

GASB 45 Strategies: Practical Approaches to Managing the Implications

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Alphabet Soup

- § **GASB** = **G**overnment **A**ccounting **S**tandards **B**oard
- § **OPEB** = **O**ther **P**ost-**E**mployment **B**enefits
- § **ARC** = **A**nnual **R**equired **C**ontribution

GASB #43 and GASB #45

What ... benefits count as “OPEB”?

Medical
Dental
Vision
Hearing

Life insurance
Long term care
insurance

~~Pension
benefits
Termination
benefits~~

GASB #43 and GASB #45

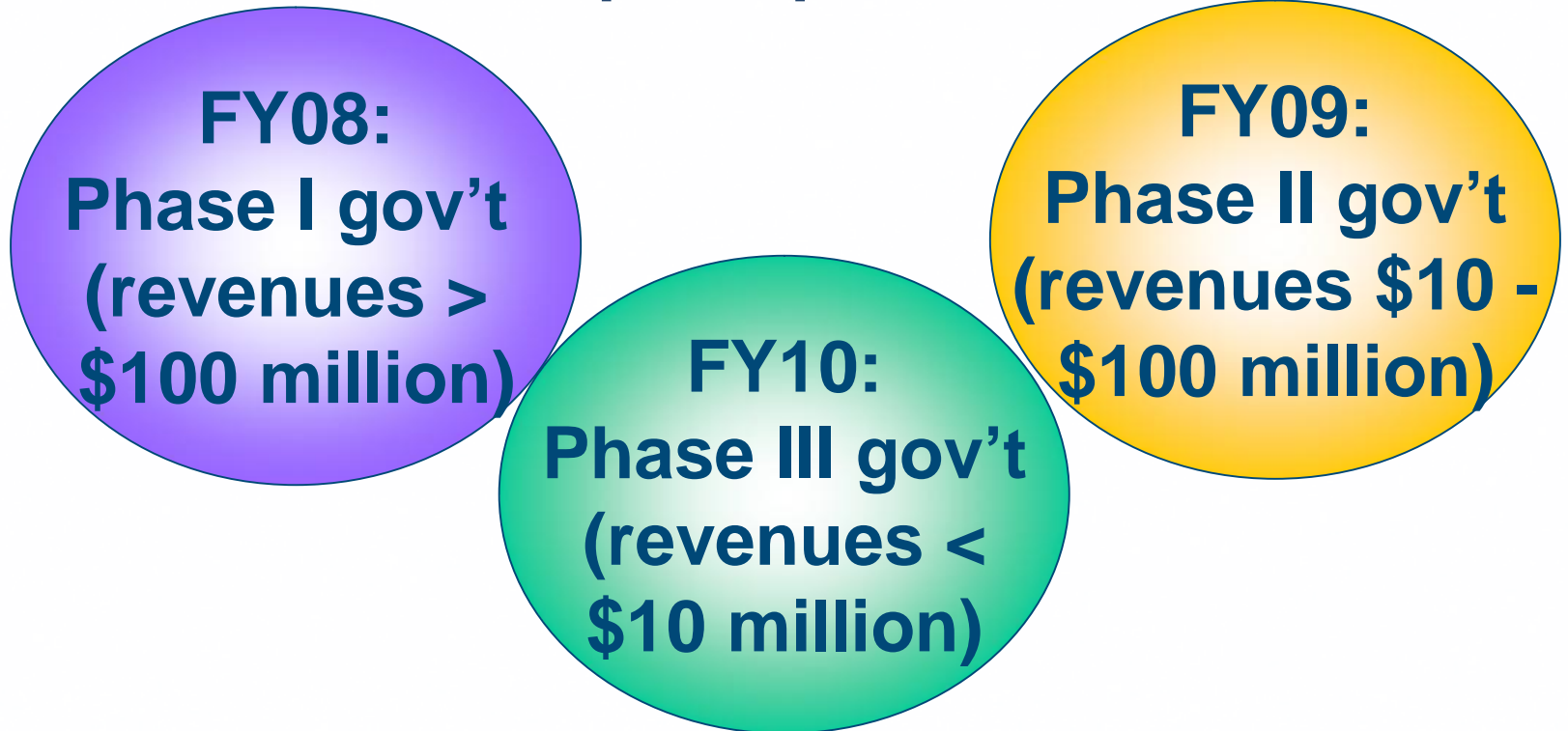
Why ... the new standard?

- § Benefits are “earned” during working years, and the obligation should be recognized over the same period
- § OPEB benefits represent significant- **IOUs** for future payments and should be taken into account when setting bond ratings
- § OPEB benefits and pension benefits should be treated the same way

GASB #43 and GASB #45

When ...will this be effective?

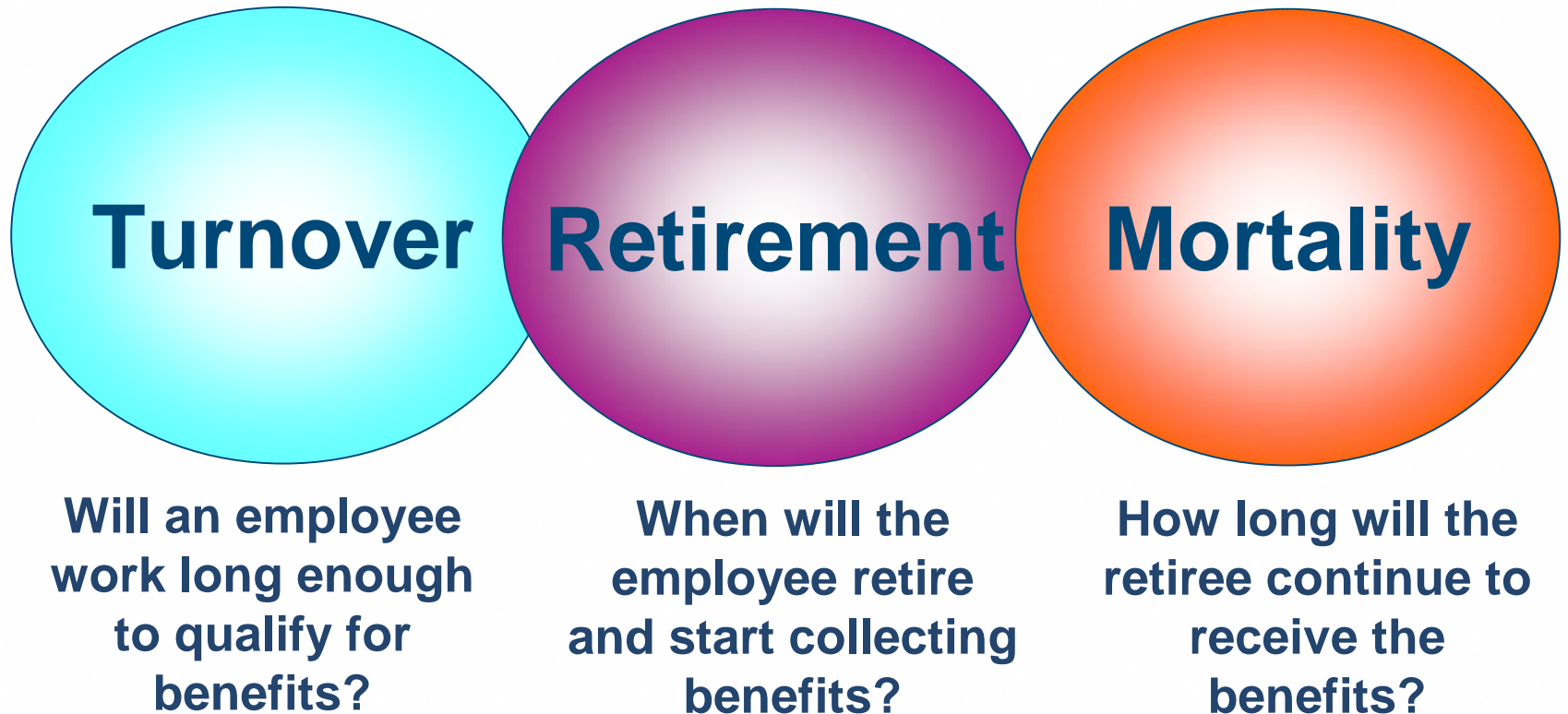
GASB #45 - based on plan sponsor:



GASB #43 reporting for funded plans - one FY earlier

Actuarial Assumptions

Demographic assumptions



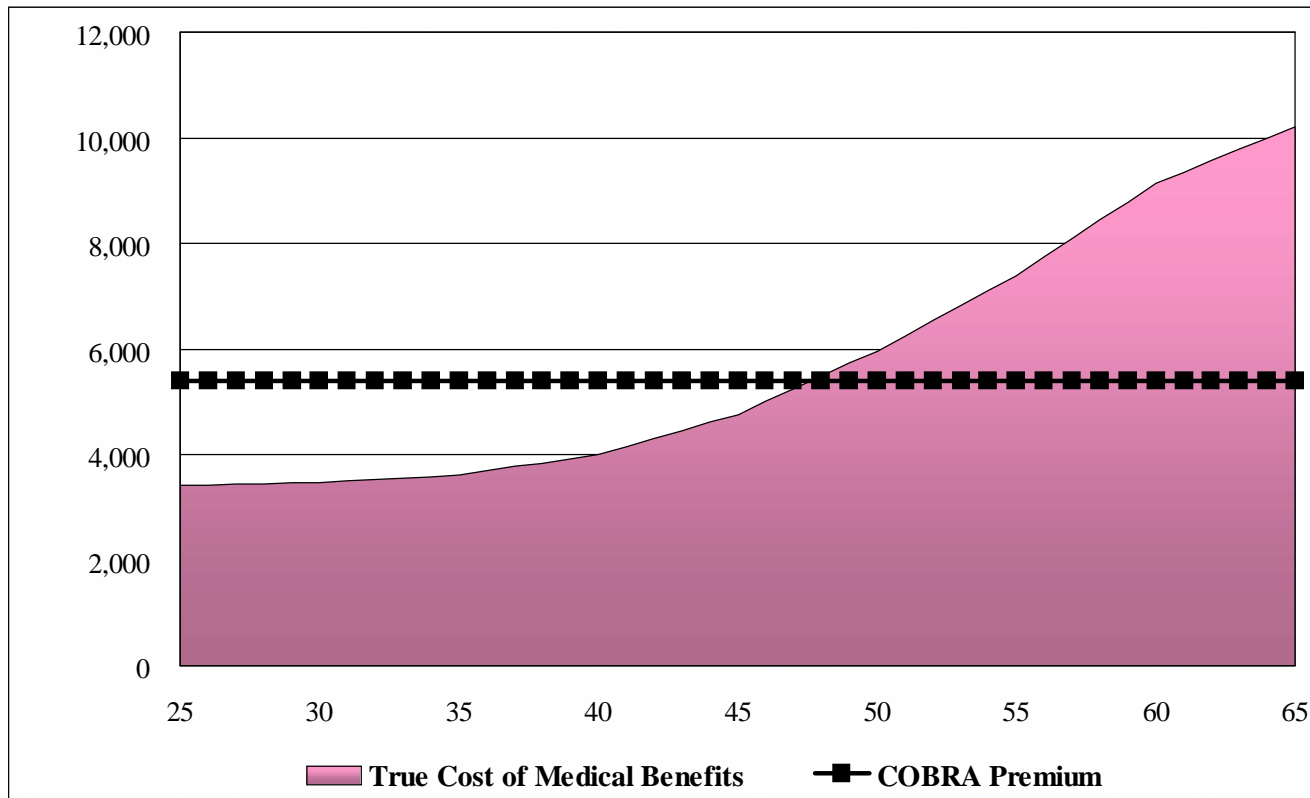
Actuarial Assumptions

Cost assumptions



When a retiree starts receiving post-employment benefits, how much are we going to have to pay for the benefits and how rapidly will costs grow?

The Implicit Rate Subsidy



If retirees or dependents have access to medical benefits but “pay their own way” via a COBRA premium, they are most likely paying far less than the true cost of the benefits they are receiving.

Actuarial Assumptions



Discount Rate

What is the present value of all of those future benefits in terms of today's dollars?

If we put money aside today, what rate of return can we expect to earn on it?

If we **don't** fund these benefits, what rate of return do we get on our unallocated assets?

Annual Required Contribution (ARC)

Note that there is no requirement to actually pay this amount - just a requirement to calculate it



Normal Cost

= cost of benefits
earned this year



**Past Service
Cost**

= amortization of
Unfunded Liability
§ over 10-30 years
§ as a level \$ or level % of
payroll

Why Does This Matter Now?

- § Get an idea of the magnitude of the numbers.
- § Plan for the cash flow needed in coming years.
- § Address the question of whether or not to pre-fund or fund.
- § Examine ways in which the overall cost of providing medical benefits can be reduced, for instance through use of the Medicare prescription drug subsidy.
- § Evaluate the cost impact of proposed benefit changes in the context of union negotiations.

Some New Controlling Factors

§ CT Public Act 06-123

- Protects retiree benefits
- No changes can be made to current retiree benefits
- Does allow for change to future collective bargaining agreements
- Does allow for change in carriers

Medicare Part D Subsidy

- § Earmark the Medicare Part D subsidy to fund the OPEB liability – Can Not offset the liability
- § Is drug coverage for Medicare eligibles creditable and eligible for the subsidy?
- § Change under 65 benefits to same as active
- § Explore the Employer Group Waiver Premium Option
 - Purchase drug coverage from carrier for premium
 - Could be more cost effective than the Part D Subsidy
 - Could remove some risk

Mitigating the liability

§ Lower the cost of the benefits and the size of the liability will shrink (somewhat!)

- Managed care
- Disease management and wellness programs
 - Reduces overall cost
 - Can also reduce trend assumption
- Prescription drugs
 - Promote generic utilization
 - Promote mail order utilization

How Much Of The Cost Can Be Shifted By Increasing Copays Or Deductibles?

- § \$5 office visit copay worth about 1% in plan cost
- § Adding \$5 to Rx copay (each tier) worth about 2% in plan costs
- § Going from \$500 to \$1,000 deductible worth about 6-7% in plan costs

How Big is the Employer's Share?

§ Control future increases in employer-paid portion of retiree medical benefits

- Flat, hard-dollar cap on employer paid premium
- Cap on annual % increase
- Cumulative cap on % increase

§ Adjust premium sharing

- Employer share of cost is tied to length of service
- Provide benefits only for a set period of time
- Provide benefits for “x” years after retirement

§ Switch to a defined contribution design

§ Amount in accumulation account used at retirees discretion for medical costs

Re-define who receives retiree benefits

§ Only normal retirees get OPEB

- No benefits for members who terminate or retire early

§ Provide coverage for fixed period of time

- For example, 10 years after retirement

§ Eliminate coverage for certain groups

- Pre-65 benefits
- Post-65 benefits
- Dependents
- Non-spouse dependents

§ Make change effective for new retirements rather than for new hires

What Plan Sponsors Need to be Doing **Now**

- § Educate elected officials, taxpayers, employees, and the press.
- § Examine ways in which the overall cost of providing medical benefits can be reduced, for instance through the Medicare Part D drug benefit.
- § Evaluate the cost impact of proposed benefit changes in the context of union negotiations.

What Plan Sponsors Need to be Doing **Now**

- § Understand the issue – it is manageable
- § Get at it early
- § If you don't manage the issue, it will manage you

GASB Issues

- § Trust Fund Issues and Requirements
- § Cost Cutting Measures and Techniques
- § Union Negotiations and Benefit Costs
- § Covering Funding Gaps With Interim Financing
- § Keeping Rating Agencies in the Loop

Correcting GASB 43 & 45 Misconceptions

- § Advance funding of OPEB liabilities (while desirable) is not required (Term “annual required contribution” or “ARC” is used for financial reporting purposes only)
- § Existing unfunded liabilities need not be recognized immediately on employer’s financial statements
- § Informal and unwritten arrangements must be recognized under GASB 43 & 45

Why All the Concern?

- § Some observers have suggested that employers need not be concerned about a mere “reporting” obligation
- § This view is strongly disputed by the three major municipal debt rating agencies
- § Likelihood that most employers OPEB liabilities, if not pre-funded will eventually lead to a financial disaster
- § Rating agencies will closely monitor employer financial statements and will downgrade credit rating of those failing to fund OPEB liabilities

Examine Results of Actuarial Valuation

- § It is likely that the valuation will produce an ARC considerably higher than recent pay-as-you-go costs – typically by multiples of 7-8 times
- § However, a properly documented actuarial report can provide valuable information to employers which will enable them to cut costs
- § Important that the report allocates costs categories of benefits and employee groups so that cost cutting efforts can be targeted to the appropriate groups

Explore Cost Saving Measures

- § Depending upon the magnitude of the ARC, employers will be required to implement drastic cost saving measures
- § The balance of the presentation identifies and discusses the implications of these cost saving measures

Why a Trust Fund?

- § Preliminary estimates are that the typical ARC will exceed a typical employer's pay-as-you-go cost by 7 to 8 times.
- § However, if the program is funded through a trust fund the typical increase will be only 3-4 times
- § Difference is that the actuaries can apply "long-term" trust fund earnings assumptions to offset future costs, and can validly assume that funds will not be used for other purposes

Trust Fund Options

§ Three Options-

- Voluntary Employee Benefit Association – Trust qualified under section 501(c)(9) of the Code
- Medical Accounts for Retirees – Trust qualified under section 401(h) of the Code
- Governmental Trust – qualified under section 115 of the Code

§ Each option has advantages and disadvantages – Must be structured so that earnings are tax-deferred, and to permit maximum flexibility

§ Determination of the appropriate option for each employer depends upon the specific characteristics and needs of each employer

Trust Fund Requirements

- § Once made, contributions may not be recovered by the employer
- § Contributions and accretions can only be used to pay OBEB benefits
- § Resources must be sheltered from the claims of the creditors of the employer and the employee
- § Trust fund “equivalents” permitted if the arrangement satisfies the foregoing conditions

State Legislation

- § Many current state laws do not provide, or even permit, pre-funding of OPEB – Home rule issues
- § New legislation may be required to permit employers to establish trust funds (and invest) OPEB benefits
- § It is important that municipal and district employers determine the status of their state legislatures efforts to permit local employers to establish trust funds

State Legislative Issues

- § May each local employer establish its own trust fund?
- § May each local employer select its own investment manager and investment policies?
- § Are local employers permitted to establish common trust funds and programs?
- § Should local employers be permitted (or required) to participate in a state system?

Interim Funding Strategies

- § It is likely that many states have not yet enacted legislation encompassing all of the issues arising in connection with GASB 43 & 45
- § In particular, without the ability to establish a trust fund, employers are deprived of one of the most powerful tools available
- § In the absence of legislation, employers should earmark, and to the extent permitted under existing law, dedicate funds for OPEB purposes
- § Earmarking funds is an important signal to rating agencies

Additional Cost Containment Measures

- § Targeted benefit reductions – may require union negotiations
- § Elimination of “implicit subsidies ”
- § Integration with Medicare
- § Part D Medicare subsidies
- § Additional employee contributions
- § Cost sharing and resource pooling

Targeted Cost Reductions

- § Target those groups with the highest benefit levels
- § Detailed actuarial valuation with allocated costs is essential
- § Work with benefit providers to identify other likely areas
- § Identify those benefits not protected by collective bargaining agreements or state statutes

Union Negotiations

- § True cost of OPEB should be communicated to each affected union
- § Separate plans and trusts may be required so that costs for each discrete group may be identified for negotiating purposes
- § Where level of benefits is mandated by statute, legislation may be required to reduce benefit levels for new and current employees
- § Employers, unions and workers require an understanding and appreciation regarding the real costs of continuing to provide benefits at current levels

What is an Implicit Subsidy?

- § An Implicit Subsidy is an indirect subsidy to the cost of retiree coverage by an employer's active population
- § Example - An employer provides coverage to its retirees' dependents, but requires those employees to pay the "full" cost of the coverage. The cost of the coverage is the same as paid by active employees.
- § In effect, active employees are paying part of the cost of retiree coverage – because retiree benefit usage is higher

Elimination of Implicit Subsidies

- § Employers need to identify and evaluate the cost of implicit subsidies
- § Separate cost valuations on a per population or employee group basis are helpful in confronting employees representative with the true cost of coverage
- § In some cases, implicit subsidies can be unilaterally eliminated

Identification and Elimination of Cross Group Subsidies

- § Existing programs may consist of several different employee groups, each of which may have one or more different levels of benefits
- § Such combinations tend to involve the subsidization of the costs of groups with higher benefits
- § Identification and segregation of discrete groups and their respective costs is a first step in controlling costs
- § Separate funding of benefits through separate trusts and sub-trusts

Integration with Medicare

- § Some plans permit do not require otherwise eligible employees to participate in Medicare – purely as a convenience to the retirees
- § Requiring all relatively non-controversial cost saving measure would be to require all eligible employees to participate in Medicare

Part D – Medicare Subsidies

- § To the extent that medical program provides prescription drug benefits, the state or municipality may qualify for subsidies under Part D of Medicare
- § Actuarial certification required to the effect that the prescription benefits are at least as generous as the federal prescription drug plan
- § Application for subsidy will be required
- § In some cases it may be preferable to drop coverage and require employees to utilize Medicare coverage as the primary insurer
- § Full cost of benefits is recognized as a plan cost and subsidy is recognized as a contribution when received

Additional Employee Contributions

- § Additional employee contributions may be easier to “sell” to unions and other employee groups
- § Conforms with current trends in the private sector
- § Properly structured, contributions may be made on a pre-tax basis

Resource Pooling and Cost Sharing

- § By combining resources, smaller employers and plans be able to save costs and gain access to more sophisticated professionals
- § Need to consider issues relating to allocation of retiree and professional costs
- § Unless fair and workable allocation methods are established in advance, inadvertent subsidies are likely to result

Keep Rating Agencies in the Loop

- § Despite their concern about the level of unfunded retiree benefits, rating agencies have stated that they do not expect that most employers will be able to fund the entire ARC in the first year
- § However, those agencies do expect employers to take appropriate steps to control and fund their liabilities
- § Employers should keep rating agencies apprised of their efforts, and convey the impression that they are making progress

Covering Funding Gaps With Interim Financing

- § Even if a trust fund is established, initial costs are expected to triple or quadruple
- § Need for interim financing through issuance of municipal bonds or otherwise
- § OPEB bonds will generate taxable income
- § Risk of replacing a balance sheet liability with a “real” liability.
- § Concern with negative arbitrage – New Jersey retirement plan example

Conclusion

- § Understand GASB 43 and 45 requirements
- § Document plans and obtain actuarial valuation as soon as possible
- § Aggressively implement cost cutting measures
- § Work cooperatively with unions and employee groups to implement cost cutting measures
- § Inform rating agencies of efforts to control and fund GASB 45 liabilities

Questions and General Discussion

