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GASB Standards & What They Mean for Public Pensions

A Synopsis in Plain English

In 2012, the Government Accounting Standards Board (GASB) adopted a new set of guidelines that significantly impact how states and municipalities report their pension obligations. Those standards – laid out in GASB Statements 67 and 68 – have the potential to make pension obligations look far more expensive. Boston College's Center for Retirement Research found that the new guidelines could make total liabilities appear 20 percent higher on average.

It is important to remember that despite the GASB changes, pension obligations *have not changed* in any significant way. In GASB's own words:

> "While this information will, in some cases, give the appearance that a government is financially weaker than it was previously, **the reality of the government's situation will not have changed**."

Further, the new GASB standards only apply to how pension obligations are reported on financial statements and have no direct impact on how public officials decide to fund public pension system. Again, according to GASB:

> "The Statements do not address how governments approach pension plan *funding* – a government's policy regarding how much money it will contribute to its pension plan each year…The Board crafted its new Statements with the fundamental belief that funding is squarely a policy decisions for elected officials to make as part of the government budget approval process."

The bottom line is, don't panic.

While the new financial reports will give pension opponents an excuse to declare a crisis, the reality is that very little has changed. The best way for local and state governments to provide a secure retirement for public employees is to continue to pay the *actuarially required contribution.*

<u>What's Different?</u>

Funding Based Approach vs. an Accounting Based Approach

The old GASB standards focused on how plans were *funded* each year. State and local governments were required to report whether or not they made their full *actuarially required contribution,* better known as the ARC. In simple terms, the ARC is what a state or local governments need to pay into the pension fund each year to keep it on sound financial footing.

The new GASB standard takes an accounting-based approach rather than a funding-based approach. Instead of reporting the ARC, state and local governments will be required to report a new figure called the *net pension liability* on their balance sheets. Before, these liabilities were only reported as supplementary information.

This new *net pension liability* figure has been compared to the unfunded liability numbers that we are already familiar with, but it is not the same. Due to the use of different methods and assumptions, the new net pension liability is not an apples-to-apples comparison to the unfunded liabilities from the prior year.

Why Debt Numbers May Look Bigger

Pension debt numbers could look bigger due to two main changes in the financial reporting:

1) Instead of being "smoothed" over time, assets will now be valued at a specific date in time.
2) The *net pension liability* will be calculated using a lower discount rate.

Asset Valuation Date

Pension funds are invested in the stock market, and assets can fluctuate with the ups and downs on Wall Street. In the past, pension plans have "smoothed" (or averaged) market returns over a 3-5 year period to reduce the volatility of these fluctuations.

Under the new GASB standard, pensions are forced to report a one-day snapshot of their asset values for each plan year. This means greater volatility in the reported value of pension assets, and therefore, higher reported liabilities. It may also mean greater volatility in contribution rates from year to year, as private sector plans experienced when they were forced to move to a similar market-based approach.

Discount Rate, Or Rate of Return

Pension assets are diversely invested and assume an average rate of return of 7-8%, a rate that most plans have achieved over the last few decades. In any given year, returns may come in at a higher or lower rate.

Under the new GASB standard, however, any unfunded pension liabilities must be discounted at a different rate of return—that of high-grade municipal bonds. These bonds have achieved anywhere from 2.5 - 4.5% recently, far lower than the 7-8% that most plans currently assume. When a lower discount rate is assumed, the current year liability looks larger.

If the Financials Aren't Really Any Different, What's the Problem?

Anti-pension activists will use the new *net pension liability* as a scare tactic, claiming that taxpayers owe pensioners vast sums of money. They may use the large liability numbers to push for pension reductions, or even, elimination.

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This is incredibly dishonest. For most states, unfunded pension liabilities represent a manageable debt that can be paid down over time, similar to a homeowner making a mortgage payment. An initial mortgage debt of $300,000 might seem scary, but of course, the homeowner does not have to pay the bank this entire amount at once, instead paying it down monthly over 15 or 30 years. Pension debt works the same way.

Also, most systems will continue to fund their pensions and make calculations for funding the old way—reporting the actuarially required contribution, along with its liabilities and the unfunded actuarial accrued liability (UAAL). These numbers will differ from the new GASB numbers, perhaps significantly. Seeing multiple sets of pension numbers could be confusing for stakeholders, who may not necessarily understand the differences between the two sets of calculations.

What Should State and Local Governments Do Now?

With the switch from a *funding-based approach* to an *accounting-based approach,* GASB standards are now completely disconnected from an advisable funding policy. With so much ambiguity, 11 nonpartisan public sector organizations joined together in 2013 to create a new guide to help elected officials address pension-funding policy.

The report concludes what we already knew – governments need a credible and consistent funding approach and should base long term funding policies on *actuarially required contributions.*

The report also suggests the following:

- Build funding discipline to ensure that promised benefits are paid.
- Maintain intergenerational equity. Meaning, keep a balance of older and younger workers within a pension plan.
- Make employer costs a consistent percentage of payroll.
- Require clear reporting to show how and when pension plans will be fully funded.

Questions on how to talk about GASB standards?

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