuable public service in this regard.

In the case of **Kentucky**, your public statements, quoted earlier, make no mention of this issue. Paragraph 4 of your May 11 letter does. It provides some additional detail to the description in my paper (note 22) of Kentucky SB2's treatment of payroll.

Specifically, your point is that the proposed statute, in conjunction with existing statute, would have applied level percent to a declining closed group, so the contribution rate would be high and, moreover, that this high contribution rate would then be applied to total payroll. Thus, under this interpretation of proposed statute, the existing statute's provision for level percent would lead to a greater acceleration of amortization than if the existing provision was ignored.

This additional detail is interesting, but it has no bearing on my account of your Kentucky statement. Indeed, the account in your May 11 letter bears no resemblance to the account provided to the public. Your public statements unambiguously assert that "GASB requirements" for closed funds lead to an acceleration of amortization payments. Your letter of May 11 states

otherwise, that it was the language of proposed *statute* (not GASB) that forces acceleration. The distinction is quite important, since statute – unlike GASB – is under the control of the drafters.

In short, while your Kansas statement made it crystal clear that the state had the option of closing its DB plan without accelerating amortization by continuing to use level percent on total payroll, your Kentucky statement left the public with the indelible – and incorrect – impression that GASB requires amortization to be accelerated when the DB plan is closed. In the final analysis, that is the key failing of your Kentucky statements.

Miscellaneous Allegations

In paragraph 6 you claim that my account is "contradict[ed]" by a specific fact. However, your account simply provides a different interpretation of the same facts reported in my paper. The legislature left in place existing statutory language specifying level percent for all three systems (under 61.565(1)). It reiterated that language specifically for CERS in a section of the proposed bill that made other changes. In your view, the fact that the legislature did this knowingly "contradicts" my statement that "Cavanaugh continued to opine that GASB trumped statute." I do not see how that follows. Cavanaugh stated unambiguously that GASB required level dollar; statute unambiguously specified level percent. All your paragraph 6 adds is that Kentucky legislators may have failed to put in language what they privately had in mind. But that is irrelevant to the accuracy of my account: Cavanaugh did indeed continue to opine that GASB trumped statute, even if, on your account, the statute did not represent Kentucky's private intent.

In paragraph 7, you argue that my example is not strong because the Kentucky legislature habitually contributed below actuarially determined contribution rates. But the exact same thing was true in Kansas, as quoted in your statement above. And yet, in Kansas your letter was perfectly clear on both issues in question: the role of GASB and the option of using total payroll. In Kentucky your statement was misleading on GASB and silent on total payroll.

Conclusion: A Modest Suggestion

Finally, in paragraph 8, you suggest that my paper would have been stronger if I had talked to you first. In an odd way, I agree, but not for the reasons you state. There is nothing in your letter that changes any of my conclusions or that supports your claim of inconsistencies or contradictions in my paper. And yet, your letter provides compelling evidence that I could only hint at in my paper, namely **the wide discrepancy between what some members of the public pension community say in public and what they say in private.**

The contrast between your May 11 letter to me and your public Kentucky statements supports the reaction that the Arnold Foundation received from a rather prominent observer of the public pension policy world. That individual stated, "**Some of the people Costrell cites as taking contrary views actually have expressed views similar to his in private conversation, but this is the first time I have seen the arguments laid out and hammered down**" [my emphasis].

It seems to me that the public is ill-served by those who are paid to provide public information when their private statements differ so markedly from their public statements. Your letter seems to imply (paragraphs 6 and 7) that this is not so important, since private thought processes are made "obvious" by decisions not taken. If that is your view (and I may well misunderstand you), I disagree. Legislators depend on public opinion to validate their choices. It is the public statements of public actuaries that inform public opinion – or the absence of their public statements that leaves the public uninformed.

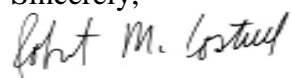
In the case of Kentucky, incorrect conclusions, based on your misleading statement were reported in the [Louisville Courier-Journal](#) and the [Lexington Herald-Leader](#). Your statement was also the basis for erroneous conclusions presented in the Legislative Research Commission's [Fiscal Impact Estimate](#); as you know, such Fiscal Notes are heavily relied upon by legislators. These conclusions not only included the soon-to-be-moot point about GASB's role; they clearly implied that is impossible to close a DB fund without accelerating amortization.

The current case of Michigan's PSERS debate is a good current example of knowledgeable actuaries being missing in action. [Key legislators](#), relying on a misleading report of the Senate Fiscal Agency, claimed that closing the DB plan would cost \$1.4 billion over six years, due to GASB-required acceleration of amortization. As you would agree, this claim is false, and yet the actuarial community was silent (at least in public). As a result, the Michigan House voted to fund a [\\$100,000 study](#) to examine the question. Taxpayer money could surely be saved if the actuarial community would speak up with statements similar to your Kansas statement.

I would like to close on a constructive note. Although GASB's "divorce" from funding will become clear to all soon enough, confusion may continue to be spread by advocacy groups such as NIRS on the impact of closing DB plans. To be sure, recent statements by NIRS and [NASRA](#), in response to my paper, have now belatedly acknowledged that GASB does not govern funding policy (contrary to previous claims by NIRS, supported and circulated by NASRA). But the same NIRS statement doubles down on the flawed claim that the GASB rule for closed plans is required for actuarially sound funding. That is, NIRS ignores the total payroll vs. member payroll issue, laid out in my paper and, before that, in your Kansas statement.

As this actuarially flawed argument about the impact of closing DB plans continues to be deployed, firms such as Cavanaugh could be of great service in disseminating such information as found in your Kansas statement on this point. It is not widely understood that basing amortization on total payroll can be an actuarially sound alternative to accelerating payments upon closing the DB plan. Cavanaugh could be particularly helpful in informing the public, and straightening out advocacy groups such as NIRS, who continue to sow confusion on this point. I know that I will continue to draw on your Kansas statement in my own public efforts. Indeed, I just did so in an [op-ed](#) posted today by *Pensions and Investments*.

Sincerely,



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