STANDARD & POOR'S
RATINGS SERVICES

# RatingsDirect®

## Credit FAQ:

# Standard & Poor's Approach To Pension Liabilities In Light Of GASB 67 And 68

**Primary Credit Analyst:**
John A Sugden, New York (1) 212-438-1678; john.sugden@standardandpoors.com

**Secondary Contacts:**
David G Hitchcock, New York (1) 212-438-2022; david.hitchcock@standardandpoors.com
Katilyn Pulcher, ASA, CERA, Chicago (1) 312-233-7055; katilyn.pulcher@standardandpoors.com
Robin L Prunty, New York (1) 212-438-2081; robin.prunty@standardandpoors.com

## Table Of Contents





1160768 | 300187765

## Credit FAQ:

# Standard & Poor’s Approach To Pension Liabilities In Light Of GASB 67 And 68

On June 25, 2012, the Governmental Accounting Standards Board adopted statements 67 and 68 related to financial reporting for pension plans and to financial accounting and reporting for pensions, respectively. The statements significantly change how pension liabilities are accounted for and reported on in state and local governments' financial statements. Statement 67 will take effect for pension plans for fiscal years that begin on June 15, 2013 or later; Statement 68 will take effect for employers and governmental nonemployer contributing entities for fiscal years starting June 15, 2014 or later.

## Frequently Asked Questions

### What are Standard & Poor's views on GASB 67 and 68?

Standard & Poor's will be incorporating GASB statement 67 (Financial Reporting for Pension Plans) and statement 68 (Accounting and Financial Reporting for Pensions) as its basis for analyzing pension liabilities for states. In our view, the new GASB standards have some limitations but do make significant changes to how pension liabilities are calculated, accounted for, and reported in financial statements. The changes include the use of a blended discount rate, the proportional reporting on pension liabilities for multiemployer cost sharing plan participants, and the elimination of the ARC reporting requirement for those funding pension contributions based on statutorily or contractual requirements, among others. There will also be other key changes such as increased disclosure on funding policies, faster recognition of plan changes, and a sensitivity analysis based on different rate of return assumptions. In our view, the new standards will lead to more conservative liability estimates that the current standards and provide some additional disclosure.

### What are Standard & Poor's views on the use of a blended discount rate?

We view the use of a blended discount rate as one of the most significant changes made under the new statements and as an improvement to financial accounting and reporting of pension liabilities. Under the new statements, the rate used to discount a government's pension liability will be a blend of the long-term assumed rate of return, to the extent that assets are projected to be available to fund projected benefits, and the use of a 20-year tax-exempt, 'AA' category or better, GO municipal bond index rate. This blended rate approach is based on GASB's recognition that investment returns can't be earned unless there are assets invested on which to earn those returns. We consider this approach as more reflective of reality than the current practice of discounting the entire liability at the long-term expected rate of return.

### What impact will the proportional reporting on pension liabilities have on governments?

GASB's requirement that governments participating in a multi-employer cost sharing plan report their proportional share of the total plan liability is another significant change under statements 67 and 68. States have varying degrees of responsibility for funding plans on which they report in their financial disclosure. For multi-employer cost sharing systems, which can include a number of local jurisdictions, such as school districts, which are funded by contributions from both employers and employees, the state may be a non-employer contributor. Therefore, with some exceptions, states are generally not directly responsible for fully funding the liabilities of these pension systems. However, even in cases where pensions are direct liabilities of and funded from local entities, a portion of the local entities' funding may be derived from the states. Given the important role states play in funding and reporting these liabilities and in the absence of this proportional share data, we have historically allocated the plan's entire liability to the state sponsor. In our view, GASB's proportional share reporting requirement is more transparent because it allocates the liability to the entity(ies) responsible for funding it. As a result, we believe that, all things being equal, the state's liability will fall in plans that are mainly funded at the local level.

### Is Standard & Poor's currently planning to make further adjustments to the discount rate used under the new GASB 67 and 68 statements to arrive at the net pension liability (NPL)?

We do not anticipate making additional adjustments to the net pension liability. With the separation of pension liability accounting and reporting from funding under GASB 67 and 68, market participants will have access to an actuarially based pension liability calculation and a GASB-based pension liability calculation with an accompanying sensitivity analysis, each with its own set of assumptions. We believe that adjusting the NPL based on an arbitrary discount rate may provide greater comparability at the expense of accuracy. In addition to the discount rate, there are many other financial and economic assumptions used to establish the liability. Because of the numerous assumptions that go into these calculations, pension liability figures are not exact calculations of the liability, but rather estimates of the liability that will change over time based on changes to assumptions and actual experience. Instead, we will continue to focus on commitment to funding, investment performance, trend analysis, affordability, and efforts at maintaining plan sustainability.

### What impact will the elimination of ARC reporting have on Standard & Poor's evaluation of pension liability funding progress?

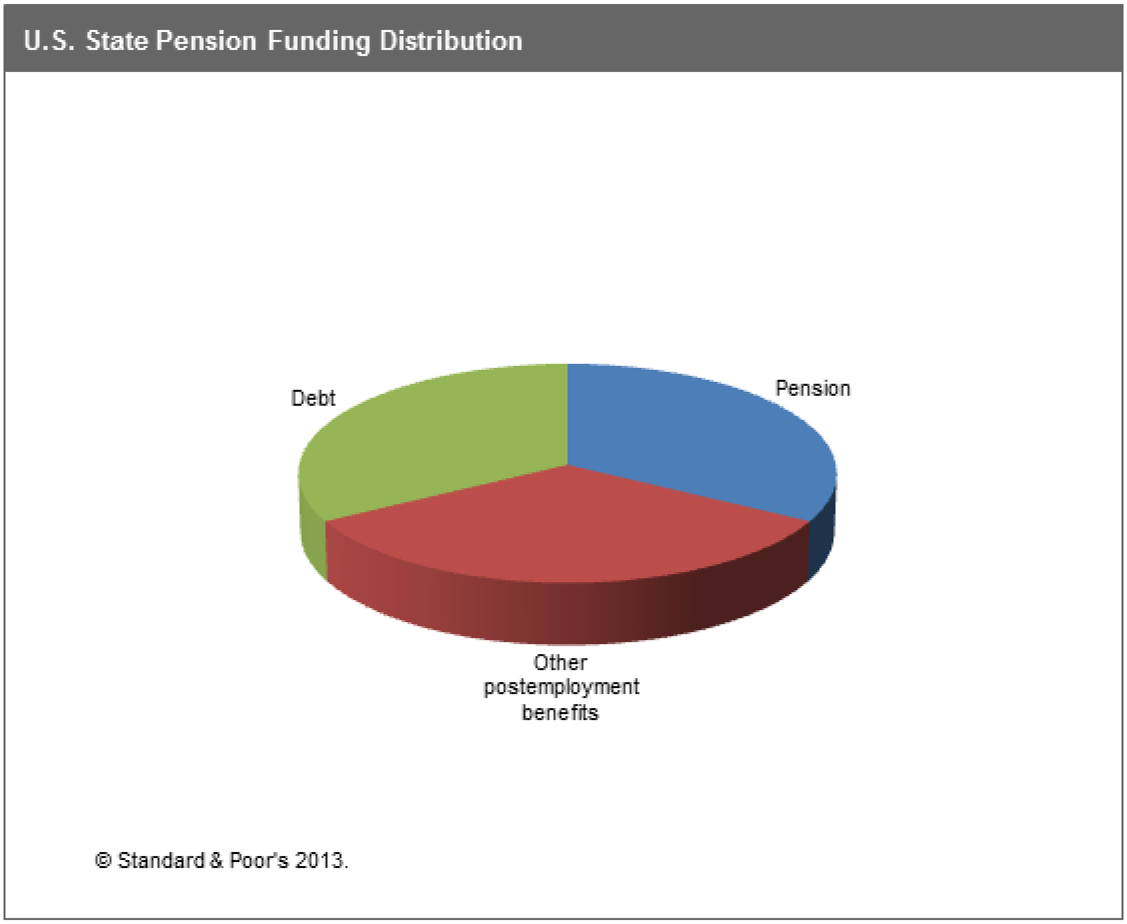
Under the new GASB standards, plans that have a pension funding policy based on an actuarially determined annual required contribution (ARC) will continue to have to report the ARC, while those governments whose funding is based on statutorily or contractually determined contributions will not be required disclose an ARC. We believe the ARC has become an easily recognizable and understandable measure for governments both large and small. It has provided a certain discipline to pension funding strategies and has been a factor in improving funding levels over time. We've observed that historically, pension plans that are funded based on statutorily or contractually determined contribution and those that underfund their ARC tend to have lower funded levels. Our current metrics evaluate with what frequency governments fully fund their ARC. As we have done historically, we expect to continue to factor a government's funding progress and discipline into our overall evaluation of its long-term liabilities.

### How does Standard & Poor's Ratings Services factor pension liabilities into state government ratings?

Pension liabilities and the annual funding costs are important credit factors in our review of state governments. We view pension obligations as long-term liabilities that must be funded over time, and while the funding schedule can be more flexible than that for a fixed-debt repayment, it can also be more volatile and may cause fiscal stress if not managed. Our focus is primarily on the pension's affordability and management's ability and record in managing this liability. Key considerations in evaluating pensions include the size of the liability, the current funding status, and funding progress over time.

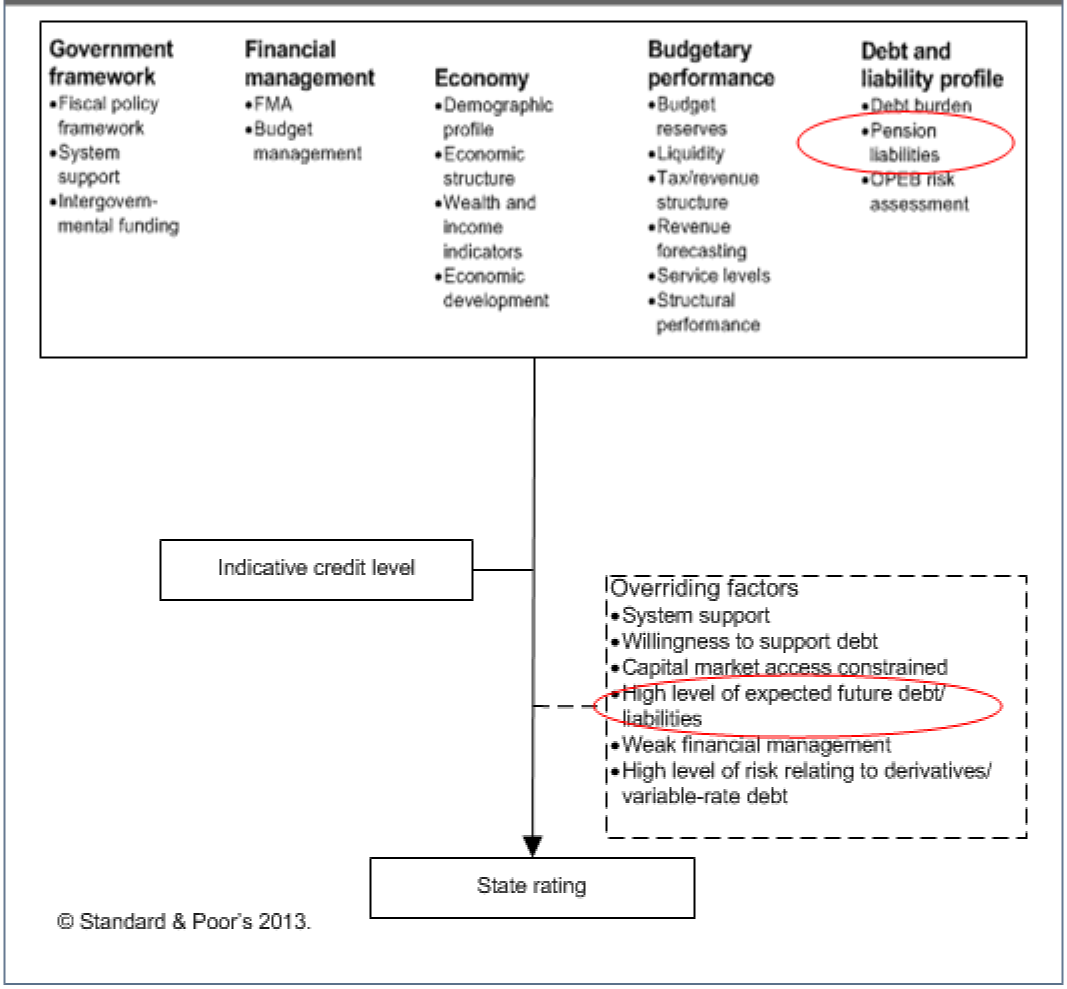
Under our U.S. state ratings criteria, the debt and liability profile is one of the five major factors that determine a rating. Within this factor, debt, pension liabilities, and other post-employment benefits are key metrics in our analysis. We measure a state's pension funded ratio, its record of fully funding its actuarially determined annual required contributions (ARC), and unfunded accrued actuarial liability per capita and as a percentage of personal income.

**Chart 1**




Additionally, our scoring approach is flexible, allowing for adjustment to the indicative rating if we consider there to be overriding factors, such as a high level of expected future debt or liabilities that justify a lower rating. We believe that this overriding factor allows for a forward-looking assessment of future debt and liabilities and their potential impact on the state's operating performance. Finally, the burden of servicing pension liabilities will also be captured in other key areas such as budgetary performance.

**Standard & Poor's Analytic Framework For Rating U.S. States**




### Will Standard & Poor's criteria change to incorporate GASB 67 and 68?

We will be evaluating our existing criteria and may implement adjustments to our metrics based on the new standards. As always, our focus will be on the liabilities, how they are managed, and affordability of the servicing costs.

### Does Standard & Poor's anticipate revising state government ratings based on changes to the new GASB statements?

We do not anticipate significant revisions to state ratings solely on the changes to GASB reporting. Our rating criteria allow for pension liabilities to be scored within certain ranges. While we expect some movement within those ranges and potentially some changes to our overall debt and liability scoring, we don't anticipate these changes to result in significant changes to overall scores. In our view, the changes to pension liabilities resulting from the new GASB standards, such as the use of the blended rate, are more likely to affect governments for which we have already factored their weak pension funding status into our ratings. We will continue to differentiate states' credit profiles where pension liabilities are large and growing, there is limited funding discipline and progress, and there has been limited action on reform.