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New Public Pension Accounting Standards To Cause Unnecessary Confusion and Volatility

New Standards No Threat to Government Credit Ratings

The pension plans of public education employees face intense scrutiny throughout the country. Often, critics of NEA members' plans focus on the funded status of pensions—the degree to which plan assets are on hand to meet plan obligations. Newly approved changes to the accounting standards for the pension plans of state and local government employees stand to intensify that scrutiny. The changes are so significant, in fact, that misunderstanding and misrepresentation are likely to result. One of the biggest changes in the new standards is that state and local governments will, for the first time, have to include on their balance sheets the full amount of their unfunded pension liabilities. Sooner or later, policymakers, legislators, journalists, and others will ask what type of plan design changes will be necessary because of the new standards. We expect that the standards' impact on bond ratings will often be at the heart of that question.

With respect to the way the new pension standards require state and local governments to include on their balance sheets pension plans' unfunded liabilities, there is a clear answer about bond ratings. Credit-rating companies have already been factoring key financial information into their analyses of state and local governments, including unfunded pension liabilities, even though current accounting standards don't require that information to be on employers' books. As a result, credit-rating companies don't foresee the inclusion of unfunded liabilities on employers' books as having an impact on their ratings of state and local governments.

Adequate and secure pensions are a crucial part of ensuring that great public schools attract and retain the best employees. The fact that public employees' pension benefits are modest, not overly generous, is often lost in politicized analyses of pensions. Similarly, a simple focus on unfunded liabilities can lead to confusion and exaggerated calls for an end to pension plans. Most public pension plans were in good shape before the economic crisis and the stock market crash hit pension fund investment portfolios hard. Those events reduced the value of most funds tremendously and increased their unfunded liabilities. The new accounting standards will certainly bring even more attention to pension plans' unfunded liabilities, but they should not serve as an excuse to undermine plans.

NEA, which takes the financial status of its members' pension plans very seriously, produced this fact sheet in order to promote fact-based discussion of the new pension accounting standards. The questions and answers in this document are divided into three parts. The first set focuses on the new pension accounting standards. The second addresses bonds, credit ratings, and bond-rating companies. The final set of questions and answers covers the potential impact of the new standards on bond ratings.

New Developments Related to Pension Accounting Standards

Q1: What is the GASB, and why do its standards matter?

A1: The Governmental Accounting Standards Board (GASB) is a non-governmental organization that sets accounting standards for state and local government entities, including cities, counties, school districts, and the trust funds that they establish. The GASB, which releases its standards in what it calls "statements," does not have the legal authority to compel compliance, but some states mandate compliance and the accounting profession and investors view the standards as part of the baseline for proper accounting. The GASB's statements become part of generally accepted accounting principles.

Q2: Why are pension accounting standards for state and local governments coming up now in the context of bond ratings?

A2: For several years, the GASB has been developing new standards for pension accounting and financial reporting for employers, pension plans, and entities like state governments that make contributions on behalf of local governments. The GASB approved the new standards in June 2012 and indicated that it would release the standards in final, written form in August 2012. Based on prior GASB publications and the minutes of GASB board meetings, we already know a lot about the new standards.

Q3: When are the new standards to be applied?

A3: For both employers and state government that contribute to the pensions of the local employees of a school district, the GASB's new standards for pension accounting and financial reporting are to be effective for fiscal years beginning after June 15, 2014. So, for example, a school district with a fiscal year that begins on September 1 would apply the new standards for the fiscal year September 1, 2014, through August 31, 2015. The new standards are to be applied by pension plans a year earlier—for fiscal years beginning after June 15, 2012.

Q4: What are some of the biggest changes in the new standards?

A4: One of the biggest changes in the new standards is that governments will have to show on their balance sheets the total amount of pension plan unfunded liabilities—the amount of promised pension benefits for which funding has not yet been set aside. Until the new standards become effective, state and local governments show on their balance sheets the cumulative amount of required pension contributions that they have not actually contributed, and they show in notes what the plan's unfunded liability is. The new standards could potentially add billions of dollars to the liability side of a government's balance sheet.

Another change will be to require local governments that participate in state plans to show on their own books a proportionate share of the plan's overall unfunded liability. Such plans—called cost-sharing multiemployer plans—are the most common type of plans in which NEA members participate. Currently, local employers are only required to show on their books the amount related to how much they are legally required to contribute to the plan, not amounts related to the plan's unfunded liability.

Q5: Is the inclusion of unfunded liabilities on balance sheets the only significant change included in the new pension accounting standards?

A5: No. The new standards include many other changes that will lead to significant upheaval in public sector pensions. The new standards will lead to far greater volatility in the amount of an employer's annual pension expense, and they will eliminate any standards-based measure of required annual pension contributions. Public employers' will find it harder to budget for pensions. One of the unfortunate results is likely to be much more short-term pension-related decision making by policymakers, even though pension plans are best analyzed through a long-term lens.

Q 6: How has the NEA approached the new pension accounting standards?

A6: For several years, the NEA has analyzed the GASB's work on the issue of new pension accounting standards. The Association provided detailed comments to the GASB at several stages in recent years and has kept NEA member trustees and affiliate staff updated through publications and meetings.

Among the educational materials we have produce is a 50-page glossary of actuarial terms and concepts. In addition to providing definitions, the glossary includes analytical comments and examples designed to clarify the importance and implications of existing and new accounting standards. The glossary is currently being updated to include the final, new GASB standards.

Bonds, Credit Ratings, and Credit-Rating Companies

Q7: What are bonds?

A7: Bonds are agreements in which the company or government that issues the bond receives money from a lender (the bond buyer) in exchange for a promise to pay interest to the lender and, eventually, to pay back the original money that was borrowed.

Q8: Who issues bonds, and why?

A8: Many state and local governments, including school districts, issue bonds to raise money for new school buildings or to satisfy other financial needs.

Q9: What are credit ratings, and why do they matter?

A9: A credit rating, sometimes called a bond rating, is a measure of a borrower's creditworthiness. It is a measure of how much risk the investor should expect regarding the borrower's ability to make promised interest payments and to pay back the money that was lent. The more creditworthy the borrower, the lower the interest rate the borrower must pay to investors. Therefore, the better its credit rating, the less costly it is for a government to finance its capital needs. In addition, pension funds frequently use credit ratings to prescribe the types of investments that can be held by the fund. Securities regulators and legislators also have built credit-rating requirements into certain regulations or laws.

Q10: Who issues credit ratings?

A10: Credit ratings are issued by companies in the business of analyzing the creditworthiness of companies and governments. Standard & Poor's, Fitch Ratings, and Moody's Investors Service are the three credit-rating companies commonly cited in this regard.

Q11: What do credit ratings and pension benefits have to do with each other?

A11: Pension benefits and credit ratings are linked because the current and future cost of providing pension benefits is one of many things that compete for resources in a government's budget. Pensions are one of many factors that credit-rating companies take into account when analyzing a government, but it is crucial not to over-estimate the significance of information on unfunded liabilities within the broader credit-rating framework. Indeed, Standard & Poor's indicates, "We believe that the historical and forecast trends in pension funding are as important, if more so, than the specific liability level at a single point in time."[1]

Q12: Is it new for bond-rating companies to focus on the pension plans of state and local government employees?

A12: No. Credit-rating companies have for many years been analyzing in great detail the pension obligations of state and local governments.

The Impact of New Pension Accounting Standards on the Bond Ratings of State and Local Governments

Q13: What have the bond-rating companies said about the way the new pension accounting standards will affect their analyses of state and local governments, particularly with respect to the inclusion on balance sheets of unfunded pension liabilities?

A13: The NEA is aware of direct answers to this question from two of the three main bond-rating companies, and their answers were as clear as they were direct: They expect the

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[1] Standard and Poor's, "S&P's Views Of GASB's Proposed Changes In Government Pension Accounting," December 10, 2010, p. 5.

inclusion of unfunded liabilities on employers' balances sheets to have no impact on their ratings, because the companies already factor into their analyses pension plan unfunded liabilities (even though pension accountings standard haven't required that those liabilities be shown on balance sheets).

In the words of Fitch Ratings: "The first major change proposed by GASB would result in unfunded pension liabilities being reported on the government wide statement of net assets, rather than just being included in supplementary schedules…. *This measure is not expected to have an impact on Fitch's analysis, because Fitch has always considered the reported actuarial pension liability disclosed in the entity's comprehensive annual financial report footnotes (not the net pension obligation as now reported on the statement of net assets) in its analysis*"[2] (italics added).

In a similar vein, Standard and Poor's reports: "*Whether pension information is reported in the notes to the financial statements, as currently required, or on the balance sheet itself, as proposed, should not, in our view, affect bond ratings—Standard & Poor's already evaluates a government's pension funding status as part of its general obligation (GO) rating criteria*"[3] (italics added).

Q14: Given the views of rating agencies on the inclusion of unfunded liabilities on state and local governments' balance sheets, is there any reason a pension plan has to make changes in anticipation of the new accounting standards' treatment of unfunded liabilities?

A14: No. In essence, the rating agencies are saying that it's always been part of their job to look at and factor into their analyses pension plans' unfunded liabilities. As a result, the future inclusion of unfunded liabilities on an employer's balance sheet should not spur changes to pension plans in order to protect credit ratings.

Q15: Should pension plans be making changes now because local governments participating in cost-sharing multiple employer plans (as most NEA members' employers do) will have to carry on their books their proportionate share of the plan's overall unfunded liability?

A15: No. Accounting standards issued by the GASB do not—and cannot—change which governmental entity makes pension contributions, so a municipal government that didn't have financial responsibility for pension contributions before the new standards wouldn't have that responsibility once the new standards are in effect. Bond-rating companies are sophisticated enough to distinguish between how pension liabilities are calculated and reported (the subject of GASB standards), and how governments contribute to those plans (the subject of state and/or local arrangements). The information disclosed because of the new standards, and the fact that liabilities would be on employers' books, shouldn't lead to any new revelations about local employers that would change their credit ratings.

[2] Fitch Ratings, "The Reporting of U.S. State and Local Government Pension Obligations," February 23, 2011, p. 6.
[3] Standard and Poor's, "S&P's Views Of GASB's Proposed Changes In Government Pension Accounting," December 10, 2010, p. 3.

Q16: Will credit-rating companies ignore information disclosed because of the new accounting standards?

A16: No. The new pension accounting standards will lead to the disclosure of information that has generally not been available before—the amount of a plan's unfunded liability attributable to a local employer, for example. So, rating agencies will certainly be interested in looking at the new information. Indeed, Fitch Ratings has indicated that it will consider creating a new metric that includes the unfunded liability of local employers. But, that doesn't mean that they expect the information to change how they rate governments. In fact, they don't expect that. The new information won't affect the key measures they've been looking at all along, including how much local governments are required to pay into pension plans and whether they make their required payments.[4]

NEA CB/MA, June 2012

[4] Fitch Ratings, "Enhancing the Analysis of U.S. State and Local Government Pension Obligations," February 17, 2011, p. 5