The Myths of "Marked-to-Market" Pension Accounting

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"Marked-to-market" pension accounting (MMPA) is not gaining popularity these days. Financial statements that utilize the principles of MMPA show growing "liabilities" that are virtually meaningless. Funding regulations that utilize the principles of MMPA require painful contribution increases while these resources could be used more productively elsewhere. Overall, MMPA creates significant difficulties for plan sponsors.

Regulators have taken notice. For corporate DB plans, the discount rates mandated by the MAP-21 (Moving Ahead for Progress in the 21st Century signed into law in July 2012), are based on 25-year average corporate yields with a "corridor" — a clear rejection of MMPA. For public DB plans, the Governmental Accounting Standards Board declined to fully implement MMPA in adopting new pension accounting standards for measuring pension commitments in June 2012. In Europe, regulators in several countries are taking steps to mitigate the negative impact of MMPA. It is becoming increasingly clear that MMPA may be detrimental to the health of retirement systems.

In light of these developments, it is informative to inquire why a seemingly good idea in theory — to account for current pension obligations as the market prices of matching bond portfolios — has not worked well in practice. Clearly, it is reasonable to benchmark a plan that intends to settle its pension commitments by investing in a matching bond portfolio to the market price of this portfolio. The proponents of MMPA, however, wish to expand it to *all* DB plans — public and private, ongoing and frozen, etc. — regardless of the intentions of these plans. This expansion is based on several myths that include the following.

- *MMPA is a good public policy*. It is hard to find any evidence of MMPA's beneficial impact on retirement systems. To the contrary, retirement systems that implement MMPA normally experience numerous plan closures, freezes, and terminations. Moreover, there is some evidence to suggest that the management of pension assets implied by the MMPA mindset leads to suboptimal allocation of capital.
- *MMPA promotes better pension plan management*. MMPA produces confusing and inexact measurements of the quality of pension plan management. In particular, the movements of interest rates that are a major factor in the MMPA measurements are outside of control of pension plan managers.
- *Matching assets and MMPA "liabilities" is in the best interests of plan participants*. Optimal policy portfolios generated by asset-"liability" matching generally neither maximize the safety of benefits, nor minimize the cost of funding these benefits. Instead, these portfolios minimize the volatility of the plan sponsor's financial statements, which is not necessarily the most sensible goal of pension investing.

- *MMPA "liabilities" are indispensable for the development of optimal policy portfolios.* The process of optimal policy portfolio selection requires risk measurements rather than accounting entries. These risk measurements may have little to do with MMPA.
- *Financial economics necessitates MMPA*. There is no sound principle of financial economics that serves as the foundation for MMPA. MMPA is an attempt to apply the principles of financial economics beyond the scope of their applicability.

But the biggest myth is that the right pension *accounting* reform is the solution to all problems that plague DB plans. The origins of this myth are unclear, even though many appear to believe in it. To those who have faith in the special healing powers of "economically proper" pension accounting (e.g. MMPA), the following reminders should be in order.

Conventional accounting is an inherently *backward*-looking undertaking. In contrast, a pension valuation is an inherently *forward*-looking undertaking. No accounting reform can resolve this conflict. In this context, the phrase "pension accounting" is an oxymoron.

Over the years, there have been numerous fine-tunings of the reporting and funding requirements for DB plans. Some of them moved these requirements toward MMPA; some went in the opposite direction. Every one of them had a reason du jour: to ensure or improve solvency, stability, predictability, transparency, comparability, etc. Yet, the only tangible result of these activities appears to be the growing negative sentiment toward DB plans among the majority of plan sponsors.

Objectives matter. If the objective of a reporting framework is to determine winners and losers in the "pension game," then there is a real risk that the game would be finally over as players exit it. At some point, creative regulators may design a perfect reporting framework for DB plans and discover that it applies to no one. An entirely different framework may be required if the objective is to keep the players in the "pension game" indefinitely.

In a healthy retirement system, the objective of a DB plan is twofold: to maximize the safety of pension benefits and minimize the cost of their funding. The system's reporting and funding requirements should be based on the measurements of the ability of the existing assets and future contributions to fund the benefits. Other objectives should be of lesser importance.

The vast majority of DB plans endeavor to fund their pension commitments via investing in risky assets. DB plans need major advances in risk management rather than pension accounting. Any attempt to transparently "account" for the future behavior of risky assets is futile. The future is not transparent. There is nothing anyone can do about it.

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