GASB's and Moody's Proposed Changes

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By: David Kausch, FSA, EA, MAAA

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Gabriel Roeder Smith & Company
Consultants & Actuaries
www.gabrielroeder.com

Outline

- New GASB Requirements
  - Background and Summary
  - GASB Statement No. 68 in depth
  - GASB Statement No. 67 in depth
- Moody's Proposal

Background

- In June 2012, the GASB approved two new accounting and reporting standards for pensions provided by state and local governments.
- GASB Statement No. 67, *Financial Reporting for Pension Plans*, replaces Statements 25 and 50.
  - ► Effective for plan fiscal years beginning after June 15, 2013 (essentially FYE's ending in 2014)
- GASB Statement No. 68, *Accounting and Reporting for Pensions*, replaces Statements 27 and 50.
  - ► Effective for employer (and contributing nonemployer) fiscal years beginning after June 15, 2014 (essentially FYE's ending in 2015)

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Summary of Key Changes

- Under GASB Statements 25 and 27, there was a close link between accounting and funding measures, which is now changed:
  - Discount Rate: For funding purposes, the rate will continue to be the long-term expected return. For accounting purposes, the new rate will potentially include a portion based on municipal bond rates.
  - Asset Valuation: For funding purposes, asset values may still be smoothed. For accounting purposes, assets will be measured at fair (market) value.
  - Amortization Period: For funding purposes, the amortization period can still be relatively long. For accounting purposes, it will be considerably shorter.
- Overall, the changes will likely make the accounting measures more volatile than the funding measures.
- Note that the GASB's changes only apply to the accounting measures and not to the funding measures.

Statements Apply to Pensions

- GASB's new Statements 67 and 68 apply to pensions provided either through a defined benefit (DB) plan or defined contribution (DC) plan (although the standards differ for DB and DC plans). Pensions include:
  - Retirement income
  - Certain postemployment benefits (e.g., death, life insurance, and disability) provided through a pension plan
- Statements 67 and 68 do not apply to:
  - Postemployment healthcare benefits and termination benefits
- When postemployment benefits are provided separately from the pension plan, they are classified as other postemployment benefits (OPEB) and should be accounted for under GASB's OPEB rules.

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Classification of DB Pension Plans

- For GASB purposes, DB pension plans are classified based on (1) number of employers and (2) whether benefits are shared across plans.
  - <u>Single-employer plans</u> provide benefits for a single employer.
  - <u>Agent multiple-employer plans</u> provide benefits to multiple employers. Assets are pooled for investment purposes but held in separate employer accounts for the payment of benefits.
  - <u>Cost-sharing multiple-employer plans</u> provide benefits for multiple employers. Assets are pooled for investment purposes and can be used to pay the benefits of any employer.

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GASB Statement No. 68

Accounting and Financial Reporting for Pensions

Key Pension Accounting Measures

- For state and local employers, two key pension accounting measures are provided in their government-wide financial statements:
  - Pension Liability measures the employer's financial responsibility for pensions as of a given measurement date; and
  - Pension Expense measures the employer's cost of pension benefits over a given period.

Standards for Single & Agent Employers

- Under Statement 27:
  - ►Pension Expense is the "Annual Pension Cost" (APC), consisting largely for the "Annual Required Contribution" (ARC).
  - ►The ARC is the normal cost plus amortization of any unfunded (or overfunded) liability over a maximum period of 30 years.
  - ►Pension Liability is the accumulated difference between the APC and actual pension contributions (starting in fiscal years beginning after June 15, 1997).
- All of this is about to change.

Standards for Single & Agent Employers

- Under Statement 68:
  - Pension Liability is the "Net Pension Liability" (NPL)
    - Equal to the "Total Pension Liability" (TPL) minus the "Plan Fiduciary Net Position" (PFNP)
      - PFNP is essentially the fair (market) value of assets.
  - The NPL is reported as a balance sheet item in the employer's government-wide basic financial statements.

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Standards for Single & Agent Employers

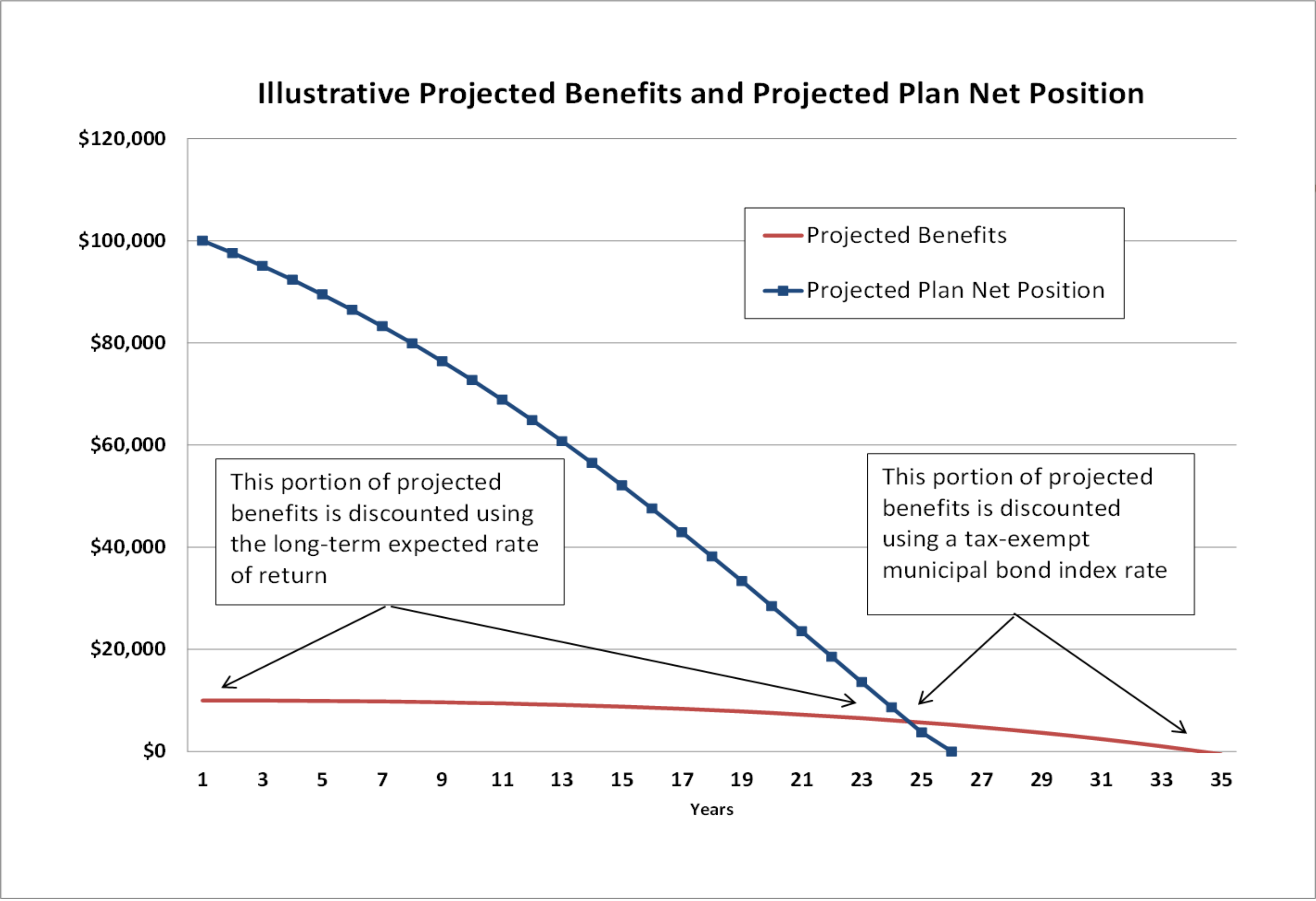
- Total Pension Liability (TPL):
  - The liability for projected benefits attributable to past service including:
    - Automatic COLAs and
    - Substantively automatic ad hoc COLAs
      - Determined based on historical patterns, consistency of amounts, and evidence that they might not be paid in the future.
  - TPL determined using the traditional entry age normal cost method and the "single discount rate." Normal cost is expressed as a level percentage of payroll.

Standards for Single & Agent Employers

- Single Discount Rate:
  - Based on the long-term expected return to the extent projected plan fiduciary net position is sufficient to pay future benefits.
  - However, a portion is based on a tax-exempt municipal bond index rate to the extent projected plan fiduciary net position is not sufficient.
    - 20-year, tax-exempt general obligation municipal bond index rate

Standards for Single & Agent Employers

- Steps for determining the single discount rate:
  - Project future benefit payouts for current active employees, inactives, and retirees.
  - Project plan fiduciary net position, including future investment earnings and contributions (but only to the extent they pay benefits for current members).
  - Calculate the PV of projected benefits covered by the projected plan fiduciary net position using the long-term expected return (PV1).
  - Calculate the PV of projected benefits not covered by the projected plan fiduciary net position using the municipal bond rate (PV2).
  - Solve for the single discount rate that when applied to all projected benefit payments results in a PV equal to the sum of PV1 and PV2.


Illustrative Projected Benefits and Projected Plan Net Position
$120,000
$100,000
$80,000
$60,000
$40,000
$20,000
$0
Projected Benefits
Projected Plan Net Position
This portion of projected benefits is discounted using the long-term expected rate of return
This portion of projected benefits is discounted using a tax-exempt municipal bond index rate
1 3 5 7 9 11 13 15 17 19 21 23 25 27 29 31 33 35
Years

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Standards for Single & Agent Employers

- Pension Expense:
  - Under Statement 27, pension expense represented the annual required contribution (ARC) needed to pay future benefits.
  - Under Statement 68, pension expense largely represents the change in the Net Pension Liability from the prior year, with provisions for deferring certain items.

Standards for Single & Agent Employers

- Items <u>immediately recognized</u> in pension expense include:
  - Service cost (additive)
  - Interest on TPL (additive)
  - Projected investment earnings (subtractive)
  - Actual member contributions (subtractive)
  - Administrative costs (additive)
  - Changes in TPL due to changes in benefits

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Standards for Single & Agent Employers

- Certain other changes are treated as "deferred outflows of resources" and "deferred inflows of resources"
  - ►Changes in the plan's fiduciary net position due to differences between projected investment earnings and actual investment earnings
    - Recognized over a closed 5-year period
  - ►Changes in total pension liability due to (1) changes in assumptions or (2) differences between assumed and actual actuarial experience
    - Recognized over a closed period reflecting average remaining service life of all members (active, inactive, and retirees)

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Standards for Cost-Sharing Employers

- Under Statement 27, a cost-sharing employer's:
  - <u>Pension Expense</u> is its contractually required contribution to the plan.
  - <u>Pension Liability</u> is its accumulated difference between contractually required contributions and actual contributions.

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Standards for Cost-Sharing Employers

- Under Statement 68:
  - Cost-sharing employers are required to report their "proportionate share" of the cost-sharing plan's collective net pension liability, pension expense, and deferred outflows and inflows.
  - Cost-sharing plan's net pension liability, pension expense, and deferred inflows and outflows determined in the same way as single and agent employers.
  - An individual employer's proportionate share is determined in a manner consistent with the method used by the cost-sharing plan to allocate contractually required contributions.
    - GASB encourages that the proportionate share be based on the employers' "long-term contribution effort" to the plan.

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Standards for Cost-Sharing Employers

- Under Statement 68:
  - Pension expense for a cost-sharing employer includes its proportionate share of the plan's collective pension expense.
  - In addition, it includes deferral and recognition of the net effect of:
    - Annual changes in the employer's proportionate share
    - Annual differences in the employer's actual contributions and it's proportionate share of contributions
    - Recognized over the average expected remaining service life of current members (active, inactive, and retired)

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Special Funding Situations

- In some cases, governmental entities that do not employ plan participants make contributions to pension plans.
- Special funding situations are situations in which a nonemployer contributing entity is required to make contributions <u>directly</u> to the plan, and:
  - The contributed amount is not dependent on events unrelated to pensions, or
  - The nonemployer is the only contributing entity.

Special Funding Situations

- In these situations, the nonemployer contributing entity is treated in a manner similar to a cost-sharing employer.
  - Employers and nonemployers calculate their proportionate shares of the NPL, pension expense, and deferred outflows and deferred inflows.

Measurement Timing and Frequency

- Under Statement 68:
  - The employer should recognize the NPL as of the "measurement date" which should be no earlier than the end of its prior fiscal year.
    - The plan measures its NPL as of its fiscal year-end.
  - If the TPL is not actuarially measured as of the "measurement date," it can be "rolled forward" from an actuarial valuation performed not more than 30 months plus 1 day prior to the employer's fiscal year-end.
  - The employer's pension liability should be fully (actuarially) measured at least every two years.

Effective Dates and Transition

- In transitioning:
  - The effects of the standards should be reported as adjustments to prior periods and the beginning balance sheet liability should be restated.
  - GASB encourages restatement of beginning deferred outflows and inflows, but only if this is practical.

GASB Statement No. 67

Financial Reporting for Pension Plans

Overview

- With regard to the basic financial statements, Statement 67 is not too different from Statement 25.
- However, under Statement 67, the notes and required supplementary information (RSI) will need to reflect the new measures of pension liability and expense.

Financial Statements

- Statement of Fiduciary Net Position
  - Very similar to current requirements:
    - Assets - receivables, investments (fair value), etc.
    - Liabilities – only currently due and payable
    - Fiduciary Net Position Restricted for Pensions
  - Does include
    - Deferred Outflows and Deferred Inflows – although these are largely placeholders.
- As of the end of the plan's fiscal year.

Financial Statements

- Statement of Changes in Fiduciary Net Position
  - Additions
    - contributions, net investment income, etc.
  - Deductions
    - benefit payments, administrative expenses
  - Net Increase (Decrease) in Fiduciary Net Position
- For the plan's fiscal year.

Notes to Financial Statements

- Disclosures applicable to all plans:
  - Plan description
  - Pension plan investments
  - Receivables
  - Allocated insurance contracts
  - Reserves
  - Deferred retirement option programs

Disclosures for Single-Employer and Cost-Sharing Pension Plans

- Components of the liability:
  - TPL, PFNP, NPL, PFNP as a % of TPL
- Significant assumptions:
  - Inflation, salary change, COLAs, mortality
  - Discount rate
    - Long-term rate, bond rate, periods of projected benefits to which long-term rate applies
    - Assumed asset allocation, real rate for major investment classes
    - Impact of +/- 1% change in discount rate on NPL
- Date of actuarial valuation and update procedures use to roll forward TPL, if applicable

Required Supplementary Information

- For single employer and cost-sharing plans:
  - 10-year schedule of changes in net pension liability
  - 10 year schedule of TPL, PFNP, NPL, PFNP % TPL, Payroll, NPL % Payroll
  - 10-year schedule of actuarially determined employer contributions (if calculated)
  - 10-year schedule of money-weighted rates of return
- Notes to RSI
  - Significant methods and assumptions

Required Supplementary Information

- Agent plans
  - 10-year schedule of money-weighted rates of return
- Notes to RSI
  - Significant methods and assumptions

RSI Restatement

- In the year Statement 67 is first implemented, the 10-year schedule of actuarially determined contributions should be presented, if applicable.
- Pension plans are encouraged, but not required to present other RSI retroactively.
- If RSI is not presented for 10 years, it should be presented for as many years as information conforming to Statement 67 is available.
- The schedules should not include information that does not conform with Statement 67.

Effective Date and Transition

- Statement 67 is effective for financial statements for fiscal years beginning after June 15, 2013.
- Changes made to comply with Statement 67 should be treated as adjustments to prior periods and financial statements for the periods affected should be restated.
- If restatement is not practical, the cumulative effect of applying Statement 67 should be reported as a restatement of beginning net position for the earliest period restated.
- The nature of any restatement should be reported. The reason for not restating prior periods should be explained.

Moody's Proposal

Adjusted Reporting for Pension Plans

Moody's Investors Service Proposed Adjustments

- In July 2012, Moody's issued a Request for Comments on Adjustments to US State and Local Government Reported Pension Data.
  - Pension Obligations are already considered in ratings.
  - Goals are to
    - Improve comparability of pension information across governments.
    - Facilitate the calculation of combined measures of bonded debt and unfunded pension liabilities in credit analysis.
  - Part of an ongoing effort to bring greater transparency and consistency to the analysis of pension liabilities.

Adjustments Under Consideration

- Adjustments to as-reported pension information
  - Multiple-employer cost-sharing plan liabilities will be allocated to government employers on proportionate shares of total plan contributions.
  - Accrued actuarial liabilities will be adjusted based on a high-grade long-term corporate bond index discount rate (5.5% for 2010 and 2011).
  - Asset smoothing will be replaced with reported market or fair value as of the actuarial reporting date.
  - Annual pension contributions will be adjusted to reflect the foregoing changes as well as a common amortization period.

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Comments Requested

- Moody's RFC sought feedback on two items.
  - The usefulness of the adjustments in enhancing the comparability of pension obligations among state and local government entities.
  - The efficacy of treating pension liabilities similarly to debt to improve the analysis of the long-term liabilities of these governmental entities.
- Comments were due by August 31, 2012 (subsequently extended to September 30, 2012).
- Estimated adjustments for state governments to begin in September 2012 (subsequently extended to later this year).

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Interaction with GASB

- Moody's acknowledges that the new GASB standards will move toward some of their objectives.
  - Use of market value of assets will be the same.
  - Allocating cost-sharing plans will be similar.
  - The discount rates will be very different.
  - The GASB pension expense will not be similar to Moody's adjusted contribution requirement.
- Moody's does not want to wait until the GASB implementation date and they believe key differences will persist across public plans.

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Potential Impact

- Adjusted Fiscal 2010 state and local unfunded pension liabilities reported at $766 billion would increase to $2.2 trillion.

Fiscal 2010 $Billions	50 States	Rated Local Governments
Reported UAAL, adjusted for CSP shares	$391	$375
Adjusted UAAL, 5.5%, smoothed assets	$894	$967
Adjusted UAAL, 5.5%, market assets	$1,056	$1,135
Reported funded ratio	73%	79%
Adjusted funded ratio (smoothed assets)	55%	59%
Adjusted funded ratio (market assets)	46%	52%

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Potential Impact

- Moody's contribution adjustments include a 17-year level dollar amortization of the adjusted unfunded actuarial accrued liability.

Fiscal 2010 $Billions	50 States	Rated Local Governments
Reported annual contributions	$37	N/A
Adjusted annual contributions	$129	N/A
Adjusted UAAL % of revenues	74%	N/A
Adjusted UAAL % of NTSD*	211%	N/A

*Net tax-supported debt

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Additional Q&A

- In August 2012, Moody's issued 20 Questions and Answers about the proposed adjustments.
  - "Q4. Do you expect that Moody's adjustments will force issuers to change their accounting and disclosure practices?"
    - "No. As a credit rating agency, it is not Moody's role to prescribe mandatory accounting rules…there is no expectation that issuers will add those adjustments to their disclosures. To the extent that issuers disclose more details about their pension systems, … our adjustments would better reflect the status of each plan."

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Additional Q&A

- "Q6. Why is Moody's discount rate of 5.5% so much less than the investment rates of return assumed by pension plans?"
  - "Our proposed adjustments separate the rate of return on pension assets from the discount rate used in the measurement of liabilities."
  - "…A discount rate based on a high-grade bond index
    - is consistent with how we measure bonded debt…;
    - measures risk … similarly to that … of bonded debt;
    - is a reasonable proxy for a government's cost of financing portions of its pension liability with additional bonded debt."

Additional Q&A

- "Q12. Why does Moody's not place more weight on reported ARCs and contribution variances from the ARC?"
  - "Whether issuers pay 100% of their reported ARCs is an important governance and budgetary management factor in our analysis."
  - "However, because ARCs are …based on widely varying actuarial cost methods and assumptions and are amortized over inconsistent periods of time, the ARCs themselves do not provide a good basis for comparison of potential fiscal burden."

Additional Q&A

- "Q13. What is the expected magnitude of rating changes as a result of the pension adjustments?"
  - "…[W]e do not expect mass rating changes because:
    - We have long viewed pensions as debt-like obligations and considered unfunded liabilities – and the assumptions on which the liabilities are based – in our rating analysis;
    - Pensions are only one of several factors in our government rating methodology;
    - We do not expect widespread changes in relative rankings of debt and pension liabilities among governments as a result of the proposed adjustments."

Additional Q&A

- "Q14. Would there be any instances where the credit effect of the adjustments could be positive?"
  - "Yes. We expect that some local government entities, mainly school districts, would show no pension liability if the state absorbs the full cost of pensions with annual "on-behalf" payments."
  - "In addition, a handful of plans use a lower discount rate than we are proposing…"
  - "In both cases, the outcome of our proposed adjustments may or may not warrant rating upgrades…"

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Additional Q&A

- "Q15. How do you incorporate pension reforms into state and local government rating analysis?"
  - "While we view pension liabilities as debt-like obligations, we acknowledge they are not the same as debt. One important difference is that some previously accrued liabilities may be subject to amendment through legislation or negotiation. Enacted pension benefit reforms that apply to existing employees or retirees and that result in changes to accrued liabilities would be reflected in the government's reported pension data and in our adjustments."

Additional Q&A

- "Q17. How does Moody's view the issuance of pension funding bonds by governments?"
  - "Issuing bonds to fund previously accrued pension liability would have a neutral effect on our combined debt measures."
  - "However, bond financing of an accrued pension liability would also have the effect of crystallizing the liability on the balance sheet,… A significant reduction of unfunded liability through bond financing could reduce a government's incentive and political leverage to subsequently achieve meaningful modification of accrued pension benefits."

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Additional Q&A

- Q17 Continued.
  - "There is also the risk that returns on the invested pension bond proceeds may underperform expectations, leaving the government to make up the lost investment returns in addition to paying debt service on the bonds. For these reasons, extensive use of bond financing for pensions could be viewed as credit negative."
  - "Also, to the extent that a pension bond included a component to fund current-year contributions, as opposed to just previously accrued liability, we would consider it deficit financing."

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Moody's Recap

- The proposed Moody's adjustments will likely look far worse than audited financial reports.
- The adjustments will be a component of credit ratings and may even be sought by investors, the press, and legislators.
- There will be additional education and communication burdens on retirement systems and sponsoring governments to explain the meaning and purpose of Moody's adjustments.

Questions?

And Thank You!

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