

Books, Budgets, and Bonds

What Do All Those Pension Numbers Mean?

By Keith Brainard

It's time to get ready for the effects of the new GASB standards, which could give us three sets of pension numbers instead of one. However, the only thing that has really changed is the accounting.

Public pension funds hold some \$3 trillion in assets in trust for some 15 million working and more than 8 million retired employees of state and local government and their surviving family members. How these benefits are funded and accounted for is a matter of consequence and vigorous debate.

Until recently, a single set of actuarial calculations, reported by public pension plans and their sponsoring employers, in compliance with standards maintained by the Governmental Accounting Standards Board, were widely recognized as the definitive assessment of both the condition and cost of a public pension plan.

The days of a single set of numbers, however, are gone. These are being supplemented by a variety of new calculations and numbers, each with its own intended purpose and audience.

There soon could be three sets of pension numbers: one for accounting (books); one for funding (budgets), and possibly a third as part of assessing the credit risk of a plan sponsor (bond ratings). The following summarizes the three primary audiences for such public pension calculations, and the intended purpose of each: the GASB, for compliance with accounting standards; policymakers, for funding information; and bond-rating agencies, to evaluate and compare issuers of municipal debt.

THE BOOKS: GASB, OUTGOING AND INCOMING

Since the mid-1990s, accounting and financial reporting standards set by the GASB have been based on an actuarial calculation of the amount needed to fund the pension plan. In June 2012, the GASB approved new accounting and financial reporting standards for public pensions and the employers (states, cities, school districts, etc.) that sponsor them.

Known officially as GASB Statement No. 67, *Financial Reporting for Pension Plans* (an amendment of GASB Statement No. 25), and GASB Statement No. 68, *Accounting and Financial Reporting for Pensions* (an amendment of GASB Statement No. 27), the revised standards will replace the former standards and will take effect for fiscal years beginning after June 15, 2013, for public pension plans and after June 15, 2014, for employers that sponsor pension plans.

Distinction Based on Plan Type.

The GASB sets forth different guidelines for employers, depending on the type of pension plan in which they are participating:

- Single-employer (the pension covers only one governmental sponsor).
- Agent (the pension system covers multiple governmental entities that make individually calculated contributions for their respective portions of the costs/liabilities).

- Cost-sharing (multiple governmental entities that proportionately split the costs/liabilities).

Thus, any review of an employer's pension information under the incoming GASB standards should begin with understanding the type of plan in which the employer participates. Plans covering the vast majority of public employees are either agent or cost-sharing plans.

New Information on Employers' Financial Statement. An important change that will result from the incoming GASB standards will affect the basic financial statements of most employers that sponsor a pension benefit. Rather than placing on their financial statement (in the statement of position) only the cumulative shortfall in their required contribution, plus interest, as in the past, employers will be required to place their net pension liability — the GASB's new term for the unfunded pension liability — on their financial statement. Employers that participate in cost-sharing plans will be required to report on their statement of position their proportionate share of the net pension liability for all participating employers.

For some employers, this new requirement will result in placing a liability on their books that is disproportionately larger than other liabilities. In addition, because this liability figure will be based on the plan's market (not actuarial, or smoothed) value of assets, it is also likely to introduce an unprecedented level of year-to-year volatility.

BUDGETS: SEPARATION OF ACCOUNTING FROM FUNDING

Of the many changes affecting public pension accounting, perhaps the most

notable is its separation from funding. The new statements specifically state that establishing standards for financing pension benefits is outside of GASB's scope.

The outgoing standards created a single calculation that was used to identify both the cost of the plan, expressed through the *annual required contribution*; and its funding condition, via the *actuarial funded ratio*.

The incoming GASB standards are focused on accounting, but not funding. The new accounting number is separate and apart from an ARC and does not contain guidelines for calculating one.

As a result, public pensions are likely to engage their actuarial provider or

providers to calculate two sets of numbers: one to satisfy accounting requirements, per the GASB; and another to inform policymakers of the amount needed to fund the plan.

Public Employer Pension Funding Policies. To address the GASB's move away from a funding focus, groups representing public-sector constituencies and professional actuaries are working to develop public pension funding guidelines.

Most public employers that sponsor a pension benefit already have their own explicit or de facto funding policy. These funding policies are commonly structured to facilitate attainment of at least three core objectives:

- Accumulation of assets needed to pay promised benefits;

At this juncture, pension plan sponsors have three main questions, and the answers are fairly simple:

1. How much should we be paying?

Instead of following a GASB standard for determining liabilities, plan sponsors will have to figure out for themselves what they need to contribute. Most governments have funding requirements in statute or other governing policy. These are not required to change, but they should be assessed for their effectiveness. GFOA supports the use of an actuarially determined annual contribution and is developing recommended practices in concert with other national organizations that governments should follow to ensure sound funding practices.

2. What about this number for pension liabilities — which will be big, for some governments — that will now appear on the financial statement?

Nothing has really changed — the liability is the same as it was before, it's just moved from the footnote to the financial statement. In other words, the liability hasn't actually grown; it's just reported in a more visible place.

3. What about the rating agencies?

The rating agencies may use their own, possibly more conservative, criteria in their evaluations, but pensions are just one of many metrics they use to determine a sponsor's bond rating.

- Stability and predictability of cost; and
- Intergenerational equity.

State and local pension funding policies usually exist in statute and range in terms of their specificity and the elements they address. Many state funding policies require that pension plans be funded by paying the normal cost (i.e., the cost of the benefits accrued in the current year) plus the cost to amortize the plan's unfunded liability.

While not compulsory, the new GASB standards may provide an opportunity for state and local governments to assess the effectiveness of their pension funding policies.

BONDS: NEW CALCULATIONS UNDER CONSIDERATION BY RATING AGENCIES

Bond-rating agencies assess the creditworthiness of issuers of municipal debt. These agencies also evaluate public pension factors among their many considerations when assessing an employer's creditworthiness.

For example, Standard & Poor's measures the following four indicators of a pension plan's health: a) funded ratio; b) funding levels (pertaining to the plan sponsor's commitment to making their annual retired pension contributions); c) unfunded pension liabilities per capita; and d) unfunded pension liabilities relative to personal income. To date, S&P has not indicated that the criteria it uses to evaluate pension plans will change as a result of the new GASB standards.

In July 2012, Moody's solicited a request for comment to four proposed

adjustments to the way the agency measures pension obligations of public sector entities:

- Allocating liabilities of multiple-employer cost-sharing plans to specific government employers based on proportionate shares of total plan contributions (this is consistent with the new GASB standards);
- Measuring liabilities using a discount rate (investment return assumption) based on a high-grade corporate bond discount rate of 5.5 percent for 2010 and 2011 (this differs from GASB's permitted use of the plan's investment return assumption until the plan's assets are projected to be exhausted, when a bond-driven discount rate takes effect);
- Use of the market value of assets rather than a smoothed, or actuarial value (consistent with the new GASB standards); and
- Calculation of required pension contributions based on these changes and a common, 17-year amortization period (compared to the amortization period currently used by most plans, of 20 to 30 years; and compared to the new GASB standard, which is expected to be 10 to 15 years for most plans.)

Moody's received more than 100 responses to its request for comments, from a wide range of perspectives, and is currently considering them.

In 2011, Fitch announced that it would apply a uniform 7 percent investment return assumption to calculate the pension cost of plan sponsors. Fitch also announced that, like Moody's,

it would allocate costs to individual employers participating in cost-sharing multiple-employer pension plans, and that it would reconsider its criteria after the new GASB statements have been issued. To date, Fitch has not publicly released new criteria.

CONCLUSIONS

The old practice of monitoring public pension data largely consisted of understanding GASB standards. These standards provided insight into a public pension plan's funding condition and annual cost, which the bond-ratings agencies also factored into their assessment of an issuer's credit worthiness. The new world of public pension data contains different factors and methods for different groups and purposes.

While policymakers should continue to use an actuarial calculation to determine the necessary pension contribution to put in their budget, the net pension liability will be a different and separate computation on the employer's financial statement. A completely separate estimate may be made by credit rating agencies to determine how pension commitments affect a municipal bond issuer's ability to meet their obligations.

Users of public retirement system information will need to understand that each calculation has a distinct intended purpose. ■

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