Go Figure!

New guidelines are changing how public pension accounting affects the books, budget and bond ratings.

BY KEITH BRAINARD

Across the nation, public pension funds hold some $3 trillion in assets in trust for 15 million state and local government employees and 8 million retirees and their family members. How these benefits are funded and accounted for is a matter of consequence and vigorous debate.

Until recently, state and local lawmakers needed to focus only on a single set of calculations, within parameters set by the Governmental Accounting Standards Board (GASB), to assess both the condition and costs of their public pension plans. But the days of a single set of numbers are gone. In June 2012, the GASB approved new standards for public pensions and the employers that sponsor them: states, cities, school districts, etc.

Known officially as GASB Statement No. 67 and No. 68, the revised standards for public pension plans apply to fiscal years that began after June 15, and will take effect for employers after June 15, 2014.

Lawmakers will now have at least three sets of pension numbers for three different purposes—books, bonds and budget. As sponsors of public pension plans, state and local governments must understand the source, purpose and audience for each to make sound policy decisions and accurately communicate with constituents about the condition of the retirement plan.

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BOOKS: Computing an annual financial position for pensions for governmental accounting

Since the mid-1990s, financial reporting standards set by the GASB have been based on an actuarial calculation of the amount needed to fund the pension plan.

The new GASB standards set forth different guidelines for employers, depending on the type of their pension plan:

◆ Single-employer: The pension covers only one governmental entity.

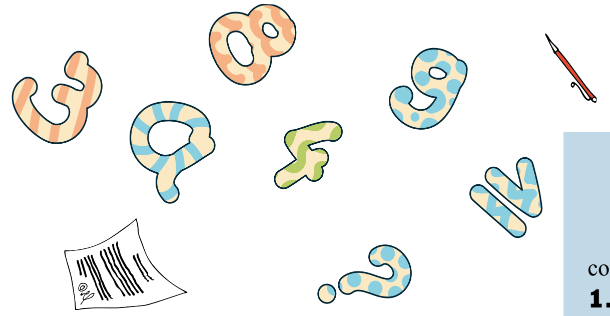
◆ Agent: The pension covers several governmental entities that make individually calculated contributions for their respective portions of the costs.

◆ Cost-sharing: The pension covers several governmental entities that proportionally split the costs.

Under the new standards, any review of a pension should begin with understanding which type of plan it is. Plans covering the vast majority of public employees are either agent or cost-sharing plans.

Another important change under the new GASB standards is that the computation of a "net pension liability" will now appear in the government's basic financial statement. It is the calculation of the difference between the market value of the pension's assets and its obligations to pension beneficiaries on a specific date.

Employers that participate in cost-sharing plans will be required to report their share of the net pension liability. For some, this new requirement will result in placing a liability on their books that is disproportionately larger than other liabilities. In addition, because the amount of this liability will be based on the assets' market value (not actuarial, or smoothed value), it is also likely to introduce an unprecedented level of year-to-year volatility.



What Legislators Need to Ask

Although similar terms and multiple numbers have the potential to cause confusion, legislators should be asking three main questions:

1. How much should we be paying? An actuarially determined annual contribution within some established parameters (most likely in statute) is what the Pension Funding Task Force recommends to ensure sound funding practices.

2. What should I know about the new pension liabilities figure that now will be on the basic financial statements? The actual liability is the same as it always was, but the calculation will move from being a mere footnote to a more visible place on the financial statement. Nothing has changed as far as the liability itself.

3. What should we know about the bond-rating agencies? Some of the agencies have announced that in their credit analytics, they will adjust pension data using uniform, generally more conservative assumptions regarding amortization periods and investment returns. However, pensions are just one of many metrics they use to determine bond ratings.

BUDGETS: Determining the appropriate annual contribution to the pension plan needed for sound funding

Of the many changes, perhaps the most notable will be the separation of public pension accounting from public pension funding. The new standards are focused on accounting, but not on financing pension benefits.

The previous standards created a single calculation that was used to identify the cost of the plan, expressed through the annual required contribution (ARC). The new accounting number is separate from an ARC and does not contain guidelines for calculating one.

State and local pension funding policies usually exist in statute and vary in how specific they are and in what elements they address. Most of these funding policies comport with accounting and actuarial standards in how they calculate an annual required contribution and are not required to change; but, they should be assessed for their effectiveness.

To guide lawmakers in reviewing the effectiveness of existing practices and governing statutes, 10 national associations representing state and local governments (including NCSL) established a Pension Funding Task Force that released "Pension Funding: A Guide for Elected Officials" in March. According to the guide, "The ultimate goal is to ensure that pension promises can be paid, employer costs can be managed, and the plan to fund pensions is clear to everyone."

In it, the task force recommends that pension funding policies:

- Be based on an actuarially determined contribution.
- Be disciplined to ensure that promised benefits can be paid.
- Maintain intergenerational equity so that the cost of employee benefits is paid by the generation of taxpayers that receives services.
- Make employer costs a consistent percentage of payroll.
- Require clear reporting to show how and when pension plans will be fully funded.

BONDS: Calculating how pension obligations affect a government's creditworthiness

Bond-rating agencies assess the creditworthiness of issuers of municipal debt based on a number of metrics, a government's pension plan being one of them.

Some ratings agencies have announced that in their credit analytics they will adjust pension data using uniform, and generally more conservative, assumptions for comparative purposes.

In 2011, Fitch Ratings announced that it would apply a uniform 7 percent investment return assumption to calculate the pension cost of plan sponsors. Fitch also indicated that it would allocate costs to individual employers participating in cost-sharing, multiple-employer pension plans and would reconsider its criteria after the new GASB standards were issued.

Moody's published a revised approach to assessing pension liability in April. Among other changes, it intends to use a risk-free discount rate (currently around 3.8 percent) instead of accepting projections of pension fund returns, and a uniform 20-year amortization period for all plans. These changes will make pension liabilities appear much greater—and also will be yet a different number than those used for accounting and funding.

To date, Fitch has not publicly released new criteria, and S&P's has not indicated whether the criteria it uses to evaluate pension plans will change as a result of the new GASB standards.

Understanding Changes is Crucial

Assessing the health of a public pension plan has always been complex, but at least it was largely confined to understanding GASB standards. These standards provided insight into a pension's funding condition and annual cost, which the bond-ratings agencies also factored into their assessment of creditworthiness.

The new world of public pension data promises to be more confusing with different factors and methods being used—and published—by different groups for different purposes.

Although policymakers should continue to use an actuarial calculation to determine the necessary pension contribution to put in their budgets, the net pension liability will now be a distinct computation on the financial statement. And yet another calculation—entirely different from the others—may be made by credit rating agencies to determine how pension commitments affect a municipal bond issuer's ability to meet obligations.

These numbers will need to be explained and put into the proper context for other lawmakers, for the media and for constituents—both public employees and the general public. Failing to do so could result in the proliferation of misunderstanding and misinformation, rather than relevant and factual data on which to base sound policy.