# GASB Enacts Pension Accounting Reforms Regarding the Use of Discount Rates

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*This issue brief provides a summary of the issues associated with the newly enacted pension reporting changes by GASB. For more detailed technical discussion of the aspects of complying with the rule, we suggest the GASB website, http://www.gasb.org/, as well as GASB's Plain Language Article on Statements 67 and 68.*

## Overview

Recent efforts by the Governmental Accounting Standards Board (GASB) to implement pension accounting reforms are intended to reduce pension risk and encourage public plan administrators to confront future liabilities with greater prudence. GASB aims to accomplish this by allowing the use of a higher discount rate for funded liabilities than for unfunded liabilities, which in theory creates an accounting incentive for state and local governments to fund pension liabilities. Requiring a lower discount rate for unfunded liabilities will reduce the funding ratio for underfunded public plans. The discount rate refers to the rate used to discount future liabilities, and is often tied to the historical average for equity market investment returns. On the surface, the change will make underfunded public pensions appear worse, but the new accounting rule will not change the amount currently owed to public employees and retirees. And while the new standards arguably add confusion and complexity to an already contested topic, it can be argued that the potential benefits outweigh the drawbacks if plan administrators and appropriators improve the funding status of pension plans to avoid being penalized by the rule change.

## Background on Pension Basics

State and local governments use assumptions to determine how much money they need to set aside in the present in order to fund retiree obligations in the future. Actuarial accounting techniques use these assumptions to determine the payment amount that must be contributed to pension funds each budget cycle to ensure that currently accruing benefits are covered by the fund. The yearly (or biennial) employer contribution to the fund comes directly from a state or local government operating budget and is called the annual required contribution or "ARC". The ARC represents the level of payment needed for the state or locality to keep pace with the accumulation of benefits.[1] Keeping pace entails meeting the cost of benefits accrued in the current year in addition to paying a portion of the unfunded liabilities. The amount owed on unfunded liabilities can be paid over time because the obligations are amortized much like a mortgage payment.

When a pension plan's accrued actuarial liability (liabilities) exceeds the actuarial valuation of assets, the plan is said to have an unfunded actuarial accrued liability (UAAL) or unfunded liabilities. The ratio of assets to liabilities is depicted as a pension plan's funding ratio, which indicates the level of funds available for paying accrued benefits. The benchmark for many state and local plans is to maintain an 80 percent funding ratio or sufficient assets to cover 80 percent of accrued liabilities.[2] Funding ratios can be used as an indicator of plan solvency, but the statistic does not always represent a meaningful comparison due to different assumptions and rules built into pension systems. However, funding ratios do signal when ARC payments must be increased or when policy oriented plan changes are needed to reduce liabilities.

Pension funds continue to derive the majority of their income through investment returns, which account for roughly 60 percent of the dollars paid out to ben-

[1] ARC payments are comprised of two components; the cost of benefits that employees accrued in the current year and the amount needed to cover unfunded liabilities over the amortization period, typically 30 years.

[2] Government Accountability Office. January 2008. "State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits." GAO-08-223.

eficiaries.[3] Plan administrators therefore make assumptions concerning the level of investment returns that can be achieved by the current assets held in a pension fund in order to better determine how much money must be put aside in the present. The present cost of future liabilities can be discounted on the basis that assets in the fund will increase in real terms, which will offset the liabilities. However, the problem GASB is attempting to address with its new standards is the discounting of unfunded liabilities or those liabilities with no underlying assets that may appreciate over time.

## Discounting Pension Liabilities Under the New GASB Rules

State and local pension systems use accounting standards that are drafted by the Governmental Accounting Standards Board (GASB). Members of GASB recently voted on a number of major changes to pension reporting and accounting methods to produce greater symmetry between pension asset risks and retiree benefits. GASB cannot require states or pension boards to establish specific funding policies, which are determined by statute, but the board does create standards by which pension balances and contributions are reported.[4] The accounting standards created by GASB are designed to ensure financial accountability, accuracy, transparency, uniformity, and reliability across state and local government financial statements. GASB standards are not federal laws and the rule-making organization has no authority to enforce compliance, yet most state and local governments choose to follow GASB standards for reporting purposes.[5]

With the recent vote, GASB has taken steps to reduce pension risk to state and local governments by creating new standards to limit the actuarial assumptions plan administrators can use to discount unfunded liabilities. Specifically, state and local pension managers will be expected to use a riskless discount rate for pension liabilities that are unfunded or promised benefits that have no assets set aside to cover the costs. According to current GASB standards, liabilities estimated to have underlying assets will still be allowed to use the roughly 8 percent discount rate, which many economists claim is still too high given a maturing domestic economy, current equity market uncertainties, and the nature of liabilities. The discount rate refers to the rate used to discount future liabilities, and is often tied to the historical average for equity market investment returns. In contrast, the riskless discount rate will be around 3 to 4 percent, equivalent to the high-grade municipal bond yield, and will only apply to estimated benefit payments that will need to occur after the plan's assets have been depleted. Pension benefits are referred to as riskless (at least from the individual's perspective) because substantial legal provisions enforce payments.

If the unfunded liabilities are discounted at the lower riskless rate, (riskless is somewhat of a misnomer because all financial investments in any form carry some degree of risk), contributions will need to increase or benefits will need to be reduced in order for funding ratios to reach levels considered to be solvent. Allowing state and local governments to continue using the current discount rate, which is typically between 7 to 8 percent, for funded liabilities encourages governments to fund their pension plan(s). A lower discount rate for unfunded liabilities will substantially decrease the overall funding ratio of the pension plan. According to the Center for Retirement Research, aggregate funding ratios for state and local pension plans in 2010 would drop from 77 percent to 53 percent using the lower rate.[6] However, rule changes that affect the assumptions surrounding investment returns do not fundamentally change the amount of promised benefits; in other words, $1 promised under the old GASB standards will still be $1 owed under the new GASB standards. The real difference will be that a greater portion of that dollar will likely need to come from employer and employee contributions rather than projected investment returns, particularly if that dollar represents an unfunded liability.

The board also voted to value plan assets at market rather than allowing plan administrators to continue the practice of smoothing asset valuations on the basis of returns over a number of years. Valuing pension plan assets at current market prices will place public retirement funds in line with private sector pension plans. If states choose to comply with this standard, this may pose challenges to budget planning because annual employer contributions will fluctuate depending on the performance of equity markets.

[3] National Association of State Retirement Administrators. October 2011. "NASRA Issue Brief: Public Pension Plan Investment Returns."
[4] Costrell, R. May 2012. "GASB Won't Let Me – A False Objection to Public Pension Reform." Laura and John Arnold Foundation.
[5] Costrell, R. May 2012. "GASB Won't Let Me – A False Objection to Public Pension Reform." Laura and John Arnold Foundation.
[6] Munnell, A., Aubry, J., Hurwitz, J., and Quinby, L. June 2012. "How Would GASB Proposals Affect State and Local Pension Reporting," State and Local Issue Brief 13. Center for Retirement Research at Boston College.

## Conclusion

The application of lower discount rates under GASB's new guidelines will have the most impact for retirement systems with large unfunded liabilities. A potential downward revision of the funding ratio for these already poorly funded pension plans may adversely affect other areas of state and local finance, such as debt issuance. However, changing assumptions about the financial cost of promised benefits is not likely to cause major disruptions for the rest of current state and local spending because pension contributions comprise a relatively small portion of state and local operating budgets. The new GASB rules may complicate comparisons across plans, fall short of providing plan solvency clarity, and the rules lack a theoretical basis for treating equivalent retiree benefits differently based on the funding status of the plan. Future promised payments to beneficiaries are equivalent whether or not the benefits are funded.

And yet, a decade of lost returns from equity markets and continued uncertainty surrounding future economic growth have prompted accounting rule-makers to build upon the widespread pension reforms being implemented across state legislatures. The GASB reforms do help delineate the linkages between equity markets and the ability of state and local governments to fund public employee retirement obligations. Limiting future budgetary impacts of pension plans by aligning investment expectations with promised benefits is a financially prudent direction for GASB, states and local governments. If the new standards prompt plan administrators and appropriators to improve the funding status of pension plans, the potential benefits for future state budgets are likely to outweigh the rules' drawbacks.

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