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S&P's Views Of GASB's Proposed Changes In Government Pension Accounting

Primary Credit Analyst:
David G Hitchcock, New York (1) 212-438-2022; david_hitchcock@standardandpoors.com

Secondary Credit Analyst:
Sherman A Myers, New York (1) 212-438-4229; sherman_myers@standardandpoors.com

Table Of Contents

New Rules Do Not Affect Contribution Requirements

No More Multiyear Smoothing Could Mean Volatility

Related Criteria And Research

S&P's Views Of GASB's Proposed Changes In Government Pension Accounting

Proposals to change governmental public pension accounting have been in the spotlight recently. These include both calls for changes in generally accepted accounting principles (GAAP), and for legislatively mandated changes in governmental pension accounting.

Three Republican members of the U.S. House of Representatives introduced legislation this month (H.R. 6484) to require changes in pension fund accounting in order for municipalities to retain tax-exemption when selling debt. These changes would include uniform reporting standards and the use of market value when reporting pension fund assets, instead of actuarial asset values. The prospects for eventual passage of such legislation are uncertain, but Standard & Poor's Ratings Services believes there is public pressure to reform how public pension systems report their unfunded liabilities.

And this summer the Governmental Accounting Standards Board (GASB) proposed changes in public pension accounting in a published Preliminary Views for the accounting of government pension systems. GASB has the power to change GAAP for state and local government financial reporting. GASB is currently evaluating written responses to its Preliminary Views on pension accounting, and Standard & Poor's expects it to issue a follow-up exposure draft proposal in the second quarter of 2011, with final accounting rules expected in the second quarter of 2012.

Standard & Poor's does not see immediate credit implications if the Preliminary Views were to be adopted. However, we believe it would make reported year-to-year unfunded pension liabilities potentially more volatile, and could make it more difficult to track government pension funding progress if GAAP reporting requirements no longer required disclosure of the actuarially determined annual required contribtion (ARC). We believe the Preliminary Views could also promote greater comparability among pension systems by standardizing reporting using one actuarial evaluation method, as well as forcing disclosure of a locality's share of a state retirement system's unfunded liability. While GASB's proposal might improve reporting comparability, we think that strict comparison with other governments could still be difficult due to possibly differing discount rates and return assumptions among different pension plans.

The Preliminary Views would require governments to report on the balance sheet Net Pension Liabilities (NPL), a modification from the current reporting of actuarial unfunded pension liabilities in the financial notes. To the extent there is no longer a requirement to report an ARC, we believe it may make it more difficult to determine a municipality's progress toward adequately funding its pension system on an annual basis, even though changes in NPL would be reported, since changes in NPL also include changes in asset values and other variables. Without a reported ARC and information as to whether governments have fully funded their ARC, Standard and Poor's may have to make additional inquiries as to annual funding status on an actuarial basis.

One unclear consequence of Preliminary Views, in our opinion, is whether adding proposed pension reporting changes to the GAAP financial statements could affect existing bond covenants, such as rate covenants for revenue bonds, or if it could affect governments that have balanced budget requirements. Depending on the nature of the accounting changes, we expect that this would require additional analysis on a case by case basis.

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New Rules Do Not Affect Contribution Requirements

An important point to remember is that the proposed accounting rules do not affect the required contributions that state and local governments must make to their pension systems. The proposal only affects the reporting of pension systems within a government's financial statement. Actual pension system contributions are set by actuarial valuations--which will use different assumption--and by state law.

Where required GASB reporting could differ in the future from the actuarial methods used to determine required pension contributions, Standard & Poor's would likely ask for additional information to determine a government's legally required pension contribution. One important way we think that GASB reporting and current actuarial reports could differ is in GASB's proposed faster amortization of investment gains and losses when a corridor threshold is exceeded.

Whether pension information is reported in the notes to the financial statements, as currently required, or on the balance sheet itself, as proposed, should not, in our view, affect bond ratings--Standard & Poor's already evaluates a government's pension funding status as part of its general obligation (GO) rating criteria.

Nevertheless, to the extent the draft rules promote standardization of reporting, we think that rules might help refine distinctions between different credits. GASB allows governments a choice of multiple actuarial cost methods. The Preliminary Views would standardize the actuarial reporting method under GAAP by allowing only the entry age actuarial cost method. Again, however, governments could still choose to fund their pension systems using a different method.

No More Multiyear Smoothing Could Mean Volatility

In a change that we see possibly creating more volatility in the reporting of pension assets in periods of large market swings, GASB would no longer allow multiyear smoothing of pension fund asset valuations in certain circumstances. Instead, GAAP reporting would require the annual differences between actual rates of investment return and the actuarially assumed rate of return to be reported as accumulated deferred inflows and outflows, up to 15% of a plan's investments. We think that normal gains and losses should balance out over time, but investment gains and losses in excess of 15% would be immediately reported as an expense or a reduction on the financial statement. The net effect of this change would be to report on a GAAP basis an immediate step-up in NPL, or GASB-calculated unfunded pension liabilities, when investment returns drop below the 15% corridor. Currently, we believe multiyear asset smoothing is widespread among governmental pension funds for reporting purposes, and this has allowed many governments to delay increases in pension fund contributions despite stock market losses in the past several years. In years where the 15% corridor was breached, there could potentially be a major difference between GASB requirements and current standard practice in actuarial reporting of pension system unfunded liabilities. If governments eventually moved from current annual pension funding requirements, based on actuarial asset smoothing, to the potentially new GAAP reporting requirements as outlined in GASB's Preliminary Views, it could lead to higher annual pension contributions in certain years with big market losses.

At present, asset smoothing methods vary widely among pension systems. The California Public Employees Retirement System, for example, uses a 15-year smoothing of certain gains and losses, while the California State Teachers' Retirement System uses three-year smoothing. If governments changed their funding procedures to match

the proposed change in GAAP reporting, the degree of change in pension funding contributions would likewise vary from system to system. Many pension systems have what Standard & Poor's views as a large difference between unfunded pension liabilities, calculated using an actuarial smoothing of the pension assets, and unfunded liabilities calculated using current market value of pension fund assets.

As an example, in its most recent actuarial report the Public Employees Retirement System of New Jersey reported a pension-funding ratio of assets to liabilities of 56.5% as of June 30, 2009, based on the actuarial value of assets, while on a market value basis, the funded ratio decreased to 42.1%. While GASB would not require governments to drop asset smoothing when calculating pension funding, those that continue to use asset smoothing might have to report higher liabilities on their balance sheets in periods when the value of investments declines.

GASB would also require benefits earned by employees and the interest on the beginning balance of the total liability to be reported as pension expenses in each period. Changes in economic and demographic factors and related assumptions would be amortized over the future service of employees. Retroactive benefit improvements would also be recognized as expenses over employees' remaining service periods. This means that expenses would be recognized sooner than the 30-year amortization period that governments currently use in actuarial reporting.

GASB would not require a uniform rate of assumed investment return, leaving it up to individual governments to determine. We note that this is a debated topic in the accounting world--some have proposed that a standard riskless rate of return be used to discount pension liabilities, as in corporate pension accounting (where corporations can go out of business). A move to a lower discount rate, to the extent it is tied to the rate of return, would increase unfunded governmental pension liabilities.

A change in the discount rate used to calculate the pension liability is what GASB proposes, but in our view, this will not often come into effect from a practical perspective. Currently, the discount rate is the same as the assumed long-term rate of return. In the Preliminary Views, GASB would lower the rate of return when it was determined that both existing pension assets and future expected governmental contributions would not be enough to cover all future pension payments. However, as long as a government represented that it would make all necessary future contributions, the provision would not go into effect. If it was determined that expected current assets and future contributions would be insufficient, the rate of return would be calculated using a weighted-averaged discount rate, based on the assumed long-term rate of return to the extent that pension benefits will be covered by current and expected plan assets, and by a high-quality municipal bond index beyond the point at which plan assets are not available.

GASB would also require that actuarial liabilities include cost-of-living increases (COLA) if governments routinely grant these increases, even if they are not legally required. This could create some differences with actuarial reporting. As an example, Wyoming's major retirement fund chose not to include COLAs in calculating its actuarial liability as of Jan. 1, 2010, unlike in previous years, when COLA projections were included.

According to our public finance GO rating criteria ("Criteria/Government/U.S. Public Finance: GO Debt," published Oct. 12, 2006, on RatingsDirect on the Global Credit Portal), pension liabilities are a significant credit factor for state and local governments. Standard & Poor's views pension obligations as long-term liabilities that should be managed in a way that will not adversely affect the bond issuer's ability to make debt service payments. Accordingly, Standard & Poor's reviews pension trends related to funding progress. Our analysis includes changes in pension assets and liabilities and funded ratios. Pension asset valuations can change, as can actuarial liabilities.

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The higher contribution requirements that result from unfunded liabilities could make any preexisting fiscal stress more acute, especially if the increase was dramatic. Therefore, Standard & Poor's will evaluate the sponsor's pension funding strategy, and the current and projected cost implications on the government's financial profile. As part of this analysis, Standard & Poor's will review the track record of annual contributions made. We believe that the historical and forecast trends in pension funding are as important, if not more so, than the specific liability level at a single point in time.

Standard & Poor's will follow GASB's deliberations and the exposure draft proposal when it is released in 2011. Although we currently think that implementation of the accounting changes outlined in GASB's Preliminary Views would likely not cause significant rating changes, despite the change to government fund balance positions as unfunded pension liabilities are added, GASB could still propose further changes before implementation of any final accounting changes.

Related Criteria And Research

- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: Public Pension Funds, June 27, 2007
- USPF Criteria:Pension Fund Credit Enhancement And Related Guarantee Programs, Sept. 25, 2006

837934 | 300098050

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