THE CASE FOR NEW PENSION ACCOUNTING STANDARDS

Tom Sgouros
Haas Institute UC Berkeley, Brown University Computer Science
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International Offshore Rule
International Offshore Rule

1979 Fastnet Race: 306 boats competing, 100 knocked down, 77 turtled, 5 sank, 18 people died.

Other result: IOR was changed.
What’s the matter with the accounting rules?

WHY DO WE CARE?
# Critique of Full Funding

From Sgouros, 2017

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LEGAL</strong></td>
<td>Public systems face zero threat of liquidation. Unlike private systems.</td>
</tr>
<tr>
<td><strong>CHRONOLOGICAL</strong></td>
<td>Present value exaggerates urgency. Liabilities due over next 50-60 years.</td>
</tr>
<tr>
<td><strong>ACTUARIAL</strong></td>
<td>Do not need full funding to pay off 100% of any debt if there is future revenue.</td>
</tr>
<tr>
<td><strong>MATHEMATICAL</strong></td>
<td>Potential error in liability estimates bigger than other numbers in the balance sheet.</td>
</tr>
<tr>
<td><strong>FINANCIAL</strong></td>
<td>Future rate of return is unknowable, but changing it has huge impact.</td>
</tr>
<tr>
<td><strong>ECONOMICAL</strong></td>
<td>Liability seems less threatening with more appropriate comparisons.</td>
</tr>
<tr>
<td><strong>POLITICAL</strong></td>
<td>Overfunding is a risk, too. Political risk is real and must not be ignored.</td>
</tr>
<tr>
<td><strong>PHILOSOPHICAL</strong></td>
<td>Pension system is a mutual aid pact among members, not an individual savings plan.</td>
</tr>
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</table>
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.
- Choice of how to portray it is not neutral in terms of funding policy.
Separation of accounting and funding

- Characterization of pension liability as debt is not neutral.
- Inclusion on balance sheet.
- Limits on discount rate.
- State laws about pension funding policy.

Accounting rules can create political risk.
Economic Impact

- $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.

Why do we need accountants at all?

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 meltdown
• UPMIFA vs. UMIFA
• Off balance sheet transactions
• Treatment of stock options
• Risk evaluation for private enterprise
Costing mismatch

• 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?
Portraying risk: Present value

- Present value masks risk.
- e.g. Closing a plan is risky, but present value says otherwise.

A system making its investment marks can still lose money.
Portraying risk: Present value

Returns 5%, sd: 4.5%

Annual payment, $3
Portraying risk: Asset composition

- Asset composition is not a part of the standard accounting.
- Overall yield is everything.
- Risky investments count the same as safe ones.
- How hedge funds and private equity are so overrepresented in the pension world.
- Occasional asset and liability studies.
How could we do things differently?

POSSIBLE SOLUTIONS
Artificial revenue bond

- Attempts to put a value on the plan sponsor’s commitment to pay and ability.
- Uses existing apparatus of bond valuation.
- Attempts to decrease degree of moral hazard in policy decisions.
Status quo ante

Government

Employees

Investment Income

Pension Fund

Retirees
Status quo post

Government

Employees

Investment Income

Pension Fund

Retirees

BENEFITS

BOND

BOND PAYMENT
# Example

## Status quo ante

<table>
<thead>
<tr>
<th>FUND</th>
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<tr>
<td>Income</td>
<td>$280 million</td>
</tr>
<tr>
<td>Employee contribution</td>
<td>90</td>
</tr>
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<td>Employer contribution</td>
<td>310</td>
</tr>
<tr>
<td>Benefit payments</td>
<td>(500)</td>
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<tr>
<td>UAL amortization</td>
<td>180</td>
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<tr>
<td>Assets</td>
<td>$4,000</td>
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<td>Liabilities</td>
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## Proposal

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<tr>
<td>Bond purchase</td>
<td>(400)</td>
</tr>
<tr>
<td>Residual payment</td>
<td>(100)</td>
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<td>UAL amortization</td>
<td>180</td>
</tr>
<tr>
<td>Assets</td>
<td>$4,000</td>
</tr>
<tr>
<td>Bond value (5 year vsn)</td>
<td>950</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(7,000)</td>
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<tr>
<td>UAL</td>
<td>(2,050)</td>
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Feedback on proposal

- Feedback events.
- Difficult to understand.
- Would require substantial restructuring of legal responsibility.
- Many moving parts and unfamiliarity with concepts would create political issues around implementation.
- Immediate feedback cuts in two directions.
Blended costing

- Reliance on standard costs won’t control 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 system in line.
- A blend cannot be precise, but current system is not precise, either.
Establish funding ratio standards

- 100% funding is not necessary, but it is principled.
- Target should vary with strength of sponsor, health of plan.
- The artificial revenue bond suggests a principled way to answer.
- Standards must be established: 10 years? 20?
- But the pricing apparatus is already in place.
Depletion date accounting

- Different kind of planning value, just as valid as funding ratio.
- Predictions not as far into future.
- GASB has made the calculation routine (for determining present value of liability).
- Would require smoothing, but statistically more sound ways to do so than moving averages.
- Still carries troubling semantic freight.
Risk weighting of fund assets

- Risky assets do not add to financial security, so should not be weighted at full value in the accounting.
- Routine for banks and insurance companies.
- Irregularly done for pension plans and asset-liability studies.
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.
Recommendations for action

CONCLUSION
Alternatives can be combined

• Blended costing can be combined with
• Risk-weighted assets, and
• Depletion date accounting, and an
• Artificial bond for X years of discounted normal costs included as asset.
Carlsbad, California

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

- Normal costs 20% of payroll: $7.2M.
- Amortization payment: $6.6M.
- Add bond for 20 years of 70% normal costs.
- Discount assets for risk: $285M
- Depletion date: +82Q
- Next year, add $6M standard costs.
- New depletion date: +82Q
Pension plan = Life insurance co.

- Why not treat pensions as life insurance companies owned by a (government) holding company?
- Equation is not exact, but the comparison apt.
- Expenses just as predictable over the long run and large numbers.
- Reveals dramatic difference in the manner of regulation.