April 2, 2015

Mr. Thomas Aaron
Moody's Investor Service
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Chicago, IL 60606

Mr. Timothy Blake, MP – Public Finance
Moody's Investor Service
7 World Trade Center
250 Greenwich Street
New York, NY 10007

Dear Messrs. Aaron and Blake:

This letter is to express concern, once again, about Moody's presentation of adjusted public pension accounting information and drawing funding conclusions from the modified data. Specifically, in your recent report, "New Pension Accounting Increases Clarity of Plan Funding Trajectories," Moody's uses unconventional metrics to conclude that most state and local governments' pension contributions were insufficient to stem unfunded liability growth, even for those that are making their full actuarially determined contribution.

Following Moody's previous publication, "US State and Local Government Pensions Lose Ground Despite Meeting Return Targets," NASRA noted its concern that Moody's used proprietary calculations of pension data to measure public pension funding levels, then failed to properly clarify both this fact and the effect on public pensions of declining interest rates and inflation. The result is a picture of public pensions that is misleading to many readers.

In this newest report, Moody's failure to factor inflation or wage growth into the assessment leads to a finding that increasing required contributions are "back-loading the funding schedule." Yet, the contribution rate is constant and remains a level percent of payroll in real inflation-adjusted dollars. These are important outcomes that Moody's ignores.

Level cost as a percent of payroll is a pension funding goal of nearly every state and local government. This method is recognized as a sound actuarial practice and is recommended by the Government Finance Officers Association. Contributions that are a level percent of payroll are intended to achieve not only intergenerational cost equity but also affordability, sustainability and budget predictability--policy objectives that recently were reaffirmed by associations representing the nation's governors, legislatures, and others as core elements of pension funding guidelines for elected officials.

Moody's approach to measuring pensions is accounting-based and bears no resemblance to existing funding practices or typical actuarial approaches. By ignoring inflation, what the report characterizes as "level" is, in fact, "level" in nominal dollars only and arguably is a front-loaded funding policy that undercharges future taxpayers at the expense of today's taxpayers. This method would require current pension contributions to be a larger percent of payroll and future pension contributions to be a smaller percent of payroll. The modeling used by Moody's fails to account for the critical fact that payroll grows over time due to inflation. Thus, if a government's funding policy aims to keep pension costs a level percent of payroll over time, by design, the costs themselves also will grow commensurately.

The chart below is intended to illustrate how a pension plan's funding progresses under the direction of a funding policy that aims to achieve the aforementioned objectives. As the chart shows, pension contributions can grow in nominal terms over 30 years while remaining a level percent of payroll, and progressively reduce unfunded liabilities in real dollars, though there is growth in nominal dollars over the first few years. This schedule results in continued improvement in the plan's fiscal position as measured by unfunded liabilities as a percent of payroll and funded ratio, and, ultimately the plan reaching its target of full funding. Yet, the Moody's report would characterize such a funding plan as "failing to tread water."

Financing Unfunded Actuarial Accrued Liabilities

30 year Closed Level % of Payroll Amortization

Fiscal Year June 30	Projected Active Member Payroll	Acturarial Accrued Liabilities (AAL)	Actuarial Value of Assets (AVA)	Unfunded Actuarial Accrued Liabilities	UAAL Adjusted for Wage Inflation	Amortization Years Remaining	Annual Contributions		UAAL as % of Payroll	BOY Funded Ratio
							Dollars	% of Payroll		
2015	$ 1,000,000	$ 6,000,000	$ 4,500,000	$ 1,500,000	$ 1,500,000	30	$ 90,056	9.01%	150.0%	75.0%
2020	1,159,274	8,613,776	7,033,878	1,579,898	1,100,492	25	104,400	9.01%	136.3%	81.7%
2025	1,343,916	12,366,189	10,762,938	1,603,252	777,888	20	121,028	9.01%	119.3%	87.0%
2030	1,557,967	17,753,264	16,222,384	1,530,880	517,385	15	140,304	9.01%	98.3%	91.4%
2035	1,806,110	25,487,107	24,182,894	1,304,213	307,029	10	162,651	9.01%	72.2%	94.9%
2040	2,093,777	36,590,038	35,753,558	836,479	137,165	5	188,557	9.01%	40.0%	97.7%
2045	2,427,262	52,529,731	52,529,731	-	-		-	0.00%		100.0%

Based on 3% inflation rate and investment return assumption of 7.5%

Moody's approach to valuing pension conditions may serve your firm's own purposes for stress-testing the financial condition and creditworthiness of state and local governments. However, publishing the outcome of your approach outside of this context and without proper qualification produces misunderstanding and misuse among many readers and pension plan stakeholders. Such confusion could be avoided and understanding improved if Moody's would explain the differences in its methodology when compared to established governmental accounting and actuarial funding methods, since the outcomes are so different and easily misconstrued.

Future Moody's reports should more clearly qualify the presentation of public pension information, including the separation of pension accounting from pension funding. In the absence of such clarifications, Moody's information about public pension plans will continue to mislead and cause confusion.

As always, we would be pleased to bring together members of the public pension community to discuss this further with you, the report's authors, or both.

Sincerely,

Keith Brainard

Keith Brainard
Research Director