THE CASE FOR NEW PENSION ACCOUNTING STANDARDS

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Why bother?

ACCOUNTING RULES
Why have accounting rules?

• Why not just collect money and spend it?
• Rules answer the question “How are we doing?”
• Compare to other similar enterprises.
• Assess hypothetical courses of action.
• Evaluate urgency.
Why not change the rules?

- They change all the time.
- Sometimes as a response to crisis.
- Often at the behest of powerful institutions.
  - Banks, post-2008 crisis
  - UMIFA becomes UPMIFA
  - Off-balance sheet transactions
  - Treatment of stock options
  - Evaluation of risk on corporate balance sheets.
PENSION ACCOUNTING RULES

What’s the matter with them?
Curious case of pension debt in the night

• Appears as an asset on nobody’s balance sheet.
• Zero value, unlike every other government obligation.
• Required to be paid decades before it is due.
• Less like a debt than like accrued but unpaid wages.
• It is not neutral to include it in the net position.
Normal cost: inaccurate

• What is “normal” about pension costs?
• Why do we use estimates for retrospective analyses?
• What confidence do we have that refinements will improve the estimates?
• Do the errors really cancel out over the long run?
Normal cost: philosophically wrong

- Pension system is not an investment vehicle, but a mutual aid pact among its members.
- Attempts to parcel out individual ownership can only confuse matters.
- Serves to de-emphasize the mutual nature of the system and devalue the premium income.
Masking risk: Present value

Returns 5%, sd: 4.5%

Annual payment, $3
Masking risk: Present value

- Present value masks risk.
- e.g. Closing a plan is risky, but present value says otherwise.
Pension debt on the balance sheet implies equivalence to other debts. Like a pension obligation bond. Significant difference in risk. Makes this unclear. Didn’t GASB?
Masking risk: Asset equivalence

- Asset composition is not a part of the standard accounting.
- Overall yield is everything.
- Risky investments count the same as safe ones.
- Hedge funds and private equity are so represented in the pension world.
- Occasional asset and liability studies.
Political risk: Moral hazard

• Few benefit or funding decisions will have a significant impact in the current or even next fiscal year.
• Relatively easy to engineer such decisions to delay further.
• Long lags between action and consequence create political risk.
Political risk: Overfunding

- Don't laugh.
- Worth consideration because it is the goal.
- "Fully funded" seems to invite benefit increases and contribution decreases.
- Result is nobody stays fully funded.
Political risk: Crowding out

- $4 trillion in state and local pension assets, most accumulated since the 1980s.
- GDP is about $19 trillion.
- Which took almost 400 years to grow.

How could we do things differently?

POSSIBLE SOLUTIONS
Better costing

• Reliance on standard costs won’t control long-term expenses.
• Normal costs, dependent on probabilities and present value are never corrected. Or correct.
• Discount normal costs, like navigators. If 50% doesn’t spiral out of control, 100% won’t, either.
• Standard costs can keep errors in check.
• A blend cannot be precise, but current system is not precise, either.
Better balance sheet

• A pension plan should honor the fundamental accounting equation.
• Can be done by assessing the value of the promise to pay in the future.
• Standards must be established: 10 years? 20?
• But the pricing apparatus is already in place.
• A pension plan is a permanent institution. Don’t chafe at the infinite time horizon. Use it.
A depletion date is a different kind of planning value, just as valid as a funding ratio.

Predictions not as far into the future.

GASB has made the calculation routine for determining the present value of a liability.

Would require smoothing, but there are better ways to do this than to use moving averages.

Still carries troubling semantic freight.
Better valuation of assets

- Risky assets do not add to financial security, so should not be counted at full value.
- Evaluating asset composition irregular for pension plans, in asset-liability studies.
- Risk weighting is routine for banks.
- Insurance companies have limitations on asset categories.
- Could also serve to make the depletion date more clearly a worst-case scenario.
Local economy valuation standards

- Ultimate source of security for a pension plan.
- True for any government debt, so a commonplace in the bond market.
- Consequences for what constitute “responsible” investments.
CONCLUSION

Recommendations for action
Alternatives can include:

- Blended costing
- Risk-weighed assets
- Depletion date adjustment
- Valuation of the promise to pay standard costs into the future
Carlsbad, California

- $241M assets
- $344M liability
- 70% funded

- Normal costs 20% of payroll: $7.2M.
- Amortization payment: $6.6M.
- Add value for 20 years of 70% normal costs, $5M/year.
- Discount assets for risk: $285M
- Depletion date: +82Q

- Next year, add $6M standard costs.
- New depletion date: +82.1Q