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Details and Interactions

A SOLUTION FOR OPEB | BRAZILIAN REINSURANCE | EDUCATION RESTRUCTURE

FINDING A SOLUTION
for OPEB in the Public Sector

Post retirement benefits are a great concern for many public entities. Actuaries, with their valuing skills, are in a perfect position to help these entities find the answers they seek.

BY MICHAEL L. FRANK

With municipalities, school districts, state/local governments and other public entities dealing with the day-to-day struggles of managing their business, OPEB, which stands for Other Post Employment Benefits, is becoming an increasingly important issue to address. OPEB deals with the promise of providing coverage for post employment non-pension benefits such as health care and life insurance. This obligation is maybe a trillion dollars in this country, but yet has been relatively ignored. Actuaries will be needed to value this liability and may also provide services (e.g., consulting, products) to address this issue.

With the recent implementation of Government Accounting Standards Board (GASB) No. 43 and 45, public entities are now forced to value and recognize that this obligation exists, a challenge and political nightmare from entities that are dealing with other challenges in their local community. If you are in a community experiencing rising property taxes and raising of school district construction bonds to pay for upgrade of your schools, then the thought of your school district or local government having to recognize an obligation of tens to hundreds of millions is horrifying. This will most likely be the largest liability that your local government and school district has to deal with.

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Most public entities offer retiree medical coverage and have been doing so for years. This obligation is not a new issue, since traditionally large single employers have been recognizing OPEB under Financial Accounting Standards Board Statement No. 106 (FAS 106). Public entities will have to deal with the communication of this liability to their local communities and explain why this number is large. Unfortunately for these entities, this liability has always been there, but now they are faced with the communication of this issue for the first time and the political ramifications of communicating on their watch.

When Will This Happen?

Over the next three years, public entities will be valuing and recording these liabilities since they will be required to do so under GASB. They will be hiring actuarial consulting firms to do these calculations to determine how big the liabilities and overall obligations will be. Entities with revenue of more than $100 million will be recognizing first, while entities with revenue under $10 million will be required to recognize these obligations by the third and final year of required implementation.

The debt market and rating agencies are keenly aware of this issue and are requiring these items to be valued for entities that are applying for debt instruments. Public entities should not be surprised when applying for a bond that they will be required to disclose the amount of liabilities under GASB 43 and 45.

The first step to solving the problem is recognizing the problem. This includes valuing what the liability and obligations are associated with these post employment benefits (e.g., retiree medical, etc.). Administrators, politicians and public entities are going to have to accept, whether they like it or not, that this is an issue.

America is aware of the health care issues today with increasing costs for health care with individual coverage potentially more than $4,000 per year and family coverage greater than $12,000 per year. These costs may be much greater for pre-65 retirees and their dependents. With inflation (health care cost inflation or trend) growing in double digits, this complicates things further since future costs will be significantly greater than current cost.

What Has Been Traditionally Done With OPEB?

For the traditional public entity, these costs have been valued on a pay-as-you-go basis, recognizing and budgeting costs as dollars are being spent. Prior to FAS 106, large employers were doing this as well. A pay-as-you-go approach unfortunately does not value the impact of vesting benefits for current active employees that are earning these retirement benefits,

nor is it reflecting the impact of inflation on this benefit. A public entity that spends $5 million a year in retiree benefits may have a liability more like $50 million to $100 million.

This issue is not a completely new issue, since employers in the private sector had to value these benefits in the early to mid 1990s under FAS 106. However, the obligations of those organizations in most cases did not have the same magnitude as anticipated for public entities under GASB 43 and 45. (Most companies that reflected FAS 106 recognized this liability as one of the largest obligations on their balance sheet, so, still an issue for the private sector.)

Under GASB 43 and 45, we need to value benefits for both current retirees (and dependents) as well as future retirees (actives that will potentially retire in the future). Those active employees will generate a significant liability especially if they potentially could retire in their 50s or even in their 40s.

An important thing to know about GASB 43 and 45 is that it establishes standards for accounting and financial reporting. The decision and level of funding is determined by the public entity itself. These public entity employers have to deal with the issues of pre-funding these obligations now or potentially waiting until later. There are no "cookie cutter" solutions for these entities and each one may be very distinct on the solutions.

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However, in the public sector, benefit eligibility may be much earlier, and individuals will be eligible in their 50s or in some cases 40s. Benefit eligibility may kick in at 20- to 25-years of service and as early as five- to 10-years, regardless of age. This means that we will have individuals receiving retirement benefits 10- to 20-years prior to Medicare kicking in, so the future cost will be significant.

What are the Key Buzz Words in GASB 43 and 45?

Some of the key terms are the Annual Required Contribution (ARC) and Unfunded Accrued Liability (UAL). The ARC is the employer's periodic contribution to the defined benefit OPEB plan, which reflects the service (normal) cost for benefits earned during the year plus the amortization of the prior liability earned prior to the initial implementation of GASB 43 and 45.

The ARC is used to determine the expense and liability values that appear on the employer's financial statements for the purposes of GASB 45. This does not refer to actual contribution requirements, but rather to employer's accrual expense for accounting under GASB.

The UAL is the excess of the accrued liability of benefits, which would be the present value of future benefits less future contributions accrued and earned to date, above the assets funded for the plan. In many cases, these asset amounts are zero except in cases whereby entities were required to fund benefits due to collective bargaining purposes. The ARC and UAL are valued by actuaries. However, the most important take away for a reader is that these numbers are material and greater than the costs reported today, which is on a pay-as-you-go basis.

What Benefits Will Need to be Valued?

Retiree benefits to be valued may include medical, dental, vision, prescription drugs, life insurance, long-term care and other benefits. Workers' compensation may not need to be valued if currently valued today under other obligations (GASB No. 10). Benefits that are being accrued (eligibility based on years of service or age) will need to be reflected.

Benefits offered may have multiple options and plan designs including multiple plan designs (e.g., legacy benefit designs from collective bargaining) and multiple retiree contribution rates, which might vary based on hire dates, collective bargaining, or types of member (retiree, dependent, surviving spouse, etc.). Valuations will become more complicated based on the number of benefit offerings and groups to report on (e.g., township government vs. school district vs. other desired groups).

What May Cause Liabilities to Increase Over Time?

There are many reasons why obligations may increase over time. Some examples include:

- Increase in health care costs and inflation (trend) above projections.
- Reduction in discount interest rates meaning more dollars are required today to cover future costs.
- More early retirements meaning more individuals are getting benefits sooner.
- Lower turnover (non-vested) resulting in more individuals working until retirement.
- Mortality improvements resulting in people living longer and collecting more retirement benefits.

- Benefit enhancements (e.g., increased benefits, reductions in retiree contribution rates, earlier retirement eligibility, etc.).

What Other Issues Exist in Valuing OPEB?

Clearly, there will be political issues (it is not just about the financial ramifications of the liability). If your local community is experiencing increases in taxes (property and school) plus raising money for a school construction bond, then public officials are bracing themselves for the reaction of the community when communicating OPEB numbers plus the annual communication of its fiscal budget (some budgets requiring voting of the community).

Reporting the tens or hundreds of millions of OPEB liability will be a tough one to swallow for any public

entity. The average individual (a fixed income retiree in the community, a blue collar worker or anyone else) does not understand that this obligation has always been here, and GASB 43 and 45 is solely the process of recognizing and valuing this obligation. Unfortunately, the perception of this liability is that their government officials and school districts are spending dollars they do not have. Politicians and administrators will need to deal with this issue, since perception will be perceived as reality.

Bond rating agencies are also going to require this so they can understand the debt obligation of the public entity for entities applying for financing. The employer will have to deal with the challenges of recognizing this number and understanding how to "spin" the results. Actuaries will be hired by public entities to value these liabilities. Actuaries will not only be providing the bad news, but will also be needed for developing the solution.

Now That We've Identified the Problem, What Do We Do?

Start talking about it with the appropriate parties and develop a strategy. Some organizations have started discussions with employees—in particular during the collective bargaining process. The first concern unions express during collective bargaining is will their retiree benefits be cut, but it becomes much more important than that. Leaving the topic unresolved could result in potential insolvency of the public entity down the road, so the promised benefits might not be there.

Some initial steps to be done for public entities would include getting file documentation in order. This would include locating and clarifying benefit levels including obligations to retirees.

What Data is Required to Value These Obligations?

Actuaries can assist with determining this based on the unique benefits of the employer. Some of the information needed by actuaries to value this benefit includes electronic census listing (active and retired employees and dependents), plan design, plan costs (e.g., premium rates, other costs if self-funded), retiree contributions and assets.

In valuing these benefits, actuaries will be making assumptions for benefit costs (pre 65 and post 65 retiree benefits), health care cost inflation (trend) rate, interest discount rate, retirement rates, turnover rates, disability rates, mortality rates, aging assumptions (age/sex factors), asset return on investments (if any of the entities are funding benefits), salary increases if benefits or funding is based on salary (e.g., life insurance), plan participation percentage (some individuals may opt out) and actuarial cost methods.

Now That We Valued Benefits, We Need to Figure Out Solutions to Mitigate This Liability

Some of the approaches taken include:

- Improved efficiency in managing benefits including implementing cost containment measures.
- Competitively shopping of benefits (this might mean looking at new insurance carriers or brokers).
- Potential negotiation of benefit reductions for current and/or future retirees (though in the public sector, elimination of these benefits may not be realistic).
- Improving integration of benefits with Medicare so Medicare benefits are exhausted prior to payment on the public entity's plan.
- Increasing retiree contributions for current and/or future retirees.
- Changing in eligibility requirements for current or more likely future retirees.
- Establishing a special purpose trust like a VEBA may provide flexibility in establishing higher discount rates resulting in lower obligations (one percentage point increase in discount rate could lower liabilities 10- to 15-percent—a big number when dealing with $100 million plus liabilities).
- Creative financing of benefits.
- Retiree buyouts including selling off the obligations.
- Securitizing of benefits—may be a good financial strategy and may be received positively in the collective bargaining process.
- Consumer driven health plans may have some impact (though I caution the reader to truly understand what this benefit is and how it will be applied since not all consumer driven health plans are a solution for growing medical cost).
- Implementation of a lower-cost option (additional option for retirees) such as a Medicare Advantage plan.
- Development of a defined contribution plan (less popular with public entities though might get some traction with the announcement of material GASB liabilities).
- Other solutions unique to a specific employer (larger insurance companies are spending significant energy to develop a solution for these public entities since the magnitude of dollars and opportunity is significant).

These solutions could be applied to legacy benefits or to current or future benefits. Each solution is unique to each organization. There will be challenges since many of these retiree benefits have not been reviewed or modified in many years so there will be significant hurdles in order to effectively make improvements in these liabilities.

Is It Time to Clean Up Documentation Regarding Retiree Benefits?

One critical area that public entity employers need to focus on immediately is evaluating and documenting communications to understand the level of benefits provided and promised including the costs associated with the benefits such as obligations that employers require of retirees (e.g., retiree contribution levels, benefit eligibility requirements, plan design commitments, etc.). Many public entities do not have a central source for all this documentation so the gathering and maintenance of this information will require some time and energy.

How Does Collective Bargaining Play in These Benefits?

Those entities that have collective bargaining (many of them have some form of this) will have different levels of benefits based on various criteria including dates of hire, dates of retirement and classes of employees (e.g., hourly, salary, type of union). Knowing the results under GASB 43 and 45 will help public entities address additional focus areas for collective bargaining. All parties involved will need to appreciate the level of obligations and the pros/cons of offering benefits and funding benefits. If a public entity cannot meet its obligation for a benefit, then the parties receiving the promise of a benefit may not really have anything.

Collective bargaining and the negotiations of benefits will be one of the biggest hurdles to manage. To make material changes in retirement benefits, two things may occur. First, public entities might have to give something back in benefits or income to actives. Second, any changes in retirement benefits may only impact future retirees (those not in retirement status today). Benefit changes could be through a reduction in benefits or increase in retiree contribution rates. Some have explored modifying eligibility requirements so that individuals may have to be older in age or completed more years of service or the combination of both in order to reach benefits. This may have a material impact on the liability.

Some public entity employers have implemented solutions to mitigate costs by charging retirees the full cost that an active employee would pay (e.g., 100 percent of active premium rate). This does mitigate some of the exposure, but this, however, may not remove the potential exposure under GASB 43 and 45, especially for pre-65 retirees. The reason for this is that the cost for medical goes up with inflation but also with aging (older people incur more costs traditionally than younger people).

The result of using this strategy might be prudent for cost control, but charging retirees (pre-65 retirees) the amount equivalent to 100 percent of the active employee rate means that there will be some potential subsidizing of costs (active costs are subsidizing retiree experience). This subsidy would need to be reflected under GASB 43 and 45.

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How about Medicare Advantage Plans?

Employers are looking at Medicare Advantage (aka Medicare Risk) plans as a potential solution. Since collective bargaining may limit one's ability to reduce benefits, the offering of an additional benefit option might be a potential solution for liability reduction. Medicare Advantage plans may provide richer benefits and potentially a lower cost, so if employers have material participation, then the reduction in liability could be significant. However, making Medicare Advantage a sole or required benefit will be a challenge, but public entities can still offer as an additional option. With proper communication, this benefit could be welcomed and the GASB liability impact could be potentially material without taking any benefits away from the current or future retirees.

How Will Defined Contribution Plans Work?

Some employers are exploring introducing a fixed dollar amount benefit with two approaches for managing. The first approach is that retiree contribution rates will be established to manage to the fixed dollar amount, so future health care cost inflation increases are passed along to the retirees. This will have a material impact on the liability since future benefit projections (or in this case benefits less retiree contribution rates) are capped reducing the adverse impact of inflation on future liabilities.

The private sector has explored this option and some have implemented when FAS 106 was implemented or shortly after the employer recognized FAS 106 since the impact of the savings was material. For example, a cap would be established at say 1.5 to two times current cost, so future retiree benefits (payments in future years) would be capped at a level mitigating future health care inflation growth beyond 1.5 to two times. This does not impact costs in the current year on a pay-as-you-go basis, but mitigates future benefits, hence the actuarial unfunded liabilities.

Other approaches would be to offer a fixed dollar amount per year and let each individual buy on their own medical insurance. This is more non-traditional and in some cases have been solutions for corporations with part time employees. This becomes more complicated for the individual since they have to go out and find their own plan.

However, employers have recognized the difficulties here and have searched for organizations that can provide a concierge-type service. For example, a company called Health Plan One (*www.healthplanone.com*), which is an individual brokerage firm, helps each employee of an employer locate a medical carrier and plan design tailored to their individual needs (both cost and geography). It is an interesting approach, since it is a different level of consumerism by creating and requiring more personal choice and responsibility in purchasing medical insurance benefits. A challenge to this is that it will not work for 100 percent of the people (many states require individual medical underwriting so some people may not get the desired coverage). However, we mention this solution since it may result in significant GASB liability savings if implemented the appropriate way.

What Other Solutions Exist in the Market?

A non-traditional solution is the use of a retiree buyout. More popular in the private sector, these measures have been explored in the public sector. We have assisted several of our clients in doing a retiree buyout. These buyouts are a way to securitize and mitigate existing liability exposure with the goal of "writing a check" to take a liability off the books. It may also remove some of the administrative burden of legacy benefits for company human resource departments.

For a buyout, payment could be made to an insurance company or in some cases a trust (the latter securitized with reinsurance) and the associated liability of these benefits is passed on to the insurance company or trust. If you are using an insurance company or a trust, please keep in mind that you do not want this liability coming back so the financial strength and security of the insurance company or trust is critical. It is important that the trust has a strong insurance company or reinsurer behind it guaranteeing the payment. Although a buyout is a powerful solution both financially and politically for our customers, we warn the reader that retiree buyouts are not easy to do and require a lot of vigor and patience working with all parties involved.

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Now that we addressed GASB liabilities as an issue, where do we go from here?

What Not to do as a Public Entity

Ignore this issue. It is a real problem and needs to be dealt with. Putting your "head in the sand" and hoping it goes away is not prudent and will not work. Public entities will need a game plan—the debt and borrowing market will probably require one. People are living longer with medical technology, which is a great thing.

These public entities will be looking for actuaries for guidance, though they may struggle with the initial news that the actuary provides, which is the first GASB 43 and 45 calculations that the actuary provides. Again, there are no cookie cutter solutions, but there may be some steps and solutions that can be implemented. ■

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