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EXCERPTS FROM THE RESPONSE OF THE PENSION FINANCE TASK FORCE TO THE PRELIMINARY VIEWS OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD ON PENSION ACCOUNTING AND FINANCIAL REPORTING BY EMPLOYERS (PROJECT NO. 34)

(The full document is available [here](#))

We believe that all interested parties, and especially taxpayers and bondholders, need to see the value of the pension obligation reported in a manner consistent with the fundamental principles of economics and the presentation of other government debt.

Our view is that the pension obligation is a liability that should be discounted at close to a default-free rate for presentation in the financial statements. Certain consequences flow from this point of view.

First, the annual cost would be calculated as the difference between the current year's pension liability and the prior year's pension liability, net of contributions, and is likely to show a great deal of volatility from one year to the next. It is our understanding that reducing volatility may be an important objective of a cash contribution method, but it is not an objective of financial reporting methods to the detriment of faithfully reporting the economics of the plan. In order for a volatile annual cost to be presented in a way that meets GASB's objectives, it will be important to show separately the different components of annual cost—the part that comes from deferred wages in the period and the parts that come from other sources. The annual operating cost of the plan, or normal cost, specifically, should be shown separately from the non-operating costs (i.e., financing and investment costs, gains and losses, etc.).

Second, other information not reported in the basic financial statements is important enough to warrant discussion elsewhere in the financial reports. In particular, employers should include a description of the plan's funding

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policy, the current and expected level of future cash flows, and the investment policy of the trust fund, including its allocation among different asset classes.

Our responses to the interrogatories thus reflect this broader view of financial reporting of pension obligations.

Should future costs be attributed to service periods using a single actuarial methodology, the entry-age-normal method, on a level percentage-of-payroll basis?

We agree with the board that a single methodology for attributing costs to periods is appropriate and promotes comparability. We do not agree with the PV that the value assigned to the pension benefits exchanged for services each year over an employee's career necessarily should bear a consistent relationship to the employee's base salary level. As a result, we also do not agree with the PV in using an entry age normal (EAN) approach to measure the obligation at a point in time.

We believe a better approach for determining the liability would be to recognize the value of the benefits attributed to service to date. Benefits earned to date represent a completed exchange transaction—a year of employee service has been exchanged for a stipulated increase in a future pension benefit. Pension obligations share many characteristics with other forms of debt. This approach would determine a liability that bears a more consistent relationship to the value of other debt in the financial statements.

We also note that the conclusions of the PV differ from the conclusions that other accounting standards rules setters have reached for pension plans in similar contexts (international accounting standards for public reporting by governmental entities, and U.S. and international generally accepted accounting standards for public reporting by nongovernmental entities). The PV does not address these differences or their effect on the public's expectations for financial statements. Very large inconsistencies, as these may be, could affect the credibility of all governmental accounting statements. We hope that the final document explicitly addresses this, and any other major differences among the accounting standards boards on similar issues.

Should the discount rate be (1) the long-term expected rate (EROA) of return on invested assets to the extent that current and future expected assets are projected to be sufficient to make benefit payments, and (2) a high-quality municipal bond index rate otherwise?

[Such a discount rate] would work against the objectives of accountability,

decision usefulness and assessment of interperiod equity. It would do so by requiring a metric that fails to represent faithfully the economics of the plan and sponsor and thereby would work against effective governance and plan management.

[Most large, well-funded pension plans would be using the EROA and we confine our remarks to that case.]

Most large pension trusts have substantial portions—often more than 50 percent—of their assets invested in equities and equity-like assets. Expected returns on the assets are usually higher than expected returns on bonds from the same issuer precisely because the returns on the underlying securities are more uncertain, or riskier, and market participants demand greater expected returns to compensate them for taking additional risk. The difference between the expected return on risky assets and the expected return on riskless assets is known as a "risk premium." Hence, the EROA rises as the actual or anticipated percentage of equities in the trust fund rises. The PV justifies using the EROA as the discount rate as follows (Chapter 4, Paragraph 16):

To the extent that plan net assets available for pension benefits have been accumulated to date in the pension plan and are reasonably expected to grow during the time when benefit payments are being made from those assets, the Board believes that the present value of the employer's projected sacrifice of resources is effectively modified (reduced) by the expected return on investments.

We disagree with this logic primarily because it implies that either (1) the risk of equities underperforming the expected return is minimal, or (2) there is no implicit cost to the risk that equities underperform the expected return. In reality, the EROA is an expected value, not a certainty (or even as probable as the expected return from a matched portfolio of bonds) and there is a cost to assuming the risk of underperformance. A discount rate based on the EROA of the actual portfolio, therefore, typically understates the liability by the amount of the assumed future risk premiums.

To develop a discount rate that does not understate the liability, the discount rate should be based on the characteristics of the liabilities, rather than those of the assets. Pension liabilities are most similar to fixed income investments because of the relatively predictable nature of the future benefit payment streams and the nearly guaranteed status of those benefit payments. A discount rate based on yields on fixed income investments of quality and term structure similar to the liabilities meets the GASB's criterion of being "reasonably expected to grow" into the liability value and is independent of future investment decisions and events.

We present below several common situations in which using an EROA as a discount rate would work against effective governance, plan management and common sense.

Example 1: Assessing the Level of Government Debt

Accurate assessment of the level of government debt is an important piece of information in assessing interperiod equity and accountability, and is decision useful for any decision regarding the level of government debt.

In our view, a discount rate based on the EROA is a poor choice for determining the value of the liability. The pension obligation is a form of debt. It differs from the employer's tradable debt (publicly traded bonds) in several significant respects—it often has constitutional protections that make it senior to the employer's tradable debt, benefit payments are subject to income tax while debt service usually is not, it includes some demographic risks, and (of course) it is not tradable. These considerations suggest modifying the employer's borrowing rate towards a default-free rate of return. In today's economic environment, we would expect to see effective rates under this approach of something like 3.5 to 4.5% as opposed to today's average rate of close to 8%.

Using a discount rate so much higher than the rate used for other government debt—both on the financial statements as well as in the market for tradable debt—creates inconsistencies and underpricing of the pension obligation.

Example 2: Assessing Compensation Costs

Plan sponsors must know the annual cost of benefit accruals if they wish to assess their total compensation costs and the costs of individual pieces of compensation. For example, in collective bargaining situations, negotiations often involve trading wages for benefits as well as negotiating the value of total compensation.

Use of the EROA is not appropriate for this purpose for much the same reasons that it is not appropriate in determining the overall indebtedness of the employer with respect to the pension plan. The cost to the employer of promising to make a future payment to an employee depends on the specific conditions of the debt (e.g., constitutional protections, taxability to the beneficiary, existence of an investment trust). It does not depend on how the employer plans to invest the trust assets. Because of the near-guaranteed nature of pension benefits, their cost is most appropriately measured with a correspondingly low discount rate. To the extent the pension benefits are priced with a discount rate based on the EROA, the employer is taking investment risk without getting anything in return from the employees. In fact, this underpricing of pension obligations may be one of the reasons why employees in the public sector have much more

generous pension benefits than employees in the private sector (employees and unions understand the valuable nature of guaranteed benefits, but employers underprice them). Thus, use of the EROA to measure pension cost in a period leads to mismeasurement of the cost of services.

Example 3: Asset Allocation Studies

Many plans use asset-liability modeling (ALM) studies as the primary quantitative analysis for determining their asset allocation. For asset allocations that reduce expected return as well as risk, using the EROA as the discount rate causes an immediate increase in the liability and decrease in the funded status. This result—a reduction in risk resulting in a decline in funded status—creates a structural bias against an asset allocation that reduces expected return, even as it reduces risk and volatility. Thus, using the EROA to discount the pension obligation makes it difficult for plan sponsors to de-risk because of the negative impact on reported funded status.

In fact, a change in asset allocation should have no immediate effect on funded status (i.e., the value of assets is unchanged and the value of the liability does not depend on the allocation policy of the trust fund). As a result, we believe a discount rate based on the EROA is not decision useful for determining asset allocation.

To be more decision useful in this context, the discount rate should be independent of the EROA, such as one based solely on fixed income yields. With this method, funded status would increase or decrease based on actual, not expected investment performance, and would only do so after such performance occurs.

The above examples illustrate how discounting the pension obligation using the EROA tends to mislead users, encourage unnecessarily generous compensation, discourage appropriate risk management of investments and encourage transactions that have no intrinsic economic value. These are surely among the reasons why virtually all other accounting standards boards have been moving away from using the EROA as the discount rate, and instead using fixed income yields.

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