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R. KINNEY POYNTER
Lexington, Kentucky

CONTACT INFORMATION

Headquarters Office
449 Lewis Hargett Circle
Suite 290
Lexington, KY 40503-3590
(859) 276-1147
Fax (859) 278-0507

Washington Office
444 N. Capitol Street, NW
Suite 234
Washington, DC 20001
(202) 624-5451
Fax (202) 624-5473

www.nasact.org

September 27, 2012

Marcia Van Wagner, Vice President and Senior Analyst
Moody's Investors Service
7 World Trade Center at 250 Greenwich Street
New York, NY 10007

Dear Ms. Van Wagner:

On behalf of the members of the National Association of State Auditors, Comptrollers and Treasurers (NASACT), I am pleased to provide our comments to Moody's proposal, *Adjustments to U.S. State and Local Government Reported Pension Data*.

We share Moody's goal of improving transparency in reporting of public pension liabilities, and we understand the potential value of a standardized evaluation methodology. Moody's is a strong, highly-respected, and highly-recognized rating agency, and many states have enjoyed a longstanding relationship with Moody's. However, for the reasons described in this letter and the attachment, we do not support the approach outlined in Moody's proposal.

Our primary concern centers around the **confusion** that we believe Moody's new evaluation methodology will produce, especially given the recent passage of the two new pension standards released in June by the Governmental Accounting Standards Board (GASB):

- Statement No. 67, *Financial Reporting for Pension Plans*—an amendment of GASB Statement No. 25
- Statement No. 68, *Accounting and Financial Reporting for Pensions*—an amendment of GASB Statement No. 27

As Moody's recognized in its request for comments, GASB Statement No. 68 is the culmination of a three-year project and was subject to extensive due process. GASB believes the new statement will "substantially improve the way state and local governments report their pension liabilities and expenses resulting in a more faithful representation of the full impact of these obligations."

Moody's acknowledges similar goals in its proposal. In fact, several of the provisions in the new GASB statements are similar to those contained in Moody's proposal (with the primary exception of a fixed discount rate). Accordingly, we **strongly** urge Moody's to wait until the new GASB statements have been implemented before developing another methodology for measuring pension liabilities and expenses.

We believe that the introduction of another set of pension numbers (unaudited in this case) at this time will only create more confusion and possibly panic for investors, policy makers, financial statement users, media outlets and the citizens (many of whom do not fully understand the debate on short-term vs. long-term discount rates and the impact on overall pension liabilities or the long-term nature of public pension plans). The one-size-fits-all approach does not seem warranted or appropriate.

The attachment to this letter provides more detailed comments to your proposal. I hope you find our comments useful and productive. Should you have any questions about our comments, please contact me at (617) 973-2315, or Kinney Poynter, NASACT's executive director, at (859) 276-1147.

Sincerely,

Martin J. Benison
President

Attachment

Moody's *Adjustments to U.S. State and Local Government Reported Pension Data*
Detailed Comments from NASACT

Two Areas Specifically Requested for Comment

In the document, Moody's indicates that it is specifically seeking feedback regarding two points:

1. The usefulness of the proposed adjustments in enhancing the comparability of pension obligations among state and local government entities.

   It is our understanding that Moody's proposes to make the same standard adjustments to the disclosures reported by various governments (for example, discount actuarial accrued liabilities using a high-grade corporate bond index rate). The logic of this approach is unclear, as we do not understand how applying a common rate or other adjustment calculation to disparate numbers produced by a variety of state and local governments, under a variety of conditions and assumptions, can somehow generate numbers that are significantly more comparable.

   Further, there are many variables that make comparability of pension obligations an unattainable goal. Among these are:

   - First, benefit structures vary greatly from entity to entity and change over time with new tiers of benefits being established. There are profound differences in employee contributions, benefit eligibility, benefit formulas, and retiree cost of living adjustments (COLAs). Moreover, some governmental entities provide Social Security coverage for their employees and some do not. Those entities that do not provide social Security Coverage generally provide a higher level of employer provided benefits to compensate for this difference. Also, entities provide different levels of benefits as part of their compensation strategy.

   - Second, the investment strategy of pension plans can vary significantly with some plans having an aggressive investment approach and others being more conservative. Plans that are more aggressive will typically realize greater volatility than plans that are more conservative. Investment strategy is a significant variable in that 40 to 60 percent of expected income to meet pension obligations will be derived from investment income.

   - Third, funding and actuarial strategies are quite diverse among entities. Some plans utilize stronger economic and demographic assumptions than others. Following the discount rate, the other major assumptions are salary, employee turnover, and mortality. Some plans utilize stronger actuarial methods than others.

2. The efficacy of treating pension liabilities similarly to debt to improve the analysis of the long-term liabilities of these governmental entities.

   There are certain aspects of pension obligations that are analogous to debt. With most pension plans providing vesting after five to ten years of service and benefits protected by constitutional provisions or by contractual rights, pension benefits are clearly an obligation of the employing entity just as bond interest and principal are obligations of the issuing entity.

   However, the measurement of pension obligations is generally more complicated, is subject to more variables, and is susceptible to greater volatility than bond indebtedness. Pension obligations can be significantly affected by: (1) external factors such as the financial marketplace and inflation, and (2)

internal factors such as mortality, turnover, and employment policies (such as salary policy and reductions/increase of the workforce). Further, the extent to which the pension liability is clear and fixed is yet to be determined, as evidenced by the variety of ongoing litigation concerning states' ability to alter pension benefits.

Further, we do not believe there is efficacy in Moody's proposal for treating pension liabilities similar to debt because of the arbitrary application of a corporate bond rate that bears no relation to the ongoing nature of most government pensions. Pension liability valuations are highly dependent on detailed actuarial assumptions and cannot reasonably be estimated at the aggregate level. In contrast, GASB Statements No. 67 and 68 will provide an audited valuation that will be viable for reporting pension liabilities similarly to government debt liabilities.

Four Principal Adjustments

Below are our comments on the four principal adjustments to as-reported pension information:

1. *Multiple-employer cost-sharing plan liabilities will be allocated to specific government employers based on proportionate shares of total plan contributions.*

   We do not object to the allocation of cost sharing multiple employer plan liabilities to participating governments. GASB Statement No. 68 takes a similar approach including allowing single year contribution amounts as the basis for the allocation when long-term contribution information is not available. Notwithstanding our conceptual agreement with this approach, there is little likelihood that Moody's will have the information necessary for an accurate allocation, and the presentation of both Moody's allocation and the audited GAAP allocation will degrade the credibility of both.

   Also, we are concerned that Moody's proposed treatment of on-behalf contributions could be inconsistent with the GASB requirements. Moody's indicates that its adjustment "in some cases may exceed the state's legal liability." The GASB has included extensive recognition and disclosure requirements related to special funding situations, and any proposed adjustment that deviates from those requirements could be significant. Also, no consideration is given in Moody's proposal to situations where employee contributions exceed their total service cost, in which case, a reduction to the total pension liability would occur.

   Lastly, since this proposed change is similar to GASB Statement No. 68, we question the need for Moody's to do something separately. While as an interim measure, Moody's suggested adjustment may be an acceptable alternative, it would seem more prudent and efficient for Moody's to await the implementation of GASB Statement No. 68 by the states.

2. *Accrued actuarial liabilities will be adjusted based on a high-grade long-term corporate bond index discount rate (5.5% for 2010 and 2011).*

   We disagree with this proposal. The high-grade corporate bond index discount rate is not reflective of the long-term nature of pension funds and the long-term expected investment return of a well-diversified portfolio of securities. Because pension plans have a long-term investment horizon, it is entirely appropriate to use a discount rate that equates to a well-diversified portfolio which is the approach GASB has taken in Statement No. 68.

   GASB Statement No. 68 states, "The rate used to discount projected benefit payments to their present value will be based on a single rate that reflects (a) the long-term expected rate of return on plan investments as long as the plan net position is projected under specific conditions to be sufficient to pay pensions of current employees and retirees and the pension plan assets are expected to be invested using a strategy to achieve that return; and (b) a yield or index rate on tax-exempt 20-year, AA-or-higher-rated municipal bonds to the extent that the conditions for use of the long-term expected

rate of return are not met." The GASB discount rate requirements were established after deliberation and consideration of a number of discount rate approaches and we believe better reflects the long-term nature of state government pension plans.

We do not believe that Moody's proposed rate, while it would be easier to calculate and apply, represents a better, more theoretically sound alternative. Quite frankly, our concern is that users will misinterpret a pension plan's financial status and continuing financial obligation if Moody's utilizes a single valuation method (a high-grade corporate bond index discount rate) and publishes only the data from this single method.

3. *Asset smoothing will be replaced with reported market or fair value as of the actuarial reporting date.*

   The GASB also will require use of market/fair value of assets in computing the net pension liability. However, although the impact on the liability will be reflected as of the measurement date, the impact on pension expense for differences between actual and estimated returns on assets will be amortized over a closed five-year period. Moody's is not clear on how the impact on pension expense would be handled under its proposal, but we recommend they adopt a process to mimic the GASB amortization requirements.

   Again, as suggested previously, it would seem more prudent and efficient for Moody's to await the implementation of GASB Statement No. 68 by the states.

4. *Annual pension contributions will be adjusted to reflect the foregoing changes as well as a common amortization period.*

   We do not believe that pension contribution amounts should be recalculated. As noted in the GASB statements, financing pensions is "a policy decision for government officials or other responsible authorities to make." Whether contributions are based on actuarial determined amounts or on some other basis, a third party should not define a one-size-fits-all funding parameter. GASB Statement No. 68 includes disclosure and required supplementary information (RSI) information that will allow readers to assess the adequacy of a plan's funding policy without defining a standard funding approach.

   Further, the use of an arbitrary amortization period (17 years) is very disconcerting given that governments have widely varying average remaining service lives in their employee populations. In addition, governments are establishing new tiers of employee benefits that result in later retirements and longer average remaining service lives. Moody's proposed approach will seriously compromise accuracy in the quest for comparability. Financial information must meet multiple objectives not just the single comparability objective.

Additional Miscellaneous Comments

We offer the following additional comments based on our review of the document.

- Footnote 1 on page 1. "*These adjustments do not apply to the non-profit sector, including hospitals and higher education, which must meet uniform accounting and funding standards set by the Financial Accounting Standards Board*." This statement regarding higher education is only correct when applied to private institutions. Higher education institutions that are governmental entities are required to follow GASB, not FASB.

- Last paragraph on page 1. "*We propose these adjustments to address the fact that government accounting guidelines allow for significant differences in key actuarial and financial assumptions, which can make statistical comparisons across plans very challenging*." It would seem appropriate for

Moody's to recognize in this sentence that GASB has issued two new standards that require consistency in application of key actuarial and financial assumptions.

- Page 2, first bulleted item. "The usefulness of the adjustments in enhancing the comparability of pension obligations among state and local government entities." We do not believe such adjustments will be either correct or useful. Actuarial methods apply the discount rate at the level of individual employees, and there is no acceptable methodology for Moody's to apply the proposed 5.5 percent discount rate to the plan in the aggregate. In addition, because the proposed discount rate will not be applied at the individual employee level and because it will not follow GASB's conditional application of a bond index rate, it will introduce an unaudited pension valuation number that will not align with audited amounts and will bring additional confusion to an already misunderstood area of financial reporting.

- Page 2, midpage. "*The proposed adjustments described in this Request for Comment would nearly triple fiscal 2010 reported unfunded actuarial accrued liability ("UAAL") for the 50 states and our rated local governments, increasing UAAL to $2.2 trillion from $766 billion."* It is difficult to understand how Moody's can assert that state ratings will not change if they are contributing material to this tripling of the UAAL; it appears that the states are a significant part of this increase given the last sentence in the same paragraph where Moody's asserts that state contributions would need to increase 352 percent for 2010 under its model. The only way to reconcile the liability increase and the unchanging ratings is to recognize that Moody's and other statistical ratings agencies already are recognizing the full effect of state's pension liabilities in the ratings provided. The result is there is little benefit to be provided by the proposed change while there will be significant cost to the credibility of all governmental financial reporting because of Moody's presentation of an unaudited valuation amount in competition with the generally accepted and audited GASB standards-based amount.
- Page 3, paragraph 3. *"While the funded ratio (ratio of assets to liabilities) is a highly visible measure of pension condition, it does not relate the size of unfunded pension obligations to the scale of an issuer's resources."* This attempt at comparability by reference to Gross Domestic Product does not honor the citizen's ability through elected officials to set the size of government. A government's resources, whether measured in GDP or revenues, is not necessarily related to its employee/retiree population. Therefore, we believe that GASB's measure of UAAL as a percentage of covered payroll to be a more relevant measure of a pension's impact on the citizen's willingness to fund personal services costs of operating the government.
- Page 4, paragraph 2. *"Once it is in effect, we believe differences in some key financial assumptions, such as determination of investment rates of return and discount rates will persist across the public plan landscape."* After recognizing on page 4 that already-issued GASB standards will address the core issues raised, the proposal discounts that fact by challenging the standard setter's rates of return and related liability discount rates. We believe that each plan's risk tolerance, investment horizon, investment expertise, and access to specialized investments dictates a unique investment return assumption that should not be one-size-fits-all as the proposal recommends. Under the new GASB standards, variances in investment assumptions will promptly be reflected in the Net Pension Liability. It will be of much greater value to all financial statement readers to know how the actual returns compared to projections for the plan than to know how actual returns compared to an arbitrary rate selected by a body that does not have standard setting authority or independence in the measurement of liabilities.
- Page 4, paragraph 4. *"We propose these adjustments for the purpose of providing greater clarity and comparability to investors, and to assess the scale of pension liabilities in a way comparable to debt obligations. We are not suggesting that they be a guide, standard or requirement for a state or local governments to fund these obligations."* As discussed above, we believe the proposed comparability will be significantly inaccurate and potentially misleading. Clarity will not result when the aggregated adjustment and the arbitrary discount rate does not align with the GASB required presentation. The credibility of Moody's and of all governmental financial reporting will suffer. It is of little consolation

that the proposal does not purport to be a guide, standard, or requirement for funding the liability – the same is true of GASB's Statements No. 67 and 68.

- Page 4, Footnote 3. *"GASB 68 is expected to be published in August 2012."* GASB 68 was published June 25, 2012.
- Page 5, paragraph 3. *"In a very few cases, states have not disclosed the contribution information necessary for us to allocate a specific cost-sharing allocation to the state. In those instances, we would assume the state share is 100%, until better public disclosure is available. We would, however, allocate CSP liability shares to the rated local government participants in the usual manner."* The assumptions throughout this section proposed for adoption in the absence of information are extreme. The necessity of such assumptions points to conceptual flaws of the approach when information is not available. We believe the investing community would be better served by Moody's waiting for the GASB pension standards to be in place than to be presented with amounts that even the proposal recognizes will be inaccurate.
- Page 6, bullet 1. *"Investment return assumptions in use by public plans today are inconsistent with actual return experience over the past decade (when total returns on the S&P 500 index grew at about 4.1% annually) and today's low fixed-income yield environment."* This statement implies a funding approach rather than a liability approach. Pensions invest with a horizon up to 70 years (a twenty year old employee expected to live to age 90). While a prudent government should adjust funding actions to reflect near term trends, the 10-year return is not relevant to the measurement of an actuarial liability. Unfortunately, it is likely that our economy will continue to generate asset bubbles such as the tech bubble, the housing bubble, and the derivatives bubble that will mitigate the current short-term low returns. It is also possible, should we not succumb to a deflationary spiral, that real inflation resulting from years of fiscal and monetary stimulation will make the 7.5 percent to 8.5 percent assumption appear woefully understated rather than overstated. Moody's proposal appears to react solely to the critics, some of whom have questionable motives, and fails to assess the long-term prospects for plans that are adjusting to changing investment conditions at a measured pace. While the proposal is convenient for mitigating Moody's ratings risk, it is not reflective of the very long-term horizons under which pensions must be managed.
- Page 6, bullet 3. *"A high-grade bond index is a reasonable proxy for government's cost of financing portions of its pension liability with additional bonded debt."* It is misleading to presume that a bond index is appropriate because stressed governments will follow one bad fiscal decision (i.e., underfunding its pension), with another bad decision (i.e., bond financing its underfunding). It is much more likely that governments will declare actuarial necessities to escape the contracts requirement and then lower benefits of existing retirees.
- Page 6 paragraph 6. *"This proposed approach to the discount rate is similar to that used in the private sector, where Financial Accounting Standards Board (FASB) regulations require pension systems to discount assets at a rate consistent with the yield on high-quality corporate bonds."* There is no basis for comparing government pensions to the private sector. The private sector has the ability to shed its pension liabilities to the federal government when its economic model fails. In the event of government pension funding shortfalls, a state government is forced to either alter benefits structures or employ its taxing and fee authority.
- Page 6 paragraph 7. *"To implement the discount rate adjustment, we propose using a common 13-year duration estimate for all plans. This is a measure of the time-weighted average life of benefit payments. Each plan's reported actuarial accrued liability ("AAL") is projected forward for 13 years at the plan's reported discount rate, and then discounted back at 5.5%. This calculation results in an increase in AAL of roughly 13% for each one percentage point difference between 5.5% and the plan's discount rate. For example, a plan with a $10 billion reported AAL based on a discount rate of 8% would have an adjusted AAL of $13.56 billion, or 35.6% greater than reported."* This text is written as if the AAL is measured at the retirement date (assuming an aggregate average post-employment life expectancy of 13 years). We do not believe that reflects what occurs in measuring

the AAL. The AAL represents the liability at the valuation date and reports the allocation of that liability to past and current service but not the portion allocated to future service. The Moody's adjustment proposal ignores the remaining service lives of current employees (previously cited by Moody's as 17 years in aggregate average) and the actuarial allocation methodology used. These assumptions are too broad and inaccurate to produce meaningful results.

- Last paragraph on page 6 (and all of page 7 and much of page 8) on asset and liability smoothing. "*While reducing the volatility of required contributions, this practice can distort the size of unfunded liabilities and limit comparability, particularly when there have been wide swings in investment performance."* We do not agree with this statement. Pension contributions are often set in state statute and do not react promptly to market volatility even if the valuations are done using market values rather than smoothed market values. In most states legislators appropriately consider the long-term solvency of the plan when setting contribution requirements not the market value of the day. Due to the time involved in the actuarial valuation process and the legislative cycle, reacting to market based valuations is not feasible or prudent. Comparability is not limited under the smoothed market values approach because most plans use comparable smoothing techniques. When a plan does not use the generally acceptable smoothing period, that condition is disclosed and investors are aware that the plan sponsors may be manipulating the plans valuation. The proposal appears shortsighted in that it addresses the risk related to lagging valuations in a declining market, but seems to ignore that ratings agencies and investors benefit when smoothed valuations prevent understating the UAAL in a rising market. It is informative that the call to "fix" smoothing was not heard during the technology or housing bubbles that overheated the markets. Given the long-term horizon of pension liabilities, a successful plan will most closely match the long-term return rates. Human beings are notoriously unreliable in making long-term decisions when presented with short-term data, but plan managers are trained to understand this phenomenon. The proposed GASB standards will provide adequate recognition and disclosure for ratings agencies and investors to assess whether smoothing is inappropriately affecting plan valuations or whether it is appropriately damping market bubbles that cause valuations that are not representative of the long-term funding condition.
- Page 8, last paragraph. "*New discount rate applied to normal cost.*" The approach described in this paragraph ignores that the actuarial discount rate is also applied in the retirement period (when no contributions are being made) – not just during the remaining service life of the employee. Correctly applying the discount rate would require knowledge of the life expectancy of the employee/retiree. Actuarial methods recognize such information is population specific and apply the statistics on a person-by-person basis; averaging assumptions are not valid within a plan or across plans. Such averaging assumptions may be marginally accurate across the industry, but governments pay ratings agencies for individual credit ratings, not for the application of sector-wide assumptions to their issuances.
- Page 9, paragraph 1. *"Uniform amortization of the UAAL."* While the proposal notes that its 17-year amortization period is similar to the GASB 68 standard, it provides no basis for selection of that period. The UAAL comprises portions related to current employees and to beneficiaries long since retired. It is significantly dependent on the current valuation of assets. As a result, there is no relationship of UAAL to the remaining service life of the current employees. The government cannot reasonably be presumed to be shutting down at the end of the average remaining service life. The selection of any amortization period is arbitrary, and we believe GASB selected average remaining service life primarily to ensure that closed plans would be required to recognize their full UAAL as a Net Pension Liability. As noted in response to other assumptions, the proposal's selection of 17 years is unlikely to be representative of any individual government, and thus will produce an amortization amount that does not align with the GASB Statement No. 68 amount. Governments may be unwilling to pay for ratings services that apply unaudited sector averages rather than accurately assessing the individual government's pension liabilities.
- Page 9, paragraph 4. *"This change decreases the funded ratio to 55%. With the additional adjustment of asset valuation, the sector's UAAL grows to $1.056 trillion, or 74% of total annual state revenues,*

from $391 billion, or 28% of revenues, an increase of 170%." The amounts in this sentence need to be placed in context. Assuming an average employee age of 45 and average life expectancy of 90 years, this liability will be paid over 45 years. Assuming level revenues of $1.427 trillion ($1.056/.74) for the ensuing 45 years (a significant understatement used only for convenience), the UAAL of $1.056 trillion represents 1.6 percent of revenues over the period in which the liability will be paid. While all plans should operate with a target of zero UAAL, it is not inconceivable that future market bubbles will produce zero UAAL measurements over the next 45 years. The proposal states, *"Our adjustments to state sector annual pension contributions result in an increase of 252%, from $36.6 billion to $128.8 billion, or from 2.6% of revenues to 9.1% of revenues."* We believe it is inappropriate to report this average; it results in very austere plans being represented as having a problem they don't have while states with crushing UAAL's disproportionately affect the sector-wide results.

- Page 10, paragraph 1. *"We do not, however, anticipate mass rating actions because in the past our analysis of pensions has included an assessment of the assumptions underlying the reported data and the fact that pensions are only one factor in our analsysis* (sic)*."* Given that Moody's expects no state ratings adjustments, it is unclear why Moody's is willing to risk applying sector-wide averages rather than government specific facts and in the process degrade the credibility of its ratings and GASB's Generally Accepted Accounting Principles.
- Page 12, paragraph 3. *"Wage Growth Assumptions."* This paragraph should reflect that the assumptions for increasing wages have remained in place over recent years when many government employees have experienced zero wage growth and in some instances real wage reductions due to requirements for additional contributions to the pension plan by employees.
- Page 13, paragraph 2. *"However, the data did provide some level of comparability across plans and the general magnitude of the assessment is reliable."* While we understand ratings agencies' desire for comparability, we believe is an unachievable goal because benefit structures vary widely and have very significant effects on benefits liabilities. In addition, there are often good and valid reasons for differences in actuarial assumption including the discount rate.
- Page 13, second to the last paragraph. *"Variance in fiscal years." "However, these vary–most operate on a June-July fiscal year, but some operate on a calendar year and others on a federal fiscal year (October 1-September 30) or something else (New York State's fiscal year begins April 1)."* Most governments operate on a July-through-June fiscal year not on a June-July fiscal year.
- Page 14, paragraph 2. "*Allocation of cost-sharing plans."* This paragraph describes succinctly why it is not possible or advisable to apply general assumptions to plan calculations that have many variables and structured standards dictating required calculations.