May 11, 2012

Dr. Robert M. Costrell, Ph.D.
Laura and John Arnold Foundation
1800 Post Oak Boulevard
Suite 380
Houston, TX 77056

Subject: “GASB Won’t Let Me” – A False Objection to Public Pension Reform

Dear Dr. Costrell:

We read with great interest your paper “GASB Won’t Let Me” – A False Objection to Public Pension Reform published in May 2012. Since you quote our work extensively, we thought it best to point out some inconsistencies and shortcomings in the conclusions you draw about that work.

First let us note that 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. That some might argue that to be the case, absent any other restraints, is a moot issue as GASB is, as you point out, very close to making revisions to the applicable accounting statements that will divorce accounting and funding. However, it is logical that many came to that conclusion when GASB established parameters for determining an annual required contribution (ARC), and then required any actual shortfall in contributions as measured against the ARC be put on the employer’s balance sheet as a liability. Including a contribution that meets the ARC parameters in a plan’s funding policy was thus a very rational decision.

The concern we have with the paper is your use of our work for the Kentucky Retirement Systems as the poster child for actuaries run amok with the GASB requirements. The quotes from our work are absolutely accurate, but you fail to point out several mitigating issues. First Kentucky statute requires a contribution based on the “actuarially required contribution” (undefined in the statute) for the Kentucky Employees Retirement System (KERS) and the State Police Retirement System (SPRS). The contribution is phased in over a number of years, eventually reaching 100% of the actuarially required contribution. The statute does refer to using a level percent of payroll amortization of the unfunded accrued liability (UAL).

When SB 2 was under consideration we noted the problem with level percent of payroll on a closed group. SB 2 would have closed the existing retirement systems to new members and created an entirely new defined contribution plan for new hires. It would have further required employers to contribute on total payroll at the same rate as was calculated for the DB plan participants. In other words the bill would have required a calculation of the plan rate for the closed plan, and then required contributions on total payroll at that rate.
Even though statute requires the use of level percent of payroll and the contributions being phased in for KERS and SPRS ambiguously used the term “actuarially required contribution” which, though as noted above undefined was interpreted by many to mean the GASB ARC, we suggested using level dollar amortization because the rate would be lower than level percent of a declining payroll. The projections we performed reflected the additional contributions anticipated to be made by employers on the payroll of members in the new DC plan, but at a rate determined using level dollar amortization.

You go on to note the apparent contradiction when the legislation was changed to specifically require level percent of total payroll financing for the County Employees Retirement System (CERS). Obviously by making that change the legislature was aware of the issue and could have required level percent of total payroll financing for KERS and SPRS, but chose not to. The fact that they did not change the statute contradicts your claim that “Cavanaugh continued to opine that GASB trumped statute”.

Finally your example would have been much stronger had you not selected an entity whose legislature is very aware that they alone control funding policy for the plans. The Kentucky legislature has for years ignored the Board of Trustees’ certified actuarially determined contribution rates, choosing instead much lower rates to the detriment of the plans’ funded status.

We would have been pleased to discuss all this with you when you were researching your paper. We hope that in the future you will give those whose work you plan to incorporate an opportunity to make sure you have the full picture so as to make the strongest case for any conclusions you draw.

Sincerely,

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Chief Executive Officer

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Chief Pension Actuary