

Response to Invitation to Comment  
Pension Accounting and Financial Reporting

By

Alicia H. Munnell, Ph.D.  
Director, Center for Retirement Research at Boston College  
Peter F. Drucker Professor in Management Sciences  
Boston College Carroll School of Management

Thank you very much for the opportunity to comment on GASB's proposals with regard to Pension Accounting and Financial Reporting.

I am the Director of the Center for Retirement Research at Boston College. I am also the Peter F. Drucker Professor in Management Sciences at Boston College's Carroll School of Management. Prior to my tenure at Boston College, I was a Member of the President's Council of Economic Advisers (1995-1997) and served for nearly three years (1993-1995) as Assistant Secretary of the U.S. Treasury for Economic Policy. Previously I spent 20 years at the Federal Reserve Bank of Boston, where I became Senior Vice President and Director of Research in 1984. I have written extensively on tax policy, Social Security, public and private pensions, and productivity.

State and local pensions and OPEB plans constitute a major component of the work of the Center for Retirement Research. As economists, we use pension data generated under GASB's standards to address three main economic issues: 1) basic comparisons of pension finances across states and over time; 2) the impact of pensions and OPEBs on government budgets and borrowing capacity; and 3) the relative compensation of public sector workers. In order to produce useful analysis, the data need to provide meaningful measures of government obligations and be consistent across states and localities and over time.

Rather than responding to the specific questions raised in the GASB documents, these comments first address the potential damage associated with GASB's proposed method for discounting liabilities. They then move to issues where reasonable people could disagree, and finally make a plea for GASB to require additional information on benefit flows underlying the liability, on the allocation of ARC between states and localities, and on interest payments for Pension Obligation Bonds (POBs).

#### I. Discounting Projected Benefit Payments

GASB's proposal to value liabilities based on the plan's funding status makes no sense at all. Moreover, the proposal has the pernicious effect of creating a second measure of funding that will confuse an already obscure landscape.

The process of converting the projected benefit payments of a pension plan to a liability requires assuming a rate of discount. GASB's current procedure of using the expected long-run return on assets has been widely criticized as inappropriate. Financial theory dictates that future benefit payouts need to be discounted at rates for similar cash flows in traded securities. Thus, the

discount rate should be related to the nature of the liabilities; the nature of the funding is irrelevant. If the benefit commitments of state and local governments are viewed as inviolable, the liabilities should be discounted at the riskless rate. If some parts of the benefit commitment, such as COLAs, become less secure, that portion should be discounted at a higher rate. But the principal holds; the discount rate should be related to the riskiness of the liabilities, not to the expected return on assets.

Instead of adopting the financial approach, GASB has proposed a discount rate equal to the long-run expected return for the portion of liabilities that is backed by assets and the rate on high quality municipal debt for the portion not covered by assets. This approach creates three major problems:

- It creates a meaningless liability number, with no theoretical underpinnings, in terms of the potential burden on states and localities. It makes no theoretical sense for two identical streams of benefits to have different values based on the funded status of the plan.
- It makes comparisons across states and localities impossible because both the numerator and the denominator of the funded ratio will reflect the value of the assets. Moreover, a change in the funded status of a given plan will be attributable to both the change in assets and the impact of that change on the value of liabilities. This feedback complicates a systematic analysis of why funding has improved or deteriorated.
- It creates a new measure of funding that will compete with the traditional measure. The determination of the portion of benefits funded requires a projection of plan assets available each year to cover promised benefits. The asset projection would include assumptions not only about plan returns but also about future contributions from the government and from employees.<sup>1</sup> These contributions may or may not come to pass, but the process produces an estimate of the percent of promised benefits covered by projected assets. This ratio of projected assets to projected benefits is likely to be misinterpreted as a measure of the current funded status. The “projected” funded ratio will thus compete with the traditional funding ratio – assets divided by liabilities – and create unnecessary confusion.

In short, the discounting proposal would create more problems than it solves and should not be adopted. Discounting all liabilities by a long-run rate on high quality municipal bonds would be a much better alternative.

## II. Continuity versus Precision

---

<sup>1</sup> Interestingly, FASB considered and rejected such an approach not only because the contribution assumptions are so uncertain but importantly because it would “unnecessarily complicate the recognition and disclosure requirements.” (FASB 87)

GASB's recommendations on two other issues – PBO vs. ABO and EAN vs. PUC – appear to value continuity over precision. That seems like a good choice.

The purpose of financial accounting is to allocate to a particular period accurate measures of resources committed in that period. In the case of pensions, taxpayers should know how much they have awarded public employees in the form of deferred pension benefits in order to evaluate the appropriateness of public sector compensation.

One could make an argument that the ABO precisely recognizes the value of benefits accrued as of a given year. Employees may stay until retirement and have their accrued benefit factor applied to final rather than current earnings, but it is by no means certain. And, to the extent that employees do stay, the ABO properly recognizes the backloaded nature of defined benefit plans and the higher cost of older employees. On the other hand, the PBO smoothes salaries across careers by basing the accrued benefit in each period on projected salaries. While an imperfect measure of accruals, the PBO has the advantage of having served as the accrual concept for several decades. Retaining the concept allows historical comparisons that would not be possible with a shift to the ABO.

Similarly, basic comparisons are often confounded by the fact that plans use different actuarial accounting methods. Additionally, at times, individual plans change their methods, making comparisons against historical statistics difficult. Requiring a single accounting method is a simple solution that would make for easier, and more accurate, comparisons across states and over time.

One could argue that the PUC actuarial method accurately allocates costs to the period when they are incurred, whereas the EAN smoothes costs as a percent of payroll. But again, the EAN has been the actuarial cost method of choice in the public sector for decades. Retaining the method and making it the sole costing approach would greatly improve comparisons across plans.

### III. Ad Hoc COLAs

GASB proposes including ad hoc COLAs in the benefit projections to the extent that they have, in effect, become automatic. This proposal may be reasonable, but the uncertain future of even automatic COLAs may make the proposed change not worth the effort.

### IV. Helpful Additions for Researchers

As state and local pension researchers, several additional pieces of information would be extremely helpful.

*Provide benefit streams underlying the liability.*

The proper discount rate is a controversial issue, and arguably the most important when making comparisons between plans. One change that would make it easier for researchers to vary the discount rate would be to require that plan actuaries report the stream of projected annual benefit

payments that underlie the liability. Without such information, researchers must painstakingly re-engineer the underlying benefit streams based on data within each plan's actuarial valuation. Generally, such calculations produce liabilities that only come within 2-5 percent of the plan's reported value. Providing the underlying streams would give any so-inclined researcher the ability to more easily and more accurately revalue the future benefits using a different discount rate.

*Show pension costs separately for state and local employers.*

One major research goal is to project the costs of state and local pensions as a portion of the sponsors' budgets. The challenge in the case of state-administered plans is that actuarial valuations do not report how responsibility for the ARC is divided between the state and the locality. Including this information in the actuarial valuation would greatly improve the ability of researchers to conduct budget analyses.

*Include reporting for POB usage.*

In order to put pension finances into a budget context, it would be extremely helpful to have current information on POBs used to fund the plan. Currently, actuarial reports contain information on the issuance of a POB and its effect on plan funding. But no information is provided, on a regular basis or in a standard format, regarding the current cost of the POB to the state in the form of debt service. Such information would provide a much better picture of the fiscal finances of the state or locality.

## V. Conclusion

The centerpiece of GASB's Pension Accounting and Financial Reporting proposals – using different rates to discount the funded and unfunded portion of the liability – is fundamentally misguided and will do enormous damage. It should not be adopted. On other issues – PBO vs. ABO and EAN vs. PUC – consistency over time is probably more important than precision, as GASB suggests. Finally, we researchers could use some help. Providing benefit streams underlying the liability is the most important request. But showing pension costs separately for states and localities and providing consistent information on POB interest costs to governments would also be very helpful.