



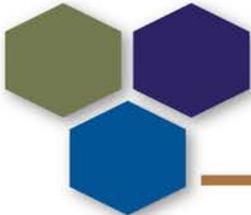
Considerations for Pre-Funding an OPEB liability

GFOA SC – Spring Conference
May 5, 2014

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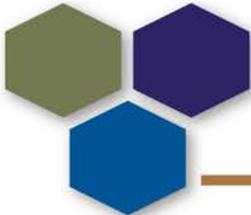
Introduction

- ◆ The balance sheet liability or Net OPEB Obligation (NOO) continues to grow for most employers
 - ▶ NOO = cumulative difference between the OPEB expense and the cash costs
- ◆ If the GASB rules change, the entire unfunded liability would be recognized on the balance sheet
- ◆ GFOA advises pre-funding OPEB liabilities as a best practice
 - ▶ Most employers have not established formal trusts to prefund the OPEB liability



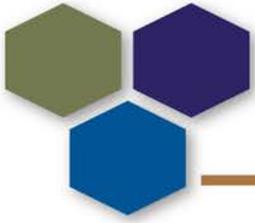
Arguments for pre-funding

- ◆ Favorable accounting impact
- ◆ Builds an asset to fund benefits **as they are earned**; promotes intergenerational equity
- ◆ Prefunding can substantially reduce the long-term costs
- ◆ Demonstrates commitment to secure a promised benefit
- ◆ Credit rating



Arguments against pre-funding

- ◆ May limit flexibility in plan design
- ◆ Retiree medical benefits are not guaranteed and are subject to constant review; there is no promise
- ◆ Funding may reduce capital available for compensating current employees or city projects
- ◆ May prefund a benefit that significantly changes in the future; funding a trust is traditionally viewed as a long-term investment
- ◆ Does the implicit subsidy merit pre-funding?



Defining the Objective

“If you don’t know where you are going, you’ll end up someplace else.”

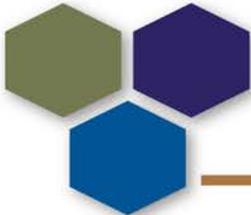
- Yogi Berra

“Always plan ahead. It wasn’t raining when Noah built the ark.”

- Stephen Covey

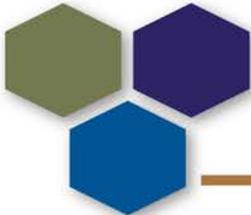
“Prediction is difficult, especially about the future...”

- Yogi Berra



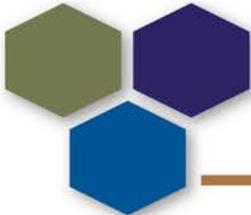
Goal # 1 - Keep the balance sheet liability from growing

- ◆ Just need to fund the ARC, for now
- ◆ Accounting rules may change?
(similar to GASB 68)
- ◆ May desire the smallest ARC allowable under the current rules
- ◆ 30-year, level percentage of payroll amortization provides for very slow funding progress (may lead to asset depletion)
- ◆ May take many years before the ARC is less than the pay-go benefits (dead money)



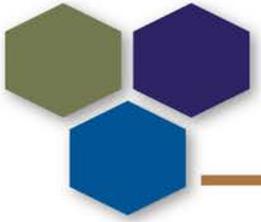
Goal #2 – Funding goal other than 100% fully funded

- ◆ Reserve of 1-3 years of benefits
- ◆ Dollar target for trust assets
- ◆ Reserve for bad claims year
- ◆ Only fund the explicit subsidy
- ◆ Blended discount rate – what % of future benefits will be paid by the trust?

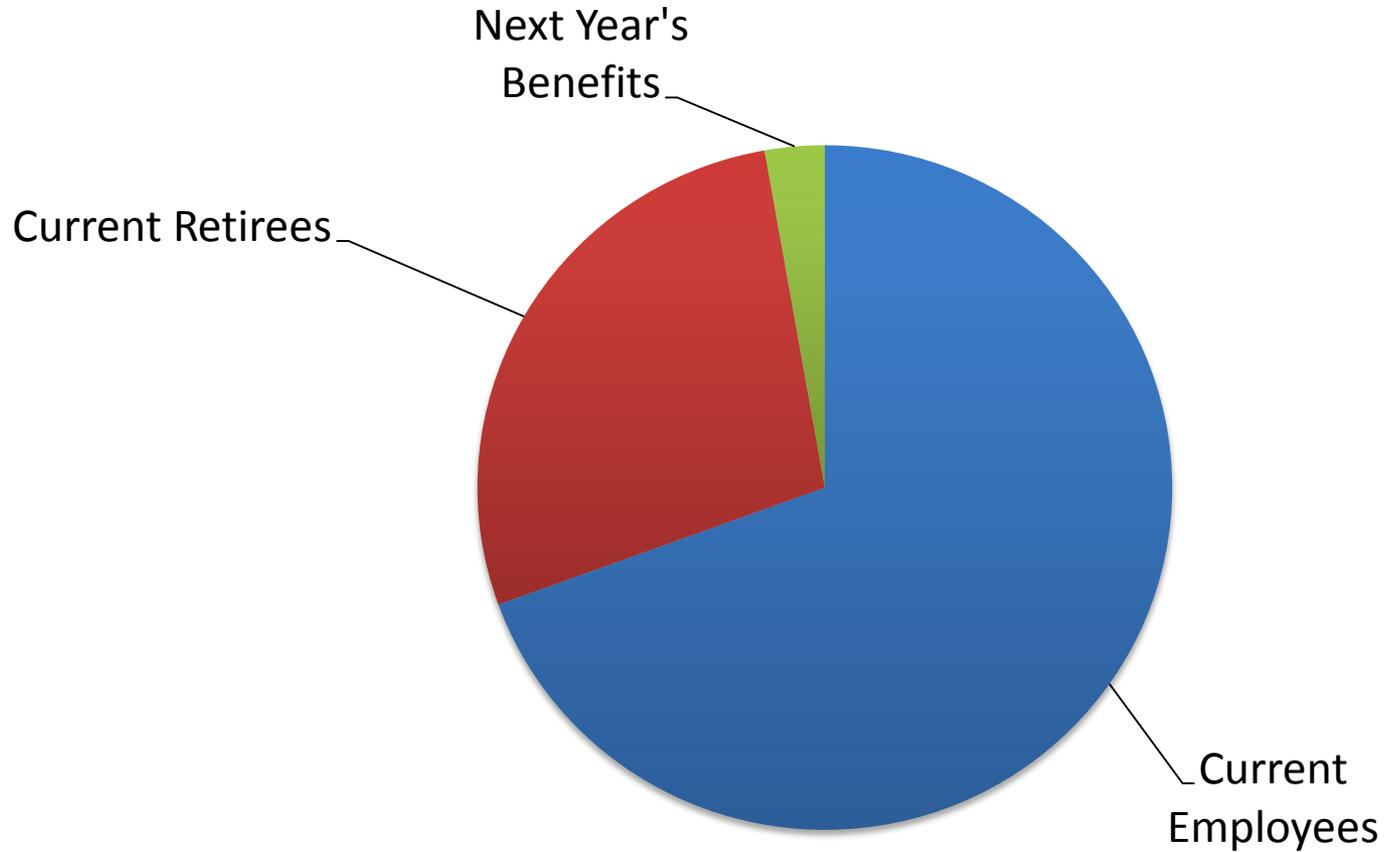


Goal #3 – Desire 100% funded actuarial liability

- ◆ Close the amortization period
- ◆ Fund the implicit subsidy
- ◆ Initial start-up contribution?
- ◆ Level \$ vs Level \$ amortization
- ◆ Entry Age Normal vs. Projected Unit Credit
- ◆ Amortizing gains/losses

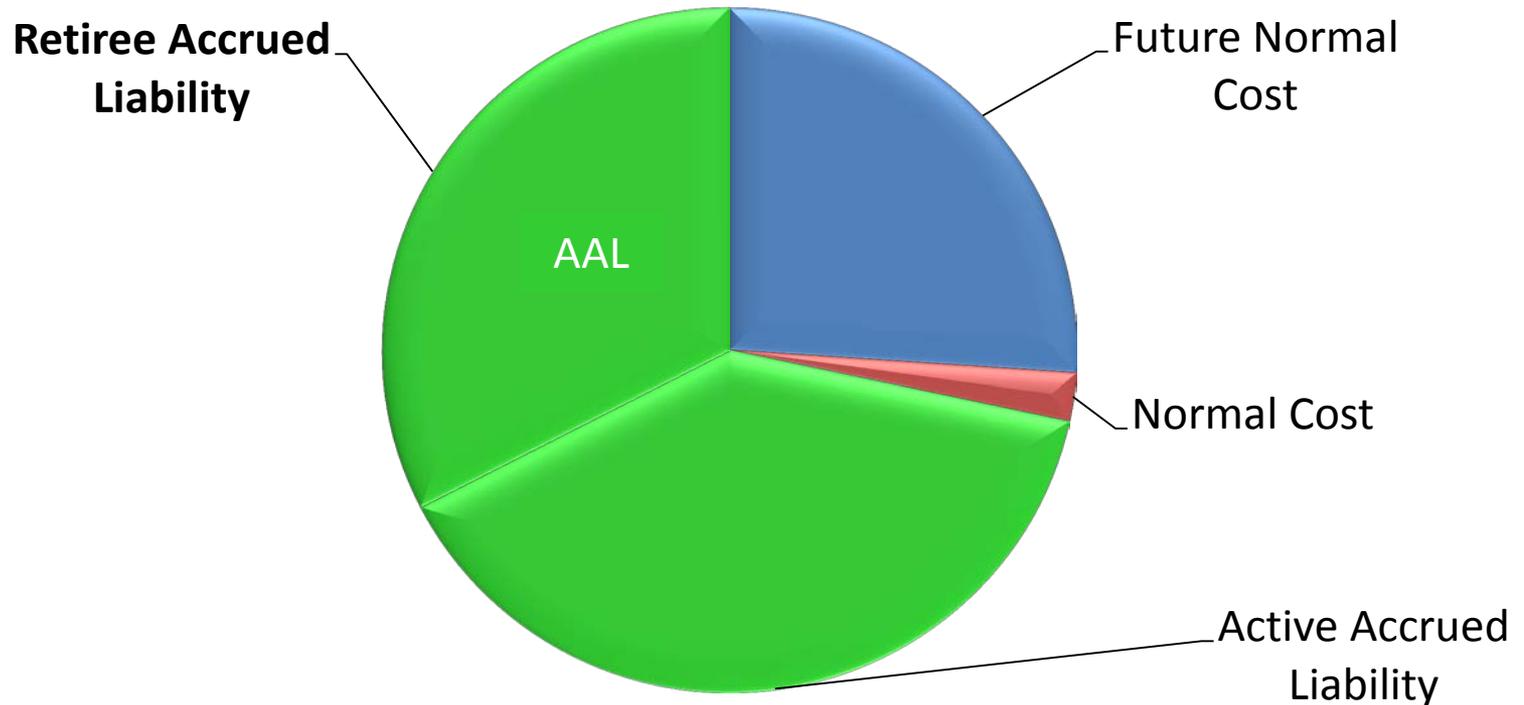


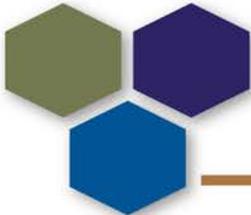
Present Value of Future Benefits



What is Normal Cost?

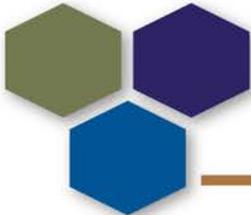
Present Value of Future Benefits





Review the GASB 45 ARC

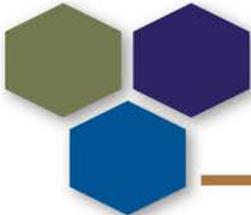
- ◆ The ARC is designed to
 - ▶ save for the active employees (normal cost); and
 - ▶ pay catch-up contributions for unfunded past liabilities (amortize UAAL)
- ◆ The ARC should eventually be lower than the pay-go costs



Amortization of UAAL – Open vs. Closed

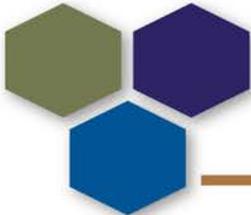
◆ Open vs. Closed amortization

- ▶ GASB allows an employer to amortize the UAAL over a maximum period of 30 years.
- ▶ An employer can keep the same amortization period each year (open amortization) or decrease the amortization period in following years (closed amortization)
- ▶ Most employers will choose an open amortization due to lack of funding objectives
- ▶ A closed amortization schedule will accelerate funding progress
- ▶ A longer amortization period will reduce the volatility in the ARC



Level \$ or Level % of Payroll Amortization of UAAL

- ◆ Level dollar amortization:
 - ▶ like a traditional home mortgage.
 - ▶ same payment is made every year
 - ▶ some principal is paid at the beginning
- ◆ Level percentage of payroll amortization:
 - ▶ payment should grow each year
 - ▶ payments can be less than the interest at the beginning (negative amortization)
 - ▶ If the amortization period is over 20 years, UAAL is expected to grow even if the ARC is paid
 - 7.5% discount rate and 3.0% payroll growth assumptions



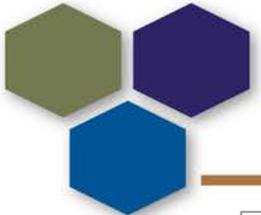
30-year open, level % of payroll amortization of the UAAL.

◆ Reasons for:

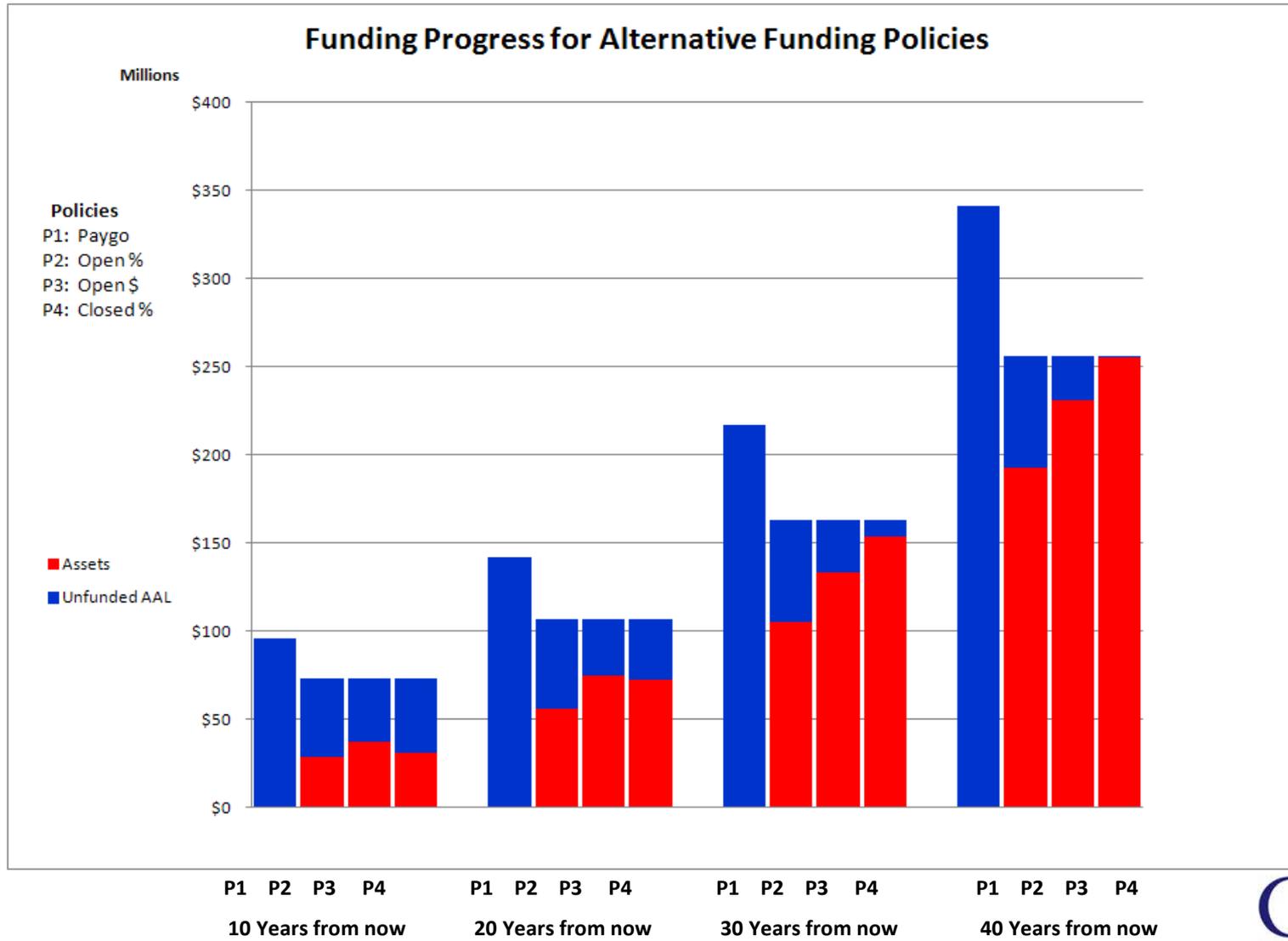
- ▶ Smallest ARC allowed under GASB 45
- ▶ Don't want to play catch-up for past unfunded liabilities; focus on paying the normal cost (current and future service)
- ▶ Funded ratio usually improves

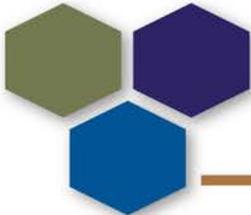
◆ Reasons against:

- ▶ ARC and UAAL will be expected to grow
- ▶ ARC will exceed pay-go costs for many years
- ▶ May deplete assets if benefits are front-loaded

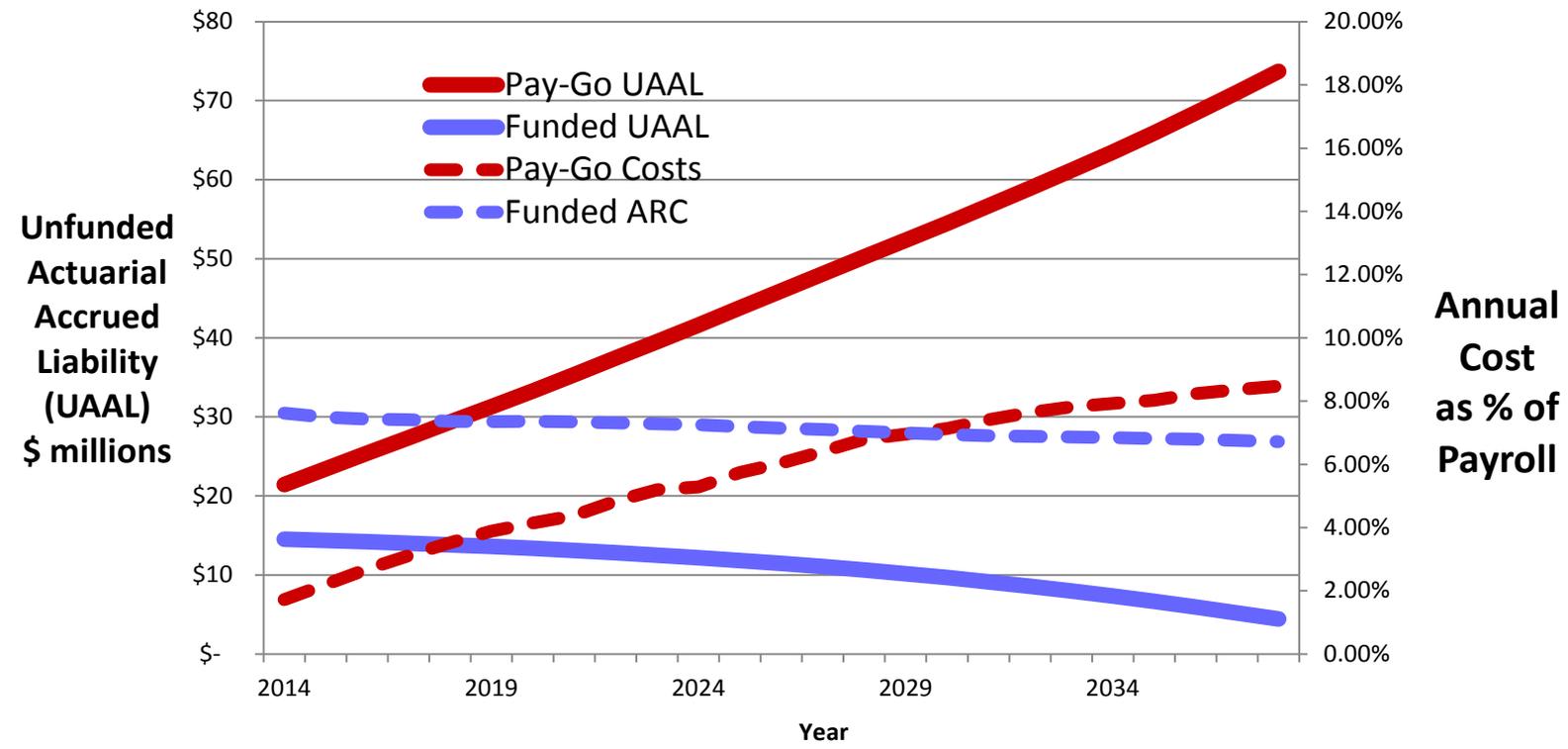


Hypothetical Plan – Funding Progress

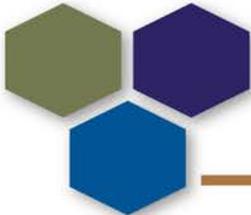




Pay-Go versus Funding Example

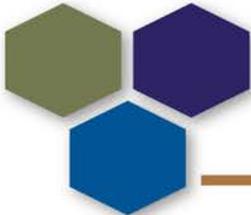


30-year closed, level dollar amortization (7.50% vs. 4.50% discount rate)
Over the first 25 years, the cumulative pay-go costs equal \$58 million and the cumulative ARC payments equal \$67 million. The trust has \$50 million in assets after 25 years.



Discount Rates

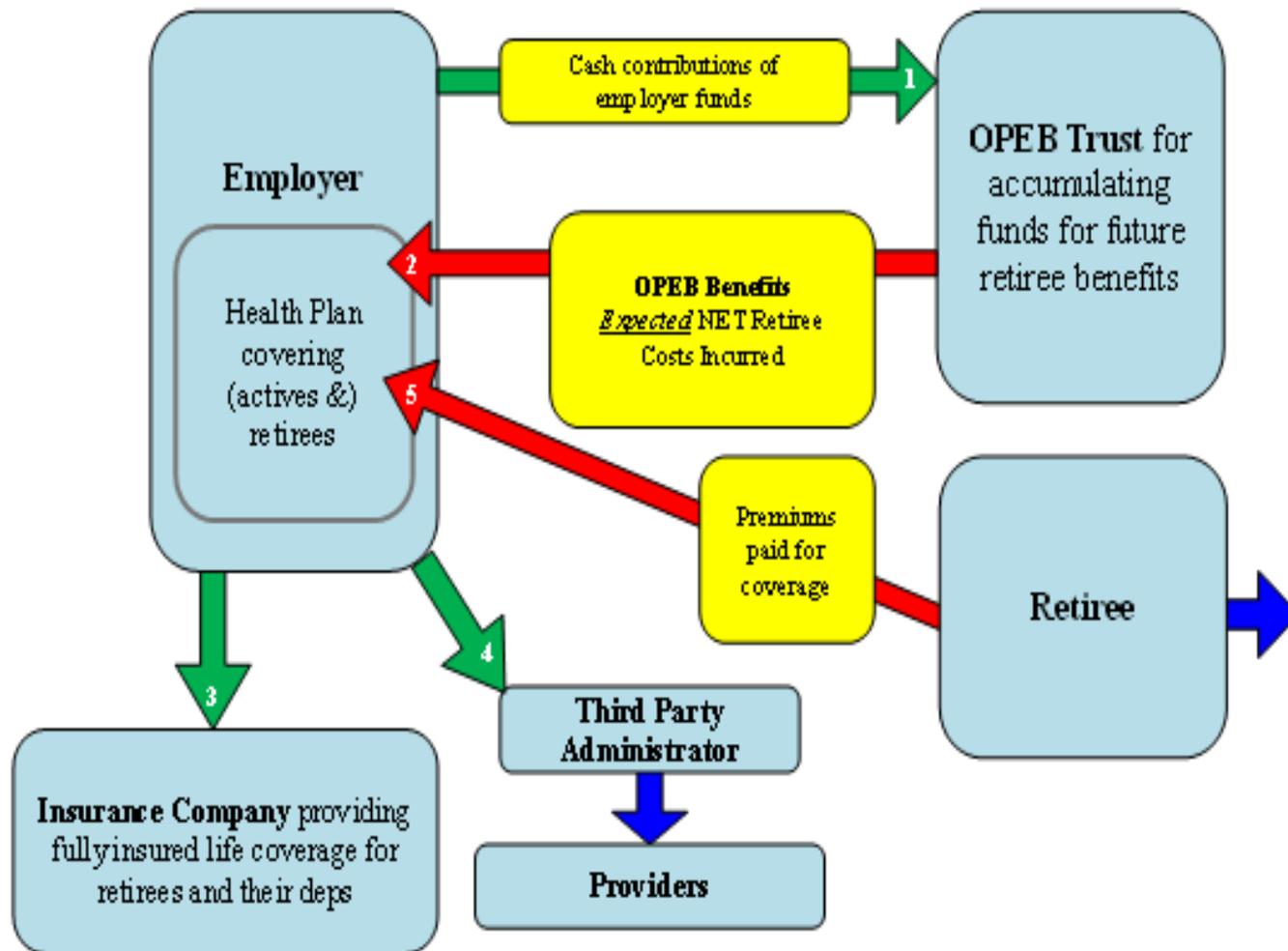
- ◆ Typical discount rate for an unfunded plan is 4.0% - 4.5%
- ◆ How much higher can be assumed given SC investment restrictions?
- ◆ For GRS clients in SC who pre-fund, discount rate is between 4.5% - 6.0%
- ◆ Liabilities vary between 12%-18% per percentage point of the discount rate
- ◆ Investment restrictions may decrease incentive to prefund an irrevocable trust

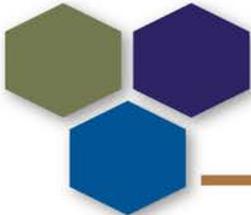


Using the Trust to Pay Benefits

- ◆ Initially, $ARC > \text{benefit payments}$
 - ▶ Employer can pay the full ARC into the trust and let the trust pay the benefits
 - ▶ Employer can pay the benefits and make a trust contribution to satisfy the ARC
- ◆ Eventually, $ARC < \text{benefit payments}$
 - ▶ Trust needs to start paying benefits
 - ▶ Options:
 - Reimburse the employer (explicit and implicit costs)
 - May want to use estimated net costs to draw down trust
 - Trust pays third-parties directly

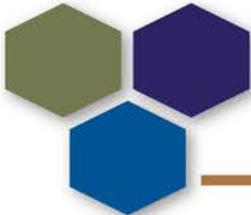
Cash Flow Example





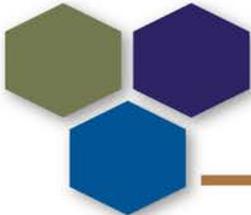
Cash Flow Example

- ◆ Assume plan is fully funded
 - ▶ ARC = Normal Cost = \$1,000,000
 - ▶ Benefit Payments = \$3,000,000
- ◆ Option 1: Deposit \$1,000,000 into trust; employer pays benefits and gets reimbursed from the trust
- ◆ Option 2: Employer pay benefits of \$3,000,000 and gets reimbursed \$2,000,000 from the trust



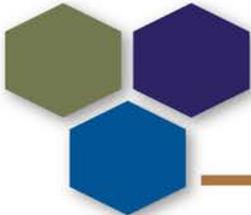
Implicit Subsidy

- ◆ Active employees are subsidizing some of the cost for retirees
- ◆ If retirees were separately underwritten, the active premiums would likely decrease
- ◆ GASB 45 requires this “hidden” cost to be reflected in the accounting cost
- ◆ Easy to identify for large, self-funded plans



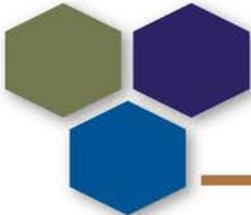
Implicit Subsidy

- ◆ How would the trust pay the implicit subsidy?
 - ▶ Fully-insured plan
 - ▶ Self-insured plan (not a concern)
- ◆ What if the majority of the liability is due to the implicit subsidy?
- ◆ Employer may be more comfortable only funding the explicit subsidy



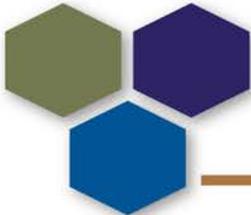
What if the benefit changes?

- ◆ Trust assets would revert to employer if there are no more beneficiaries
- ◆ Many employers want to find ways to leverage the public/private exchanges
- ◆ May want 2-3 years of benefits
- ◆ Funding may be viewed as one of several ways to mitigate future costs



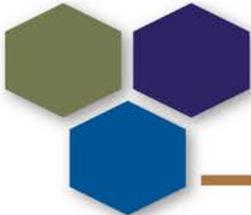
Understanding “Velocity”

- ◆ The speed for change to take effect (e.g. the lowering of the GASB liability and costs) depends on what employee groups can have benefit changes.
 - ▶ If new hires only, we find it takes about 10-15 years to begin to observe the impact of the change
 - ▶ Current Actives (prospective benefits), the velocity of change can be sooner, depending on the depth of the change
 - ▶ Changing for all members (active, retiree and new hire) creates the highest velocity.
- ◆ A governmental entity may say “the Actuarial Required Contribution must go from 15% to 7% in 7 years”.



Trends

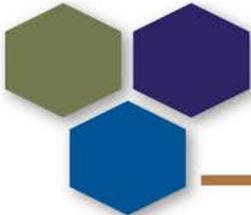
- ◆ Fully insured Medicare Supplements or EGWP for self insured plans
- ◆ Discontinuing benefits after the age of 65
- ◆ Private Exchanges for Medicare Retirees
- ◆ Private/public exchanges before age 65
- ◆ Clinics/Preventive Medicine
- ◆ Soft/Hard caps
- ◆ Designating an internal fund for OPEB
- ◆ Eliminating benefits for new hires



Private Exchanges

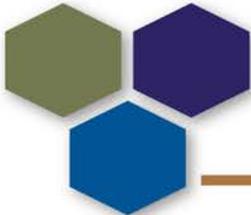
◆ Disadvantages:

- ▶ May see an increase in retiree participation due to increased plan choices
 - Employer subsidy may need to be adjusted for increased participation
- ▶ No control over benefit design
- ▶ Retiree's who have a stand alone HRA plan will not be eligible for income based subsidies on the public exchanges
- ▶ Prices on pre-65 exchanges could become volatile if membership is skewed towards older members



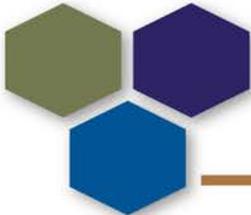
The Federal Exchanges

- ◆ Second Lowest Silver Plan in Florence County:
 - ▶ \$606/month for one 60-year old
 - \$3,500 deductible/\$3,500 max out-of-pocket
 - ▶ \$1,211/month for two 60-year olds
 - \$7,000 deductible/\$7,000 max out-of-pocket
- ◆ Premiums for a 40 year old are roughly half



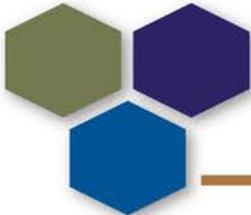
The Federal Exchanges

- ◆ Sample Gold Plan in Florence County:
 - ▶ \$720/month for one 60-year old
 - \$1,000 deductible/\$4,000 max out-of-pocket
 - ▶ \$1,441/month for two 60-year olds
 - \$2,000 deductible/\$8,000 max out-of-pocket



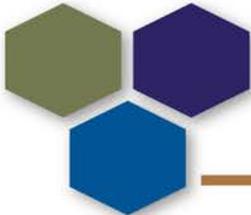
The Federal Exchanges

- ◆ Retirees who have access to an employer plan at a “blended” rate (implicit subsidy) will likely stay on the employer’s plan; unless they qualify for an income based subsidy
- ◆ To be eligible for a subsidy:
 - ▶ the employer’s plan would need to be unaffordable (9.5% of household income) or doesn’t meet minimum standards
 - ▶ household income < 400% of poverty level (\$45,000 for 1-person household; \$62,000 for 2-person household)



OPEB Obligation Bonds

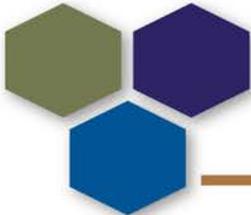
- ◆ Potential for arbitrage
- ◆ Added commitment:
replacing soft debt with
hard debt
- ◆ Added risk/volatility



Defined Contribution Approach

◆ Retiree Health Savings Plan

- ▶ Defined contribution plan for qualified retiree medical expenses
- ▶ Only available to public employees
- ▶ Requires additional funding now
- ▶ Tough sell to mid-career employees
 - Not enough time to build a meaningful balance
- ▶ May still have an OPEB liability



Questions to ask?

- ◆ Is the current benefit sustainable?
- ◆ Will “funding” delay inevitable decisions?
- ◆ How important is the OPEB liability?
- ◆ Funding considerations:
 - ▶ What’s the objective?
 - ▶ Cost stability
 - ▶ Target funding ratio
 - ▶ Fund the implicit?
 - ▶ Investment return assumption
- ◆ If funding, should request projection of assets, liabilities, contributions and benefits