Retiree Health Plan Liability

Background

In 2004, the Government Accounting Standards Board (GASB) finalized two new accounting standards, GASB 43 and 45, for public sector entities. Because of this, governments must report costs that pertain to post-employment benefits other than pensions, known as OPEB (Other Post-Employment Benefits). These GASB standards require that governmental employers report liabilities that are accrued in OPEB plans over the service time of employees, rather than as the current year's cash outlay, as most governments previously reported. In the past, government employers would simply account for OPEB benefits on a "pay-as-you-go" basis when claims were actually paid. The new accrual accounting approach may create significantly higher annual accounting expenses than the previous cash basis. GASB 43 and 45 serves the same purpose as FAS statements 106 and 112 for private and corporate employers, which have been in effect since the early 1990s. The accrual method is similar to GASB 25 and 27 for pension-related benefits.

Summary of OPEB Actuarial Liabilities and Costs

	January 1, 2009	**January 1, 2011**
Fully Projected Liability	$ 26.9	$ 34.9
Entry Age Normal Actuarial Accrued Liability (AAL)	16.2	21.3
Normal Cost	0.9	1.2
Normal Cost as a Percentage of Pay	2.07%	2.73%
Amortization of Unfunded AAL as a Percentage of Pay	1.33%	1.92%
Total Cost as a Percentage of Pay	3.40%	4.65%
Projected Cost for Fiscal Year 2011	$ 1.6	N/A

Funding

There is no obligation to pre-fund OPEB benefits as an entity would on their pension promises. However, there are significant advantages in doing so in terms of utilizing higher discount rates, and therefore, reporting lower liability. There are several possible vehicles for funding, including:

- Voluntary Employee Benefit Account (VEBA) Trust
- 401(h) Account
- Health Savings Account
- Retiree Health Savings Account

GASB Statement 43 has particular requirements pertaining to the legal structure of a trust fund when determining whether assets can be considered to be accumulated for the purposes of pre-funding the OPEB benefits, specifically:

- Contributions to the plan are irrevocable
- Plan assets are dedicated to providing benefits to their retirees and their beneficiaries in accordance with the terms of the plan
- Plan assets are legally protected from creditors of the employer or plan administrator

The City must satisfy these requirements if it wishes to use these assets to offset the retiree healthcare liabilities for GASB purposes.

Consequences of GASB 45

- Lower bond rating - Large GASB liabilities, especially if unfunded, may result in a decline in credit rating, thereby increasing the cost of borrowing money.
- Increased expense - GASB 43 and 45 may require reporting and funding of annual expenses that are as much as 10 times the current pay-as-you-go cost for OPEB benefits.
- Budget constraints - Annual GASB expense may be as high as 20 percent of active payroll. A late start on valuing under GASB can result in a wild scramble to find extra money in an already tight budget.
- Negative publicity - An unprepared organization can face potentially damaging publicity, which can have negative political and public relations outcomes.

City of Lawrence Situation

The current funding guideline related to fund balance from the Healthcare Committee's Ongoing Goals and Objectives is:

> *"Recommended levels of 16% of projected costs will be maintained in retained earnings for at least one year beyond the year for which the budget is being prepared. Retained earnings fund the cost of catastrophic claims, which is defined by the claims administrator each year not to exceed 120% of projected expenses. Interest earned on retained earnings will be used to offset the budget request to fund retained earnings."*

Operation of the fund balance allows the City to maintain adequate funding to cover the plan's actual cashflow, reserves, claim fluctuation, an excess number of catastrophic claims and to some extent the retiree liability for currently retired plan members and those employees approaching retirement.

Excess operational funds set aside for health care expenses may give bond raters some assurance that the retiree liability is partially funded even though a segmented fund does not exist. A healthy health care operational fund balance also assists in managing the required new revenues to the health care fund when City revenues are flat or growing at a level lower than the increase in City costs (this was the case in 2006, 2007, 2008, 2009, 2011 and 2012 (proposed)). Private employers have a greater ability to quickly adjust other business factors, such as simply reducing profit, raising revenues or cutting products/services.

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Background on Reserves

An insurance carrier typically considers four factors in determining the total cost of insuring a risk – paid claims, reserves, administrative charges (retention) and claim fluctuation margin. Under an insured contract, the carrier agrees to underwrite the plan for claims incurred during the plan year regardless of when the claims are paid. During the first plan year, paid claims would be on an "immature" basis, equal to approximately nine months of mature claims due to the payment lag between incurral and payment dates. However, the carrier establishes the funds to pay for this claim lag, which will come due upon termination of the contract. These funded are called incurred but not reported reserves or IBNR. In the first year, the carrier must establish funds to cover the claim lag. Combining the IBNR with paid claims produces a full year's worth of claims. In subsequent years, the paid claims reflect a mature (12-month) level, and the IBNR needs to be adjusted to reflect changes in the liability due to claims cost, plan and enrollment changes. Under self-funding, the employer will typically consider the same four factors in determining the total self-funded risk – paid claims, reserves, administrative charges (retention) and claim fluctuation margin. Reserves reflect the plan's liability to pay benefits in the future for a loss incurred during a plan year. As a self-funded plan, you have control over the magnitude of the reserve level as well as the prerogative to fund the reserve or just book it as a liability.