Municipal Credit Update

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Pension Liability Disclosure Changes

Municipal pension liabilities have been a major headline recently as unfunded pension liabilities have contributed to multiple municipal bankruptcies like those of Stockton, CA and San Bernadino, CA. Municipal pension funding had previously been overlooked partly due to the lack of transparency of pension liabilities. Reporting requirements were incomplete and, due to the many assumptions involved in determining the pension liability, there were numerous ways for municipalities to report a smaller pension liability than what they would likely realize. In response to the investing community's feedback regarding the lack of transparency of pension liabilities, the Governmental Accounting Standards Board (GASB) prepared two new statements in June 2012 to replace the prior statements regarding pension reporting.

The changes in pension reporting provided by the two new statements will greatly improve financial transparency of pension liabilities, comparability of pension liabilities among municipalities, and the issue of unrealistic assumptions.

GASB Statement No. 67

The first of these statements updates guidance related to the financial reports of governmental pension plans. This statement is focused on the plan itself and the calculations involved in determining the net position of that plan. It requires that governmental pension plans present the fiduciary net position as well as a statement of changes in that position.

One key change introduced by this statement is that a more conservative discount rate must be used if the projected benefit payments owed to current employees and retired employees exceed the projected plan net position. Currently, the expected investment rate of return may be used as the discount rate that determines the level of annual payments required to fund the plan. In some cases, the expected investment rate of return may be unrealistically high. Under the new requirements, if the projected benefit payments owed to current employees and retired employees exceed the projected plan net position, then the index rate for a high quality, tax-free 20yr GO municipal bond must be used. This will increase the required contributions needed to fully fund the plan so the projected plan net position will rise to meet the projected benefit payments. If the net position is greater than the projected benefit payments, then the expected investment rate of return may continue to be used.

GASB Statement No. 67 has already been phased in for all periods beginning after June 15, 2013.

GASB Statement No. 68

This statement is designed to improve the reporting of pension liabilities provided by municipalities and applies to employers rather than the plan itself. The requirements set forth in this statement will improve the transparency of employers' pension liabilities owed to their current and past employees.

One change that will likely make a large impact in the financial statements of municipalities is that Statement No. 68 requires the municipality to recognize the net pension liability with long-term liabilities on the balance sheet as opposed to just being reported in the notes to the financial statements. Reporting the net pension liability on the balance sheet will decrease the net assets of the municipality by the value of the net pension liability. We can expect net asset values to decline as a result of this change. It is important to note that although these pension reporting changes will cause some financial figures to appear worse in many cases, the actual financial position of a given municipality will not change due to these requirements. Instead, creditors will be able to see a more accurate picture of all liabilities on the balance sheet.

Another major change is that there is now only one acceptable actuarial cost method for finding the present value of benefit payments. Previously, there were 6 acceptable methods and 2 different ways in which each of those 6 methods could be applied, effectively resulting in 12 variations. This resulted in a lack of comparability among municipalities. With this change, comparability will be greatly increased and there will be fewer factors to consider when evaluating a municipality's pension liabilities.

GASB Statement No. 68 is effective for fiscal years beginning after June 15, 2014, and we should begin to see its effects in financial statements for periods ending after June 15, 2015.

Our Approach

Baker has been tracking pension data for the past several years and we have integrated pension credit metrics into our standard credit review process for municipal bonds. The new reporting requirements will help our analysts gather the necessary information in a much easier, more reliable manner. The pension information will be available more often than it is right now since municipalities that didn't have to report the pension data in the past might have to report it now, and the pension data will be easier to locate. Also, the pension data should be more comparable across municipalities once the new statements are fully implemented.

Pension liabilities are not considered general obligation debt therefore no adjustment needs to be made to a policy benchmark for the general obligation debt to tax assessed value ratio. We will continue to provide a debt-to-assessed ratio for as long as possible, but it might be beneficial to create a new benchmark for pension liabilities once the new requirements are fully implemented and the effects of those requirements are seen.