Considerations for Pre-Funding an OPEB liability

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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 prefunded 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

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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

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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)

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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?

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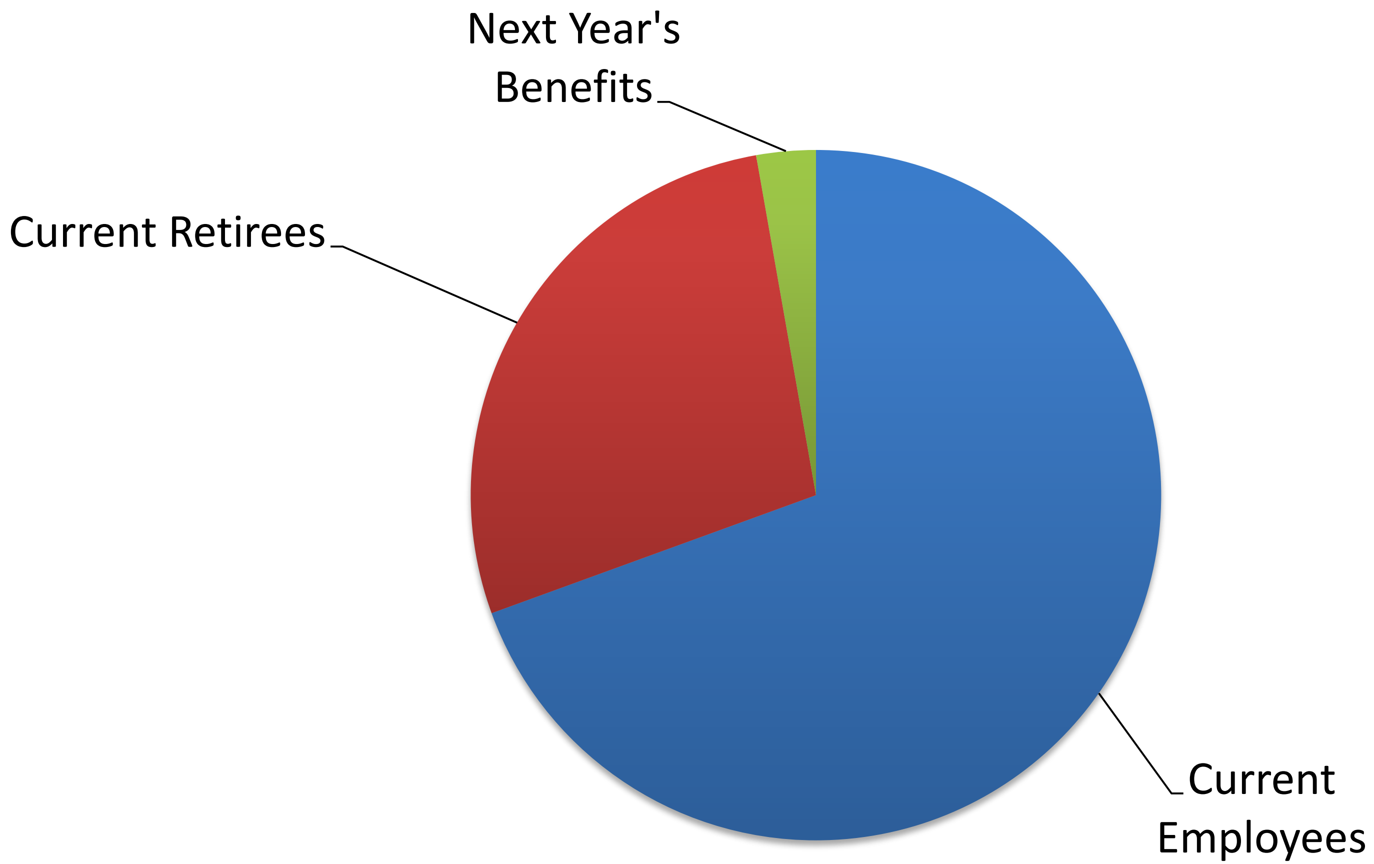
Goal #3 – Desire 100% funded actuarial liability

- 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



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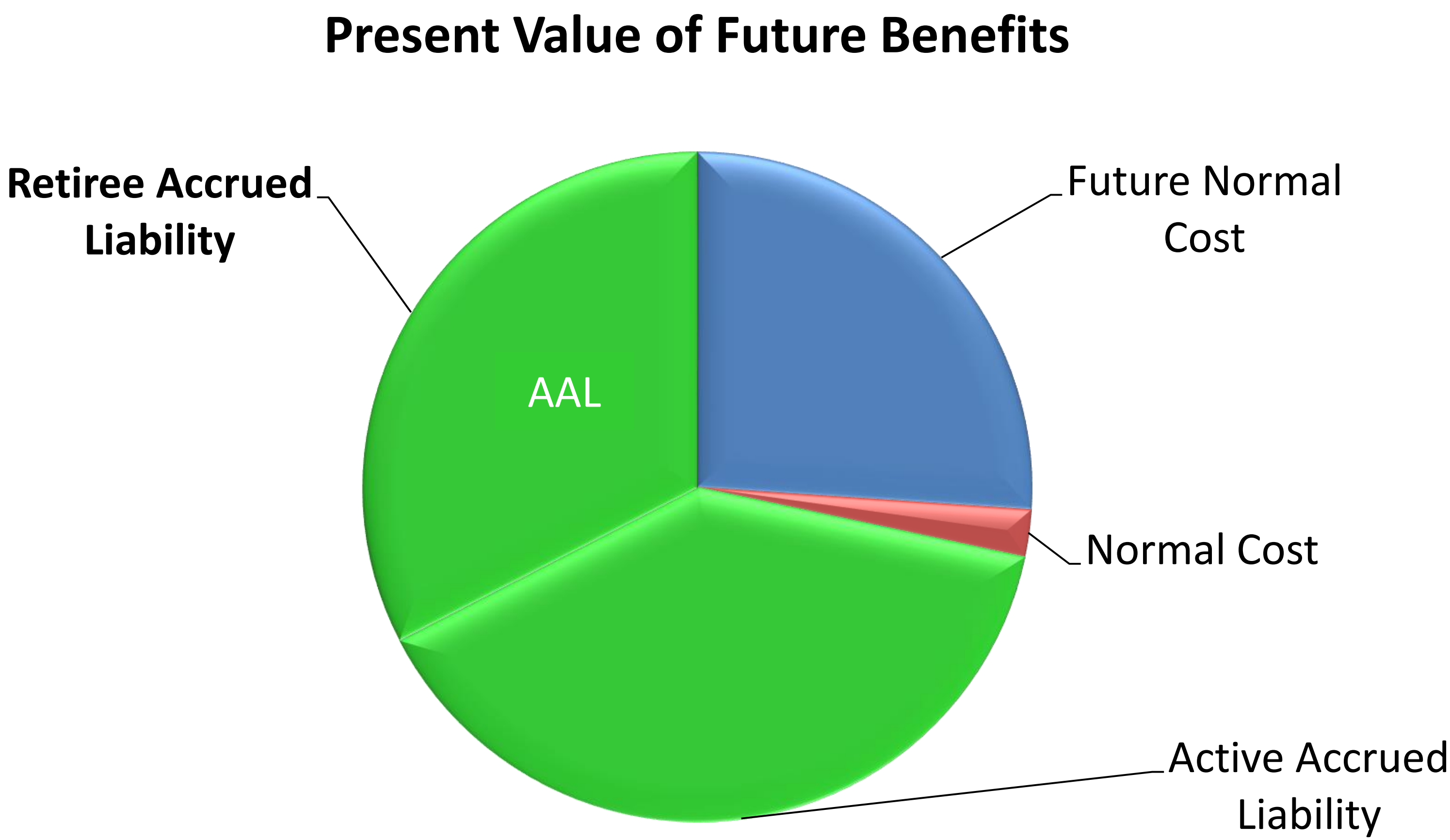
What is Normal Cost?



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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

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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

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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

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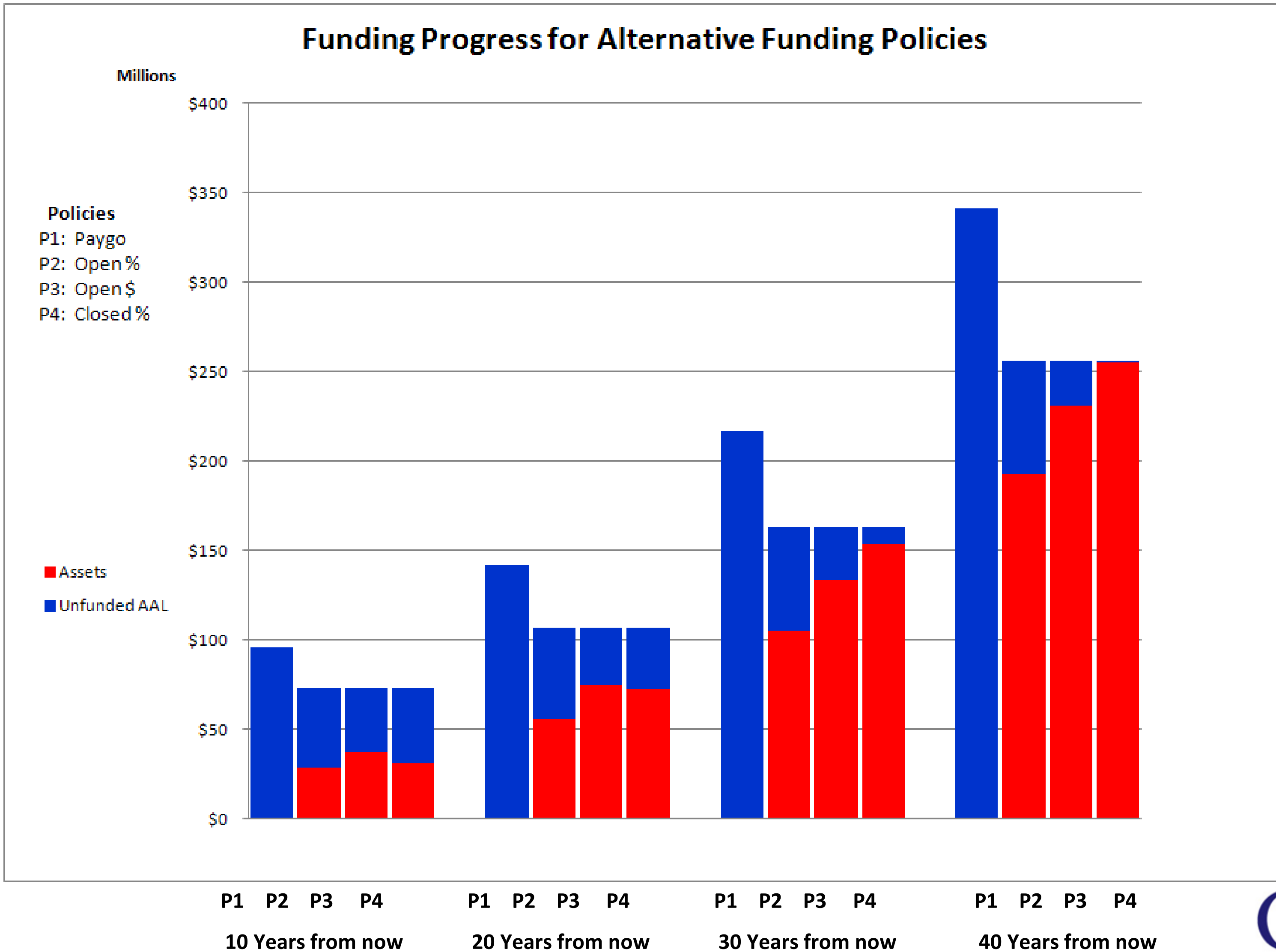
Hypothetical Plan – Funding Progress



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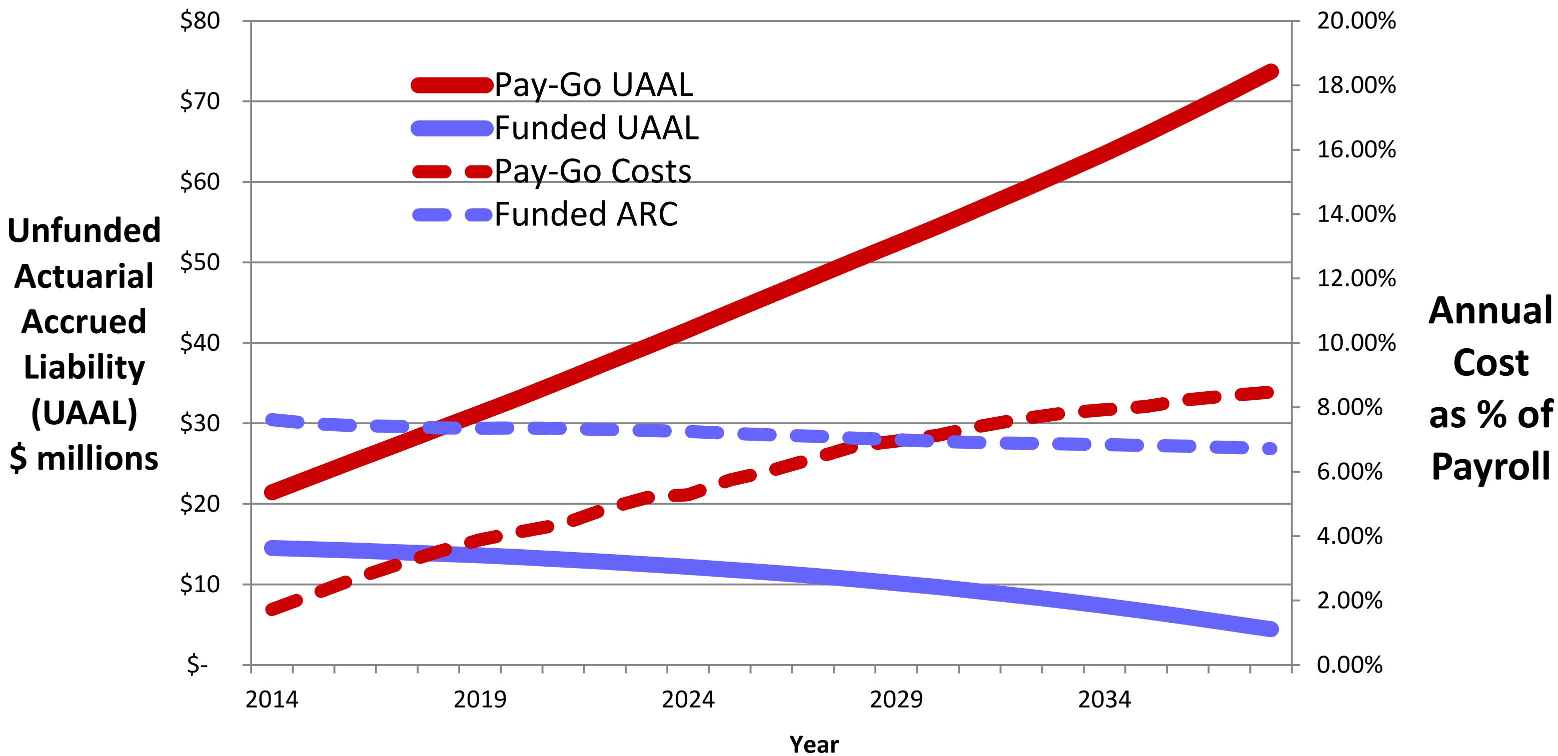
Pay-Go versus Funding Example



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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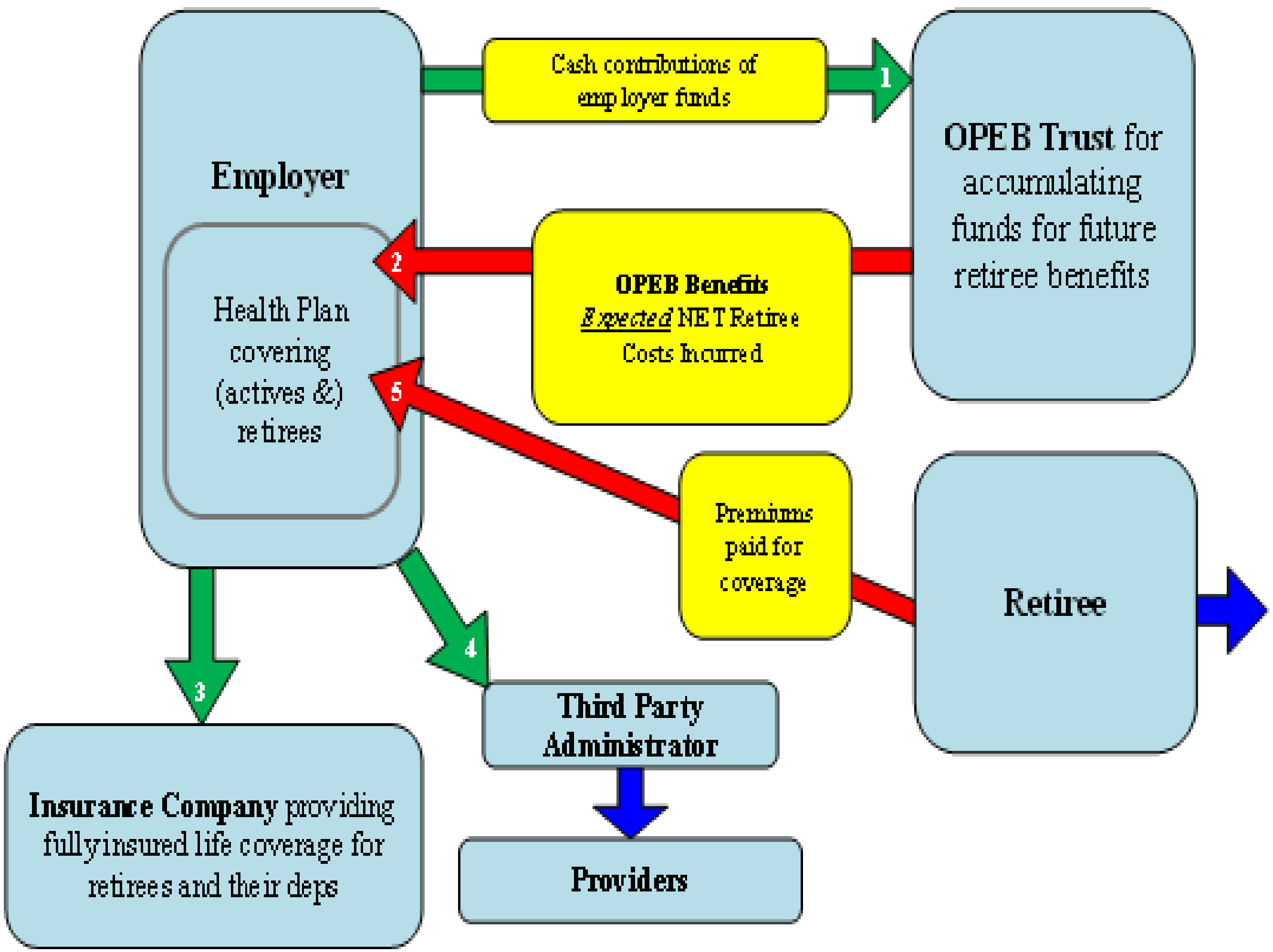
Using the Trust to Pay Benefits

- Initially, ARC > 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 < 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



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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 only benefit is 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”.

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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

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

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The Federal Exchanges

- Second Lowest Silver Plan in Collin County:
  - BCBS HMO
  - $578/month for one 60-year old
    - $3,000 deductible/$6,350 max out-of-pocket
  - $1,157/month for two 60-year olds
    - $6,350 deductible/$6,350 max out-of-pocket
- Premiums for a 40 year old are roughly half

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The Federal Exchanges

- Sample Gold Plan in Collin County:
  - BCBS PPO
  - $706/month for one 60-year old
    - $1,500 deductible/$3,500 max out-of-pocket
  - $1,411/month for two 60-year olds
    - $3,500 deductible/$3,500 max out-of-pocket
- 38 plans to choose from on HealthCare.gov in Collin County

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?
- If funding, should request projection of assets, liabilities, contributions and benefits