Pension schemes treatment in a reviewed SNA 93

Recognition of (implicit) liabilities

International Workshop on the Balance Sheet of Social Security Pensions

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1993 SNA under review

- Decision by the UN Statistical Commission (spring 2003)
- Deadline 2008
- Under the direction of the ISWGNA (intersecretariat working group on national accounts)
- An Advisory Expert Group (AEG)
  - Three 1-week meetings over 2004-2005
  - Examines, discusses and votes on reports by various task forces/Electronic Discussion Groups (EDG)
- EDG on pensions:
  - first report on employer schemes in December 2003
  - 32 contributors ; 44 answers to a detailed EDG questionnaire
  - large agreement
  - Accessible to the public at: http://www.imf.org/external/np/sta/ueps/index.htm

Current SNA 93

- Within **social insurance**, distinction between **employer schemes** and **social security schemes**
- **Employer schemes** (private and general government employees)
  - Autonomous
  - Non autonomous
    - Funded
    - Unfunded
- **Social security schemes** defined as**:**
  - Public units which provide pensions
  - Certain/large groups of the population are obliged (by law) to participate (« imposed »)
  - General government is reponsible for the management of the institution in respect of the settlement or approval of the contributions and benefits (« controled »)

Current SNA 93
Employer retirement schemes

- Employer schemes are either **funded** or **unfunded**

- Funded means they have « segregated reserves », widely interpreted to mean the existence of (significant) assets earmarked for the payment of benefits

- **Funded** schemes => recognition of a liability

  – The scheme is recorded as if it was a saving scheme : contributions and benefits are considered financial transactions, an imputed property income flow is recorded (+ a parrallel non-financial recording)

- **Unfunded** schemes => no recognition of a liability

  – The scheme is recorded as a pay as you go scheme: contributions and benefits are recorded above the line

- They are generally unfunded, but some may be (partially) funded
- But, in SNA, even when separate assets can be identified, by convention no matching liability is recognized
- => Social security = no recognition of liability (even if funded)

Problems with the current SNA 93

Several reasons lead us to propose to revise the current SNA

- 1/ **deviations to accrual principles**
  - The criterion funded/unfunded deviates from the fundamental asset recognition criterion (asset of the household) otherwise followed in the 1993 SNA and from most other accounting standards
  - The correct criterion is to rely on whether a promise is enforceable and whether future economic benefits will flow from it (economic asset)
  - The measure of labor costs is distorted and deviates from GAAP
- 2/ **problem of international comparability of national accounts**:
  - the current situation generates differences in aggregates (deficit, debt, households assets) that are not « economic » but « institutional »

Problems with the current SNA 93

- **3/ problems with exchange of liabilities:**
  - What happens when a funded scheme assumes (makes an exchange of) pension obligations of (with) an unfunded scheme, with a counterpart lump sum (France télécom, Belgacom)?
  - Interpreting the current SNA, European statisticians decided that such events were not financial in nature (pension obligations would not be recognized as liabilities), and thus the lump sum improved the net lending borrowing (deficit) of the government on the date of the transfer
  - This decision complies with the current SNA but poses a problem of accounting rationality

Problems with the current SNA 93

- 4/ **conventions are changing in other accounting standards**
  - **In the business world:** IAS 19 clearly recommends to record implicit liabilities of defined benefits schemes. IAS 19 should be implemented in Europe starting 2005. Corresponding standards are already or will be implemented in other OECD countries. Businesses record (or are going to) in their balance sheets the liabilities of unfunded defined benefits schemes
  - **In the public finance world:** public accountants in several countries have adopted similar conventions: Australia, Canada, USA. Both, the IMF-GFSM 2001 and IFAC-PSC standards also recommend recording implicit liabilities for general government employees pension schemes even if they are not funded

=>National accountants are in an awkward situation where economic agents recognise a liability but national accountants cannot acknowledge it in the macro accounts!

Two steps proposals for the new SNA

- First step: Employer schemes (including general government as an employer)

- Second step: Social security

- Why this prudent approach?
  - The benefit provided by employers is clearly of the nature of a deferred compensation (arise from an exchange transaction; employee-employer contract)
  - Common view that pension commitment is stronger as an employer than as an organiser of a public collective system

- But we recognize that this poses a problem,
  - As it could make the treatment potentially dependant upon minor institutional differences, falling in the trap of the current SNA; social security reforms (statistical desincentives)
  - As the issue of exchange of liabilities will not be fully resolved if this extension is not made

Proposals for employer schemes

- **First, liability recognition:**

- The criterion of the existence of a fund would be abandonned: unfunded employers schemes would be treated as if funded

  => there is a liability even for unfunded defined benefits schemes (pay as you go)

- a liability is recognised when there is a « constructive obligation »

  Constructive obligation = less narrow than legal obligation

  « the enterprise has created a valid expectation on the part of those other parties that it will discharge these responsibilities »

Proposals for employer schemes

- **Second, actuarial valuation:** contribution and property income on liabilities and contributions are recorded on an **actuarial** basis (present value); aligns on business accounting; improvement in the measure of the cost of labor;

- schemes are recorded as if they were « a saving scheme ». This implies including an imputed interest flow to the policyholders (present/future pensioneers), above the line
  - use of accrued benefits methods (only past services' commitments are taken into account)

- **Third, immediate liability recognition**: pension schemes net assets allocated to the sponsor

Impact of proposals

- For unfunded schemes, and in particular for unfunded general government employees schemes, the recognised expense would considerably increase
  - The net impact on the cost of labor may be positive or negative (in current demographics conditions, it will be positive)
  - But a **new property income** (imputed interest) flow appears as a new expense: reflect the unwinding of the discount factor, i.e. the value of the pension liability increases over time owing to the sole passing of time
  - Increase in deficit results from the trend increase in change in debt, even in the steady state. Mathematics: pension debt ratio of 20%; GDP growth of 6%; => impact on deficit is 1.2% of GDP
- Example of general government employees scheme

Current SNA 93
Unfunded government employee scheme

Uses		Ressources	
Compensation of employees (including imputed employer contributions)	14		
		Employee contribution	1.5
		Employer contribution	14
Pensions	11		
B9 Net lending borrowing	**-9.5**		
Financial accounts			
Cash	-9.5		
Net financial transactions			**- 9.5**

New SNA 93
Unfunded government employee scheme

Uses	Ressources
Compensation of employees (including imputed employer contributions) 14	
Imputed interest to households 6	
B9 Net lending borrowing -20	
Financial accounts	
Cash -9.5	
Net equity of households	10.5 (1.5 + 6 +14 -11)
Net financial transactions	**- 20**

Impact of proposals general government employees

- Approximate size (in terms of GDP) of implicit debt (depends of course on the discount rate):
  - Canada: 20%
  - Australia: 20%
  - France: 50%
- Structural increase of deficit figure: between 0.5% and 2%, depending of the country and discount rate used
- In Europe, it may call for an adaptation of the Maastricht criteria in due course

Importance of national accounts for general government accounts

- In Europe, obvious importance: SNA is the framework of the Maastricht criteria

- In non European OECD countries: OECD Economics departement is using national accounts data for its monitoring of public finance

- New IMF GFS manual 2nd edition (*Government Finance Statistics Manual 2001*) aligns on 1993 SNA
  - but GFSM 2001 deviates on employer pension schemes…
  - Canada, Australia: change already implemented

Implementation issues: feasibility in national accounts

- National accountants will need to take into account actuarial calculations, which is a new approach for them
- They will not be able to make good use of actuarial calculations without the help of experts from pension schemes
- Detailed information is needed on demographics, on specific pension rules (in particular regarding dependents), etc…
- In practice, this means that national accounts implementation will be only possible (short of exceptions) if pension schemes (or the employers) make in practice their own calculations of the implicit liabilities
- **SOLUTION proposed:** Rely on newly emerging business accounting standards that will be progressively implemented in private pension schemes (IAS 19: accounts of the employer); pressure governments and civil servants pensions schemes to recruit actuaries

Impementation issue
Choice of discount rate

- The value of the discount rate governs the value of the implicit debt, the value of the imputed property income, and the value of contributions
- Therefore the implementation recommendations should give clear guidance on the choice of the discount rate to avoid undermining the credibility of the accounts and international comparability
- Should we use a market discount rate or a fixed one?
- Should countries use their own discount rates or, for international comparability, should they use an agreed unique discount rate?
- Should we use a nominal discount rate or a real discount rate?
- Should we use a pure risk free rate (government bond) or allow for some private risks (AAA rated bonds)
- **SOLUTIONS discussed**: use the rate used by actuaries, use a real discount rate of 3%, or use the current rate for inflation-indexed government bonds

Change of actuarial parameters

- Change in the value of actuarial parameters modify the amount of the pension (implicit) debt

- As the national accounts is a (complete) system, this change should be recorded somewhere, in the flow accounts; the main issue is to **where**, in the current sequence of accounts, this change will be recorded

- Depending on the location, it would affect or not the main aggregates, such as net lending/borrowing

- Possible changes include:
  - Change in discount rate
  - Change in life expectations
  - Granting of new rights
  - Change in benefit structure (decrease of promised benefits)

Change of actuarial parameters

- **SOLUTIONS proposed (discussed)**:

  - Change in discount rate: record the impact of the change in reevaluation accounts (no impact on net lending / borrowing)

  - Change in life expectancy: record the impact in reevaluation accounts **or** perhaps in the « other change in volume account » (no impact on net lending / borrowing)

  - Granting of new rights: record the impact as a transfer to policy holders (impact on net lending borrowing)

  - Change in benefits structure: record the impact in the other change in volume account (no impact on net lending borrowing), when there is no intention to convey net benefits; otherwise treat as granting of new rights

Provisional Conclusions

- Should we implement these changes?
- From an accounting principle perspective, the response seems to us clear: we should go ahead with these proposals, simply because they correspond to **accrual accounting**, which is a principle in national account
- Remaining issues regarding the two steps approach:
  - International comparability: will it be improved if do not extend the change to social security?
  - Exchange of liabilities: will it be improved if we do not extend to social security?
- Remaining issues of implementation: choice of the discount rate
- OECD Workshop with economists, June 2004

Reactions of OECD Economists

- Very significative reactions by economists, in particular in Europe (Maastricht criteria)
- National accounts' framework are more and more used to monitor public finance
- Impact of EDG proposals modifies substantially the main indicators (public deficit, public debt)
- Two groups
  - Strongly opposed or very prudent: Economists from Belgium, France, DG-ECFIN, OECD-Economic Department
  - Support the change: Economists from Australia, Canada, USA
  - Japan: already publishes estimates but separate from the core accounts

Arguments of the critical camp

- Economists make better projections (timing, including new rights) of the impact of ageing on government accounts than what is proposed. What is the usefulness of the proposals?
- Can one consider that there is a liability when the obligation can be changed by a reform (recent examples: France and Belgium)?
- There is no difference for a government between future pension obligations and future health costs obligations. What is the rationale that allows national accounts to focus on the first but not on the second?

Arguments of the critical camp

- The proposal implies that « social security » obligations could not be recognised while « employer schemes » obligations would be recognised.

- This means that major NA variables could be affected by simple changes in administrative arrangements. This is unsustainable, and could make the headline aggregates of the national accounts useless for policy purposes.

- Actuarial estimation would introduce in the national accounts estimates of doubtful quality (arbitrary choice of discount rate). It would be better to reseve them for satellite accounts.

Proposals…
to take into account the critics

Two main critics:

- Is it possible to separate the cases of employer schemes and social security?
- Can we introduce in the core national accounts estimates that are very approximate?

Employer/social security

- The organisation of pension obligations varies between OECD countries.

- There are two extreme groups of countries:
  - Countries like USA, Australia, Canada, the Netherlands where pension arrangements are centered on employer schemes *plus* a « safety net » called « social security »
  - Countries like Belgium, France where pure employer schemes hardly exist and pension arrangements are centered on *one major collective* « multi-employer » system, also called « social security ».

- The SNA should try to avoid that its headline aggregates is not affected by those institutional differences

Employer/social security

- The current strategy of the EDG to separate the issues between employer schemes and social security is unsufficient
- It could lead to the unwelcome situation that pure (and small) changes in institutional arrangements could have, in some countries a major impact on general govenment variables
- The case of « collective multi-employer schemes » must be studied by the EDG in parallel with pure employer schemes
- Objectives: make sure international comparability is guaranteed, avoid that headline aggregates are affected by pure institutional arrangements

Employer/social security: possible solution

- Extend the borderline of the recognition of implicit pension liabilities to all schemes, whether pure employer or « collective multi employer schemes ».
- All pension schemes' constructive obligations would be treated similarly, independantly from the institutional arrangement
- Advantage: better rationale, better international comparability
- Disadvantage: this would increase recorded pension liabilities by an enormous amount. They could reach between 200 and 400% of GDP.

Should (approximate) actuarial estimates impact the core accounts?

- As seen, the impact of the EDG proposal is big (debt: 20 to 50% of GDP)

- Very big if extended to all schemes (from 200 to 400% of GDP)

- Economists are concerned by:
  - (1) the quality of the resulting data (actuarial calculations are difficult)
  - (2) the high dependance of the results on the « arbitrary » value of the discount rate.

- Main message from economists: they want to clearly distinguish the observed flows from the imputed flows, in order to choose one or the other.

Observed/imputed:a possible solution

- A compromise proposal would be
  - (1) to include quasi pension liabilities in the SNA, but to record them separately from other pension liabilities, in a special category.
  - (2) record changes in implicit pension liabilities in a special account separated from the normal transaction accounts
  - (3) as a result, the existing B9 net lending borrowing would not be affected by the imputed flows
  - (4) another balancing item, located in the sequence of accounts after B9, would reflect an « augmented » B9, including imputed actuarial liabilities

Observed/imputed:a possible solution

- Such a proposal would allow users to have both information:
  - the current one, based on observed flows
  - and the new one, based on the extended recognition of implicit liabilities and the corresponding imputed flows
- This is not another name for memorandum items:
  - The quasi-liabilities would be recognised in the SNA
  - The treatment of transactions on these quasi liabilities would be clarified
  - The new accounts would be normal tables of the SNA, and thus compulsory tables of the OECD/Eurostat questionnaire on national accounts