The Proposed OPEB Accounting Standards: The Bride of Frankenstein

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The Big Picture

- The proposed OPEB standards would bring OPEB accounting in line with the new pension standards GASB #67 (plans) and GASB #68 (employers)
- Dr. Frankenstein is forced to tempt fate again by creating a suitable mate for his monster…

The Big Picture

- Balance Sheet
  - Employers recognize a Net OPEB Liability (NOL) on their balance sheets ***(NOL is code for the Unfunded Accrued Liability based on Market Value of Assets)***
- Income Statement
  - Employers recognize a new OPEB Expense on their income statements. Expense (and deferred inflows and outflows of resources) results from changes to the Net OPEB Liability
- Footnotes and RSI
  - Additional disclosure information and 10-year trend information

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The Big Picture

- The Good
  - Greater transparency; additional disclosures
  - Greater uniformity of measurement
- The Bad
  - Impact on balance sheet “liability”
  - Overemphasis on a point-in-time liability
  - Financials will no longer include an ARC
- The Ugly
  - Additional complexity to an already complex subject
  - Most 10-year trend information will start from scratch
  - Volatile balance sheet liability and OPEB expense could make trending difficult

Income Statement vs. Balance Sheet

GASB has Shifted the Focus from the Income Statement to the Balance Sheet

GASB #45	Proposed Standard
Expense drives the Balance Sheet recognition	Balance Sheet drives the OPEB Expense
Accountability focused on whether the employer is making the Actuarially Required Contributions	Accountability focused on the Net OPEB Liability

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Terminology

GASB #45	Proposed Standards
Actuarial Accrued Liability	Total OPEB Liability
Actuarial Value of Assets	Fiduciary Net Position
Unfunded Actuarial Accrued Liability (UAAL)	Net OPEB Liability
Normal Cost	Service Cost
ARC & UAAL Amortization	Accounting expense is not tied to a funding contribution
Net OPEB Obligation – cumulative difference between expense and contributions	Net OPEB Liability & Deferred Inflows/Outflows of Resources

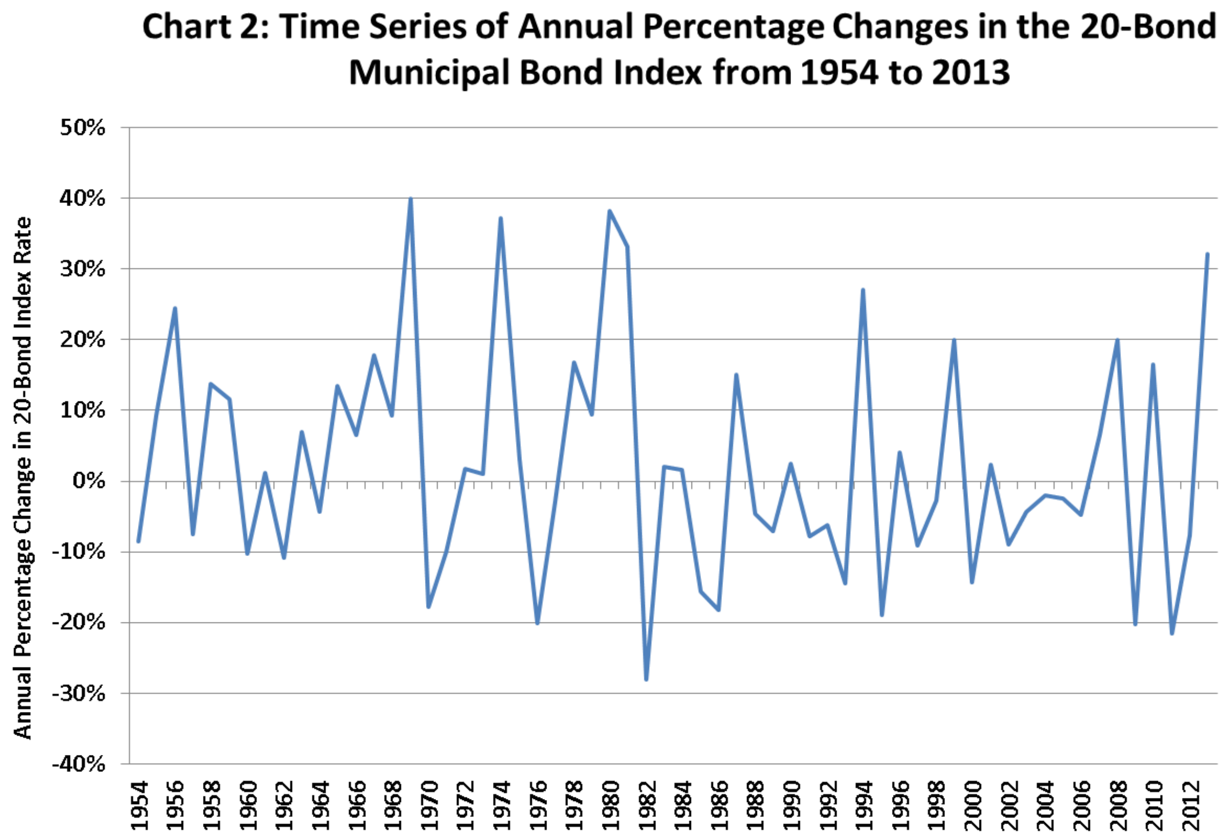
Discount Rate

- For pay-as-you-go plans, the discount rate will be based on the average yield for an index of 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher.
- Plans with assets will be required to perform a test to determine when assets will be depleted. The discount rate will be a blend of the long-term expected rate of return on plan assets and the municipal bond index rate.

Discount Rate

- The municipal bond index has been between 4.17% and 4.48% in 2014.
- 3.46% in December 2012; 4.73% in December 2013; (1.27% difference could mean a 12-25% change in the Total OPEB Liability)
- Accrued liability sensitivity is typically 10-15% per 1% in discount rate if there is no post-65 benefit and 15-20% if there is a post-65 benefit.

Changes to 20-year Bond Municipal Bond Index



Source: Federal Reserve, State and Local Bonds - Bond Buyer Go 20-Bond Municipal Bond Index, Annual Rates. Annual percentage changes calculated as a percent of prior year rate rather than as a change in basis points.

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Sensitivity to Discount Rate and Trend Assumption

- Employers would be required to disclose the Net OPEB Liability for 8 additional scenarios.

Net OPEB Liability			
	1% Decrease (3.0%)	Discount Rate (4.0%)	1% Increase (5.0%)
1% Decrease (8.5% - 4.5%)	$985,000	$833,000	$688,000
Health Care Trend (9.5%-5.5%)	$1,211,000	$1,000,000	$826,000
1% Increase (10.5% - 6.5%)	$1,474,000	$1,218,000	$1,006,000

Type of Plan

- Single-employer or multiple-employer plan
  - For this classification purpose, a primary government and its component units are considered to be one employer
- Agent multiple-employer or cost-sharing multiple-employer plan
  - Agent plan – liabilities and assets are separated for each employer
  - Cost-sharing plans – obligation is pooled and assets can be used to pay benefits for any employer (think SCRS and PORS)

OPEB vs. Pension

- Pension: Most SC employers belong to a cost-sharing pension plan (SCRS/PORS)
  - Assigned a proportion of the total unfunded liability, expense and deferred inflows/outflows
  - Balance sheet liability = approximately 230% of payroll
  - Pension expense = approximately 16% of payroll

Contribution Requirement

- Some employers have expressed a concern that their share of the pension liability will be based on the total contributions to the State, which may include health care contributions. This is not the case!

OPEB vs. Pension

- OPEB accounting – similar approach as pension for school districts and employers who fall under the State's retiree medical liability
  - These are the employers who pay the retiree medical payroll surcharge; 5.00% of payroll for FYE15
  - Proportion of liability, expense, deferred inflows/outflows based on employer's "contribution requirement" relative to total contributions
- Employers who have their own OPEB plan will not be assigned a portion of the State's OPEB liability.

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Changes to Total OPEB Liability

	Total OPEB Liability
Balance 6/30/2018	$851,095
Changes for the year:	
Service Cost	16,712
Interest Cost	33,898
Changes in Benefit Terms	(203,619)
Difference between expected and actual experience	58,936
Changes in assumptions or other inputs	45,945
Benefit Payments	(23,983)
Net Changes	(72,111)
Balance 6/30/2019	778,984

10-year schedule, showing previous discount rates
Similar 10-year schedule for changes in Plan Fiduciary Net Position
Doesn't apply to cost-sharing employers

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Sample OPEB Expense

Calculation of the OPEB Expense:

1. Service Cost	$16,712
2. Interest Cost (on Total OPEB Liability)	33,898
3. Benefit Changes (assuming reduction)	(203,619)
4. Member Contributions (non-retirees)	0
5. Projected Investment Earnings	0
6. Administrative Expenses	0
7. Other	0
8. Deferred Outflow/(Inflow) due to Liabilities	10,540
9. Deferred Outflow/(Inflow) due to Investments	0
10. Total Pension Expense/(Income)	**$(142,469)**

Contributions from the employer are not recognized in OPEB expense.

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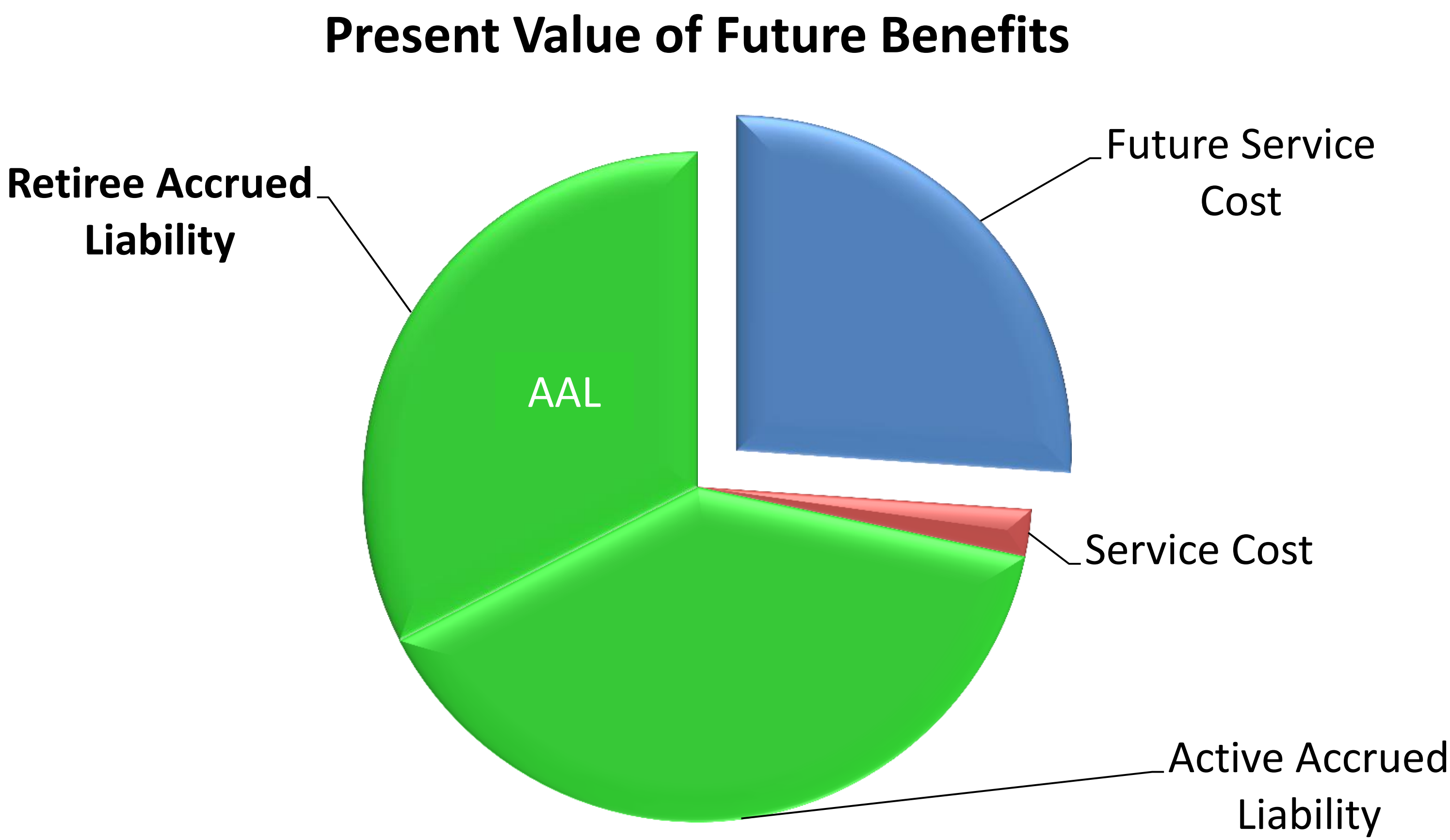
What is Service Cost?



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OPEB Expense – Smoothing Gains/Losses

- Changes to the Total OPEB Liability (TOL) due to benefit changes are immediately recognized. Results in no deferred outflows or inflows of resources.
- Changes to the TOL due to assumption changes or differences between expected and actual experience are amortized over the average future working lifetime of the plan participants.
- The difference between actual and expected investment returns are amortized over a period of 5 years.

Deferred Outflows and Inflows

- The amounts not recognized in OPEB expense are reported as deferred outflows or deferred inflows of resources related to OPEB.
- Deferred Outflow – quasi asset
- Deferred Inflow – quasi liability
- Notes will include schedule of future deferred outflows and inflows that will be recognized in the employer's expense

Deferred Outflows/Inflows of Resources Related to OPEB

	Deferred Outflows of Resources (Losses)	Deferred Inflows of Resources (Gains)
Differences between expected and actual experience	$25,970	$14,134
Changes of assumptions	-	855
Net differences between projected and actual earnings on OPEB plan investments	17,782	-
Total	$43,752	$14,989

Deferred Outflows/Inflows of Resources Related to OPEB

- Amounts reported as deferred outflows of resources and deferred inflows of resources related to OPEB will be recognized in OPEB expense as follows:

Year ended June 30:	
2018	$ 7,064
2019	7,384
2020	6,007
2021	4,482
2022	114
Thereafter	3,712

Employer Reporting Requirements - Footnote Disclosures

- Expanded footnote disclosures
  - Basic information about each OPEB plan
  - Classes of employees covered
  - Information regarding TOL, OPEB Expense, proportionate share, deferred outflows/(inflows) of resources related to OPEB
  - Significant actuarial assumptions
  - Target asset allocations and projected rates of return by asset class
  - Sensitivity of the NOL to changes in the discount rate

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Target Asset Allocation and Assumed Real Returns

- Required disclosure for funded plans

Asset Class	Target Allocation	Long-Term Expected Real Rate of Return
Fixed Income	60%	1.2%
Domestic Equity	0	5.8
International Equity	0	6.2
Private Equity	0	9.7
Real Estate	30	3.5
Commodities	0	2.1
Cash	10	0.0
Total	100%	

Real rate is the rate above inflation.

Employer Reporting Requirements - RSI

- Expanded disclosures in the RSI
  - 10-year schedule of changes in the Net OPEB Liability
  - 10-year schedule similar to current funding progress schedule (funded ratio; ratio of Net OPEB Liability to covered payroll)
  - 10-year schedule of contributions relative to actuarially determined contribution and contributions as a percentage of payroll
    - Only applicable for cases where an actuarially determined contribution is calculated or there is a statutory or contractually established rate
  - Notes to the RSI
    - Comment on events that significantly affect trends in historical schedules

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OPEB Trust Criteria

- Contributions and earnings are irrevocable
- OPEB plan assets are dedicated to providing OPEB to plan members in accordance with the benefit terms
- OPEB plan assets are legally protected from the creditors of employers, non-employer contributing entities, the OPEB plan administrator, and the plan members

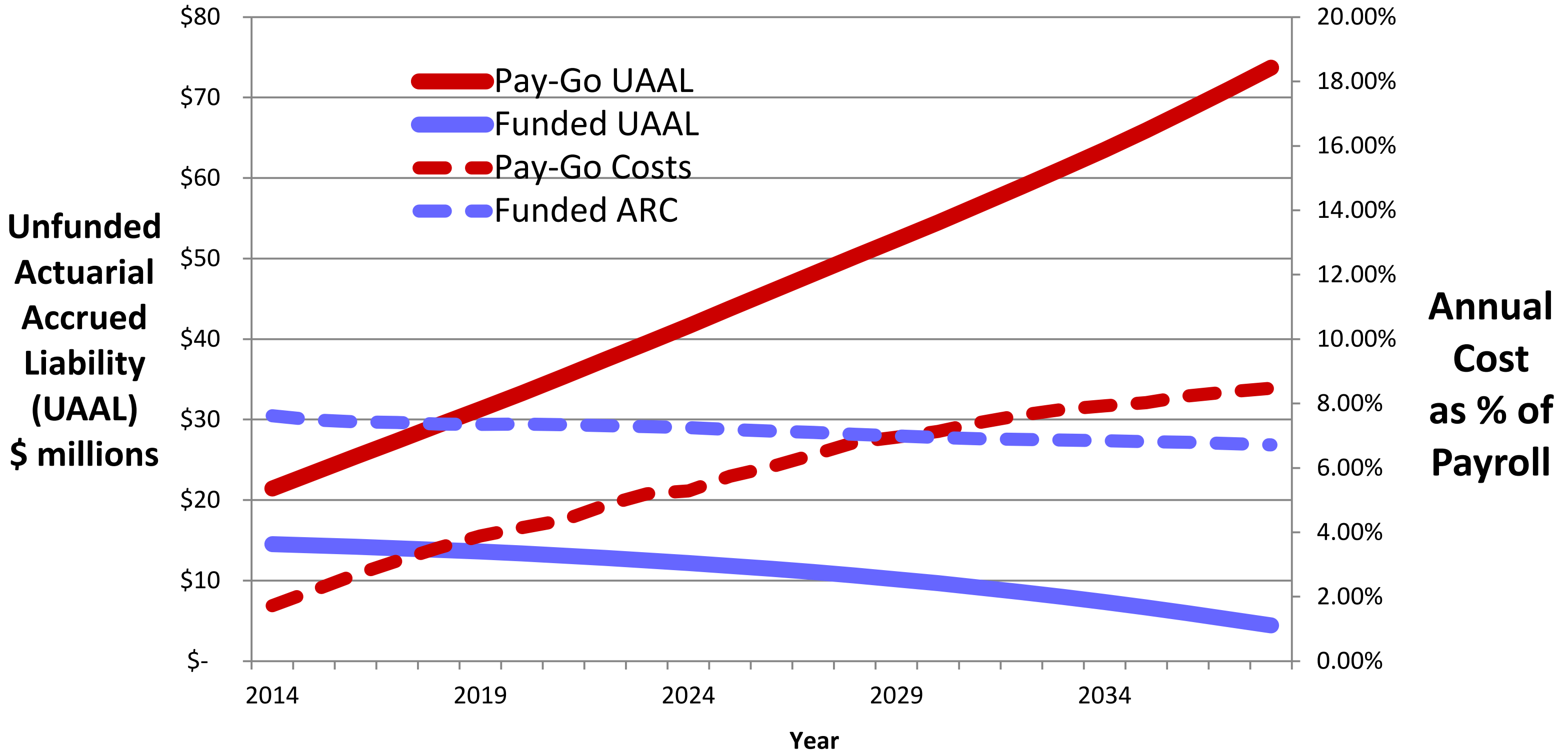
Should you fund an OPEB trust?

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

Funding Considerations

- What's your goal?
  - $10,000,000 in 5 years
  - 80% funded in 10 years
  - 100% funded in 30 years
  - Rainy day reserve
    - When/how would the money get used?
- Trust assets would revert to the employer if there is no more liability
- How long will it take before the trust contributions are less than the pay-go benefits?

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.

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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

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Understanding "Velocity"

- The speed for change to take effect (e.g. the lowering of the GASB liability and costs) depends on which employee groups can have benefit changes.
  - For new hires only, we find it takes about 10-15 years to begin to observe the impact of the change
  - For current actives (prospective benefits), the velocity of change can be sooner, depending on the depth of the change
  - Changing all members (actives, retirees and new hires) creates the highest velocity.
- A governmental entity may say "the Net OPEB Liability (unfunded accrued liability) must go from $30 million to $10 million."

Proposed Effective Dates

- For plans, effective for fiscal years beginning after December 31, 2015.
- For employers, effective for fiscal years beginning after December 31, 2016.
  - Fiscal year ending June 30, 2018 for employers with a June 30 fiscal year end.

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Miscellaneous

- Proposed standards would require the use of the Entry Age Normal Cost Method.
- Valuations will need to be performed at least every two years. No three year cycle for employers with less than 200 employees.

Comments to Exposure Drafts

- More transparency is good
- Would it be possible to stagger the implementation date?
- Too much volatility; municipal bond rate is unrelated to employer's OPEB
- OPEBs are typically not liabilities

Comments to Exposure Drafts

- Too many sensitivity scenarios; causes confusion
- Some believe Projected Unit Credit is a more appropriate cost method for OPEB
- What discount rate to use for employers who have a small level of assets but are never projected to deplete the trust?

Take-aways

- Balance sheet will reflect the entire unfunded liability (FYE18)
- Discount rate volatility
- Expense will be driven by changes to the balance sheet liability
- OPEB liability will likely get more attention