MOCKENHAUPT BENEFITS GROUP

pebr

March 2007

Public Employee Benefit Review

By William C. Asay, CEBS
President
(412) 394-9332
bill.asay@MBGbenefits.com

Bill Asay, CEBS, is a public pension plan expert having worked in the industry for close to three decades. As President and Chief Operating Officer of Mockenhaupt Benefits Group, he and his team service over 500 municipalities annually. Bill is a frequent speaker on issues relating to the design and administration of retirement programs and has written numerous articles on public pension plans and retiree medical plans. He is a member of the International Society of Certified Employee Benefit Specialists and the International Foundation of Employee Benefit Plans.

What You Need to Know About GASB's Accounting Standards for OPEB Benefits: GASB 43 and GASB 45

"How will liabilities from our retiree medical plan affect our budgets?" This is a common question often asked about GASB 45 from Pennsylvania governmental employers providing retiree healthcare coverage. Let's take a closer look at this question and determine the answer by beginning with some background...

History

In June 2004 the Governmental Accounting Standards Board (GASB) approved the final accounting standards applicable to "other postemployment benefits" (OPEB) including healthcare benefits like medical, dental, vision and hearing as well as non-healthcare benefits such as life, disability and long-term care if provided separately from a defined benefit pension plan. Termination offers, including inducements to terminate employment *(such as severance pay and early retirement incentives)* are excluded from this standard unless they affect the OPEB benefit liabilities. Additionally, pension benefits are not included in this measurement because they are covered by other standards.

(CONTINUED INSIDE)

The two GASB statements affecting OPEB benefits are:

GASB 43 Financial Reporting for Postemployment Benefit Plans other than Pension Plans

GASB 45 Accounting and Financial Reporting By Employers for Postemployment Benefits other than Pension

Current Funding

Most Pennsylvania OPEB benefits, as well as those across the country, are funded on a "pay as you go" basis. What this means to most governmental employers is that they pay the current premium, or portion of the premium, based on various agreements made with their employees over the years. Unless employers complete a study to measure liabilities during negotiations, officials typically have no idea what the actual benefits cost may total. Over the years, many elected officials have said that the only liability they were concerned with was the premium necessary for the following year in order to finalize their budget. The GASB does not require OPEB benefits to be funded like a pension plan; however, keep in mind that the liabilities **must** be measured whether the governing body wishes to continue to fund the benefits on a "pay as you go' basis or pre-fund the plans.

> ***"GASB's primary objective is to ensure that the long-term cost of retiree health care and non-health care benefits be determined on an actuarial basis."***

Actuarial Valuation

GASB's primary objective is to ensure that the long-term cost of retiree health care and non-health care benefits be determined on an actuarial basis. Many of the assumptions and variables used in your pension plan actuarial calculations are also used in your OPEB studies. However, the tools are specific to health care plans. For employers with 100 or more total members an actuarial valuation would be done to calculate the "annual required contribution" (ARC). For employers with fewer than 100 members an alternative method is also allowed.

Substantive Plan

Typically, one of the biggest challenges is to determine the "Substantive Plan," the plan as understood by both the employer and plan members. Governmental employers have granted benefits through many means including collective bargaining agreements, individual negotiations, arbitration awards and others.

Often, benefits for a single employer have been granted through various union contracts where plan specifics differ from contract to contract. Another problem is when municipal collective bargaining agreements (CBA) don't contain enough detail to properly interpret the plan. For instance, I have seen many municipal CBAs that have included language such as, "*The Borough agrees to pay healthcare for retirees and spouses at retirement*" or "*The Township agrees to pay Blue Cross benefits until age 65.*" The CBA doesn't include specific eligibility requirements or restrictions. In both of the examples, the CBA doesn't say if it only pertains to Normal Retirement retirees or to all retirees. Would vested deferred participants or disabled participants begin to receive a benefit when retirement commences? Would early retirement retirees be eligible when they begin to receive retiree payments? Would it be restricted to medical insurance or would vision and dental also be included?

A specific benefit structure must be included in the Substantive Plan in order for it to be properly valued and the OPEB accounting requirements be met. I'd suggest that the employer take this opportunity to formalize each separate commitment in a formal plan document, specifically the terms of the plan as understood by the employer and the members. This action will lead to smoother administration and fewer future legal expenses.

Implicit Rate Subsidy

Another area typically misunderstood is what the GASB refers to as the "implicit rate subsidy" - the cost difference between an active and a retired member's rate. Most employers who cover active and retired employees under the same plan are charged the same premium for all members. If the retiree must reimburse the employer for the cost, the premium is usually based on the same schedule. *(The retiree group will generally be older than the corresponding active member group.)* It is commonly understood that average yearly claims for most health insurance coverage increase as age increases. Older members tend to use the health care system more often and their individual claims may tend to be more expensive. The OPEB valuation is required to recognize the estimated difference between the rates that would apply if only active members were covered and the rates that would apply if only retired members were covered. In essence, even if the retiree is paying the full premium determined on a combined basis, the employer may have an OPEB liability because of the implicit rate subsidy. Your specific situation will determine the potential liability.

What does the actuary calculate?

Actuaries typically calculate:

- **Past** Service Liability – The accrued liability for benefits earned prior to the valuation date (the unfunded amount is amortized over a period of up to 30 years).
- **Current** Normal Cost – The current year's cost.
- **Future** Service Liability – The anticipated cost for future years

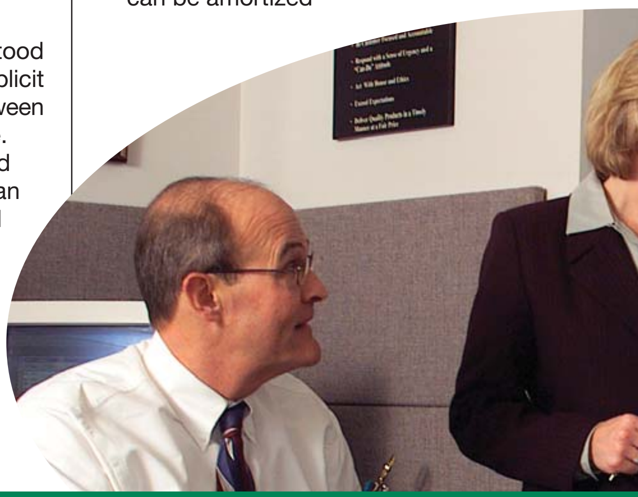
However, the annual accounting cost will only include the Normal Cost and the amortization of unfunded Past Service Liability.

What does all of this mean?

To help illustrate calculations, I'll provide the following example: Tom and Mary had a son; they plan for him to attend the university of his choice after high school graduation. They estimated and calculated the tuition (*liability*) needed to be $180,000.

Tom and Mary never begin to fund this plan; and, after 10 years, they calculate the liabilities like GASB 45. Their child is now 10. Since nothing has been saved, this college program was on a "pay as you go" basis of accounting. As of Jan. 1, 2007 the program would be:

- **Past** Service Liability - $100,000 which can be amortized



- **Current** Normal Cost - $10,000
- **Future** Service Liability - $70,000
- Tom and Mary's Annual Expense is the amortization of the past service liability + the Normal Cost.
- Funding this amount on an annual basis would be a reasonable way to ultimately reach their goal.

Obviously Tom and Mary are not required to fund this liability until the tuition is due ("pay as you go"), however, their unfunded liability will continue to increase each year and their credit rating could suffer.

The OPEB valuation, although infinitely more complicated than the example, would reflect the funding status of the plan and reflect the liabilities, at a specific date. Although GASB 45 does not require the employer to pre-fund the liabilities, it does require the calculations to be made. The employer's financial statement will disclose an annual expense determined as if the Annual Required Contribution (ARC) is made, along with a liability for any accumulated net deficit. That liability will grow as long as the ARC exceeds the "pay as you go" amount. In addition, should your entity wish to consider the issuance of bonds in the future, the rating agencies will require this information.

Funding Mechanisms

It is always beneficial to fund plan members' OPEB benefits at the time the benefit is earned. However, this has not been the custom. Pre-funding the benefit does more than just match funding to the benefit earned. The assumed valuation interest rate will have an impact on the total benefit cost. If you fund the plan on a "pay as you go" basis, the valuation interest rate used will reflect only rates available for the employer's general investments and will typically result in a much lower rate of return than allowed for a funded plan. If the plan is funded and you are able to set a long term investment strategy, expected long term rates of return should be higher and may therefore be assumed.

If an employer is pre-funding some or all of the liabilities and it would like to benefit from the difference between short and long-term interest rates, the assets must be in an OPEB qualifying trust or equivalent arrangement. To qualify under GASB 43 there must be an agreement between plan members and beneficiaries through the substantive plan in which:

- Employer contributions to the plan are irrevocable.
- Plan assets are dedicated to providing benefits to their retirees and beneficiaries in accordance with plan terms.
- Plan assets are legally protected from employer or plan creditors.

It is essential that the employers or persons involved in the above functions serve in a fiduciary capacity and act accordingly.

The different investment mechanisms emerging lend various degrees of comfort in their compliance with the requirements of GASB 43. Voluntary Employee Benefits Association (VEBA), under IRC § 501(c)(9), appears to be a safe alternative. A few governmental employers are also considering IRC § 115 trust. Although these integral governmental trusts may offer an alternative, there continues to be some question as to whether they comply with the requirement of GASB 43. If you intend to pre-fund your OPEB benefits be sure to retain a qualified advisor and consult your solicitor. You may also want to carefully scrutinize the investments being offered in conjunction with your applicable state codes before determining an investment strategy.

Implementation Dates

Most of the employers reading this newsletter will represent single employer plans. Their required schedule for GASB 45 implementation is:

Annual Revenues in the First Fiscal Year Ending After June 15, 1999	Effective for Fiscal Years Beginning After
Phase 1 $100 Million or more	Dec. 15, 2006
Phase 2 $10 million or more, but less than $100 million	Dec. 15, 2007
Phase 3 Less than $10 million	Dec. 15, 2008

The Government Accounting Standards Board encourages the early implementation of the standards. It also makes sense to have the liabilities calculated if you are negotiating a collective bargaining agreement prior to the required dates.

Defined Benefit v Defined Contribution

Most of this article has dealt with employer plans that are of a defined benefit in nature. GASB 43 and 45 do include requirements for defined contribution plans, but the affects are limited, and actuarial valuations are not required.

Cost Control Methods

Placing cost controls on your plans may be very painful, and changes may cause employee concern. However, it is important to consider cost containment options. Plan structure must be analyzed very carefully to determine what changes are important to both the employer and employees. Some areas that may be reviewed include:

• Pre-funding of the plan to enable the use of long-term interest rates. We have discussed this method previously.

• Reducing the cost of the current benefit offering. This would include cost shifting measures such as raising deductibles, co-insurance, co-payments, and out of pocket limits; redesigning the prescription benefit to integrate with Medicare Part D; and many others.

• Modify eligibility for current and/or future employees. This would include such things as increasing the years of required age, service or both to receive a benefit. You may consider a change in the benefit duration.

• Limit or eliminate benefit programs for future retirees or benefits for future hires.

• Change from a defined benefit to a defined contribution program.

Since Pennsylvania municipalities administer their own pension benefit structures independently from a statewide system, they must realize that some pension benefit changes can have a direct impact on their OPEB cost. Benefit changes like reducing the normal retirement age and adding an early retirement benefit could provide the municipality with a very large unintended consequence.

Obviously, altering the benefit structure is problematic and must conform to Pennsylvania labor laws. You should involve your solicitor, labor attorney, actuary and healthcare professionals before altering any of your plan provisions.

Mockenhaupt Benefits Group...Your Long-Term Partner in Planning

Mockenhaupt Benefits Group understands the business of public employee benefits…and, we should since we've been assisting local government clients with their needs for over 40 years.

In fact, we service over 500 municipalities and more public employee pension plans than any other consulting firm headquartered in Pennsylvania.

We also employ the most experienced consultants in the industry and are often called upon to provide pension seminars for the state and various associations throughout the commonwealth.

Our clients also quickly find that our treatment is personal. When you partner with us, you'll receive a dedicated consultant who knows the laws and regulations applicable to Pennsylvania governmental plans and insurance programs. We pride ourselves on our experience, knowledge of public employee benefits and personal service.

We also understand that managing plans isn't your only concern. That's why you can rely on us to handle your questions, problems, administrative responsibilities and legislative changes. And, because our costs are much more affordable than many of our competitors, you'll save money, time and stress by depending on us.

Contact Us Today To Get Started…

MOCKENHAUPT
BENEFITS GROUP

Suite 1225, One Gateway Center
420 Fort Duquesne Boulevard
Pittsburgh, PA 15222
Phone: 412-394-9660
Toll-Free: 1-800-405-3620

Or, visit us online at
www.mockenhauptbenefits.com

EXPERIENCE THE MOCKENHAUPT DIFFERENCE.

MOCKENHAUPT
BENEFITS GROUP

Suite 1225
One Gateway Center
420 Fort Duquesne Blvd.
Pittsburgh, PA 15222
www.mockenhauptbenefits.com