MOODY'S
INVESTORS SERVICE

SPECIAL COMMENT

Governmental Pension Contributions May Increase Due to New Guidance

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The Governmental Accounting Standards Board (GASB) recently issued Preliminary Views (PV) on *Pension Accounting and Financial Reporting By Employers*. The PV is part of the GASB's effort to improve accounting and financial reporting standards for postemployment benefits. If the PV is adopted as currently proposed, the three major differences will be: 1) the unfunded portion of an entity's pension obligation will be recognized in the financial statements, 2) the discount rate used to calculate the pension obligation will be lower for the portion of any plans which are expected to be unfunded, and 3) faster recognition of expenses caused by plan amendments and certain actuarial gains and losses.

The new GASB rules will allow entities to calculate funding requirements the same way as present whilst requiring different methods to calculate financial reporting expense. This should mean that even though liabilities and expenses will increase for reporting purposes, the Annual Required Contributions (ARC) should not. We believe that the new rules will more closely align public pensions' reported expense and obligation with economic reality. With new insight into the true cost and funded positions of state and local pension plans elected officials might choose to increase employer or employee contributions to boost funding levels. At the same time, it will improve transparency and comparability. Any increased pension funding pressure from GASB's rule revisions will be felt across the board, but the biggest impact would be for governments that are most out of line with what GASB is proposing.

Recognition of Liability

Neither the total obligation for pensions nor the unfunded portion is reported as a liability in a government's financial statements under GASB's existing standards. Rather, a liability is reported if a government contributes less than the ARC calculated by actuaries (based on the requirements of the GASB's standards). The PV states that pension benefits are a form of compensation promised by governments to their employees in exchange for work performed. The pension plan is primarily responsible for the pension obligation to the extent that assets have been accumulated in the plan (by government and employee contributions and investment earnings) to finance the pension benefits; the government is secondarily responsible for this *funded* portion of the obligation. The PV further reasons that as the government is primarily responsible for the remaining *unfunded* portion of the obligation, an obligation should be recognized in the financial statements equal to the unfunded amount. Although the GASB approach is conceptually similar to current requirements governing the private sector, the PV mandates different methods for calculating the obligation.

Discount Rate

One major change in how the pension obligation will be calculated is the discount rate that will be used to present value pension obligations. It is the GASB's view that a reasonable long-term expected rate of return on the plan's investments would continue to be the basis for discounting projected benefit payments to their present value, but only to the extent that the current and expected future plan net assets will be sufficient to cover the future benefit payments. Benefit payments that are expected to occur beyond the point at which expected plan assets are projected to be exhausted would be discounted to their present values using a high-quality municipal bond index rate.

This average discount rate will almost certainly be lower than is being currently used to present value plan obligations. A general rule of thumb is that a 100 basis point movement in the discount rate results in an inverse movement in the obligation of approximately 8-12%. For plans that are expected to be underfunded, this lower discount rate will result in large increases in the plans' underfunding, but only for financial reporting purposes.

Acceleration of Expense

The size of a government's net pension liability changes from year to year for a variety of reasons:

1. Employees work and earn more benefits
2. The outstanding liability accrues interest
3. Actual economic and demographic factors differ from what was assumed in the calculation of the pension liability
4. Changes are made in assumptions about economic and demographic factors
5. Changes in the terms of the pension plan affect benefits associated with employee services in past years
6. The value of plan net assets changes.

The PV states that each year, benefits earned by employees in exchange for their services and the interest on the beginning balance of the total liability would be reported as expenses. Likewise, the effects of changes in plan net assets other than investment earnings (for instance, contributions) would be incorporated into expenses when the changes occur.

However, governments may currently recognize changes resulting from Items 3–5 over a period of up to 30 years. Most governments would therefore recognize these costs as pension expenses sooner than they do at present. For instance, benefit changes affecting retirees and other persons no longer working for a government (and thus with no remaining service period) would be recognized as expense immediately.

The GASB makes clear that these proposals would be required only for accounting and financial reporting purposes. Governments would not have to change their annual pension contributions to match the change in expense reporting.

While the financial reporting should not change required contributions, we believe that by providing more transparent information on the true economic cost of providing pension benefits the changes outlined in the PV would shine a light on any differential between the economic cost of pensions and the amounts contributed. The clearer provision of this information should better inform state and local policymakers about the need to increase contributions or reduce benefits granted in order to achieve full funding of these obligations. While in the short term additional contributions may cause some pain, in the longer term well funded pension plans will reduce the fiscal and credit risk of the government sponsor.

Moody's Related Research

Special Comments

- Employee Pension Costs Pressure State and Local Governments, November 2009 (120474)
- Pension Funding May Suffer from 2008 Stock Market Declines, November 2008 (112335)
- Review of Financial Audits Shows Rise in Major Cities' Pension Liabilities, December 2006 (98053)
- Survey Shows that Cost of Other Post-Employment Benefits (OPEB) for the Largest U.S. Cities Outpacing Inflation, December 2006 (101468)
- Other Post-Employment Benefits (OPEB): New Accounting Requirements to Shed Light on Cost of State and Local Retiree Health Benefits; Funding Pressures Expected to Vary Widely, July 2005 (93649)
- The Effects of Aging on Public Sector Pensions and Healthcare Systems: A Rating Agency Perspective, June 2004 (87245)

Methodologies

- Moody's State Rating Methodology, November 2004 (89335)
- General Obligation Bonds Issued by U.S. Local Governments, October 2009 (119982)

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