New Policies in the World of Pensions

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Financial Reporting -- The GASB Revolution

- New accounting and financial reporting standards approved June 25, 2012
  - Statement 67 replaces Statement 25 for Plan reporting
  - Statement 68 replaces Statement 27 for Employer reporting

- Major Game Changers in the new rules
  1. Placing the Net Pension Liability on the Balance Sheet
  2. Decoupling Expense from Funding
  3. Accounting for Cost-Sharing Plans
  4. Expanding Disclosure Information (Notes & RSI)

- “Mythconceptions”, Effective Dates
Game Changer #1:
Net Pension Liability Reported on Balance Sheet

Net Pension Liability (NPL)

- Total pension liability (TPL) minus plan assets at market value ("plan net position")
  - TPL uses new “blended” discount rate and “Entry age” cost method
- Similar to Unfunded Actuarial Accrued Liability (UAAL) but using market assets, not “smoothed” assets
  - Note 5-year asset smoothing still allowed (in determining pension expense), but reported separately
Game Changer #1: Net Pension Liability Reported on Balance Sheet

- NPL must be reported on the employer’s balance sheet
  - Currently, UAAL is reported in the Required Supplementary Information (RSI)
  - Currently, only the Net Pension Obligation (NPO) is reported on the balance sheet
    - Cumulative difference between “annual required contribution” (ARC) and actual contributions
The New “Blended” Discount Rate

- Discount rate is based on projected benefits, current assets, and projected assets for current members
  - Projected assets include future contributions that fund benefits for current members
  - For projected benefits that are covered by projected assets
    - Discount using long-term expected rate of return on assets
  - For projected benefits that are not covered by projected assets (i.e., after the “cross-over date”)
    - Discount using yield on 20-year AA/Aa tax-exempt municipal bond index
  - Solve for a single rate that gives the same total present value
    - Use that single equivalent rate to calculate the total pension liability (TPL)
The “blended” discount rate is not based on the plan’s current funded status, but on projected benefits and assets. This includes future contributions to fund benefits for current employees. Many plans with contributions based on a written actuarial funding policy will continue to use the long-term earnings assumption as the discount rate.
Currently, pension expense is based explicitly on an actuarially determined funding requirement

• The ARC, which is the “annual required contribution”
  – Even though is not required to be contributed!
• Based on established practices for managing contribution volatility
  – Asset smoothing and UAAL amortization
• The ARC served as a de facto funding standard

New GASB pension expense is the change in NPL each year, with deferred recognition of only certain elements

• Specifically not intended to be a funding target or standard
New Pension Expense Components

- Changes in Total Pension Liability that are recognized (i.e., expensed) immediately—no deferrals allowed
  - All plan amendments – actives or retirees
  - Probably different from funding

- Changes in Total Pension Liability where some deferrals are allowed (i.e., expensed over multiple periods)
  - Changes in actuarial assumptions
  - Actuarial gains and losses
  - These changes are recognized in expense over average expected remaining service lives of active and retired members
    - Resulting amortization periods will be very short
      - 5 to 10 years
      - Shorter than for funding (currently ranges from 15 to 30 years)
New Pension Expense Components

- Changes in Assets where some deferrals are allowed (i.e., expensed over multiple periods)
  - Differences between actual and projected earnings over the year (i.e., investment gain/loss)
    - Recognized in expense over closed 5-year period
    - Most systems use 5 to 10-year smoothing for funding
  - NPL on the balance sheet will be “market volatile”,
  - But effect on expense and on employer net position will still reflect asset smoothing
    - GASB *does* still uses 5-year asset smoothing
      » Another “mythconception”
    - But to see it, need to look at “Deferred Outflows and Inflows”
Decoupling Expense from Funding

- The faster — often immediate — recognition of net pension liability changes will introduce much greater volatility in the reported pension expense.
  - This volatility will be reflected directly on the income statements of plan sponsors.

- This volatility is what disqualifies this new expense as a basis for determining a funding policy.
  - Means there will be two competing measures of plan cost

- Plans will want to review or adopt funding policies, now that GASB expense no longer provides funding guidance.
  - Funding policy also needed for discount rate calculation – and for disclosures
“Mythconceptions”

**Scare**

The new GASB rules will require much larger contributions than are currently being made.

Also those contributions will now vary much more from year to year.

**TRUTH**

The new GASB rules only redefine pension expense, not contributions. Employers and plans can still develop and adopt funding policies under current practices.
Current standards are simple

- Pension expense is equal to the contractually required contribution
  - No “ARC”

- Balance sheet liability is the accumulated difference (if any) between the contractually required contribution and the actual contribution
  - Similar to current NPO

- Unfunded actuarial accrued liability is not reported at all
Accounting for Cost-Sharing Plans

- Under new standards these plans are treated like single employer plans
  - Recognize proportionate share of collective net pension liability and pension expense

- Proportionate share of NPL
  - Calculation must reflect any different contribution rates associated with different components of the collective NPL
    - For example, rates based on separate assets and liabilities for different classes or tiers

- Proportionate share of collective pension expense
  - Allocate collective pension expense based on each employer’s proportionate share of collective NPL
    - Note: Amortization items based on average expected remaining service life of all employees
Game Changer #4: Expansion of Disclosure Information

- Includes both Notes and Required Supplementary Information (RSI)

- **Greatly** expanded plan and employer disclosures, including:
  - Description of the plan and assumptions
  - Policy for determining contributions
  - Sensitivity analysis of the impact on NPL of a one percentage point increase and decrease in the discount rate
  - Changes in the NPL for the past 10 years
  - Development of long-term earnings assumption
  - Annual rates of investment return for past 10 years (plan only)
Expansion of Disclosure Information

More new disclosure information
- “Actuarially determined (employer) contribution”
  - ADC is the “New ARC”
  - Basis and amount – if determined!
  - Comparison to amount actually contributed
  - May encourage review (or creation) of actuarial funding policy

Expanded disclosures greatly increase the pension information needed for plan and employer’s financial statements
- New and challenging questions for employer’s financials:
  - Which actuary/auditor develops this information?
  - Can employer’s auditor rely on info from plan’s auditor?
  - Who pays for it?
GAS 67 & 68 Effective Dates

- GAS 67 (for plan reporting): Effective for plan years beginning after June 15, 2013
  - 2013/2014 for June 30 fiscal year plans
  - Calendar 2014 for calendar year plans

- GAS 68 (for employer reporting): Effective for fiscal years beginning after June 15, 2013
  - 2014/2015 for June 30 fiscal year employers
Key Implications of the New GASB Rules

- The new rules represent a shift of focus from the long-term commitment to fund to a short-term snapshot of funded status based on market assets.

- Putting the NPL on the balance sheet will add a large and unstable element to an employer’s net financial position as presented in the basic financial statements.

- Having two different “cost” numbers—funding and expense—will present a communications challenge around what is the “true cost” of the plan.

- Cost-sharing plans in particular will have new expense and liability reporting that may be difficult both to produce and to interpret.
Key Implications of the New GASB Rules continued

- Both the timing and the scope of the new reporting will require greater coordination between the plan and employer, as well as between the actuary and the auditor.

- Having the NPL on the balance sheet could mean more involvement by the auditor in actuarial results. This could change the roles of the auditor and actuary.

- Under current GASB rules, the ARC serves as a *de facto* contribution standard. With pension expense no longer a basis for funding, public plans will need new guidelines for setting funding policies.
NCSL Legislative Summit

Actuarial Guidance on Pension Funding

Minneapolis
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Renewed Focus on Funding Policy

- GASB Statements 67 and 68 make a clear separation between accounting cost (expense) and funding cost (contributions)
  - Contrast with Statements 25 and 27, where expense was the “ARC”: Annual Required Contribution

- No longer look to GASB for funding policy guidelines
  - Not that we ever should have
  - 30 year amortization “out-of-bounds” marker interpreted as an acceptable place to live

- Resulting regulatory void inviting discussion
Under new GASB statements, funding policy has two roles

“Actuarially Determined (Employer) Contribution”
• If determined, disclose method and amount
• Compare amount to actual contributions
• No basis given except “actuarial standards of practice”
• “ADC” is the new ARC, but not the new expense

For “blended” discount rate, projected assets include future contributions
• Consider any “formal, written policy related to employer contributions”
Renewed Focus on Funding Policy

- Starts with the governance issues
  - Independent determination of an “actuarially determined contribution”
    - Including actuarial assumptions and funding policy
  - Legally enforceable contribution demand on employer
    - If you are not going to fund it, it matters less how you measure it

- California provides a good model for both
  - Proposition 162 (1992)
  - “Retirement board … shall have the sole and exclusive power to provide for actuarial services …”
  - Almost all CA systems require actuarially determined contributions
Who will replace GASB’s role defining, monitoring and enforcing acceptable funding policies?

➢ Actuarial organizations
  • Actuarial Standards Board - Actuarial Standards of Practice (ASOPs)
    – Revised ASOP 4 addresses some aspects of funding policy
  • California Actuarial Advisory Panel (CAAP)
  • Academy of Actuaries Public Plans Subcommittee
    – Issue Brief on Objectives and Principles issued Feb. 2014
  • Conference of Consulting Actuaries Public Plans Committee (CCA PPC)
  • Society of Actuaries “Blue Ribbon Panel Report”, also Feb. 2014
Who will replace GASB on funding policy?

- Actuarial organizations may develop model and/or acceptable practices, but not enforcement mechanism
  - May need more specificity than a typical ASOP
  - CCA PPC White Paper is very detailed, but not binding

- Government Finance Officers Association (GFOA) Best Practices (BP)
  - Issued by GFOA’s CORBA Committee on Retirement and Benefits Administration
  - October 2013 BP: Core Elements of Pension Funding Policy
Who will replace GASB on funding policy?

- State regulatory agencies
  - Texas Pension Review Board, etc.

- State or Federal legislatures
  - Could refer to actuarial or GFOA guidance
  - Could develop funding policy requirements independently
    - See recent legislation in Tennessee:
      » 100% funding of actuarially determined contribution
      » Entry Age cost method
      » Maximum 10 year asset smoothing, 20% corridor
      » Level dollar UAAL amortization (!)
      » Closed maximum amortization period of 30 years
Remarkable consistency on Funding Policy Objectives

- Fund the expected cost of all promised benefits (*i.e.*, fund normal cost plus 100% of any unfunded actuarial liabilities).
- Match funding cost of benefits to years of service (*i.e.*, target demographic matching or generational equity).
- Have costs emerge stably and predictably (*i.e.*, manage contribution volatility).
- Balance competing funding-policy objectives.
- Actually fund the “actuarially determined contribution” as determined by the plan’s funding policy.
Comparison of Recent Actuarial/GFOA Guidance

- General consistency on funding policy specifics
  - CCA PPC White paper by far the most detailed
  - Entry Age cost method
  - Five year asset smoothing preferred
  - 15 to 20 year UAAL amortization preferred
  - “25 is the new 30” for maximum UAAL amortization period

- Considering contacting CCA PPC members when drafting funding policy legislation
QUESTIONS