

To: Special pension commission members
From: Tom Sgouros
Date: 14 December 2023
Re: ERSRI, into the future

Thank you for the time to speak. My name is Tom Sgouros, and I am a research faculty member in the Computer Science department at Brown, where I am also a fellow at the Policy Lab. For several years, one of the main topics of my research has been the accounting rules we use for evaluating the health of a pension fund.

I wrote two reports on the subject for the National Conference of Public Employee Retirement Systems, and I consult with pension systems around the country about how better to measure their capacity and funding progress.

The problem with the current accounting rules is that they tend to emphasize risks that are not real, while also de-emphasizing risks that are. Liquidation of the plan sponsor is an example of a risk that isn't real. Rhode Island is not going to be liquidated, and that means that 100% funding is not essential to the operation of ERS, even if it's nice to have a big healthy cushion against investment volatility.

Volatility is, of course, a risk that a pension plan does face, but plays no part in the accounting rules, since they use present value. Investment risk is also ignored, and all assets are accounted at their market value. In essence the accounting rules completely ignore the lessons of the last century in banking and insurance, where accounting for risk is a big deal.

This misplaced emphasis is not just a curiosity — the effect it has is to encourage bad decisions: to load up on risk to boost yield, to make projections assuming no market swings, and to treat a system as a financial institution, instead of what it really is, a mutual aid pact where risk is widely shared to reduce its burden on any individual.

I ran a working group in 2021 made up of nationally recognized experts in the public pension world, to think of metrics that might do a better job of identifying the real threats.¹ For example, we looked at the ways in which the current rules privilege the balance sheet over questions of cash flow, and proposed a metric to rigorously answer the question of how much money one needs to add to a system to leave it in the same condition at the end of the year as it started.

Remember, the most important thing about a pension plan is that the checks always clear. The second-most important thing is that this be done in the least

¹The reports I wrote are available at <https://sgouros.com/finance>.

expensive way possible. These are cash flow issues, but the standard accounting is all about the balance sheet: the total liability and the total assets on hand. These are useful ideas, but they distract from the goal.

Another of our metrics suggests that the best way to measure a pension liability is not merely as a big number, but as a big number that might be usefully compared to the financial clout of the sponsoring government.

When you look at the total liability of the ERS system, both the state employees and the teachers, it rises very little, a bit more than half a percent per year from 2023 to 2028. According to the projections used for the state budget, the economy is projected to grow 3-4% per year over that same time, and income tax collections by 4.1% per year, and state revenues by 2.6% per year. The total liability of the system becomes more affordable every year.

Another thing that happens with pension funds is the endless arguments about the rate of return one can expect to receive. Here, too, there is another way to look at things. If you consider a specific plan member, during their career they represent money flowing into the fund and after retirement they are money flowing out. From a simple cash flow like that it is easy to derive an interest rate to make that cash flow net out to zero. Do that for all the members, at the current contribution rates, and you have an estimate of the returns you need to make to fund those benefits. Instead of a prediction of the future, you have a threshold, and an estimate of how much risk is entailed by promising those benefits.

A friend asked me a couple of days ago, "is the money there" to be more generous, to change the rule of 95 to the rule of 90, for example, or restore the COLA before getting to 80%. I don't want to be the guy who says hey everything is possible because that's kind of the source of lots of the legacy liability. I do think that at this point, it makes sense to counter benefit improvements with compensating system changes, to give in order to get, and keep things in balance.

But the gives and gets don't have to be only on benefits, strictly construed. For example, I've heard of plans that sell annuities to their members at the maturity of their DC plans, and earn a little money on that business while still providing better value than insurance companies can. This would provide the fund with additional assets, as well as cash flow, making it more secure.

I know of other plans that maintain their funding levels by pushing a certain amount of risk onto their members. In a sense, that is what was done here, making all the retirees bear the burden of inflation risk, or the members bear the burden of investment risk on their 401k contributions. But not all members are equally able to bear those burdens, and it would seem feasible to distinguish levels of benefits when reallocating risk. Can the retired plumber with the

\$19,000 pension bear inflation risk as easily as the retired department director?

And this is the message I want to leave with you. There are a lot of invisible boxes that surround the way we think about pension systems. Again, the goal should not be some illusory funding target, but simply to make sure the checks are good and do it in a sustainable way, both politically and financially. This means paying more attention to cash flow than is traditional, and more to the many issues of risk: how much is it and who assumes it?

I'd like to reiterate something I said early, that a pension system is not a financial institution as much as it is a mutual aid pact, where many people share the inevitable risk that comes from living in a complicated and confusing world. In the end, sharing that risk is the only way anyone has ever invented to make it better.

A pension system — and let me be clear that I mean only what we have come to call a defined benefit system — is a brilliant invention, in its day as important a contribution to our society as refrigeration or internal combustion. We are the stewards of that invention and our mission should be not only to preserve this particular system, but to preserve the idea that this kind of risk-sharing institution is possible because in the end, this is how we make life better for all.

