NABL Pension Disclosure Task Force

Draft of May 2, 2011

CONSIDERATIONS IN PREPARING DEFINED BENEFIT PENSION PLAN DISCLOSURE IN OFFICIAL STATEMENTS

DISCUSSION DRAFT

GENERAL BACKGROUND

In light of the heightened focus of the Securities and Exchange Commission (the "SEC") on the quality of disclosure concerning state and local government defined benefit pension plans, the National Association of Bond Lawyers has undertaken this project to provide some basic guidance to its members on the issues to be considered when assisting their clients in the preparation of disclosure on this topic. This material is based principally on a review of the following:

- GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, which establishes financial reporting standards for such ***pension plans***

- GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, which establishes standards for pension information in the financial reports of ***state and local government employers***

- GASB Statement No. 50, *Pension Disclosures*, which amended in part GASB Statements Nos. 25 and 27[1]

- *In re* City of San Diego, California, SEC Rel. Nos. 33-8751, 34-54745 (Nov. 14, 2006)

- *In re* State of New Jersey, SEC Rel. No. 33-9135 (Aug. 18, 2010)

- the various Official Statements referenced herein

Based on a review of such materials, we have provided an overview of the issues and the information to be considered when assisting an issuer with disclosure regarding a defined benefit pension plan. We have also set forth in Appendix A hereto those definitions, derived from the GASB guidelines, which are key to an understanding of governmental pension disclosure.

This material represents a compendium of the sources mentioned above and is intended to provide an overview of the issues to be considered when preparing comprehensive and detailed disclosure of the financial health of the related pension system. As new material is released or becomes available, NABL will consider whether this material requires updating.

In addition, NABL is concurrently facilitating the preparation of a comprehensive pension disclosure project involving all interested parties, including representatives of those actuaries that prepare actuarial valuations for government sponsors of pension plans, accounting firms that specialize in municipal accounting, financial analysts, investors, issuers, and interested persons. As a facilitator, NABL has a goal for this group to complete the comprehensive pension disclosure project by December 2011. In the interim, NABL determined that it would be useful to provide this basic overview of the issues and guidance regarding pension disclosure. That comprehensive pension disclosure project will incorporate and replace the then-current version of this material.

[1] GASB has an ongoing financial reporting project, including pension disclosures, which can be monitored on its website: www.gasb.org. GASB has released a Preliminary Views on major issues related to pension accounting and financial reporting by employers (June 16, 2010).

PENSION PLANS IN GENERAL

Although there are different types of pension plans, the most common are Defined Contribution Plans and Defined Benefit Plans. Defined Contribution Plans, which are plans with terms that determine how contributions are to be made versus how benefits are to be paid, are beyond the scope of this project. Defined Benefit Plans can include single-employer plans (separate municipal pensions for general employees, public safety, and fire), multi-employer plans (aggregation of multiple plans with shared administration but no cost or risk sharing; individual valuations are done for each plan) and cost sharing plans (all risks and costs, including benefit costs, are shared by participating employers; only one valuation is done on entire plan).

With respect to financial reporting concerning Defined Benefit Plans, there are three types of information: (a) the current financial information about the plans' assets and financial activities, (b) the actuarial-determined liabilities of the plan, and (c) information about the funded status of the plan and the progress being made in accumulating assets to pay benefits when due. The current financial information appears in the financial statements and the notes related thereto. The actuarial-determined information, which is prepared based on a long term, ongoing plan perspective that is used to determine the funded status or funding progress of the plan, is prepared using certain methodologies that include various economic and demographic assumptions. The actuarial-determined information appears in the required supplementary information ("RSI"). GASB 25 requires inclusion of a minimum of six years of actuarial information, which is presented in two schedules that are to be included in the RSI that follows the notes to the financial statements. The two schedules that provide this information are (i) the Schedule of Funding Progress, which contains a comparison of the actuarial value of the plan assets to its actuarially determined liabilities (the benefits to be paid out) and the relationship of the two over time, and (ii) the Schedule of Employer Contributions, which supplies information about the employer's annual required contribution ("ARC") and the percentage of the ARC that was recognized by the plan as contributed. Under GASB 25, the actuarial information should be presented with disclosures as to the actuarial methods and significant assumptions used for this reporting. The assumptions upon which information is determined can and do change over time. Actuarial reports are required to be done at a minimum every two years; however, it is not uncommon for plans to be valued each year. The actuarial report is prepared based on the prior period's information and the methodologies and assumptions as to future events. This report is then used to determine employer contribution levels for the following year or years, resulting in an inherent lag of at least a year in the valuation information regarding the pension plan. Recognition of this time lag points out why mere reliance of the information in the notes to the financial statement may not be sufficient to provide a complete understanding of both the current financial status of the plan and the actuarial determined funded status of the plan. This time lag will necessitate making inquiries regarding changes to plan benefits and actuarial assumptions that may have occurred subsequent to the date of the last actuarial report. Some state laws require the preparation of an actuarial impact statement any time the plan is amended to determine the cost, if any, of the proposed change.

WHAT DOCUMENTS WOULD BE HELPFUL TO GATHER THE NEEDED INFORMATION

Before starting to prepare or assist in the preparation of pension disclosure, it would be helpful for counsel to obtain and review copies of the following documents, if available:

- Government Sponsor's Financial Statements
- Pension Plan Actuarial Reports
- Actuarial Impact Statements
- Pension System's Financial Statements
- Experience Studies

Certain critical information is required by the GASB accounting guidelines to be set forth in the notes to the sponsor's financial statements (audited), while other information (*e.g.*, the funded status and funding progress for the more recent actuarial valuation and the two preceding valuations, is required to be set forth as RSI (limited audit procedures). The drafter will need to determine whether to cross-reference such material or include or incorporate it directly into the body of the Official Statement.

It is important to remember that given the inherent time lag in the actuarial reports key assumptions with respect to the plan may have been changed subsequent to the date of the actuarial report. Plans may be amended during the course of the year that may have a financial impact on the plan. Once the drafter has gathered the key documents containing the plan information to be disclosed, it is important to make inquiries as to changes in assumptions, funding policies, contribution levels or plan benefits that would impact the presentation of the historical information. The drafter should be aware that certain reports listed above are normally prepared at regular intervals and are not updated in the interim unless significant changes in the benefits provided by the plan occur. For instance, actuarial impact statements are typically prepared when a change in benefits is being considered. Also, experience studies are often prepared only when requested by the pension board.

KEY DEFINITIONS

Certain key definitions and concepts used in pension plan reporting are set forth in Appendix A. It is critical to understand the definitions when reviewing or preparing pension disclosure.

OFFICIAL STATEMENT DISCLOSURE

The following examples are ***not*** *intended as guidelines or as best practices for Official Statement disclosure regarding municipal pension systems. Rather, they represents simply a compendium based upon review of (i) the materials listed under "General Information" above and (ii) Official Statement disclosures recently made by issuers that have determined to provide comprehensive and detailed disclosure of the financial health of the related pension system. The Official Statements that were reviewed for this purpose were:*

1. Official Statement dated February 23, 2011, relating to the State of Illinois General Obligation Bonds, Taxable Series of February 2011 CUSIP 452152

2. Official Statement dated November 5, 2010, relating to the State of Oregon General Obligation Veterans' Welfare Bonds, Series 91, 92A, and 92B CUSIP 68608K

3. Official Statement dated September 30, 2010, relating to State of New Jersey General Obligation Bonds, Refunding Bonds, Series Q, R, and S CUSIP 646039

4. Official Statement dated June 23, 2010, relating to City of San Diego, California 2010-11 Tax and Revenue Anticipation Notes CUSIP 797236

5. Official Statement dated June 2, 2010, relating to County of San Diego and San Diego County School Districts Tax and Revenue Anticipation Note Program CUSIP 797381

DRAFTING DISCLOSURE LANGUAGE

When assisting an issuer in the preparation of pension disclosure, the following information should be considered:

A. General Overview of Pension System

- A plain language summary of each pension plan in the pension system for which the employer provides funding. Such summary is typically provided in the Notes to the Financial Statements of the plan.

- Cautionary language that (i) the information included in the pension disclosure section relies on information produced by the pension plans and their independent accountants and actuaries, (ii) actuarial assessments are "forward-looking" information that reflect the judgment of the fiduciaries of the pension plans, and (iii) actuarial assessments are based upon a variety of assumptions, one or more of which may prove to be inaccurate or be changed in the future, and will change with the future experience of the pension plans.

- For each pension plan in which the employer participates, consider providing:

    - A general plan description, which includes (i) the legal authorization, (ii) the type of pension plan and the significance of that form of plan (*e.g.*, defined-benefit, defined-contribution, single-employer, multiple-employer, or cost sharing), (iii) the number of active members, retired members and beneficiaries and deferred members, (iv) whether members contribute to the pension plan, (v) whether there are any tiers by which to classify members and the significance of each tier, (vi) the pension plan's fiscal year, (vii) whether there is any regulation as to how the assets of each pension plan may be invested,[2] and (viii) whether there is any pending legislation that is likely to have an impact on the pension system (or specific plan) and the disclosures provided in the official statement. For cost sharing plans, it should be noted that actuarial information is provided for the plan in total. Statement of Significant Accounting Policies

    - Statement of Funding Policies and Reserves, which would include a description of funding policies and practices (*e.g.* funding is provided through legislative appropriation process or required contributions from participating employers, employees or other contributing entities).

B. Summary of Fiscal Health

- Current and projected funding status of each pension plan in the pension system in a plain language summary.

- Plain language analysis of impact of ARC payments on current and future budgets of the government sponsor.

- If projections show that the future ARC payments are unsustainable, consider providing a description of what steps/plans the governmental sponsor has, if any, to address such future payments.

- If any determinations have been made regarding priorities of funding of ARC, current payroll, current pension payments, contractual obligations, debt service, etc., consider providing a discussion of such

[2] The employer may consider providing some of this information in tabular format. For example, a table setting forth the total number of members, the number of active members, retired members and beneficiaries and deferred members, and the percentage of member contributions for each pension plan could provide a visual enhancement of the disclosure in the narrative overview of the pension system.

analyses, if material. Factors regarding materiality in this context would include who was party to the determinations, whether they have been formally adopted or accepted, and the likelihood of being implemented.

C. General Funding Practices of Pension System

- General. Consider including: (i) an explanation of the legal requirements regarding commission of actuarial valuations, experience studies, any other evaluations of the pension system, (ii) a discussion of the pension system's historical practices of commissioning valuations/studies in relation to legal requirements, and (iii) indicate the identity of the pension system's actuary, as well as method and frequency of appointment. Consideration should be given to any terminations of prior actuaries for reasons other than normal course of business rotations and disclosure of the causes for any such termination.

- Actuarial Cost Method. An overview of the actuarial cost method employed to calculate the employer's actuarially determined ARC.

- Smoothing Method. Include a description of any Smoothing Method employed in calculating the AVA.

- Amortization of UAAL. Describe any amortization of the UAAL, including (i) the length of the amortization period, or if components of the UAAL are amortized over different periods, the equivalent single amortization period, (ii) whether such period or periods is/are rolling or fixed, and (iii) whether the employer may change (or has changed) the amortization period or periods from time to time.

- Actuarial Assumptions. Describe the actuarial assumptions employed by the actuaries and the methodology for reviewing/updating such assumptions and the process of determining the actuarial assumptions to be used. In addition, consider any recommendations for changing such assumptions and the fiscal impact of implementing such changes.

- Employer Offsets. Describe whether the employer has agreed to pay any Employer Offsets. If disclosed consider including (i) the percentage of salary assumed by the employer, (ii) whether such obligation is firm or contingent, and (iii) whether and how such obligations are reflected in the calculation of the ARC and UAAL.

D. Funding Status of the Pension System

- Current Funding Status. Describe the current funding status of the pension system and highlight the (i) AVA, (ii) AAL, (iii) Funded Ratio, and (iv) UAAL.

- Historical Funding Status. For ease of presentation, consider setting forth the historical funding status of the pension system based on actuarial value and market value in separate ten-year tables.

    - Ten-Year Table - Actuarial Value. Consider providing a table indicating the AVA, AAL, UAAL (actuarial value), the Funded Ratio, member payroll, and ratio of UAAL (actuarial value) to member payroll. The information needed for this table can typically be found in the Schedule of Funding Progress required by the GASB guidelines as RSI included with the plan's financial statements.

HISTORICAL FUNDING PROGRESS
ACTUARIAL VALUE

Valuation Date	Actuarial Value of Assets	AAL	UAAL	Funded Ratio	Member Payroll	UAAL to Payroll Ratio

Source: (include source).

- Ten-Year Table - Market Value. Consider providing another table that indicates the market value of assets, AAL, UAAL (market value), Funded Ratio, member payroll, and ratio of UAAL (market value) to member payroll. This table would only be necessary if the plan does not use the market value of assets as the actuarial value of assets. The information for the market value of assets can typically be found in the plan's statement of plan net assets. The UAAL (market value), funded ratio, and ration of UAAL (market value) to member payroll would then be recalculated.

HISTORICAL FUNDING PROGRESS
MARKET VALUE

Valuation Date	Market Value of Assets	AAL	UAAL	Funded Ratio	Member Payroll	UAAL to Payroll Ratio

Source: (include source).

- Explanation of Table Data. Following the inclusion of the above tables, provide a discussion covering the following:

  (i) historical and anticipated sources of contributions by the employer (*e.g.*, plan assets, investment earnings, reserves or cash);

  (ii) the method for expanding pool or beneficiaries and increasing benefits, including whether the legislature has expanded benefits within the last five years and the impact of such benefit increases upon the pension system's funding status (Funded Ratio, UAAL) and the employer's budget;

  (iii) any revaluations of the pension system within the past five years, the impetus for such revaluations and the impact of such revaluation on the ARC, the employer's actual contributions, the UAAL and the Funded Ratio; and

  (iv) if a UAAL is present or expected, plans for reducing/avoiding such UAAL noting whether such plans are firm or flexible and expected or likely to change, and the anticipated source of funds to reduce/avoid such UAAL.

➢ Comparative Ratios. The information in the following table is a convenient presentation of the comparison of the actuarial value of assets to the market values, the ratio of the AVA to market value and the funded ratio based on AVA compared to funded ratio based on market value of assets.

Fiscal Year	**Actuarial Value of Assets**	**Market Value of Assets**	**% of AVA to market value**	**Funded Ratio (actuarial value)**	**Funded Ratio (market value)**

Source: (include source).

➢ Ten Year Table Annual Employer Contribution Status. The following table indicates, on a Fiscal Year basis, the ARC, Employer Offsets, if any, the actual contribution and any amount unfunded. The information needed for this table can typically be found in Schedule of Employer Contributions required by the GASB guidelines as RSI and included with the employer's financial statements.

ANNUAL EMPLOYER CONTRIBUTION STATUS

Fiscal Year	**ARC/Contractually Required Contribution**	**Employer Offsets**	**Actual Employer Contribution**	**Amount Unfunded**

Source: (include source).

- Explanation of Table Data. Following the inclusion of the above tables, provide a discussion covering the following:

  (i) contingent or deferred contributions (including Employer Offsets) and the manner of reflecting such contributions in historical and prospective calculations of the ARC, AAL, UAAL and Funded Ratio;

  (ii) how/when employer's contributions may/have deviate(d) from the ARC and required Employer Offsets and whether contributions are subject to appropriation or otherwise subject to underfunding; and

  (iii) historical (last five years) and/or future (next ten years) anticipated underfunding of pension system, indicating reasons for such underfunding and the actual/potential effects of such underfunding;[3] and

  (iv) current and anticipated NPO.

- Prospective Funding Status. If available, the prospective funding status of each pension plan in the pension system based on projections by the actuary in a ten-year table. Inquiry needs to be made of the plan sponsor or the plan manager to determine if internally prepared or publicly available reports have been prepared that contain projections of funding status.

  - Ten-Year Table - Prospective Funding Status. This table indicates the projected ARC, Employer Offsets, AVA, AAL, UAAL, and Funded Ratio.

[3] The discussion of underfunding will include failure to fund or deferral of Employer Offsets.

PROSPECTIVE FUNDING STATUS OF THE PENSION SYSTEM

Fiscal Year	**ARC**	**Employer Offsets**	**Actuarial Value of Assets**	**AAL**	**UAAL**	**Funded Ratio**

Source: (include source).

- Summary of the Funding Status of the Pension System. Following the inclusion of the above table include a discussion of the following funding analysis:

  (i) the impact of the ARC and Employer Offsets on the employer's budget;

  (ii) whether there have been any reports or evaluations on the funding of the pension system;[4]

  (iii) a discussion of any deviation from actuarially-recommended actions such as a difference in funding between the ARC and the actual contribution made;

  (iv) a discussion of any sensitivity analyses of the fiscal impact of changes in actuarial assumptions; and

  (v) if pension obligation bonds have been issued consider adding a column and disclosing the annual debt service for such obligations.

E. Investment Policy

- Asset Allocation Policy. Describe the asset allocation policy setting forth the (i) Actuarial Assumed Rate of Return and (ii) Historical Investment Return for the prior year, the prior three years, the prior five years, and the prior ten years. Compare the Historical Investment Return to Actuarial Assumed Rate of Return and also note the percentage of the pension system that is invested in hedge funds or other "alternative" investments, the approximate market value of such investments, and the market value of such investments as a percentage of the total market value of the portfolio.

F. Litigation, Investigations

- Describe all (i) material litigation brought in connection with the pension system, (ii) investigations of the pension system by any authority, and (iii) investigations of the employer's prior disclosures regarding the pension system.

[4] This discussion would also review any material internal or third party reports or evaluations of the pension system, and any recommendations regarding and/or evaluations of current assumptions employed by the pension system's actuary.

G. Transfers of Investment Earnings

- Excess Earnings Policy. If “excess earnings” (*i.e.*, earnings generated as the product of an investment rate of return that exceeds the assumed investment return) are used as a credit against ARC payments, explain such policy and the permitted/planned uses thereof.

- Explanation of Table Data. Following the inclusion of the above table, note the uses of such excess earnings and the impact of such use on the historical and projected fiscal health of the pension system.

H. Reserves

- Reserves Policy. Define “reserves” and explain the policy on reserves.

    - Ten-Year Table - Historical Funding Level of Reserves. Prepare a table setting forth the historical funding level of pension system reserves.

    - Five-Year Table - Projected Funding Level of Reserves. Prepare a table setting forth the projected funding level of pension system reserves.

I. Pension Obligation Bonds

- Describe the aggregate principal amount of all outstanding pension obligation bonds, a description of each issuance of outstanding pension obligation bonds, and any plans for future issuances of pension obligation bonds.

J. Independent Reports

- Bring any independent reports or analyses that may have been commissioned that either support or criticize the current plans for funding of the pension system to the attention of the working group so that a collective decision can be made whether they might be considered material to an investor.

- Describe the results of any experience studies conducted by actuaries and what recommendations to the pension system may result from such analysis.

- Describe the results of any actuarial impact statements conducted by actuaries regarding plan amendments.

Appendix A

KEY DEFINITIONS

- **Actuarial Accrued Liability (or AAL)**: that portion, as determined by a particular Actuarial Cost Method, of the actuarial present value of pension plan benefits and expenses that is not provided for by future Normal Costs.

- **Actuarial Cost Method**: a method used to develop the actuarial present value of benefits and the allocations of such costs to certain periods of time in order to develop the AAL. Two common Actuarial Cost Methods are projected unit credit, or PUC, and entry age normal, or EAN. The PUC method tends to push more costs into the later part of a member's service. The EAN method develops a level contribution as a percent of pay (Normal Cost) which, if contributed and invested throughout the member's career, is expected to generate sufficient funds to equal the actuarial value of the future benefits by the time the member retires. In order to keep the costs level, EAN allocates a large Normal Cost for the earlier years and a relatively smaller Normal Cost to the later years compared to the PUC method.

- **Actuarial Value of Assets (or AVA)**: the value of cash, investments, and other property belonging to a pension plan, as used by the actuary for the purpose of an actuarial valuation. An Actuarial Value (in contrast to a current market value) attempts to smooth annual investment return performance over multiple years to reduce annual return volatility.

- **Amortization Period**: the period over which the UAAL is amortized, which can be either a "fixed" (or "closed") period or a "rolling" (or "open") period. During a fixed period, the UAAL is amortized over a declining number of years; for example, 30 years the first year, 29 years the second year, etc. During a rolling period, the UAAL is amortized over an unchanging number of years; for example, 15 years the first year, 15 years the second year, etc.

- **Annual Pension Cost (or APC)**: the aggregate in a particular year of (i) the ARC, (ii) one year's interest on the NPO, and (iii) an adjustment to the ARC to offset, approximately, the amount included in item (i) for amortization of past contribution deficiencies.

- **Annual Required Contribution (or ARC)**: the aggregate in a particular year of (i) the Normal Cost and (ii) payments made to amortize the UAAL.

- **Assumptions**: an actuarial report will utilize demographic and economic assumptions as to the occurrence of future events affecting pension costs, such as investment rate, inflation rate, interest credited to member contributions, salary increase rate, annual cost-of-living adjustment, rates of separation from active membership, post-retirement mortality, active member mortality, and rates of retirement.

- **Employer Offsets**: that portion of the employees' required contribution to the pension system, if any, that (generally through collective bargaining agreements) the governmental sponsor agrees to make on the employees' behalf.

- **Funded Ratio**: the ratio of (A) the AVA or market value of assets to (B) AAL. Such valuation can be on an actuarial or a market value basis. If a plan has a funded ratio of less than 100%, then the plan has a UAAL.

- **GASB**: Governmental Accounting Standards Board of the Financial Accounting Foundation.

- **Market Value of Assets**: as of the valuation date, the value of assets as if they were liquidated on that date.

- **Net Pension Obligation (or NPO)**: the cumulative difference between the APC and the actual employer contribution (*e.g.*, does not include contributions by the employees or any Employer Offset) in a particular year.

- **Normal Cost**: the present value of the benefits that the pension system projects to become payable in the future that are attributable to a valuation year's payroll.

- **Smoothing Method**: a method used in determining AVA that is intended to reduce the impact of market volatility on the assets of a pension plan. Under a Smoothing Method, the annual investment return performance is "smoothed" over multiple years to reduce annual contribution volatility. For example, by use of a "five-year smoothing" methodology, a percentage difference between the net market value and the net book value for each of the most recent five years is calculated. The resulting percentages are averaged for the five-year period and applied to the valuation's year's market value of assets to arrive at the actuarial value of assets, with the result that only 20% of investment gains or losses in a particular year are taken into account in the annual actuarial valuation.

- **Unfunded Actuarial Accrued Liability (or UAAL)**: the difference between (A) the AVA or market value of assets and (B) the AAL. Such valuation can be on an actuarial or a market value basis.