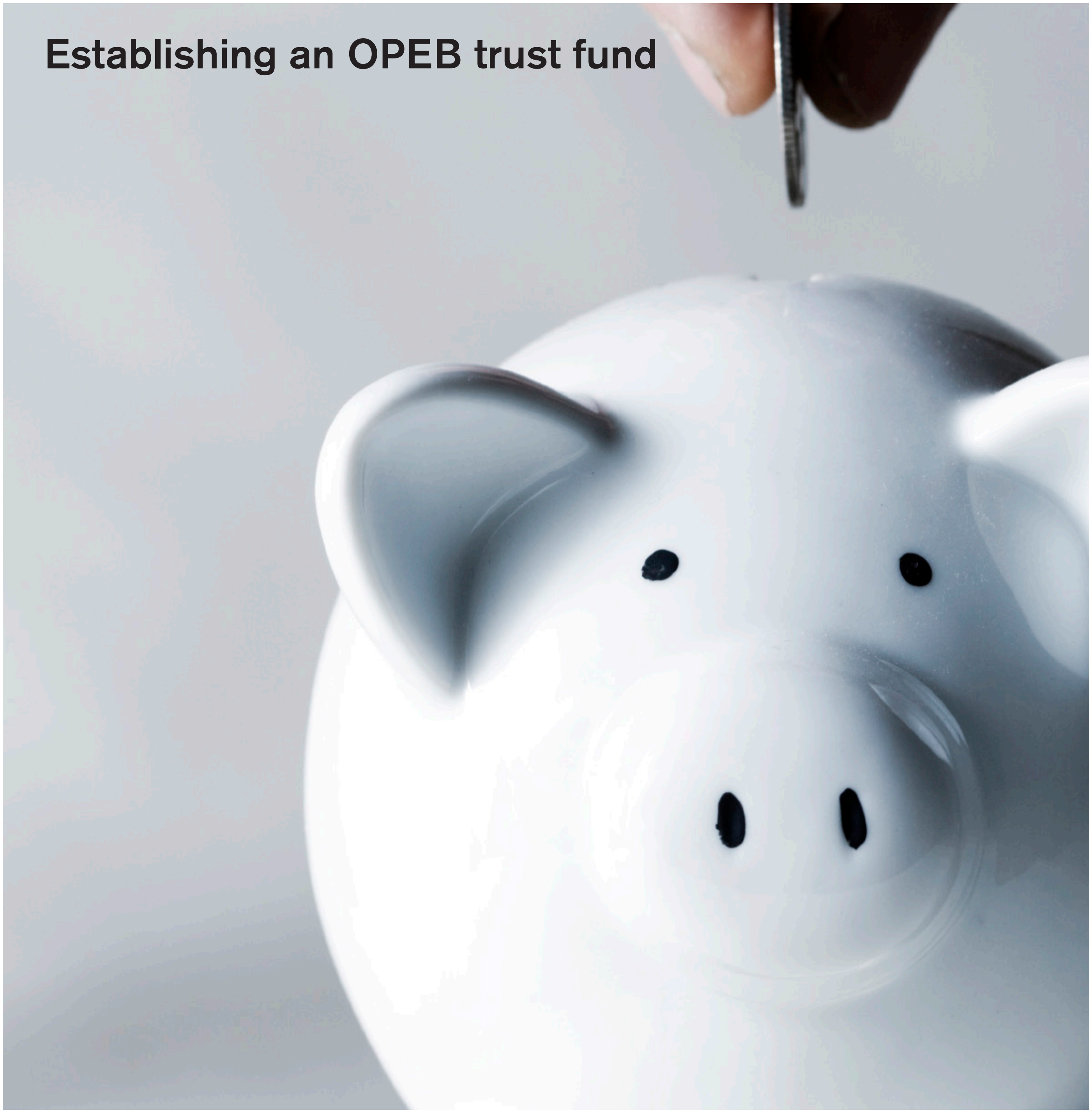
Milliman

Milliman OPEB Consulting Services

Establishing an OPEB trust fund



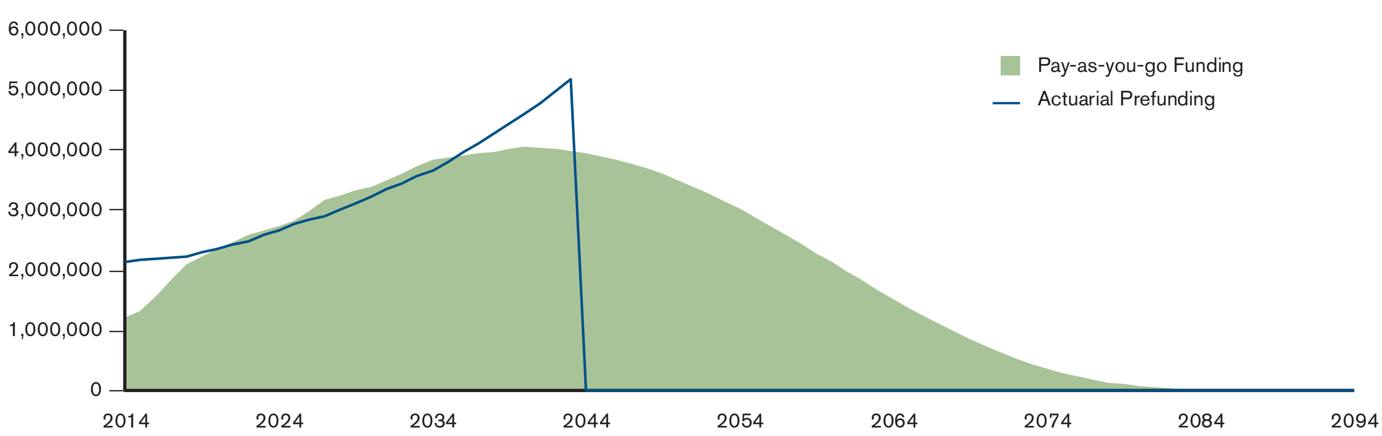
Prior to the implementation of the accounting standards under GASB 43 and GASB 45 in recent years, most public sector employers had not established a trust fund for "other postemployment benefits" (OPEB). Now that employers are aware of the large magnitude of the actuarial liabilities for OPEB benefits, they are looking at ways to manage and reduce those costs. In addition, municipal budgets continue to be under extreme pressure in general, which is adding another reason to find solutions to the current situation. Establishing a trust fund is one way to address the challenges that public sector employers are facing with respect to OPEB benefits.

WHY SHOULD YOU SET UP AN OPEB TRUST FUND?

Reason #1 – Harness investment returns to help pay for the benefits. In the absence of a dedicated trust fund, an employer pays for OPEB benefits on a "pay-as-you-go" basis as eligible participants retire and receive those benefits. Once a trust is established, the employer funds the OPEB benefits each year while the participant is working, and those accumulated contributions—together with investment returns compounded over the participant's career—are designed to fully pay for the OPEB benefits that the participant is expected to enjoy during his or her retirement. The power of compound interest generates a significant amount of investment return over a participant's career, thereby resulting in a significant reduction in the employer's contributions needed to fund the OPEB benefits versus the amount needed under the pay-as-you-go approach.

In Figure 1, the projected annual cost is shown for the OPEB benefits payable for a sample group of participants for a public sector employer. Without an OPEB trust fund, this employer is expected to make payments of about $160 million over the lifetime of the plan for the existing participants. In contrast, if the employer establishes a trust and actuarially prefunds the OPEB benefits, it is expected that investment income will total about $62 million over the same period, assuming that investment return on OPEB trust fund assets is 7.25% per year. The investment income reduces the employer's contributions dollar for dollar, so the employer's funding cost is lowered to approximately $98 million over the lifetime of the plan (a reduction of about 39%).

FIGURE 1: ANNUAL COST FOR A CLOSED GROUP



	WITHOUT A TRUST	WITH A TRUST
Employer payments	$160,000,000	$98,000,000
Investment income (7.25%)	0	62,000,000
Total cost of benefits	**160,000,000**	**160,000,000**

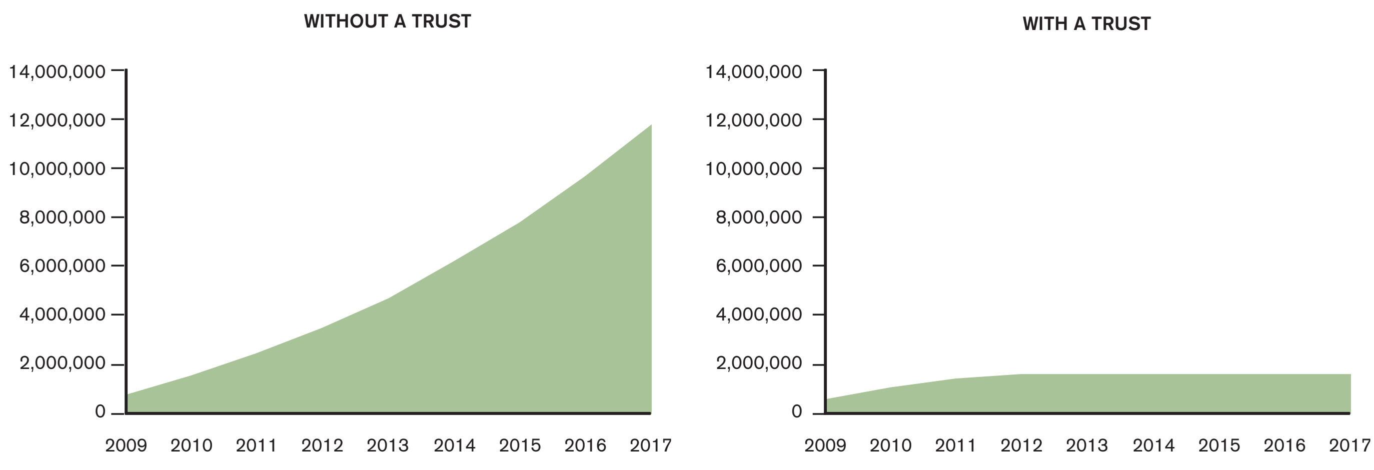
Reason #2 – Improved financial statement and favorable view from credit rating agencies. Under the GASB accounting standards, the actuarial valuation of the OPEB benefits must reflect an investment return assumption—also known as the “discount rate”—that is consistent with the expected long-term rate of return on the assets used to pay those benefits. Figures 2 and 3 below contain examples of how the discount rate affects financial disclosures under GASB 43 and GASB 45. In Figure 2, an employer that is using a pay-as-you-go approach is paying OPEB benefits from general fund assets, which are typically invested in short-term instruments that are expected to earn 4% per year over the long term. The actuarial liability for OPEB benefits is about $200 million, and the annual actuarial cost (annual required contribution, or “ARC”) reported in the financial statement is about $14.3 million. The employer is allowed to recognize the pay-as-you-go retiree OPEB payments of about $7.5 million toward the annual actuarial cost. The resulting shortfall of roughly $6.8 million is recorded as long-term debt on the employer’s balance sheet, and is called the “net OPEB obligation.” If the employer sets up an OPEB trust that generates an investment return of 8% per year over the long term, and if the employer actuarially prefunds the benefits, then the actuarial liability is reduced to about $121 million (a 39% reduction) and the ARC is lowered to $10.6 million (a 26% reduction). The employer prefunds $3.1 million, which is the difference between the $10.6 million ARC and the $7.5 million in OPEB benefits currently being paid to retirees. In this example, the employer has fully covered the annual actuarial cost of $10.6 million by making the full $3.1 million prefunding contribution. As a result, there is no net OPEB obligation developed and there is no long-term debt on the balance sheet for OPEB benefits.

FIGURE 2: GASB 45 DISCLOSURES LOOK BETTER WITH A MORE FAVORABLE DISCOUNT RATE

WITHOUT A TRUST		WITH A TRUST	
Discount rate	**4.00%**	Discount rate	**8.00%**
Accrued Liability	200,537,200	Accrued Liability	121,357,100
Annual Required Contribution	14,339,000	Annual Required Contribution	10,565,800
Expected annual benefit payouts	7,486,500	Expected annual benefit payouts	7,486,500
Net OPEB Obligation	6,852,500	Net impact on budget	3,079,300

Figure 3 shows the long-term impact of an OPEB trust on the net OPEB obligation. If no trust is established, the net OPEB obligation continues to grow over the years, since the pay-as-you go cost consistently falls short of the annual actuarial cost. On the other hand, if the employer sets up an OPEB trust and regularly makes prefunding contributions, the net OPEB obligation remains low or zero. Note that in this particular example, the employer implemented a five-year phase-in strategy to ease into full prefunding of OPEB benefits. Therefore, a relatively small net OPEB obligation developed in the initial years, and then did not increase once the employer began to fully prefund the benefits within five years.

FIGURE 3: NET OPEB OBLIGATION REMAINS LOW OR ZERO



5-year phase-in strategy being used to ease into full prefunding

Credit rating agencies are also looking at GASB 45 as a management issue, as summarized in Figure 4 below. Establishing an OPEB trust and consistently prefunding the benefits shows the rating agencies that long-term obligations are being funded, that the municipality's ability to pay debt service is not hampered over the long term, and that management is on top of the OPEB issue.

FIGURE 4: CREDIT RATING AGENCIES ARE ALSO LOOKING AT GASB 45 AS A MANAGEMENT ISSUE

WITHOUT A TRUST	WITH A TRUST
Long-term obligations are not being funded	Long-term obligations are being funded
Ability to pay debt service is hampered	Ability to pay debt service is not hampered
We are not on top of the issue	We are on top of the issue

Reason #3 – Enhance intergenerational taxpayer equity. Setting up an OPEB trust fund enhances intergenerational taxpayer equity by having the employer (and taxpayers) fund OPEB benefits during the same time period that the plan participants are earning those benefits. Figure 5 shows the impact on taxpayers if an OPEB trust fund is established. Without an OPEB trust fund, this hypothetical town employee works for the town for 20 years, but the employer does not record any costs for OPEB benefits from 2014 through 2034. Only when this employee retires in 2034 does the town (and the taxpayers) begin to pay for OPEB benefits on a pay-as-you-go basis. As a result, future generations of taxpayers are paying for OPEB benefits that were earned in the past. However, if the town sets up an OPEB trust and prefunds the benefits during this employee's career, then the OPEB benefits are fully funded by 2034, and future generations of taxpayers stop paying for OPEB benefits that were earned long ago.

FIGURE 5: TAXPAYER IMPACT

WITHOUT A TRUST

2014	2034	2044
Pat Smith works for town Town does not prefund OPEB benefits Taxpayers only pay for current comp	Pat retires Pat's OPEB benefits are not funded Taxpayers **start** paying for Pat's OPEB	Pat lives on Town pays on Taxpayers pay on

WITH A TRUST

2014	2034	2044
Pat Smith works for town Town prefunds Pat's OPEB benefits Taxpayers pay for all of Pat's benefits	Pat retires Pat's OPEB benefits are fully funded Taxpayers **stop** paying for Pat's OPEB	Pat lives on

IMPLEMENTATION ISSUES

Legal issues

Milliman recommends that you contact your own legal counsel to discuss the various legal issues involved in establishing an OPEB trust fund. Those issues may include, but are not necessarily limited to, governance issues (Which governing body will control the trust? Which governing body will administer the trust?), authority to establish the trust (Does an ordinance or statute exist that allows for such a trust?), and document issues (A legal document typically will need to be created with respect to the trust).

Investment issues

Milliman's Consulting team assists OPEB trusts in a number of areas integral to the implementation of the trust, meeting their fiduciary duties and ongoing investment oversight:

Trust establishment:

- Initially setting up a custodial account will be required to fund the OPEB trust. Understanding the various options among custodial accounts and the variety of investment vehicles available across the platforms is key to the initial setup process.

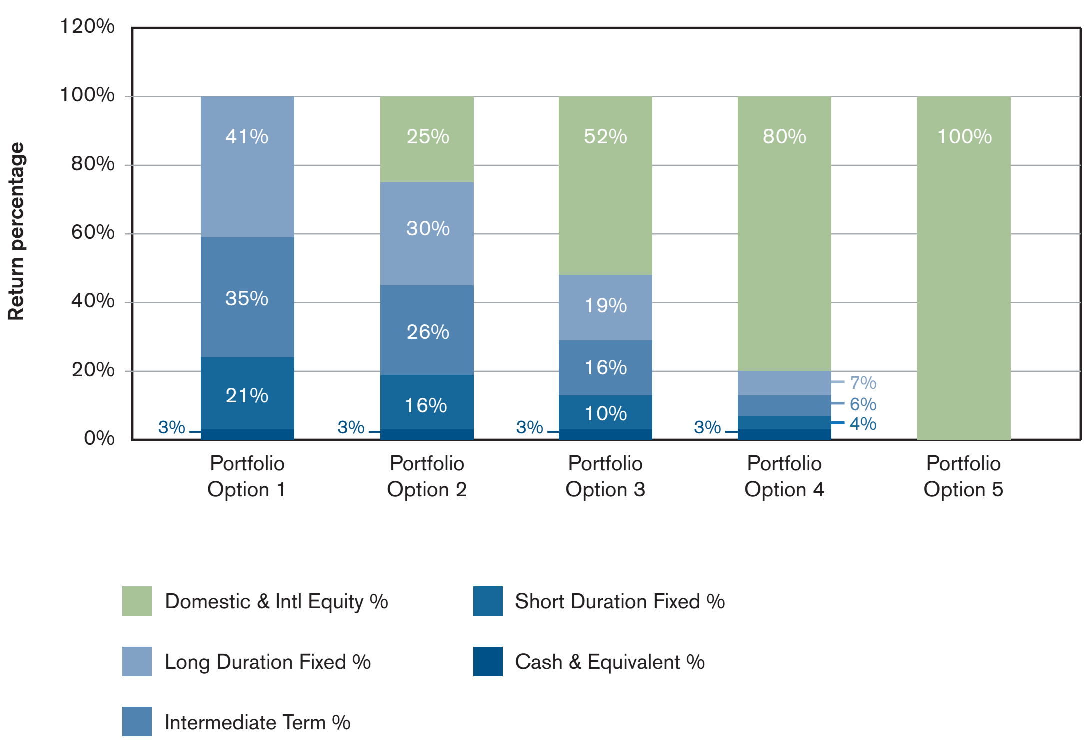
Investment policy statement (IPS) drafting:

- The IPS serves to provide a formally documented mandate for the fiduciaries to follow in the execution of the plan's investment strategy. The statement lists the plan's general goals and objectives, and covers key areas such as asset allocation and risk parameters, along with legal, liquidity, and investment constraints. A solid, well-outlined IPS is essential not only to the effective management of plan assets, but also to help protect fiduciaries from liability.

Asset allocation optimization:

- The investment consulting and actuarial teams should work in unison to determine a target rate of return, which will be used as the foundation in an asset allocation study designed to find the efficient means of achieving this return. Incorporated into the study are matters such as risk tolerance, capital market assumptions, results of the asset-liability model, and macroeconomic concerns. Studies typically include a few to several scenarios, from which the trust's administration should understand the impact of the risk and return on their investment portfolio. Figure 6 illustrates output from a sample asset allocation optimization study. Another consideration is regularly reviewing and rebalancing the trust's investment allocation to ensure that investments stay within a reasonable range of the target allocation weights.

FIGURE 6: EFFICIENT ASSET ALLOCATION OPTIONS



Asset-liability modeling:

- OPEB trusts and pension plans do not share the same cash-flow assumptions; timing and size will be different. Relative to pension benefits of the same populations, OPEB benefits are greater in the short run, decreasing over time. To this end, OPEB investment allocations should be tailored to the shorter duration, and reflect the trust's unique liability structure, rather than that of any associated pension plan.

- Asset-liability analysis should analyze the entire OPEB structure to more accurately predict the timing of benefits. The output from this analysis is designed to facilitate an investment strategy that efficiently satisfies the trust's cash-flow demands, which in turn can alleviate liquidity pressures and optimize contributions. This means greater savings, and, of course, less capital that you have to budget from core operations to your postretirement benefit obligations.

Investment manager selection and portfolio performance monitoring:

- Trusts typically have a profile that includes a number of investment funds, each mandated to a particular style or category within its asset class (e.g., large-cap domestic equities, intermediate-duration fixed income, emerging market equities, etc.).

- Consideration of active versus passive-index manager strategies may be an initial step in developing an investment portfolio to meet the allocation targets developed in the asset allocation optimization study.

- Manager selection consists of two factors:
  - *Quantitative analysis:* including a review of the performance, risk analytics, management expenses, peer group analysis and various other measurements of manager effectiveness.
  - *Qualitative due diligence:* including developing an understanding of the policy of the manager for the investment vehicle(s), the overall organization and staff, research structure, buy-sell policies and other team and corporate issues.

- Once managers are selected, the process is not over. Ongoing monitoring is essential to ensure that investment managers continue to follow their policies, as well as meet their performance and risk expectations.

Many public sector employers sponsor defined benefit pension plans and also maintain formal investment policy guidelines regarding the pension fund assets. While it may be tempting to use those same guidelines for OPEB benefits without modification, we recommend that OPEB trustees carefully review the structure of the OPEB liabilities along with the particular circumstances surrounding their OPEB program.

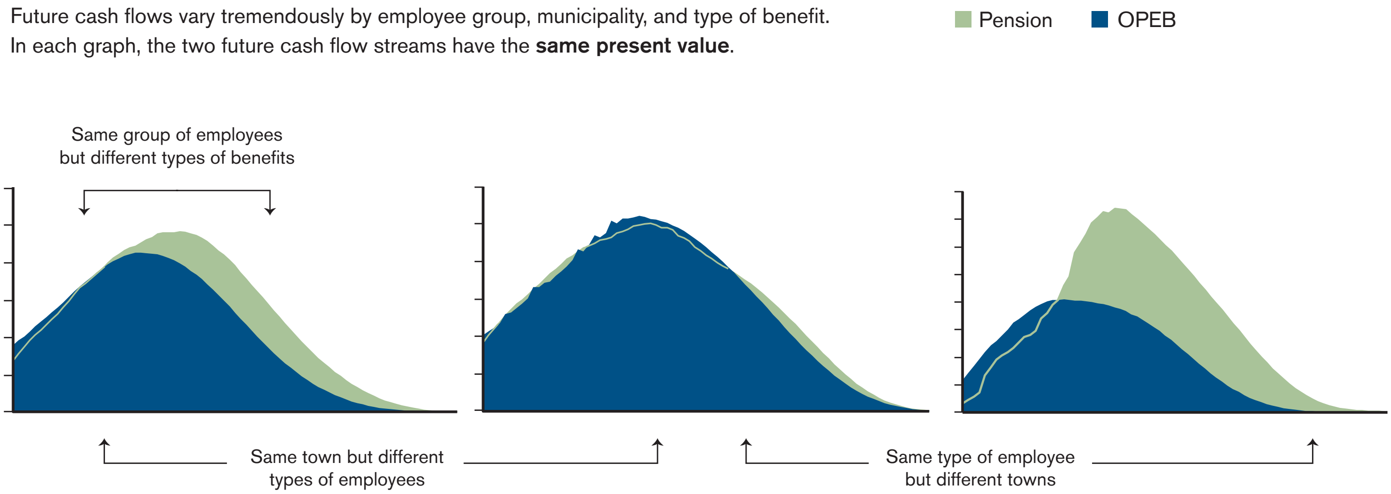
The investment allocation for the OPEB trust should reflect the timing and size of benefits that will eventually be paid out of the trust. As shown in Figure 7 on page 6, OPEB benefits do not have the same timing and size as pension benefits. As a result, OPEB trusts should not necessarily have the same investment allocation as pension trusts.

Figure 7 also shows that future cash flows vary tremendously by employee group, municipality, and type of benefit. For example, OPEB benefits for public safety groups tend to have a high duration, since participants often retire at a relatively young age and both pre-65 and post-65 benefits are provided. In contrast, OPEB benefits for a general government group may have a very short duration, since the average age at retirement may be at about age 60, and if only pre-65 benefits are provided through the municipality's OPEB program.

In general, OPEB benefits tend to be larger in the short run and smaller in the long run compared to pension benefits for the same population. As a result, OPEB asset allocations should reflect this generally shorter duration. However, each OPEB program will have a different liability structure, so asset allocations and investment policy guidelines need to be analyzed and established on a case-by-case basis.

FIGURE 7: THE STRUCTURE OF OPEB LIABILITIES

Future cash flows vary tremendously by employee group, municipality, and type of benefit.
In each graph, the two future cash flow streams have the **same present value**.



HOW MILLIMAN CAN HELP

Milliman can assist your organization in a variety of areas with regard to your OPEB—including developing actuarial valuations and projections on funding, creating funding and investment policy statements to invest your contributions, coordinating the funding through a custodian, and selecting and monitoring investment managers.

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

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For further information, please contact your local Milliman office or:

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