Investment trusts for OPEB: The right thing at a better price

Milliman

Rebecca A. Sielman
FSA

Thanks to the urgency created by Governmental Accounting Standards Board (GASB) Statement No. 45, many government employers have put a dollar value on their liability for other post-employment benefits (OPEB), and some are now taking steps to manage the long-term cost implications of these expensive benefits. The OPEB numbers can be staggering, raising a big question: What do we do about this liability? One option is to establish a trust and start prefunding the benefits.

If the benefits are important and the intent is to keep them in place, then prefunding makes sense. The old pay-as-you-go basis, with benefits reimbursed out of current revenues, no longer cuts it.

For state and local governments and other public-sector employers, establishing an OPEB trust:

- improves the financial statement and status in the eyes of credit-rating agencies (for when the time comes to borrow money for capital improvements)
- harnesses investment returns to help pay for the benefits
- enhances intergenerational equity, allowing today's taxpayers to pay for the future benefits of today's public workforce

By contrast, failing to prefund could impact the jurisdiction's credit ratings, future borrowing ability, and, ultimately, overall fiscal health.

A government that prefunds the full actuarial amount each year will have a net OPEB obligation of zero, but a government that continues pay-as-you-go funding will have a large and rapidly growing net OPEB obligation—potentially a red flag for credit raters.

DISCOUNT RATE ADVANTAGE

Because GASB 45 allows use of a higher discount rate—say 7% to 8%—when computing OPEB liabilities, having a trust reduces the actuarial accrued liability. With no trust, an employer has to use lower discount rates—say 4% to 5%. Lower discount rates mean higher liabilities. That difference can significantly affect a financial statement.

CHART 1: EFFECT OF OPEB TRUST

	WITH A TRUST	WITHOUT A TRUST
DISCOUNT RATE	8.00%	4.00%
ACCRUED LIABILITY	$121,357,100	$200,537,200
ANNUAL REQUIRED CONTRIBUTION	$10,565,800	$14,339,000
EXPECTED ANNUAL BENEFIT PAYOUTS	$7,486,500	$7,486,500
NET IMPACT ON BUDGET	$3,079,300	N/A

GASB 45 also requires financial statements to keep track of how much has been *actually* set aside in an OPEB trust to prefund the benefits, compared to an actuarially determined prefunding contribution. The resulting number is called the net OPEB obligation, and it shows up right on the financial statement balance sheet, rather than hidden away in footnotes.

A government that prefunds the full actuarial amount each year will have a net OPEB obligation of zero, but a government that continues pay-as-you-go funding will have a large and rapidly growing net OPEB obligation—potentially a red flag for credit raters.

But it's not just the numbers that are important. Credit-rating agencies have made it clear that they are also looking at how governments deal with GASB 45 as a *management* issue: How will unfunded OPEB benefits impact an employer's ability to make debt-service payments? Is there a plan for controlling long-term costs? *Setting up an OPEB trust is a positive sign that a government is on top of the issue.*

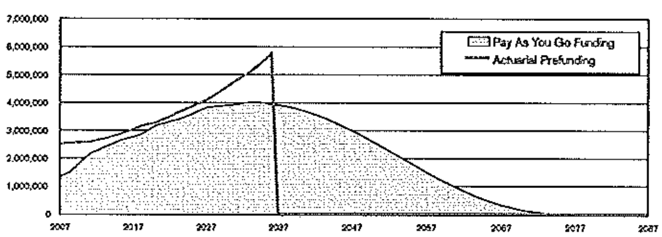
LONG-TERM SAVINGS

An OPEB trust can lighten the burden of retiree insurance benefits, which typically are for medical coverage but can also cover prescription drugs, dental, life insurance, disability, and/or long-term care insurance.

The trust impact can be considerable: in 2007, the California Public Employee Post-Employment Benefits Commission reported that "the investment returns brought about by prefunding could eventually pay for up to 75% of retiree health care benefits."[1] The report relied on the experience of California pension funds, which are supported to that degree from defined benefit trusts.

The example illustrated in Chart 2, Annual Cost for a Closed Group, is more modest in scope. In this example, the sponsoring government has eliminated OPEB benefits for any future employees and will be prefunding for just the next 30 years. But investment income even in this modest situation is expected to pay for 33% of the benefits.

CHART 2: ANNUAL COST FOR A CLOSED GROUP



	WITH A TRUST	WITHOUT A TRUST
EMPLOYER PAYMENTS	**$110,000,000**	**$165,000,000**
INVESTMENT INCOME	**$55,000,000**	**$0**
TOTAL COST OF BENEFITS	**$165,000,000**	**$165,000,000**

New OPEB trust investments won't yield much dollar support early on, but the potential is there. Every dollar that municipalities can set aside now, earning a 7% or 8% investment return, will provide long-term savings.

DOING RIGHT BY TAXPAYERS

Financing OPEB benefits on a pay-as-you-go basis means that the wrong generation of taxpayers is footing the bill. The taxpayers who live in a community today should be paying the costs of their public servants, not leaving that bill for the next generation. Consider these two scenarios:

CHART 3: INTERGENERATIONAL TAXPAYER EQUITY

WITH A TRUST

2007	2027	2047
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 <u>stop</u> paying for Pat's OPEB.**	**Pat lives on.**

WITHOUT A TRUST

2007	2027	2047
Pat Smith works for town. Town does not prefund Pat's OPEB benefits. Taxpayers only pay for current compensation.	**Pat retires. Pat's OPEB benefits are not funded. Taxpayers <u>start</u> paying for Pat's OPEB.**	**Pat lives on. Town pays on. Taxpayers pay on.**

This notion of intergenerational taxpayer equity underpins the funding of public-sector pension plans. It is nearly universal practice to have pension trusts and prefund pension benefits. In fact, both Massachusetts and Rhode Island have recently taken steps to shore up the funded status of pension plans in their municipalities.

Understandably, there is widespread concern about the number of public pension plans with funded ratios of just 60% or 70%. Now consider that the liability for OPEB benefits is comparable in size to the liability for pension benefits in many communities: Should OPEB plans with funded ratios of 0% also be a source of concern?

1 Public Employee Post-Employment Benefits Commission (California). "Funding Pensions & Retiree Health Care for Public Employees: A Report for the Public Employees Post-Employment Benefits Commission," August 2007, p. 177. http://www.pebc.ca.gov/images/files/final/080107_PEBCReport2007.pdf

TOUGH DECISIONS

Communities are at different stages on the OPEB continuum as they struggle to pick the best (and most politically acceptable) course of action. While there is great uncertainty about healthcare and retirement funding, officials can move ahead with a trust knowing they have a sound approach that can adapt to a changing environment.

To be fair, it's important to acknowledge that the decision to set up an OPEB trust and prefund the benefits is a difficult, politically sensitive one. Establishing a trust means paying more for benefits up front, which typically requires raising taxes–without the benefit of a new school, filled potholes, or more police officers to show for it. With all the dollar demands for government services today, officials already face disgruntled taxpayers. A prefunded trust can help maintain intergenerational equity and ensure that retiree medical benefits stay off the short list of community concerns.

Rebecca A. Sielman, FSA, EA, is a principal and consulting actuary in the Hartford, Conn., office of Milliman Inc. She has extensive technical and consulting experience in all aspects of defined benefit pension plans–public and private–and has been involved in all aspects of OPEB accounting, from valuation to plan design to strategic consulting. Contact her at 860.687.0125 or at becky.sielman@milliman.com.

80 Lamberton Road
Windsor, CT 06095-2126
+1 860 687-2110
www.milliman.com