State of Vermont

Government Accounting Standard No. 45

Dan Sherman
Director, Consulting Actuary
March 14, 2006

explore excellence[sm]

buckconsultants
an ACS company

Background

- Other Post Employment Benefit (OPEB) refers to any post employment benefit other than pensions
  - Medical
  - Long-term Care
  - Dental
  - Vision
  - Life Insurance and Disability (if not in pension plan)
- Post-employment benefits are part of the compensation for services rendered by employees; i.e., they are part of an exchange transaction
- Benefits are “earned,” and obligations accrue or accumulate, during employment

Background

- Payment is deferred until after employment
- Last deferred expense to be addressed by Government Accounting Standards Board (GASB)

Disclosures

- Annual Required Contribution (ARC) is the amount to be expensed for the year
  - Determined in a similar manner as the Pension Funding recommendation
  - Normal Cost plus amortization of unfunded accrued liability
- Accrued Liability
- Assets – Balance sheet and Income/Expense
- Unfunded Accrued Liability
- 10 year history
- Accumulated differences between the ARC and actual contributions creates an additional liability or asset
- Valuation needs to measure implicit cost subsidy

Assumptions

- Used the same demographic assumptions as the State Employees and Teachers Pension Valuations
- Discount rate for “Pre-funded” basis is 8% (represents the expected long-term return on a new trust fund)
- Discount rate for current “Pay-as-you-go” basis is 3.75% (represents the expected long-term return on current cash and short-term investments)
- Healthcare cost trend rates, initially 9% for 2006, ultimate of 5%
- Expected portion of active employees electing: 80%

Results at 8%

	State Employees	Teachers
Accrued Liability	289.17	401.68
Amortization	14.08	21.12
Normal Cost	10.02	15.42
ARC	24.10	36.54
Pay-as-you-go	13.56	11.79
Difference	10.54	24.75

Amounts in $Millions

Results at 3.75%

	State Employees	Teachers
Accrued Liability	529.03	890.41
Amortization	14.74	25.75
Normal Cost	24.44	48.64
ARC	39.18	74.39
Pay-as-you-go	13.56	11.79
Difference	25.62	62.60

Amounts in $Millions

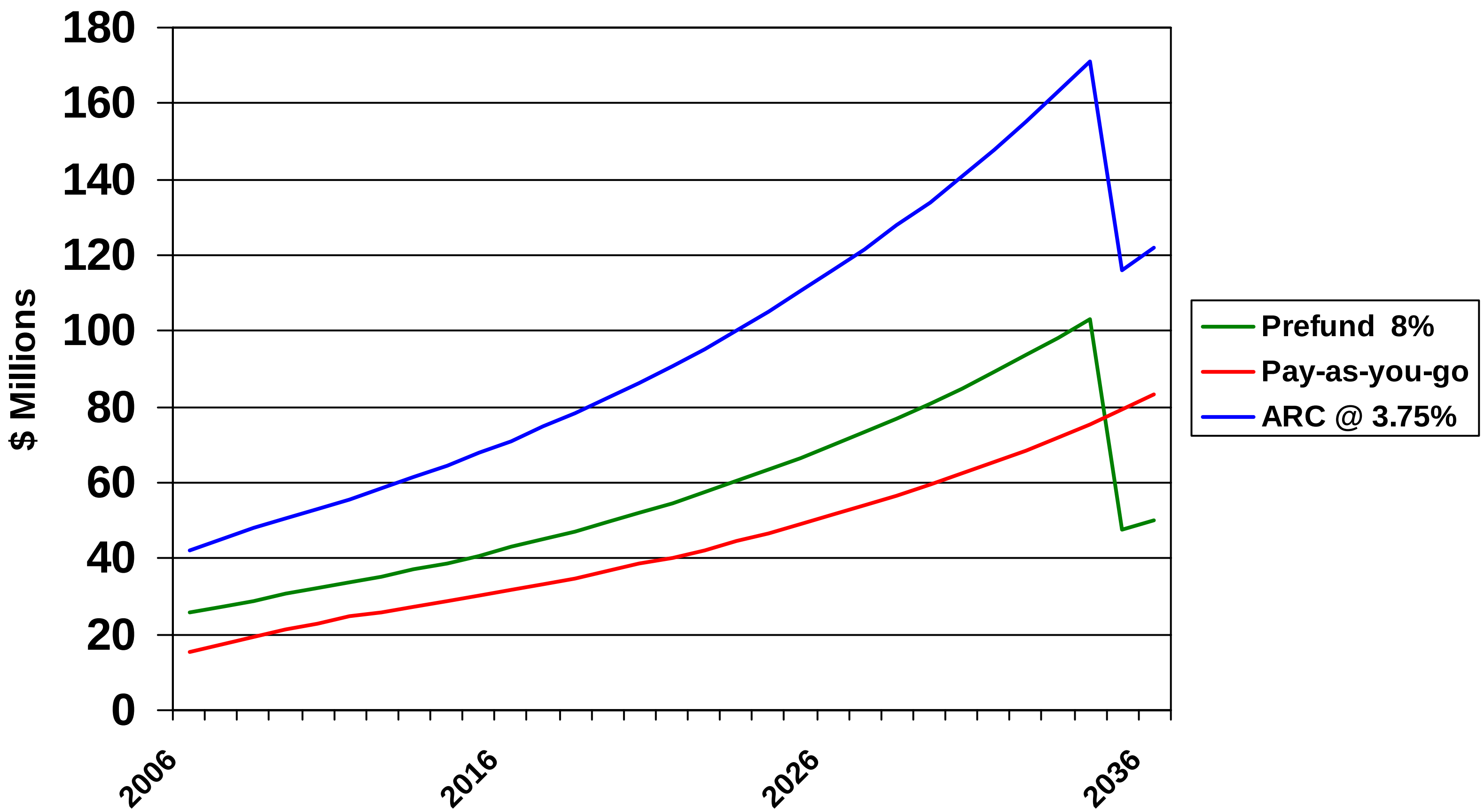
Teachers Disclosures – Pre-funded Approach

- Footnote Disclosures use 8% discount rate assumption
  - Unfunded accrued liability: $401.68 million
  - ARC: $36.54 million
- If the State only funds $5 million over the Pay-as-you-go ($16.79 million) then a Net OPEB Obligation (NOO) of $19.75 million is created and placed on the balance sheet
    - This assumes the State will increase the funding to be equal to the ARC over a short period of years
    - Contingent on the auditor agreeing with approach
- The following year, the State would need to adjust the NOO for any differences between the new ARC and actual contributions

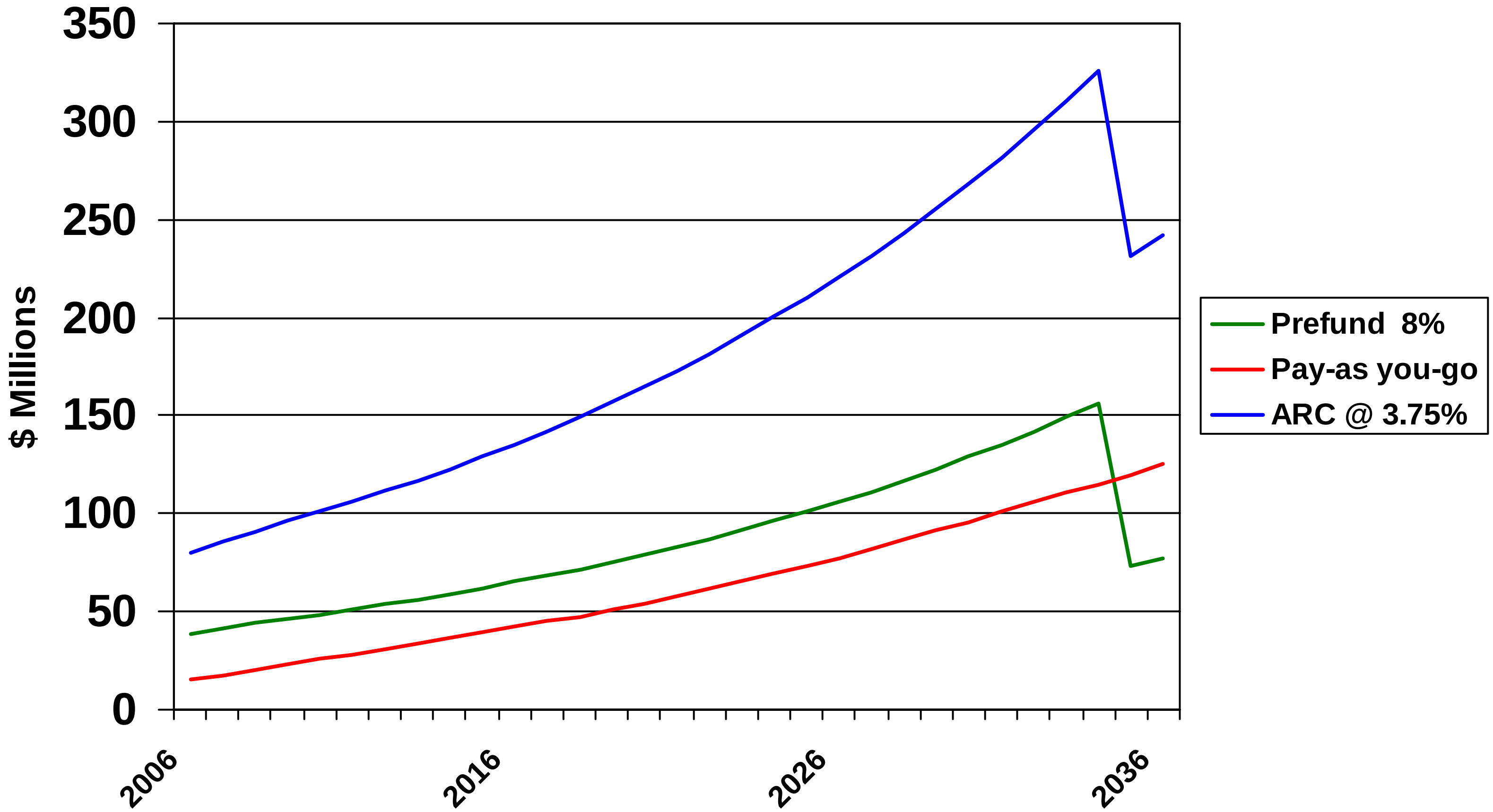
Teachers Disclosures – Pay-as-you-go Approach

- Footnote Disclosures use 3.75% discount rate assumption
  - Unfunded accrued liability: $890.41 million
  - ARC: $74.39 million
- The State funds the Pay-as-you-go ($11.79 million) then a Net OPEB Obligation (NOO) of $62.60 million is created and placed on the balance sheet
- The following year, the State would need to adjust the NOO for any differences between the new ARC and actual contributions; approximately doubling to over $135 million

State Employees - ARC and Pay-as-you-go Forecast



Teachers - ARC and Pay-as-you-go Forecast



Pre-funding

- Advantages
  - More economical over time – investment returns will supplement employer and employee contributions
  - Increased security for employees and retirees
  - Helps maintain bond rating
  - Assists in budgeting – available assets act like a reserve to mitigate large increases in medical costs
  - Keeps a new book liability under control
- Disadvantages
  - Higher current cash outlay
  - Higher administrative costs
  - More complex

Pay-as-you-go

- Advantages
  - Lower current cash outlay
  - No administrative costs associated with a new separate Trust Fund
  - Easier to understand
- Disadvantages
  - No investment earnings to offset costs
  - Potential reduction in credit rating
  - Large Net OPEB Obligation on balance sheet
  - Maintains cost shifting to the next generation of tax payers

Challenges of Pre-funding

- A trust is required with provisions that the assets are used for the exclusive use of OPEB, and related expenses
- IRS rules include 3 mechanisms for establishing trusts on a tax advantaged basis
  - Voluntary Employee Benefit Association (VEBA)
  - Medical Accounts for Retirees
  - Government Trust under IRC Section 115
- Increases in appropriations sufficient to justify using the higher discount rate
- If the State can not raise appropriations to the ARC, a discount rate between 8% and 3.75% would be required

Challenges of Pre-funding - VEBA

- Voluntary Employee Benefit Association (VEBA) is a trust that qualifies for exemption from Federal income tax under Section 501(c)(9).
  - To constitute a VEBA, the organization must be an association of employees where membership is voluntary and the benefits provided are limited to life, sick, accident or other similar benefits.
  - The drawback to a VEBA is that it can only be a single trust and there does not appear to be any authority for employees to make pre-tax contributions to the trust

Challenges of Pre-funding – 401(h) Account

- A Medical Account for Retirees can be a trust that qualifies for exemption from Federal income tax under Section 401(h)
  - This trust is similar to 401(k) retirement accounts
  - A disadvantage to a 401(h) retiree medical account can only be an adjunct to a defined benefit pension plan and receive funding only after pension plan is fully funded
  - Employee Contributions are on an after-tax basis

Challenges of Pre-funding – HSA Account

- A Health Savings Account (HSA) for Retirees is a trust that qualifies for exemption from Federal income tax under Section 1201 of the Medicare Prescription Drug, Improvement Act of 2003
  - This trust is similar to 401(k) retirement accounts
  - One disadvantage to a HSA is that Medi-gap premiums are not covered
  - Although employee contributions are on an after-tax basis, they are deductible

Challenges of Pre-funding – Section 115

- Governmental Trust is a trust that qualifies for exemption from Federal income tax under Section 115.
  - Established only for an essential government function and the income earned on the trust's investments have to accrue to the state or local government's benefit
  - A disadvantage to a governmental trust is that there is no explicit legal authority that addresses the use of the fund for the retiree health care obligation
  - However, Treasury Regulation 301.7701-1(a)(3) and several IRS Private Letter Rulings are favorable to using a Section 115 master trust to pre-fund OPEB obligations. The State of Minnesota has established a trust for OPEB purposes.

OPEB Credit Implications

- OPEB touches ratings in at least two major areas --
  - Managerial
  - Financial

Source: GASB 45- Reporting of Other Post Employment Benefits, Presentation to Northeast State Treasurer & CSPN Annual Conference, Parry Young, Standard & Poors, July 25, 2005.

Managerial Credit Implications

- How well understood are the liabilities associated with specific benefits?
- What methods and assumptions are being used to determine liabilities?
- Are the GASB 45 actuarial valuation results going to be a complete surprise?
- Once the OPEB liability and ARC numbers are known, management's plans to deal with them going forward will be of the utmost importance.
  - Are the current levels of benefits sustainable-economically and politically?
  - If not, what can be done to lighten the burden?
  - What is the plan?

Source: GASB 45- Reporting of Other Post Employment Benefits, Presentation to Northeast State Treasurer & CSPN Annual Conference, Parry Young, Standard & Poors, July 25, 2005.

Rating Agency Perspective: Standard & Poors

"OPEB obligations, which are primarily centered on health care coverage, represent a significant expense for public sector employers. The current level of OPEB promises are primarily the result of employment contracts entered into by governmental entities. The funding of these obligations is of an increasing credit concern, exacerbated by the rapid cost acceleration in many health-related areas. Government jurisdictions have a wide range of OPEB liabilities in terms of absolute size and relationship to budget resources, depending on how generous they have been in awarding benefits. The disparities between employers will now be made more apparent under the new GASB 45 reporting. In some instances, the new reporting may reveal cases in which the actuarial funding of OPEB obligations would seriously strain operations, or, further, may uncover conditions under which employers are unable or unwilling to fulfill these obligations. In such cases, OPEB liabilities may adversely affect the employers' creditworthiness, in that overall liabilities, including debt-like obligations such as OPEB, would be increased and future expenditure flexibility reduced."

- Commentary Published on Reporting & Credit Implications of GASB 45 on OPEB, Standard & Poors, December 1, 2004

Rating Agency Perspective: Fitch Rating Service

"Initially, Fitch's credit focus will be on understanding each issuer's liability and its plans for addressing it. Fitch also will review an entity's reasoning in developing its plan. An absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor…

Fitch does not expect OPEB plan funding ratios to reach the generally high levels of pension systems for many years, but steady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality."

- The Not So Golden Years: Credit Implications of GASB 45, Fitch Rating Service, June 22, 2005.

Reactions across the Country

- Most large governments have or are in the process of determining the size of the obligation now, in anticipation of implementation later.
- Some States have already established trusts and are starting to pre-fund. A 2/17/06 report from California indicated 11 states have started pre-funding. For example, Ohio and Minnesota
- Several municipalities have also established trusts and started pre-funding. For example, the Massachusetts communities of Arlington, Bedford, Needham, and Wellesley.
- City of Gainesville issued OPEB bonds
- Benefit studies seeking to reduce the obligation, or at least keep it from rising as rapidly as in the past via multi-tiered plans

Q & A