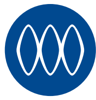
A MILLIMAN GLOBAL FIRM



Milliman
Consultants and Actuaries

PERiScope
Public Employee Retirement Systems

APRIL 2005

Managing OPEB Costs under New GASB Rules

Available Funding Options Can Help Control Costs

by John Botsford, FSA, MAAA

Last year the Governmental Accounting Standards Board (GASB) issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post-employment Benefits other than Pensions*. This new standard will require governmental employers to account for post-retirement healthcare benefits on an "actuarial basis" during an employee's career instead of using the current practice, which accounts on a "pay-as-you-go" basis during retirement.

The new accounting rules apply to "other post-employment benefits" (OPEB), which include medical, prescription drug, dental, vision, life, and long-term care (LTC) benefits for retirees. While similar rules have applied to pensions for many years under GASB 27, pension obligations for employees and retirees have generally been funded in a separate trust, whereas OPEB benefits remain largely unfunded. Although the new rules do not mandate funding OPEB obligations, funding may lead to significantly lower annual expenses and balance sheet liabilities. This article discusses several funding vehicles available to governmental plan sponsors.

Overview of New Accounting Requirements

Governmental employers subject to GASB accounting must calculate and accrue a cost based on the Annual Required Contribution (ARC) for OPEB benefits. The ARC includes an amount that covers the current normal cost (or service cost) of benefits as they are earned during active employment and an amount that amortizes the unfunded OPEB liability for prior service, if any. The excess of the ARC over the sum of contributions made to a separate trust to fund benefits and actual benefit payments made directly by the employer accumulates each year as a net OPEB obligation on the employer's balance sheet (which must be disclosed as a note in financial statements). Since the ARC may be several times greater than actual benefit payments, balance sheet net OPEB obligations might grow rapidly unless additional funds are set aside each year to reduce the balance sheet liability.

How Big Will OPEB Liabilities Be?

The size of OPEB liabilities for prior service will vary with each sponsoring employer, depending on promised benefits, average age of the employee group, the number of retirees relative to actives, etc. As a general rule, the liability for retirees alone may be 10 - 20 times current annual benefit payments. The liability for prior service of active employees significantly adds to this ratio. The ARC may be 5 - 10 times greater than current annual benefit payments. Consequently, the size of the OPEB liabilities has drawn the attention of credit rating agencies.

How Will Funding OPEB Obligations Help Control Costs?

One of the most important factors in determining OPEB liabilities and costs is the interest rate used to discount future benefit payments to the present. As a general guideline, a 1% decrease in the discount rate may cause a 15% - 20% increase in liability and the ARC. GASB rules state that the discount rate to value OPEB liabilities must reflect expected returns on assets used to pay benefits. If OPEB liabilities are not funded in advance, this means the discount rate would be the expected return on the assets of the sponsoring employer. Statutory restrictions on fund investments (and the fact that few entities have extra funds that can be invested) likely means a low rate of return on assets. This results in the mandated use of a low discount rate for OPEB liabilities (and correspondingly high liabilities and costs). On the other hand, if the OPEB liabilities are funded in advance in a separate trust dedicated to provide OPEB benefits, the assets may be invested in longer-term investments with higher expected returns.

Table 1 illustrates how the discount rate might impact OPEB liabilities and ARC costs for an employer with approximately 500 active participants and 100 retirees.

TABLE 1

	Discount Rate		
	7%	5%	3%
OPEB Liability			
Actives	$8,300,000	$12,500,000	$20,100,000
Retirees	1,700,000	2,100,000	2,700,000
Total	$10,000,000	$14,600,000	$22,800,000
Annual Required Contribution	$1,400,000	$2,100,000	$3,500,000
Current Year Benefit Payment	$200,000	$200,000	$200,000

If an employer commits to setting aside funds at least equal to the ARC each year, then the expected return on the trust fund (rather than the employer's operating funds) would be the basis for setting a discount rate. Note that simply earmarking or reserving money that remains part of the employer's general assets does not count as a contribution for this purpose under GASB 45 rules. Instead, contributions must be made to a separate trust with assets designated to pay only OPEB benefits. Since the trust would be funding long-term obligations (and possibly have fewer statutory restrictions), it may be appropriate to invest in assets expected to earn a higher return than assets invested in an employer's general account.

Funding Vehicles for OPEB Obligations

An effective funding vehicle for OPEB benefits should meet the following criteria:

- Contribution limits, if any, are high enough to allow sufficient funding.
- Earnings in trust or account are not subject to unrelated business income tax (UBIT).
- Contributions to the trust are not taxable to employees, and benefit payments from the trust are not taxable to retirees.
- Funds are protected from creditors.

Although there are many funding options that meet some of the above criteria, three options—VEBAs, 401(h) accounts, and Section 115 Trusts—offer the best means for governmental employers to fund their OPEB Obligations. A sponsor could also accomplish somewhat similar results by purchasing insurance for future benefits, although the availability and affordability of insurance may be a problem.

A VEBA (Voluntary Employee Beneficiary Association) Trust may be established under IRC Section 501(c)(9). This is a separate trust for the sole purpose of paying OPEB benefits to retirees and is governed by both employer and employee trustees. OPEB benefit payments from a VEBA are tax-free to the retiree. UBIT on earnings within the trust is avoided if either the trust is maintained pursuant to a collective bargaining agreement or if all contributions to trust are made by a tax-exempt employer—conditions generally met by entities reporting under GASB 45. Some governmental employers already fund VEBAs as a way to earn a better return on assets set aside for OPEB benefits. VEBAs allow for funding up to the total OPEB liability, although expected increases in health costs may not be permitted in determining limits on funding. For most employers, these limitations will not restrict contributions for many years.

Alternatively, a governmental employer that also sponsors a pension trust may set up an account under IRC Section 401(h). This type of account is considered a sub-account of the pension trust. Contributions to the sub-account are included for GASB OPEB accounting purposes. These accounts provide the same tax-free earnings on investments as pension trusts, and assets can be invested easily and efficiently to earn higher returns compared to operating funds. The 401(h) account assets cannot be used to fund pensions, unless all OPEB benefits have been paid and no OPEB liabilities remain. Contributions are limited to one third of normal pension cost, which in many instances may be high enough to allow funding of the ARC. However, this funding option may not be possible if an employer's pension is provided through contributions to a state PERS program.

Still another option is to set up a governmental sponsored trust under IRC Section 115. Funds in a Section 115 trust held for a governmental purpose and funded by a tax-exempt governmental agency are not subject to income tax. OPEB benefits paid to retirees from a Section 115 trust are tax-free. Also, contributions to a Section 115 trust are not limited, as under 401(h) accounts or VEBAs. Section 115 trusts are not required to have the same limitations on usage of funds (i.e., the sponsoring governmental employer could decide at a later date to use the funds for something other than paying benefits). Although this feature allows the employer more flexibility, contributions would not count under GASB 45 accounting (i.e., they would not reduce the OPEB liability on the balance sheet) unless the trust was designed as an irrevocable trust. The IRS has issued little guidance with respect to the use of Section 115 trusts for funding OPEB benefits. Therefore, a governmental employer should seek advice from its attorney and perhaps an opinion from the IRS (known as a private letter ruling) to confirm that OPEB benefits paid from an irrevocable Section 115 trust are not taxable to retirees.

Conclusion

Governmental employers that sponsor OPEB plans may wish to consider funding OPEB benefits for several reasons. Funding may lead to lower actual plan costs over the long run due to higher returns on assets set aside in a trust compared to the return on general operating funds. Funding should lower the accounting liability and annual expense due to higher expected returns on assets and a higher discount rate used for valuing OPEB liabilities. Thus funding may reduce potential impact of the OPEB liability on borrowing costs. Finally, promised benefits to retirees would be more secure.

John Botsford is a consulting actuary with Milliman's San Francisco office.

If you are receiving a hard copy of PERiScope and would like to receive it electronically, please email us at periscope@milliman.com or visit our subscription website at http://www.milliman.com/eb/publications/subscriptions.asp?pub=periscope.

This publication is intended to provide information and analysis of a general nature. Application to specific circumstances should rely on separate professional guidance. Inquiries may be directed to: Brent Banister, Editor; 1120 South 101st Street, Suite 400, Omaha, NE 68124-1088; (402) 393-9400; periscope@milliman.com

OFFICES IN PRINCIPAL CITIES WORLDWIDE

©2005 Milliman, Inc.
All Rights Reserved