

# **GASB 45**

# **&**

# **OPEB**

Presented by Glenn S. Klocko, Comptroller



**GASB:  
Government Accounting  
Standards Board**

**Statement No. 45**

**OPEB:  
Other Post-Employment  
Benefits**

# Introduction



# Comptroller's Perspective

(Part 1 of 3)

# Sources

AON Consulting. Navigating the GASB OPEB Standards. Chicago, IL: AON Consulting, 2007.

Barth, Bruce, and Karen McDonough. "Retiree Health Care Funding." Letter to City of Bristol. 13 Apr. 2007.

CCM. "CCM White Paper: Provision of Non-Pension Post Employment Benefits By Connecticut Municipalities." New Haven, CT. 2006.

Douglas, Jennifer R., and Rowan Miranda. An Elected Officials Guide to Rating Agency Presentations. Chicago, IL: GFOA, 2000.

Gauthier, Stephen J. Employer's Accounting For Pensions and Other Post-Employment Benefits (OPEB). Chicago, IL: GFOA, 2005.

Gauthier, Stephen J. "OPEB In Perspective." Government Finance Review Feb. 2008: 11.

Government Accounting Standards Board. Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pensions. Vol. 231-D. Norwalk, CT, 2004.

Lemanski, Steve. "Retiree Healthcare Funding- Section 420 Transfers." Letter to Glenn S. Klocko. 4 Feb. 2008.

Moran, Michael A. The Trillion Dollar Question: What is your GASB 45 number? New York, NY: Goldman Sachs, 2007.

Merrill Lynch. "OPEB Liability/ Financial Analysis." 2006.

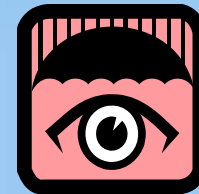
**GASB 45...**

**It's About  
Disclosure**

# **What is GASB Statement Number 45? The technical definition:**

- Establishes standards for the measurement, recognition and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial report of state and local government employers.

# Examples of Other Post- Employment Benefits



# Managerial Perspective

- How well does management understand the liabilities associated with specific benefits?
- What methods and assumptions are being used to determine liabilities?
- Will the GASB 45 actuarial valuation results come as a complete surprise?

Once OPEB liability and annual required contribution values are known, the strength of management's plan will be critical

- Will the entity be able to carry the current level of benefits economically and politically?
- If not, what can be done to rectify the situation?

# Financial Perspective

- Is there a gap between the current structure and the public's willingness to support it?
- Will OPEB's costs overwhelm the budget?
- How will financial flexibility be affected?

# Other Perspectives

- Labor Relations
- Department Administration
- Implementation Costs



## A Word About GASB 34, 43 & 45

- No. 43 applies to trusts that are established in order to prefund OPEB benefits
- The purpose of No. 43 is to require the accrual of liabilities of OPEB over the working career of plan members
- 43 & 45 go hand-in-hand for *recording requirements*
- No. 45 requires the accrual of OPEB expense over the same period

# Issues of Implementing OPEB Accounting

- Potential misconceptions
- Nature and character of post-employment benefits
- How post-employment benefits are financed
- How defined benefits are advance funded
- How employers account for post-employment benefits
- Evaluating the financial health of benefit plans
- Relevant authoritative accounting guidance

**CITY OF BRISTOL, CONNECTICUT  
STATEMENT OF NET ASSETS**

**JUNE 30, 2007**

(In Thousands)

	<u>Primary Government</u>			<u>Component Unit</u>
	<u>Governmental Activities</u>	<u>Business-Type Activities</u>	<u>Total</u>	<u>BBHD</u>
<b>Assets:</b>				
Cash and cash equivalents	\$ 65,354	\$ 2,589	\$ 67,943	\$ 1,070
Investments	110	4,147	4,257	
Receivables, net	11,320	1,183	12,503	4
Internal balances	-	-	-	
Inventory	48	152	200	
Other assets	7,229	46	7,275	
Capital assets:				
Assets not being depreciated	61,255	3,962	65,217	
Assets being depreciated, net	199,207	21,499	220,706	86
<b>Total assets</b>	<u>344,523</u>	<u>33,578</u>	<u>378,101</u>	<u>1,160</u>
<b>Liabilities:</b>				
Accounts and other payables	8,172	475	8,647	10
Accrued liabilities	8,606	75	8,681	78
Bond anticipation notes payable	-	-	-	
Other current liabilities	-	761	761	
Unearned revenue	887	21	908	19
Noncurrent liabilities:				
Due within one year	10,007	978	10,985	23
Due in more than one year	64,085	6,544	70,629	28
<b>Total liabilities</b>	<u>91,757</u>	<u>8,854</u>	<u>100,611</u>	<u>158</u>
<b>Net Assets:</b>				
Invested in capital assets net of relat	200,700	18,427	219,127	86
Restricted for:				
Trust purposes:				
Expendable	164		164	
Nonexpendable	246		246	
Unrestricted	51,656	6,297	57,953	916
<b>Total Net Assets</b>	<u>\$ 252,766</u>	<u>\$ 24,724</u>	<u>\$ 277,490</u>	<u>\$ 1,002</u>

The accompanying notes are an integral part of the financial statements

**CITY OF BRISTOL, CONNECTICUT**  
**STATEMENT OF ACTIVITIES**  
**FOR THE YEAR ENDED JUNE 30, 2007**  
(In Thousands)

Functions/Program	Expenses	Program Revenues			Net (Expense) Revenue and Changes in Net Assets			Component Unit
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Primary Government		Total	
					Governmental Activities	Business-Type Activities		
Primary Government:								
Governmental activities:								
General government	11,110	\$ 3,490	\$ 968	\$ 172,000	\$ (6,480)	\$	\$ (6,480)	\$
Public safety	24,268	1,289	435	-	(22,544)		(22,544)	
Public works	27,278	6,325	546	450	(19,957)		(19,957)	
Health and welfare	5,995	27	545	115	(5,308)		(5,308)	
Libraries	2,369	29	81	50	(2,209)		(2,209)	
Parks & Rec	3,175	291	578	62	(2,244)		(2,244)	
Education	108,150	2,247	54,647	7,792	(43,464)		(43,464)	
Miscellaneous	694	281	-	-	(413)		(413)	
Debt service:								
Interest and fiscal	2,335				(2,335)		(2,335)	
Total gov't activities	185,374	13,979	57,800	8,641	(104,954)	-	(104,954)	-
Business-type activities:								
Water	6,154	5,428		209		(517)	(517)	
Total Primary Government	\$ 191,528	\$ 19,407	\$ 57,800	\$ 8,850	(104,954)	(517)	(105,471)	-
Component Unit:								
BBHD	\$ 2,649	\$ 119	\$ 2,570	\$				40
General revenues:								
Property taxes					103,644		103,644	
Grants and contributions not restricted to specific program					6,409		6,409	
Unrestricted investment earnings					3,700	325	4,025	57
Gain on sale of capital assets					-		-	
Miscellaneous					147		147	
Total general revenues and transfers					113,900	325	114,225	57
Change in net assets					8,946	(192)	8,754	97
Net assets, July 1, 2006					243,820	24,916	268,736	905
Net assets, June 30, 2007					\$ 252,766	\$ 24,724	\$ 277,490	\$ 1,002

The accompanying notes are an integral part of the financial statements

# Notes to Financial Statements

*From the June 30, 2007 Comprehensive Financial Report (CAFR)*

## 14. Other Post-employment Benefits

For 2006-07, 233 retirees received these benefits with a cost to the City in the amount of \$1,838,732 (amt. not rounded).

The City has designated \$1,100,000 from General Fund's unreserved fund balance for implementation of GASB 45.

# CAFR

## June 30, 2008

### Schedule of Funding Progress

#### City of Bristol Other Post Employment Benefits

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial accrued Liability (AAL) Projected Unit Credit (b)	Unfunded AAL (UAAL) (a-b)	Fund Ratio (a/b)	Covered Payroll (c)	UALL as a % of Covered Payroll (a-b)/c
6/30/07	\$0	\$71,700,000	\$71,700,000	0%	\$70,000,000	-102%

# CAFR

## June 30, 2007

### Schedule of Funding Progress

#### City of Bristol Retirement System

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial accrued Liability (AAL) Projected Unit Credit (b)	Unfunded AAL (UAAL) (a-b)	Fund Ratio (a/b)	Covered Payroll (c)	UALL as a % of Covered Payroll (a-b)/c
7/1/06	\$170,138	\$124,411	\$45,727	136.8%	\$26,901	170.0%
7/1/05	152,259	118,404	33,855	128.6	26,022	130.1

# CAFR

## June 30, 2007

### Schedule of Funding Progress

#### Police Benefit Fund

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial accrued Liability (AAL) Projected Unit Credit (b)	Unfunded AAL (UAAL) (a-b)	Fund Ratio (a/b)	Covered Payroll (c)	UALL as a % of Covered Payroll (a-b)/c)
7/1/06	\$137,399	\$73,840	\$63,559	186.1%	6,768	939.1%
7/1/05	122,121	74,674	47,447	163.5	6,718	706.7

# CAFR

## June 30, 2007

### Schedule of Funding Progress

#### Firefighters Benefit Fund

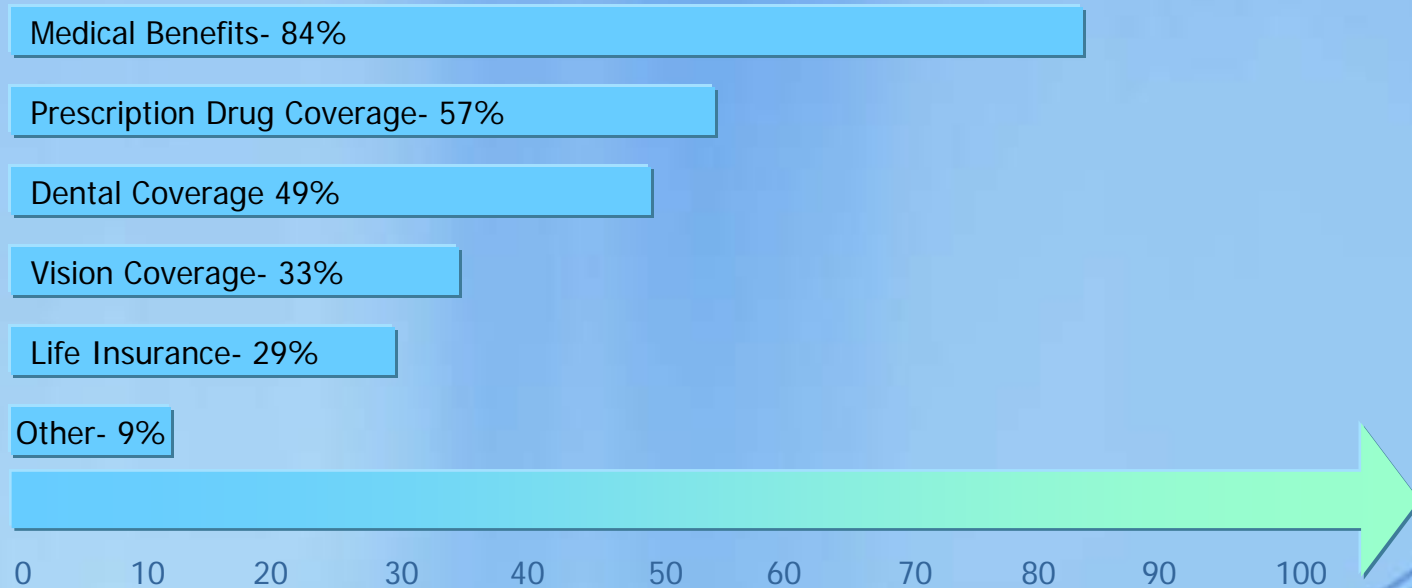
Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial accrued Liability (AAL) Projected Unit Credit (b)	Unfunded AAL (UAAL) (a-b)	Fund Ratio (a/b)	Covered Payroll (c)	UALL as a % of Covered Payroll (a-b)/c)
7/1/06	\$125,251	\$59,274	\$65,977	211.3%	\$4,696	1,405.0%
7/1/05	111,168	58,373	52,795	190.4	4,668	1,130.9



# AON Consulting's 2007 GASB OPEB Survey

Over 160 employers responded to Aon Consulting's GASB OPEB survey from all levels of government and public school systems in all regions of the United States.

## What current OPEB plans do you offer retirees?



# The Simple Guide to GASB 45

- The Governmental Accounting Standards Board, or GASB, establishes standards of financial accounting and reporting for US state and local governments
- GASB issues accounting standards, called statements, with the aim of improving accounting and financial reporting
- GASB No. 45 governs the accounting for retiree health care and other non-pension related benefits that governments provide to their employees, was issued in June 2004

## The Simple Guide to GASB 45 (cont.)

- Prior to the issuance of GASB 45 State and Local governments typically followed a “pay-as-you-go” approach
- This approach ignored the fact that these benefits are a form of deferred compensation that is earned by the employees over the course of their working careers
- GASB 45 brings the governmental accounting for retiree health care more in line with the accounting that has been present in the private sector for about 15 years

# Key GASB Facts

- Post-employment benefits are a form of deferred compensation
- *Other* post-employment benefits (OPEB) include healthcare and any type of post-employment benefits that is *not* an integral part of the pension plan

# Key GASB Facts (cont.)

- An actuarial valuation is used to determine the amount to be funded each period, known as the *annual required contribution (ARC)*
- To calculate ARC:
  - 1) Projecting anticipated future payments
  - 2) Discounting those payments to their present value
  - 3) Allocating the total present value of anticipated future payments to the appropriate period of employee service using one of several acceptable actuarial methods

# Key GASB Facts (cont.)

- Net pension obligation or the net OPEB obligation can be systematically eliminated by contributing the full amount of all future annual required contributions
- GASB does not require funding of this liability
- GASB's authority is strictly limited to accounting and financial reporting. That is, the GASB cannot tell a government what to do- only how to reflect what is has done

# Key GASB Facts (cont.)

- GASB now requires the calculation of the cost of OPEBs on an accrual basis
- GASB requires reporting the Net OPEB Obligation as a liability on the balance sheet
- GASB requires disclosure of your OPEB funding status in the notes of the financial statements

# Key Actuarial Terms

**Normal Cost:** The present value of the estimated future cost for pension benefits or OPEBs earned in the current year by current employees

**Service Cost:** The value of benefits expected to be earned during the year, again based on certain actuarial methods and assumptions

**AAL: Actuarial Accrued Liability:** is the liability or obligation for benefits earned through the valuation date, based on certain actuarial methods and assumptions

As of June 30, 2007 is \$71,700,000

**UAAL: Unfunded Actuarial Accrued Liability:** The difference between the present value of the projects costs for pension benefits or OPEBs earned to date by current and former employees and the market value of the assets pertaining to the pension fund or OPEB trust

# Key Actuarial Terms

ARC: Annual Required Contribution: Normal Cost + Amortized UAAL

Net OPEB Obligation: The shortfall of annual OPEB contributions to annual OPEB costs. Begins accruing at GASB 45 implementation

PVPB: Present Value of all Projected Benefits:

The total present value of all expected future benefits, based on certain actuarial assumptions, is a measure of total liability or obligation

PVPB is the value of the benefits promised to current and future retirees

As of June 30, 2007 Bristol's PVPB is \$115,000,000

**So...**  
**What Exactly Is Our  
Liability?**



**The liability is the same, the accounting is simply better**



**Numbers will be big,  
but the plan of action  
is more important**

# Summary of Actuarial Results

(as provided by AON Consulting)

June 30, 2007

<b>Present Value of all Projected Benefits (PVPB)</b>	<b>\$115,000,000</b>
<b>Present Value of benefits earned to date (AAL)</b>	<b>\$71,700,000</b>
<b>2005/06 Annual Required Contributions (ARC)</b>	<b>\$8,200,000</b>
<b>2005/06 Annual OPEB Cost</b>	<b>\$8,200,000</b>
<b>2005-06 Expected Benefit Premiums</b>	<b>\$3,300,000</b>
<b>Annual Required Contribution: June 30, 2008</b>	
<b>Service Cost (with interest) 2007/2008</b>	<b>\$3,600,000</b>
<b>AAL Amortization</b>	<b>\$4,600,000</b>
<b>Total Annual Required Contribution</b>	<b>\$8,200,000</b>

# Current Funding Strategy

- Adopted by the Board of Finance to eventually fund the \$4.6 million employee
- The funding starts with a base in 2007-08 of \$200,000. Each year, the base is increased by 25%, creating a new base. In the next year, 25% is then added to the new base, and so on. This year's appropriation was \$250,000.

Year	Funding (Base + 25%)	Total	Year	Funding	Total
<b>1</b>	<b>Starting Base</b>	\$200,000	<b>9</b>	238,419	1,192,093
<b>2</b>	50,000	250,000	<b>10</b>	298,023	1,490,116
<b>3</b>	62,500	312,500	<b>11</b>	372,529	1,862,645
<b>4</b>	78,125	390,625	<b>12</b>	465,661	2,328,306
<b>5</b>	97,656	488,281	<b>13</b>	582,077	2,910,383
<b>6</b>	122,070	610,352	<b>14</b>	727,596	3,637,979
<b>7</b>	152,588	762,939	<b>15</b>	909,495	4,547,474
<b>8</b>	190,735	953,674			

# Key Decision: How Should We Fund Our OPEB?

- Continue current strategy of pay-as-you-go funding (cash)
- Issue bonds
- Reduce or eliminate benefits
- Prefund



# What is Prefunding?

Let's say we want to buy an HDTV  
for \$3,000...



# Benefits of Prefunding

- Able to use higher discount rate to calculate liability
- Ability to arbitrage- "Refinance the Debt"
- Control liability growth
- Control future contributions

# Prefunding:



Benefits both sides of the funded status equation

- plan assets are higher through the cash contributed to the plan, and
- the present value of the obligation is lowered through the use of a higher discount rate

Allows state or local government to take advantage of the compounding effects of investment returns.





# **GASB Statement Number 45 is a big change for public retiree health care**



**There are important  
public policy  
implications**

**They are...**

**Credit rating agencies are looking for a plan of action.**



# To them...



*Moody's Investors Service*

STANDARD  
& POOR'S

**Fitch**Ratings  
KNOW YOUR RISK

**A plan is likely more  
important than the size  
of the obligation.**

## **How do creditors respond to the disclosures of these liabilities?**

From a Credit Perspective:

- It appears the main issue will not necessarily be the size of the obligation, because these are not new liabilities
- Although the size may be disconcerting, many creditors have already factored costs related to retiree medical benefits into their fundamental analysis
- What is not known is whether their estimates were on target



*Moody's Investors Service*

# Moody's

- In general, a state or local government's effectiveness and initiative in OPEB liability management probably will influence our overall assessment of the government's management strength

**“The choices made (or not made) by governments to address pension problems can have a significant impact on short- and long-term financial stability.”**

***-Moody's Investor Services***

# Ratings Guide-Moody's

## Bristol's Rating: Aa3

Aaa	Best quality
Aa1, Aa2, <b>Aa3</b>	High quality by all standards
A1, A2, A3	Upper medium grade
Baa1, Baa2, Baa3	Medium grade
Ba1, Ba2, Ba3	Has speculative elements
B1, B2, B3	Generally lack characteristics of a desirable investment
Caa	Poor standing; may be in default
Ca	Speculative in a high degree; often in default
C	Lowest rated class of bonds; extremely poor prospects

# Standard & Poor's

- How the liability is managed, along with a government's capacity to fund these obligations on an annual basis- either on a pay-as-you-go or an accrual basis- will be an important element of their credit review

**“The key to preserving creditworthiness in the face of any OPEB pressures will be how these liabilities are managed.”**

***-Standard & Poor's***

# Ratings Standard & Poor's

## Bristol's Rating: AA

AAA

Highest quality; extremely strong capacity to pay

**AA** (+ or -)

High credit quality; very strong capacity to pay

A (+ or -)

Strong capacity to pay principal and interest

BBB (+ or -)

Adequate capacity to pay principal and interest

BB (+ or -)

Low speculative

B (+ or -)

Speculative

CCC & CC(+ or -)

High speculation

C

Income bonds on which no interest is being paid

D

In default

# Fitch

- Will incorporate a government's approach to addressing its OPEB liability, as well as the magnitude of the liability itself, into its analysis of the main credit factors
- As more governments receive actuarial reports that estimate the liability, Fitch will evaluate those reports and discuss the governments' plans for addressing the liability

# Ratings Guide-Fitch

## Bristol's Rating: AA

AAA	Highest credit quality
<b>AA</b> (+ or -)	Very high credit quality
A (+ or -)	High credit quality
BBB (+ or -)	Good credit quality
BB (+ or -)	Speculative
B (+ or -)	Highly speculative
CCC, CC, C (+ or -)	High default risk
D	In default

# Key Credit Concerns

1. Scope of benefits
2. OPEB ARC as a percentage of budget
3. OPEB funding ratio (currently, less of a concern than pension ratios)
4. Management of future benefits
5. Plan for handling the liability
6. Comparison to peers

# The Important Message

- It has been made clear by the rating agencies, that doing nothing is not an option
- There is not a single funding answer that will fit all circumstances
- Many Towns & Cities will consider several funding options rather than trying to rectify the complex problem with only one approach

## **“Remember GASB 45 encourages, but does not dictate funding”**

This new standard does not require that the governmental entity fund the liability.

Decisions on

- If
- When
- How

to fund are a function of the desires of each Town or City.

# It's Not Too Late!

- The impending implementation of GASB 45 leaves many state and local governments with very little time to formulate a plan of action
- Many jurisdictions have already received actuarial reports on their obligations. Others will be receiving them shortly.
- Government officials should not be waiting for the arrival of these reports to begin to develop a long term financing strategy

## It's Not Too Late (cont.)

- This issue would have to be addressed even without GASB 45
- As baby boomers retire and begin to receive benefits local governments will be facing dramatically higher pay-as-you-go amounts over the next decade
- A plan of action to address retiree health care obligations should not be viewed as being driven simply by the implementation of a new accounting rule, but as a natural reaction to the shifting demographics of the workforce

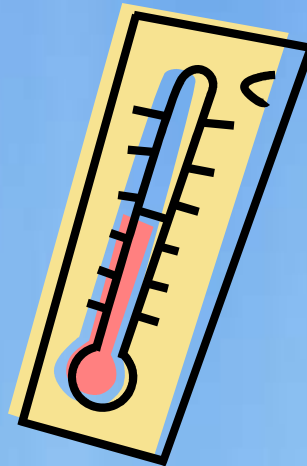
# Facts & Figures

**The first step in effective problem solving, of course, is to correctly identify the problem.**

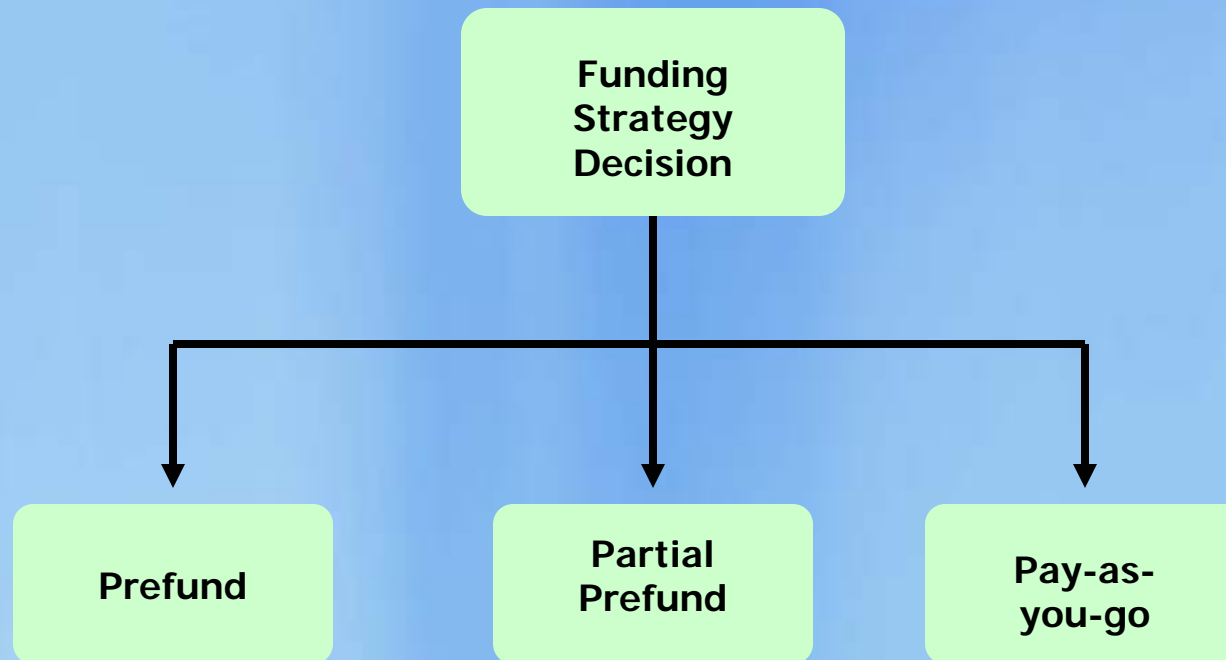


# Pension vs. OPEB

**The problem is the Fever  
Not the Thermometer!**



# Solution is in Our Funding Strategy Decision



# Summary of Actuarial Results

(as provided by AON Consulting)

June 30, 2007

<b>Present Value of all Projected Benefits (PVPB)</b>	<b>\$115,000,000</b>
<b>Present Value of benefits earned to date (AAL)</b>	<b>\$71,700,000</b>
<b>2005/06 Annual Required Contributions (ARC)</b>	<b>\$8,200,000</b>
<b>2005/06 Annual OPEB Cost</b>	<b>\$8,200,000</b>
<b>2005-06 Expected Benefit Premiums</b>	<b>\$3,300,000</b>
<b>Annual Required Contribution: June 30, 2008</b>	
<b>Service Cost (with interest) 2007/2008</b>	<b>\$3,600,000</b>
<b>AAL Amortization</b>	<b>\$4,600,000</b>
<b>Total Annual Required Contribution</b>	<b>\$8,200,000</b>

# City of Pension Plan

## 24 Year Total of Contributions

### 1982-2005

<b><u>CITY</u></b>	<u>Employer (54%)</u>	<u>Employee (46%)</u>
Total	\$22,549,000	\$19,253,062

<b><u>POLICE</u></b>	<u>Employer (86%)</u>	<u>Employee (14%)</u>
Total	\$27,263,000	\$4,607,194

<b><u>FIRE</u></b>	<u>Employer (83%)</u>	<u>Employee (17%)</u>
Total	\$14,287,000	\$3,011,785

**GASB 45 has provoked  
strong negative reactions  
in some quarters**



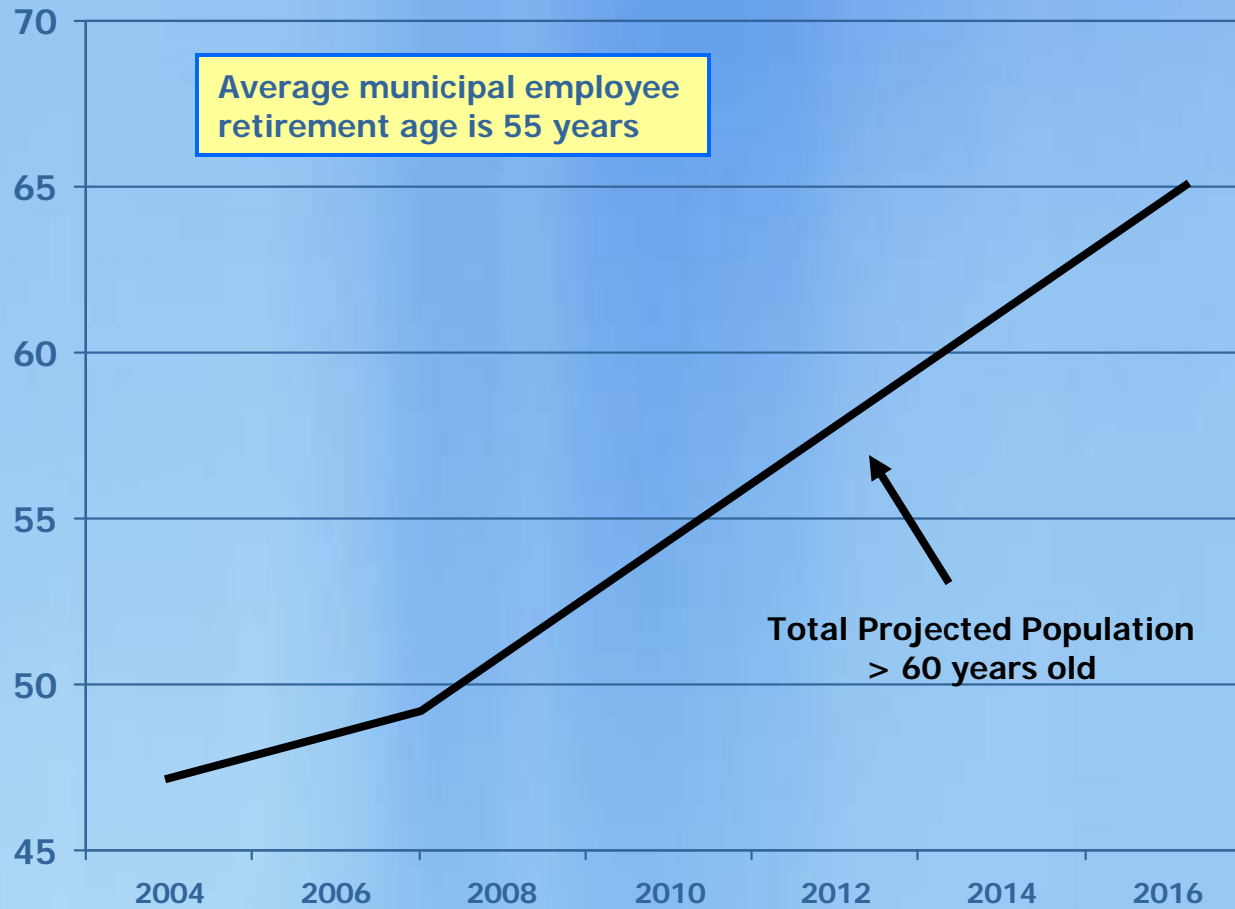
**However, it seems only fair to observe that the statement does not so much create a problem as dissolve one that has been around for a long time, just under the surface.**

# THE REAL CHALLENGE...



...is not so much accounting for OPEB as dealing with the **budgetary implications**, especially as baby boomers begin to retire in an environment of spiraling healthcare costs.

# Demographics



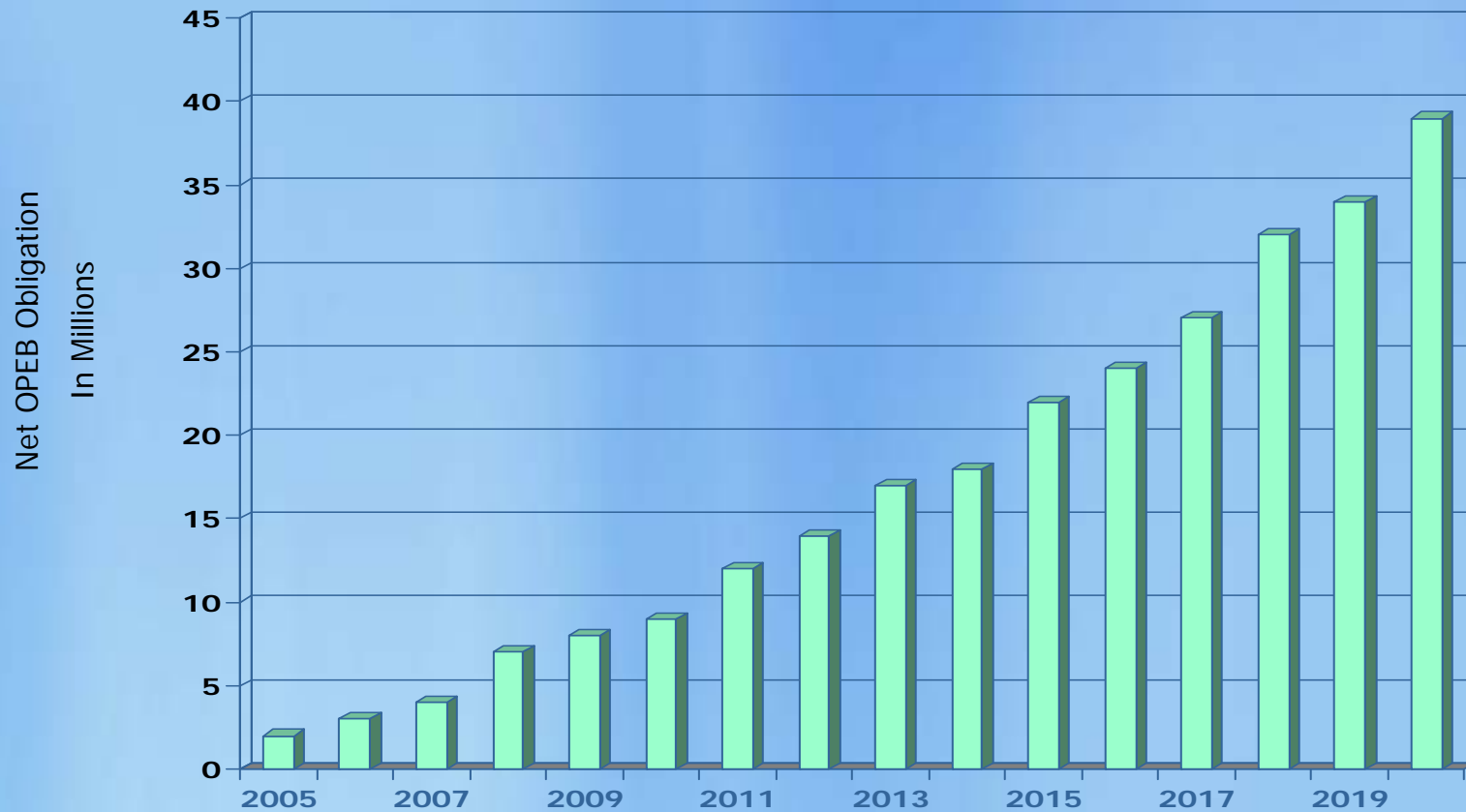
# OPEB Liabilities- Example

Impact of GASB 45 if Employer Does Not Fund the Actuarially Required Contribution



# OPEB Liabilities- Example

Impact of GASB 45 on a Municipality's Balance Sheet if Pay-As-You-Go Continues





# The Norwalk Story

(where GASB is headquartered)



In July 2007, the City began prefunding its OPEB liabilities using a Section 115 Trust, perhaps the most common form of Trust used for this purpose.

## Norwalk's Employee Benefits System Covers:

- 2,000 Active City & School Employees
- 625 Retirees
- 440 Retiree Spouses



# City of Norwalk



PVPB

\$153 million

Between Pay-Go of  
Annual Gap

\$ 6 million

\$ 8 million

And its ARC

\$ 13 million

# Wishing to maintain its AAA Credit Level

Norwalk's Common Council decided to close that \$8 million gap over a four year period by appropriating

- 1<sup>st</sup> Year \$2 million
  - 2<sup>nd</sup> Year \$4 million
  - 3<sup>rd</sup> Year \$6 million
  - 4<sup>th</sup> Year \$8 million
- Per Year



# The Section 115 Trust will be “Starting From Scratch”

Tom Hamilton, Finance Director

The Trust’s investments will be directed by an oversight board that is essentially a legal clone of the City’s pension oversight board.



# Where did they find the cash??





First:

By raising property taxes incrementally by approximately 6/10<sup>th</sup> of 1 percent each year during the phase-in period.

AND....

Second:

By renegotiating retiree health benefits with several labor unions representing City workers.



Norwalk has made dealing with its retiree medical benefits a top priority in all of its collective bargaining negotiations...

AND...



Norwalk argued strenuously that establishing and funding an OPEB Trust is the only way to assure that these benefits will be there for future retirees.



## **There has been some controversy...**

About the changes among the three collective bargaining groups affected in Norwalk

Their Outcome...

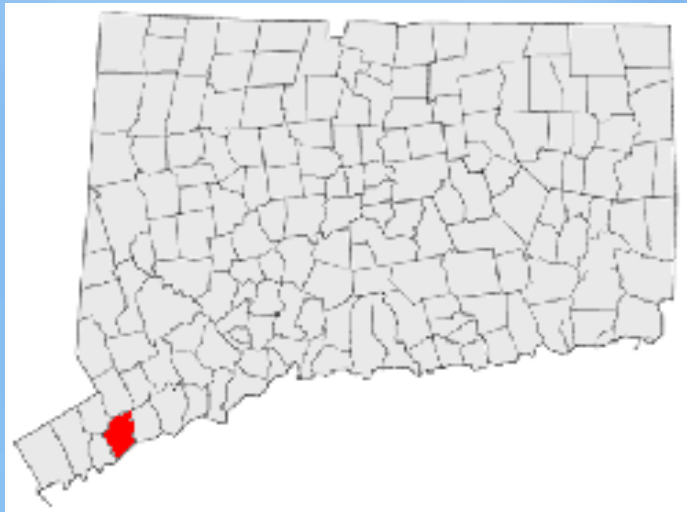


In two of the three contracts the matter was resolved through negotiations and not through binding arbitration.

In the third contract, the City prevailed in arbitration before a neutral third-party arbitrator.

# Difference between...

**NORWALK**



&

**BRISTOL**

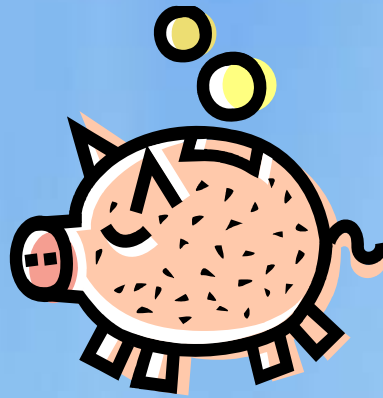






# Bristol's Advantage?

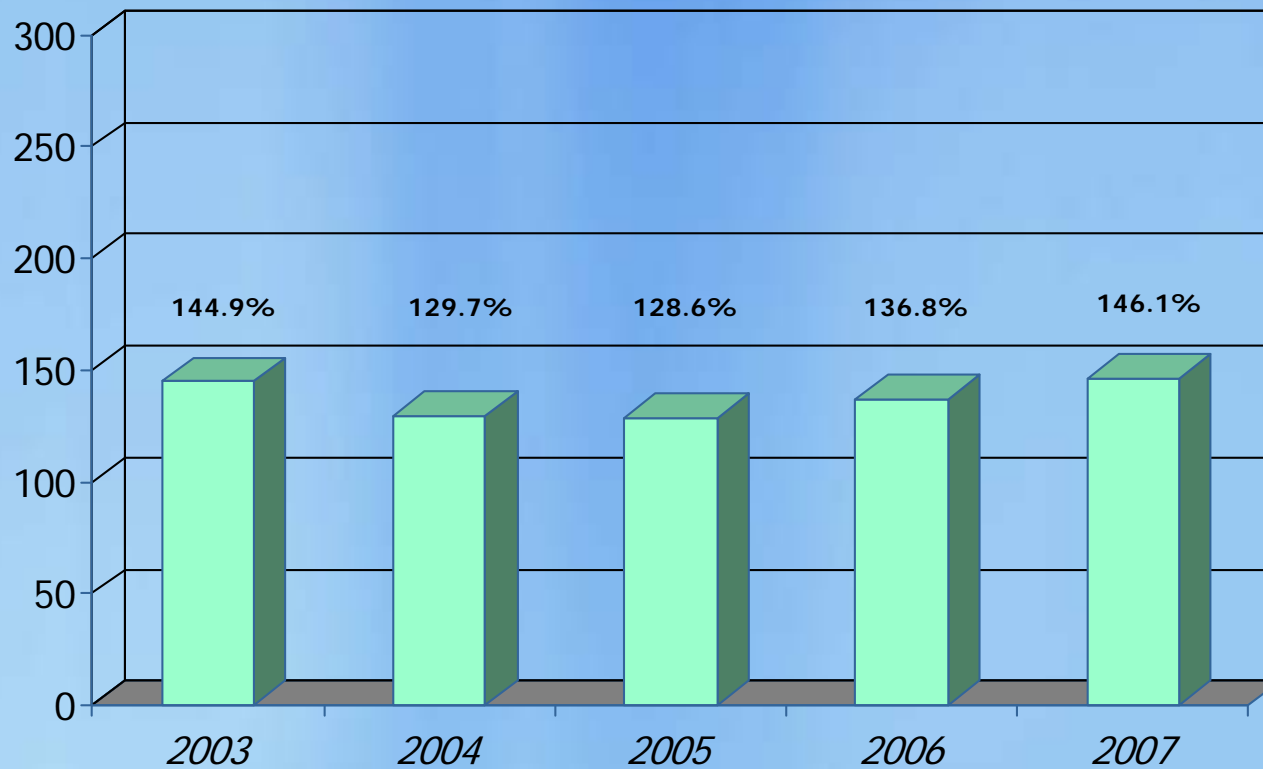
# Three Over Funded Pension Plans



# Defined Benefit Pension Plan City

This table presents a comparison of funded ratio for the Pension Plan for the past five years.

Funded Ratio

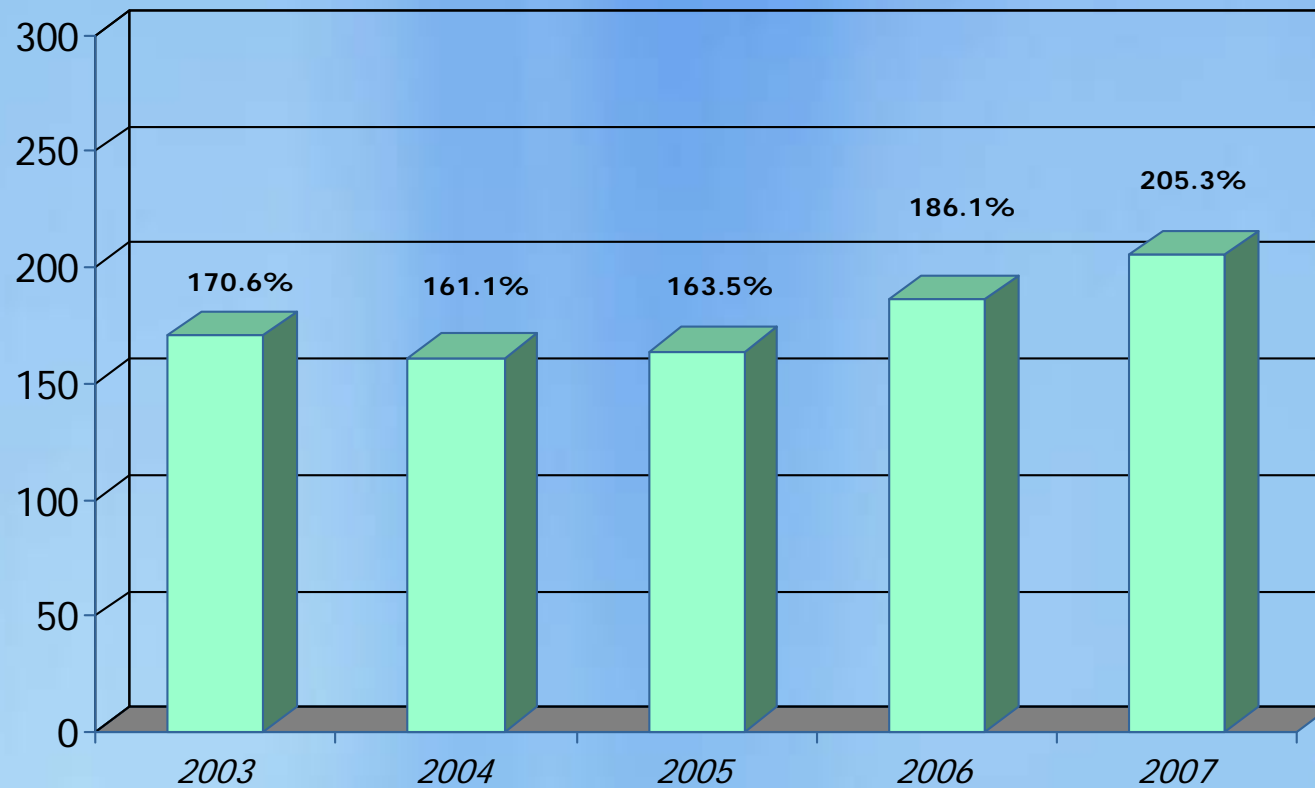


Actuarial Value of Assets/Accrued Liabilities

# Defined Benefit Pension Plan Police Benefit Fund

This table presents a comparison of funded ratio for the Pension Plan for the past five years.

Funded Ratio

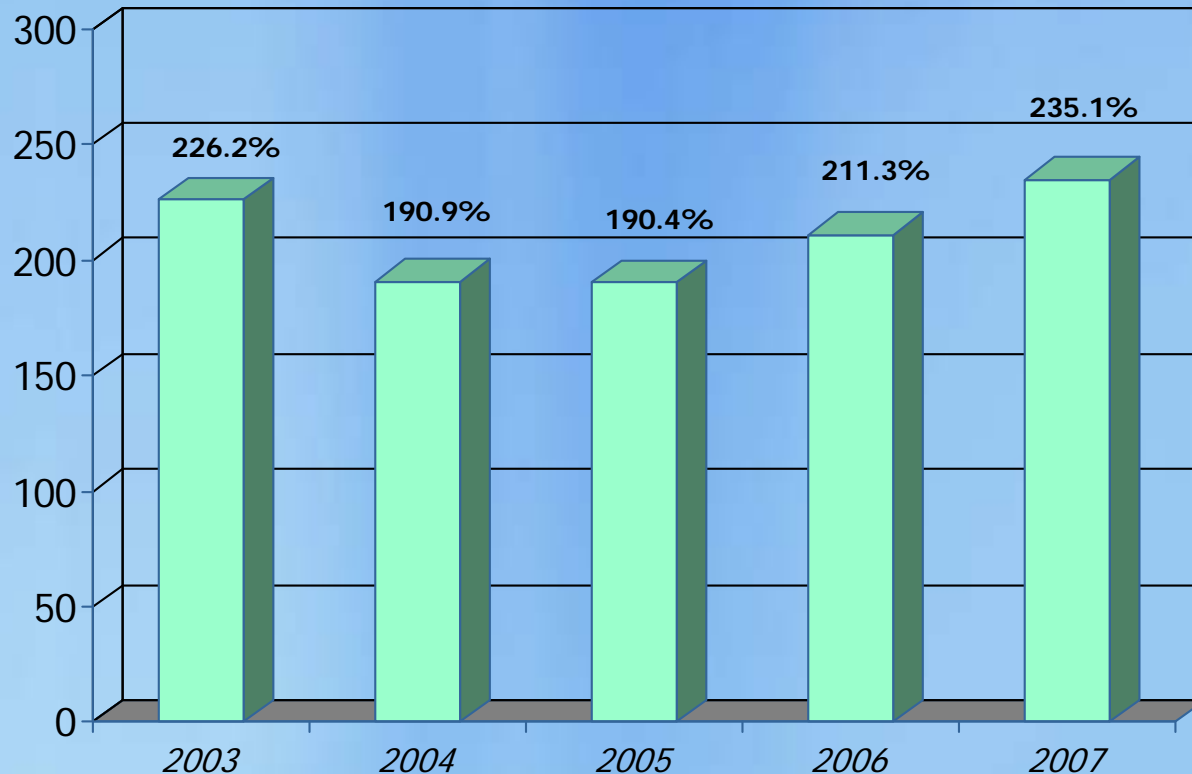


Actuarial Value of Assets/Accrued Liabilities

# Defined Benefit Pension Plan Firefighters Benefit Fund

This table presents a comparison of funded ratio for the Pension Plan for the past five years.

**Funded Ratio**



Actuarial Value of Assets/Accrued Liabilities

# Legal Perspective

(Part 2 of 3)

# Legal Stuff...

## IRS Funding Vehicles

In general, a governmental plan subject to GASB 45 can pre-fund retiree healthcare in one of three ways:

1. **Code Section 115 Trust**- this is a separate irrevocable trust established for a governmental purpose of providing retiree healthcare benefits
2. **Code Section 401(h) Account**- this is a separate account set up as a sub-account of the retirement fund trust
3. **Voluntary Employees' Beneficiary Associations (VEBA)**- this is a trust established for the sole purpose of paying retiree healthcare benefits and is governed by both employer and employee trustees

# Transfer of Pension Assets

As a general rule, retirement fund assets are to be used for the exclusive purpose of providing pension benefits to participants and beneficiaries under the plan, and they may not be used to provide retiree health care benefits.

**However**, there is a limited exception to the general rule available pursuant to Code Section 420. Section 420 permits a defined benefit pension fund to transfer excess retirement plan assets to a retiree health account established as a separate sub-account in the plan under Section 401(h)

Under Section 420 there are two ways in which a plan may transfer excess pension assets to a 401(h) account, either as a **“qualified transfer”** or as a **“qualified future transfer.”**

# Qualified Transfer of Pension Assets into 401(h) Account:

Section 420 allows defined benefit plans to make a “qualified transfer” of excess pension assets for the purpose of funding qualified current retiree healthcare liabilities, provided the following conditions are met:

1. Excess pension assets may be transferred to a separate account in the pension plan for the purpose of paying current retiree healthcare liabilities during the taxable year of the transfer;
2. Generally, transfers are limited to the lesser of:
  - i. assets in excess of 125% of current pension liability, or
  - ii. the retiree health liability for the year;
3. Participants must become 100% vested in their accrued benefits in the pension plan as of the transfer date;
4. The employer must maintain the same level of retiree healthcare costs for a five-year period after the transfer;
5. If transferred assets are not used to pay current retiree healthcare costs, such amounts must be transferred back to the plan and a tax penalty may be applied.

## Qualified Future Transfers of Pension Assets into 401(h) Accounts:

In lieu of a “qualified transfer,” Code Section 420 as amended by the Pension Protection Act of 2006, allows defined benefit plans to make a “qualified future transfer” of excess pension assets for the purpose of funding qualified future retiree health benefits for up to a ten year period. A qualified future transfer must meet the following conditions:

1. Excess pension assets may be transferred to a separate account in the pension plan for the purpose of paying retiree healthcare liabilities for not less than 2 and not more than 10 years (the “transfer period”);
2. Generally, transfers are limited to the lesser of:
  - i. assets in excess of 120% of the plan’s funding shortfall (if any) and the target normal cost, or
  - ii. the sum of the retiree health liabilities during the transfer period;

## Qualified Future Transfers of Pension Assets into 401(h) Accounts: (cont.)

3. Participants must become 100% vested in their accrued benefit in the pension plan as of the transfer date;
4. The employer must maintain the same level of retiree healthcare costs during the transfer period and for a four-year period thereafter;
5. If the plan becomes less than 120% funded at any point during the transfer period, either:
  - i. the employer must fund the defined benefit plan up to the 120% level, or
  - ii. the employer must transfer money back from the 401(h) sub-account to the pension plan in an amount sufficient to reach the 120% level of funding

# Summary

Although retiree health care may be pre-funded through the use of three different funding vehicles,

1. 115 Trust
2. 401(h) Trust
3. VEBA Account

only a 401(h) account may receive a transfer of excess pension funds, provided the conditions of Section 420 are met.

However, unlike a 115 Trust and VEBA, a 401(h) account is subject to a subordination limit that could potentially restrict contributions below the level necessary to fund the retiree healthcare costs.

It is advised, that a pension plan which transfers assets under Section 420 to a 401(h) account request a determination letter from the IRS to ensure that the plan's language complies with the requirements of Section 420 as it relates to asset transfers.

# **A Word From Our Actuary...**

## **(Part 3 of 3)**



**Steve Lemanski, Consulting Actuary**  
**Milliman**

# From Our Actuary...

We expect that the City's additional funding cost for vesting all participants in their accrued benefits would be nominal.

# From Our Actuary...

The value of the accrued benefit builds up very slowly in the early stage of an employee's career, we expect that the refund of employee contributions plus interest would be greater than the vested pension benefit for several years (on average, 7 to 8 years).

Therefore, in most cases, the refund of employee contributions plus interest would be more valuable than the newly vested accrued benefit, and there would be no additional liability for the pension funds.

## From an Administrative Perspective

- The timing of pension distributions would need to be addressed for participants who have less than 10 years of service at date of termination.
- Also, would that employee be allowed to receive a reduced Early Retirement benefits, since the current Early Retirement requirement of 10 years of service had not been satisfied?

## **Funded Status Thresholds for Section 420 Transfers**

Surplus pension assets may be transferred for purposes of funding retiree healthcare benefits, if the asset level exceeds certain thresholds.

# Interest Rate Assumptions

- The interest rate assumption used for Current Liability is based on current interest rates in the bond market, and is much lower than the 7.75% assumption used in the actuarial valuations.
- As of the most recent actuarial valuation date (July 1, 2007), the current liability interest rate was 5.83%.
- All else being equal, a lower interest rate result in a higher liability and, therefore, produces a higher funding threshold.

## On The Other Hand

- Current liability considers only the benefits accrued to date
- The Actuarial Accrued Liability incorporates additional liability for projected future salary increases through assumed dates of retirement.
- All else being equal, this difference will result in Current Liability being lower than Actuarial Accrued Liability.

## Taking into Account...

The difference mentioned, Milliman estimates that the City's three pension plans exceeded the 125% Current Liability threshold by the following amounts as of July 1, 2007:

City:	\$26 million
Police:	\$56 million
Fire:	\$65 Million

For each plan, the Section 420 transfer is limited to the lesser of the amounts shown above, or the retiree healthcare liability for the year. The City's total annual retiree healthcare benefit payments are about \$1.8 million per year. Since assets exceed the 125% threshold by amount well above this level, then this criteria is satisfied and the full amount of the retiree healthcare benefit payments could be transferred.

## The City Has The Option...

- To transfer assets to fund up to 10 years of future estimated retiree healthcare benefits.
- If the City elects such an option, then the funding threshold is 120% instead of 125%. An important difference is that the 120% funding level must be maintained during the entire transfer period.
- If the funding level falls below the 120% level, then assets must be transferred back from the Section 401(h) sub-account to the pension plan, so that the 120% funded level is restored.

# Impact on Pension Plan Funded Status and Future Contributions

- Transferred assets are no longer available to pay pension benefits and are not counted in the asset value for the pension plan's actuarial valuation
- The funded ratio of the pension plan would be lower than it would have been, had the transfer not taken place
- We recommend that the City review the actuarial assumptions used in the retiree healthcare valuation report and, where appropriate, revise those assumptions so that they are consistent with those used in the pension plan valuations.
- We also recommend that the retiree healthcare expected benefit payments and emerging liabilities be broken down into the following groups: General City, Police, Fire, Board of Education (non-certified) and Board of Education (certified)

## The Milliman Analysis is...

- Based on census data, actuarial methods and assumptions used for the July 1, 2007 actuarial valuation of the General City, Fire and Police pension plans
- As well as AON Consulting June 30, 2007 retiree healthcare actuarial valuation and the census date, actuarial methods and assumption contained therein

# Conclusion

## Decisions To Be Made

- Choice of Financing
  - Pay-go
- or
- Transfer excess pension assets

*I would like to extend a thank you to Jodi McGrane, Assistant to the Comptroller, for her assistance in the preparation and review of this presentation.*

# The End

