# New Pension Perspectives

Long-Awaited GASB Pension Changes Begin

**Special Report**

## Pension Reporting in Transition

Pension systems are releasing their fiscal 2014 actuarial valuations and financial reports under GASB statement 67, one of two new pension accounting standards announced in 2012. The transition to new GASB pension reporting has only just begun; governments will release their own financial reports subject to GASB statement 68 for fiscal years ending after June 15, 2015. This special report focuses on the changes that affect a system's reported net pension obligations.

Future comments from Fitch Ratings will focus on other aspects of the new pension reporting, as well as other topics related to governments' defined-benefit pensions.

**Net Pension Obligations Shift:** As systems release financial statements under GASB 67, their newly reported net pension liability figures often are shifting, sometimes materially, from the corresponding unfunded actuarial accrued liability (UAAL) figures reported under the old standards. The new standards require systems to conform to a narrower set of assumptions and, for some, amplify existing weaknesses, resulting in varying changes both to pension assets and liabilities.

**Reported Asset Gains Material:** Most systems are reporting materially higher asset values under the new standards relative to the actuarial asset values reported under the previous GASB standards. This reflects immediate recognition of several years of strong market gains that had yet to be fully incorporated under the asset-smoothing practices allowed by previous GASB standards. Going forward, the mark-to-market requirement under GASB 67 and 68 will fully expose reported assets and the resultant ratio of assets to liabilities to market volatility.

**Depletion Dates — Red Flags:** The new depletion date and blended discount rate reported by some systems under GASB 67 highlight existing weak practices, most notably an unwillingness to consistently fund an actuarially calculated contribution. Few systems are reporting depletion dates, and reporting a depletion date does not necessarily correspond to exceptionally low ratios of assets to liabilities. The same contribution underfunding that, over time, may lead to a reported depletion date concurrently helps to erode a system's asset base, lowering reported assets.

**Liability Calculations Little Changed:** The transition to new pension accounting has had little effect on the way total liabilities are calculated for the majority of systems that had already used certain actuarial assumptions required by the new standards. GASB 67 requires the use of the entry-age normal (EAN) cost method, a more conservative approach used by about three-fourths of large systems for actuarial valuation purposes. For the remaining systems that used one of the other five previously allowable cost methods, liability calculations under GASB 67 are moderately higher.

**Transition Not a Rating Driver:** Fitch does not expect the transition to new pension accounting to be a significant rating driver. Fitch continues to view pension obligations as debt-like, similar to bonded debt. However, Fitch recognizes that, unlike most bonded debt, reported pension figures are subject to numerous variables and, thus, to some degree of changes. More significant for credit quality is the willingness of governments to actively manage their pension obligation, including consistent progress in paying it down over time.

**Related Research**

Pension Pressures Continue (May 2014)
U.S. State OPEB Liabilities (June 2014)

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## Transition to New GASB Pension Reporting Underway

### Pension Systems Issuing New CAFRs

The season for pension system financial reporting has arrived, and the first significant wave of CAFRs and valuations has been published under GASB's new standard for pension systems, statement 67, which pertains to systems with fiscal years ending after June 15, 2014.

This report provides some initial observations on the first wave of reporting under GASB 67, primarily with respect to systems' reported assets (the fiduciary net position [FNP]) and liabilities (the total pension liability [TPL]). Understanding the extent to which new GASB requirements are affecting pension systems' FNP and TPL provides important insight into the ultimate gap between the two (the net pension liability [NPL]) that GASB will now require governments to report on their balance sheets. Future Fitch comments will focus on other aspects of the GASB pension transition and other topics of interest related to pensions.

This is only the beginning of a much longer transition to new GASB pension accounting standards, as governments' own CAFRs will begin to reflect GASB statement 68 for fiscal years ending after June 15, 2015. To date, only New York City, the state of Utah and a handful of other governments have released financial statements under GASB 68 requirements.

#### Changing Pension Terminology

| | GASB 25 and 27 | GASB 67 and 68 |
|---|---|---|
| Assets | Actuarial Value of Assets (AVA) | Fiduciary Net Position (FNP) |
| Total Liabilities | Actuarial Accrued Liability (AAL) | Total Pension Liability (TPL) |
| Net Liability Amount | Unfunded Actuarial Accrued Liability (UAAL) | Net Pension Liability (NPL) |
| Ratio of Assets to Liabilities | Funded Ratio | Ratio of FNP to TPL |
| Actuarial Contribution | Annual Required Contribution (ARC) | Actuarially Determined Employer Contribution (ADEC) |

### Parallel Perspectives Add Value and Challenges

An important caveat is that GASB is only changing the accounting of pensions, and pension systems will generally still manage themselves based on the "funding" approach that actuaries have always calculated (which was the source of data for GASB statements 25 and 27, the previous pension accounting standards). Funding is the actuarial task of assessing a system's condition and the contributions needed to sustain it. The presence going forward of "two sets of books" — one with assets, liabilities and expenses calculated for GASB accounting purposes and the another with actuarial figures calculated for funding purposes — adds complexity and possibly confusion to pension analysis.

Given their improved comparability and incorporation into government financial statements, Fitch will rely primarily on the newly reported GASB data to assess the credit impact of pensions on governments. However, important details will continue to emerge from the actuarial funding data, most notably, information on how the actuarially determined employer contribution (ADEC — GASB's new name for the annual required contribution [ARC]) is calculated and how it relates to what governments actually contribute over time.

**Related Criteria**

U.S. State Government Tax-Supported Criteria (August 2012)

U.S. Local Government Tax-Supported Criteria (August 2012)

## Good Timing for Asset Revaluation

In an accident of timing, the transition to GASB 67 is taking place at a very favorable point in the economic cycle for reporting asset valuations. In most cases, the market value of assets (MVA) reported by systems under GASB 67 (the FNP) is much higher than the smoothed asset value reported previously (actuarial value of assets [AVA]). Investment portfolio values have risen sharply in recent years, generally well ahead of the 7.5%−8.0% annual investment return rate assumed by most systems, and with the GASB transition systems are recognizing a sizable backlog of past unrecognized asset gains all at once. All else equal, the ratio of pension assets to liabilities appears materially stronger in fiscal 2014 under GASB 67 than the funded ratio in fiscal 2013.

The higher ratios of assets to liabilities being reported by many systems in fiscal 2014 should be viewed with caution. Reported asset values are now fully subject to market cyclicality, and, thus, the ratio of assets to liabilities reported by systems will rise and fall far more sharply than the funded ratio reported under prior GASB standards.

The Oklahoma Public Employees Retirement System reported an FNP as of June 30, 2014 of $8.57 billion but an AVA of only $7.76 billion. The system actuary's valuation references $811 million in asset gains still to be recognized in the AVA under the funding approach. The resultant ratio of assets to liabilities was only 88.6% under the actuarial approach, while it rises to 97.9% under GASB 67 with full recognition of asset gains.

## Depletion Dates Tell Only Part of the Story

A handful of large pension systems now have reported depletion dates under GASB 67, an entirely new metric. Under GASB 67, if a system's projected assets, including assumed future investment returns and contributions, are insufficient to cover projected benefit payments, the system must discount the future benefits payable after assets run out (called the depletion date or crossover date) using a separate, lower discount rate. Until the depletion date, the system's investment return assumption is used to discount future benefits, and, after the depletion date, a muni bond index rate is used. Combined, the two discount rates are expressed as a single equivalent or blended rate. The lower blended rate used for discounting raises the resultant TPL relative to the AAL and, thus, materially reduces the ratio of assets to liabilities.

Notably, GASB leaves some flexibility in determining whether to forecast a depletion date and use a blended discount rate. Numerous variables influence a system's forecast cash flows, and actuaries are directed to apply professional discretion regarding some of these assumptions. Consequently, two different actuaries could reach different conclusions on whether reporting a depletion date and blended discount rate is warranted.

### Red Flag for Amortization Challenges

Depletion dates are a handy red flag for a system with longer-term cash flow stress, generally as a result of an inadequate commitment to amortizing its unfunded liability through consistent, full funding of actuarial contributions. For the most part, systems with annual contributions that fall short of this total are those most likely to identify a depletion date under the new GASB standards.

Six of the seven New Jersey state pension systems have disclosed depletion dates as of their June 30, 2014 valuation, with the two largest, covering retired state employees and teachers, reporting depletion dates in 2024 and 2027, respectively. The systems' actuary used a 4.29% rate to discount future benefits payable after the depletion date, well below the 7.9% investment return assumption used to discount future benefits payable before the depletion date. The results are much higher calculated liabilities and much lower ratios of assets to liabilities in fiscal 2014, at 27.9% for state employees and 28.5% for teachers. Their funded ratios a year ago were 49.1% and 51.5%, respectively, under the old GASB standards. Underfunding plan ARCs has long been a source of budget relief in New Jersey, resulting in the progressive deterioration of the plans' funding condition.

## The Future Matters More than the Past

In some cases, it is the absence of a depletion date under GASB 67 that is noteworthy. Since a key question for the actuary's valuation is the level of expected future employer contributions, even very poorly funded systems can avoid a depletion date. GASB directs actuaries to consider the most recent five-year contribution history in projecting future contributions, but other factors affecting contributions levels — such as a recent statutory reform raising contributions — can influence the actuary's forecast.

Kentucky's Employee Retirement System (KERS) covering nonhazardous employees has reported an exceptionally low ratio of assets to liabilities, at only 22.3% as of June 30, 2014, but assumes a 7.75% discount rate for its entire liability; there is no depletion date. Kentucky, like New Jersey, is one of a handful of states whose sizable retiree obligations and history of inadequate contributions have led to credit downgrades in recent years.

KERS' ability to avoid reporting a depletion date in fiscal 2014 for its nonhazardous employees highlights the impact of recent reforms on the system's forecast sustainability. Kentucky enacted SB 2 in 2013, which lowered benefits of future employees, limited COLAs, closed the system's amortization period and required full ADEC payments beginning in fiscal 2015. These reforms and the Legislature's appropriation of the full ADEC in fiscal 2015 resulted in the KERS actuary being able to forecast that all future benefits would be covered by system assets — in other words, no depletion date is warranted. While a single year of the state fully appropriating the ADEC is clearly positive, this must be repeated annually for decades to pay down the state's UAAL.

## Systems with Higher Ratios Not Immune

By contrast, a few systems with relatively better funded ratios under the previous GASB standards are now reporting a depletion date under the new GASB standards, again due to their inadequate contribution practices.

As of its Aug. 31, 2014 valuation, Texas' Employee Retirement Fund (ERF) reported a GASB 67 ratio of assets to liabilities of 63.4% (based on a blended rate of 6.07%), well below the funded ratio of 77.2% on an actuarial basis (based on an 8% investment return assumption). Assets are forecast to be depleted in 2041.

ERF reporting a depletion date stems from the state's longstanding practice of underfunding an actuarially sound contribution level. Some states, including Texas and Oklahoma, explicitly prioritize maintaining stable annual pension contributions over time, rather than allowing employer contributions to rise and fall freely as actuaries incorporate new demographic and economic experience into annual valuations. This approach is embodied in a Texas constitutional provision restricting employee retirement system contributions to between 6% and 10% of payroll (the total state contribution to the system was 8% in fiscal 2014). Despite some reforms in 2013, the latest valuation reveals that ERF's challenges remain unresolved.

## Depletion Also Corresponds to Weaker Assets

As noted earlier, the transition to the new GASB standards for most systems means that a backlog of unrecognized market gains can be reflected all at once in their asset value, helping to raise their ratio of assets to liabilities, all else equal. This is not necessarily the case for systems with depletion dates, where persistently inadequate contributions erode system portfolio values over time and limit their ability to take full advantage of years with strong market gains.

The cumulative effect of Texas' consistent ERF contribution underfunding is that the system's MVA (or FNP for GASB 67 purposes), at $25.1 billion as of Aug. 31, 2014, actually lags the AVA of $25.4 billion, further weighing on the ratio of assets to liabilities reported under GASB 67. Texas ERF's investment pool received $913 million in total statutory contributions in fiscal 2014, equal to 14.6% of pay, about 4.13% of pay below the level calculated by actuaries as necessary to make progress toward paying down its unfunded actuarial liability. A similar dynamic has been in place for years, and contribution increases enacted in 2013 failed to correct the situation. Although ERF assumes a return of 8% and actual investment returns were a strong 14.7%, the portfolio values have lagged behind the level they would otherwise reach if they received fully funded contributions.

## Liability Calculations Mostly Unchanged

In addition to the depletion date affecting the reported TPL and FNP for a handful of plans under the new GASB standards, another category of plans will see liabilities rise in the transition given the requirement under GASB 67 to use a single actuarial cost method — EAN.

## Most Systems Already Use Entry Age Normal

Under prior GASB standards, systems could select one of six cost methods, part of a range of actuarial assumptions underlying the calculation of the AAL and ARC. The most common cost method was EAN, used by approximately 83% of plans in 2013. The second most common method was projected unit credit (PUC), which was used by about 9% of state plans. GASB 67 and 68 eliminated the use of alternatives to EAN, and, thus, plans that had used PUC or other methods are now transitioning to EAN. EAN is considered more conservative because it allocates more of the ultimate cost of a worker's future benefit to earlier periods in his/her career, leading to higher required contributions and a higher liability relative to PUC and alternative cost methods. Systems transitioning to EAN in fiscal 2014 with the GASB 67 standard are, thus, reporting marginally higher liabilities.

Connecticut's state employees' system continues using PUC for funding purposes, under which it reports a June 30, 2014 AAL of $25.5 billion. Under the EAN cost method, its total pension liability is $981 million higher, at $26.5 billion. This variance contributes to the resultant difference between the system's actuarial funded ratio, at 41.5%, and its GASB 67 ratio of assets to liabilities, at 39.5%.

Fitch believes that many of the systems whose actuaries use alternative cost methods for funding purposes will ultimately shift to EAN to better align with their valuations performed for accounting purposes.

Louisiana Act 571 of 2014 changed the cost method for the state employees' and teachers' retirement systems to EAN from PUC. The systems' actuaries reported that the change to EAN raised the state employees' system AAL by $622 million versus the level under PUC, and the teachers' system AAL by $881 million.

## Minimal Credit Impact from Transition

The pension obligation reported by systems and governments is a key variable for Fitch's credit analysis because it represents a claim on future cash flows, similar to bonded debt. However, unlike bonded debt, pension liabilities and the annual contribution necessary to fully prefund them are calculations that result from a wide range of economic and actuarial assumptions, as well as policy choices by governments regarding hiring, benefit provisions and contributions. As assumptions and policies shift, the calculated liability and annual contribution are subject to change.

Assessing the willingness of governments to actively manage their obligations, including consistently paying down their remaining obligations, is integral to assessing the impact of pensions on credit ratings. Although the new GASB standards result in a variety of changes to calculated pension figures (and temporarily make year-on-year comparison more challenging), Fitch expects few surprises to emerge from the new data. Instead, Fitch believes the data are likely to provide improved comparability and additional insights into the magnitude of government pension commitments.