

***GASB 45 – Where are States in
Implementing the Standards***



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Disclaimer

The views of the presenter are
solely those of the presenter
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Massachusetts

Agenda

- Overview of where states are in implementing OPEB
- Overview of OPEB in Massachusetts
- How does Massachusetts Compare to Other States and Large Governments
- Potential solutions to OPEB

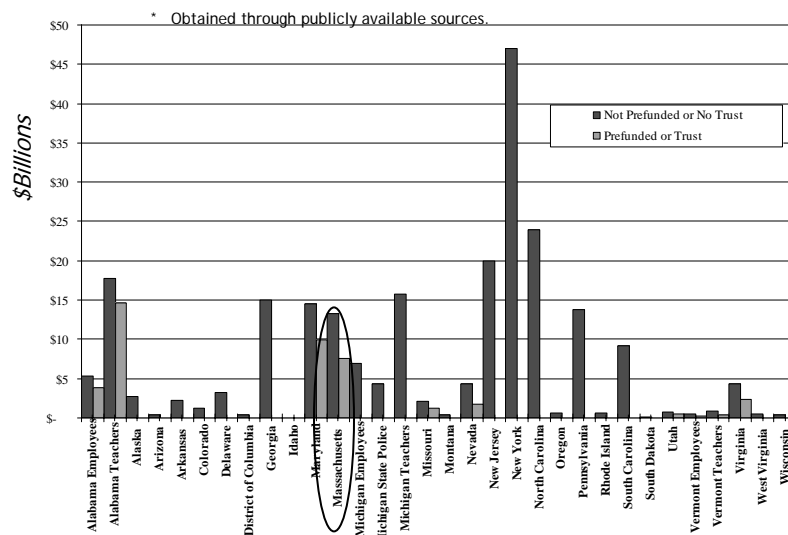
Where are States in Implementing OPEB

- Of the Implementation Group (37 states):
 - 23 have done either actuarial valuations or preliminary valuation
 - 12 have either submitted trust legislation or have already enacted trusts
 - 8 anticipate funding part or all of ARC in FY08

Where are States in Implementing OPEB

- Of the Implementation Group (37 states):
 - Funding Mechanisms being considered include:
 - % of Tobacco Settlement Payments (Massachusetts)
 - Appropriations (Many states)
 - % of payroll (Delaware, Florida, Georgia, Nevada, South Carolina)
 - % of Lottery Net Revenues (North Carolina)
 - Other Funds and Predecessor Trusts

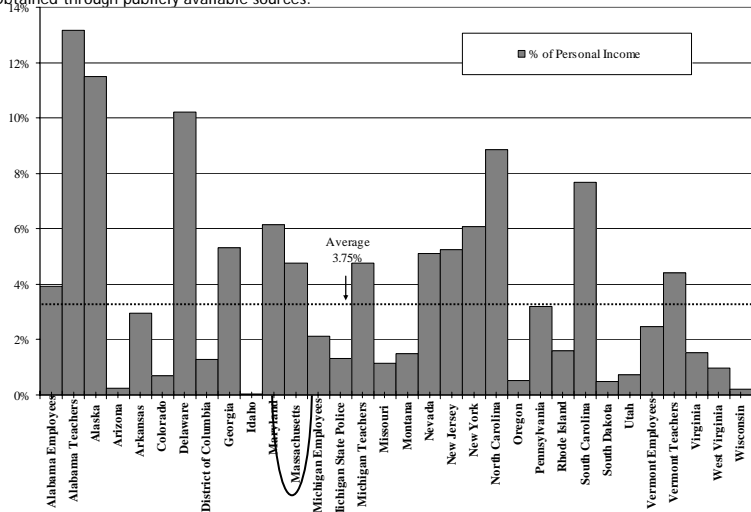
How Large Are These Liabilities? Estimated Unfunded OPEB Accrued Liabilities*



How Large Are These Liabilities?

Estimated Unfunded OPEB Accrued Liabilities as a % of Personal Income*

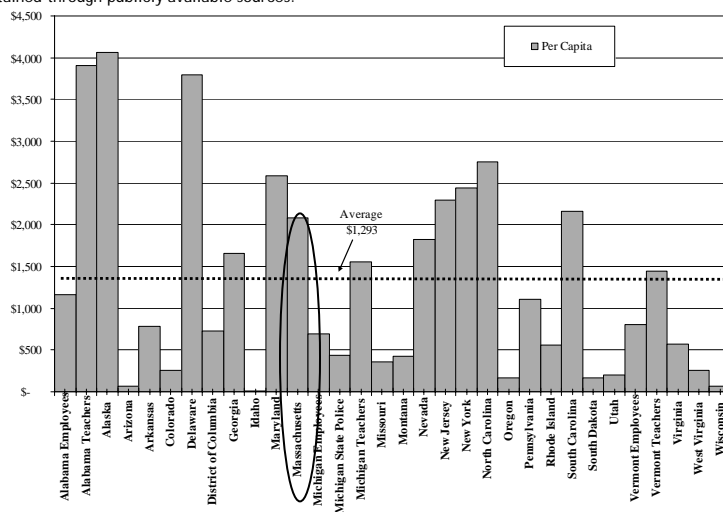
* Obtained through publicly available sources.



How Large Are These Liabilities?

Estimated Unfunded Per Capita OPEB Accrued Liabilities

* Obtained through publicly available sources.



Overview of OPEB in Massachusetts

- OPEB is retiree health care costs, inclusive of dental / vision and a small amount of life insurance
- State is responsible for state workers, *not* teachers or other municipal employees for OPEB.
- State contracts for health insurance through Group Insurance Commission (GIC)
- Municipalities contract for health insurance individually
- State and municipal employees are unionized

Strategies Massachusetts is Considering or has used to deal with OPEB

- Measured the Liability
 - Without information, there can be no strategy
 - Updated for FY2008 budget
 - Amortizing Unfunded OPEB obligations over a long time – up to 30 years
- Considering OPEB costs in any long – term personnel decision making
- Governor has proposed legislation for a Trust
 - Allows lower cost of funds due to higher return if funded

How we are Using Results to Decide Strategy

I. Assuming no prefunding of obligations

	(1) Gross Results for Health (\$ millions)	(2) Life Insurance (\$ millions)	Total = (1) + (2) (\$ millions)	Medicare Prescription Drug Savings (\$ millions)	FASB Comparable Accounting (\$ millions)
Present Value of Projected Benefits					
Active	\$13,182.5	\$66.7	\$13,249.2	\$1,343.2	\$11,906.0
Inactive ¹	\$603.2	\$3.4	\$606.6	\$47.6	\$559.0
Retirees	\$5,609.0	\$109.5	\$5,718.5	\$530.6	\$5,187.9
Total	\$19,394.7	\$179.6	\$19,574.3	\$1,921.4	\$17,652.9
Actuarial Accrued Liability					
Active	\$6,921.4	\$40.5	\$6,961.9	\$696.9	\$6,265.0
Inactive ¹	\$603.2	\$3.4	\$606.6	\$47.6	\$559.0
Retirees	\$5,609.0	\$109.5	\$5,718.5	\$530.6	\$5,187.9
Total	\$13,133.6	\$153.4	\$13,287.0	\$1,275.1	\$12,011.9
Assets	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Unfunded Actuarial Accrued Liability	\$13,133.6	\$153.4	\$13,287.0	\$1,275.1	\$12,011.9
Normal Cost at beginning of year	\$570.7	\$2.8	\$573.5	\$55.9	\$517.6

DOES NOT INCLUDE TEACHERS

How we are Using Results to Decide Strategy

II. Assuming prefunding of obligations

	(1) Gross Results for Health (\$ millions)	(2) Life Insurance (\$ millions)	Total = (1) + (2) (\$ millions)	Medicare Prescription Drug Savings (\$ millions)	FASB Comparable Accounting (\$ millions)
Present Value of Projected Benefits					
Active	\$5,642.2	\$26.2	\$5,668.4	\$487.5	\$5,180.9
Inactive ¹	\$309.1	\$1.2	\$310.3	\$18.1	\$292.2
Retirees	\$3,829.6	\$77.1	\$3,906.7	\$335.4	\$3,571.1
Total	\$9,780.9	\$104.5	\$9,885.4	\$841.0	\$9,044.2
Actuarial Accrued Liability					
Active	\$3,327.2	\$17.3	\$3,344.5	\$283.8	\$3,060.7
Inactive ¹	\$309.1	\$1.2	\$310.3	\$18.1	\$292.2
Retirees	\$3,829.6	\$77.1	\$3,906.7	\$335.6	\$3,571.1
Total	\$7,465.9	\$95.6	\$7,561.5	\$637.5	\$6,924.0
Assets	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Unfunded Actuarial Accrued Liability	\$7,465.9	\$95.6	\$7,561.5	\$637.5	\$6,924.0
Normal Cost at beginning of year	\$247.0	\$1.1	\$248.1	\$20.5	\$227.6

DOES NOT INCLUDE TEACHERS

How we are Using Results to Decide Strategy

I. Assuming no prefunding of obligations

Fiscal Year Ending June 30, 2007	
(\$ millions)	
Normal Cost	\$599.3
Unfunded Actuarial Accrued Liability Amortization	462.8
Annual Required Contribution (ARC)	\$1,062.1

II. Assuming prefunding of obligations

Fiscal Year Ending June 30, 2007	
(\$ millions)	
Normal Cost	\$268.5
Unfunded Actuarial Accrued Liability Amortization	434.4
Annual Required Contribution (ARC)	\$702.9

Current PAYGO cost is about \$330 MM -

OPEB is 2-3X

Private industry is 6-10X

DOES NOT INCLUDE TEACHERS – note – numbers unofficially updated to FY08 to \$763.1M and \$1,206M

Sensitivity Analysis – 1% Δ in Health Care Trend Rate – no prefunding

	4.5% Discount Rate (\$ millions)	Impact of 1.0% Health Trend Rate	
		Plus 1.0% (\$ millions)	Minus 1.0% (\$ millions)
Present Value of Projected Benefits	\$19,574.3	\$24,258.5	\$16,080.0
Funded Status:			
Actuarial Accrued Liability	\$13,287.0	\$15,884.1	\$11,281.9
Assets	\$0	\$0	\$0
Unfunded Actuarial Accrued Liability	\$13,287.0	\$15,884.1	\$11,281.9
Annual Required Contribution (ARC):			
Normal Cost	\$599.3	\$768.4	\$475.1
Unfunded Actuarial Accrued Liability Amortization	\$462.8	\$553.3	\$393.0
Annual Required Contribution (ARC)	\$1,062.1	\$1,321.7	\$868.1

Δ in UAAL + 19.5% / - 15.1%

Δ in ARC + 24.4% / - 18.3%

DOES NOT INCLUDE TEACHERS

Sensitivity Analysis – 1% Δ in Health Care Trend Rate – Prefunding

	8.25% Discount Rate (\$ millions)	Impact of 1.0% Health Trend Rate	
		Plus 1.0% (\$ millions)	Minus 1.0% (\$ millions)
Present Value of Projected Benefits	\$9,885.5	\$11,559.9	\$8,562.4
Funded Status:			
Actuarial Accrued Liability	\$7,561.5	\$8,622.6	\$6,699.5
Assets	\$0	\$0	\$0
Unfunded Actuarial Accrued Liability	<u>\$7,561.5</u>	<u>\$8,622.6</u>	<u>\$6,699.5</u>
Annual Required Contribution (ARC):			
Normal Cost	\$268.5	\$326.7	\$223.5
Unfunded Actuarial Liability Amortization	\$434.4	\$495.4	\$384.9
Annual Required Contribution (ARC)	<u>\$702.9</u>	<u>\$822.1</u>	<u>\$608.4</u>

Δ in
UAAL +
14.0% / -
11.4%

Δ in ARC
+ 17.0%
/ - 13.4%

DOES NOT INCLUDE TEACHERS

Sensitivity Analysis – Change in Retiree Contribution Rates to 25%

	(1) Health and Life Insurance (\$ millions)	(2) Revised for Contribution Change ¹ (\$ millions)	(3) Savings = (1) - (2) (\$ millions)
Present Value of Projected Benefits			
Active	\$13,249	\$11,690	\$1,559
Inactive ²	\$607	\$536	\$71
Retirees	\$5,718	\$5,045	\$673
Total	\$19,574	\$17,271	\$2,303
Actuarial Accrued Liability			
Active	\$6,962	\$6,143	\$819
Inactive ²	\$607	\$536	\$71
Retirees	\$5,718	\$5,045	\$673
Total	\$13,287	\$11,724	\$1,563
Assets	\$0	\$0	\$0
Unfunded Actuarial Accrued Liability	\$13,287	\$11,724	\$1,563
Normal Cost at beginning of year	\$573	\$506	\$67
Annual Required Contribution			
Normal Cost at end of year	\$599	\$529	\$70
Amortization	\$463	\$499	\$36
Total	\$1,062	\$938	\$124

Δ in
UAAL -
11.8%

Δ in ARC
- 11.7%

DOES NOT INCLUDE TEACHERS

Sensitivity Analysis – Change in Retiree Contribution Rates to 25%

	(1) Health and Life Insurance (\$ millions)	(2) Revised for Contribution Change ¹ (\$ millions)	(3) Savings = (1) - (2) (\$ millions)	
Present Value of Projected Benefits				
Active	\$5,688	\$5,001	\$687	
Inactive ²	\$310	\$274	\$36	
Retirees	\$3,907	\$3,447	\$460	
Total	\$9,885	\$8,722	\$1,163	Δ in NAAL -
Actuarial Accrued Liability				
Active	\$3,344	\$2,951	\$393	
Inactive ²	\$310	\$274	\$36	11.8%
Retirees	\$3,907	\$3,447	\$460	
Total	\$7,561	\$6,672	\$889	
Assets				
Unfunded Actuarial Accrued Liability	\$7,561	\$6,671	\$890	
Normal Cost at beginning of year	\$248	\$219	\$29	Δ in ARC
Annual Required Contribution				
Normal Cost at end of year	\$268	\$236	\$32	
Amortization	\$434	\$393	\$41	-11.8%
Total	\$702	\$619	\$83	

DOES NOT INCLUDE TEACHERS

Funding Strategies – Pros and Cons

■ Create an Irrevocable Trust

– Pros

- If funded, affords most rate of return, cutting costs dramatically – **biggest bang for the buck**
- May be a similar structure to current pension system, but separate legal entity

– Cons

- Inflexible – the only way funds can be removed is for benefits, unless all future costs are paid
- Needs to be separate account from pensions for tax purposes

Funding Strategies – Pros and Cons

■ Do Nothing

– *Pros*

- No budgetary effect

– *Cons*

- Debt ratings may be changed if peers are funding OPEB
- Ratios will be downgraded due to increased liabilities

Funding Strategies – Pros and Cons

■ Partially Fund

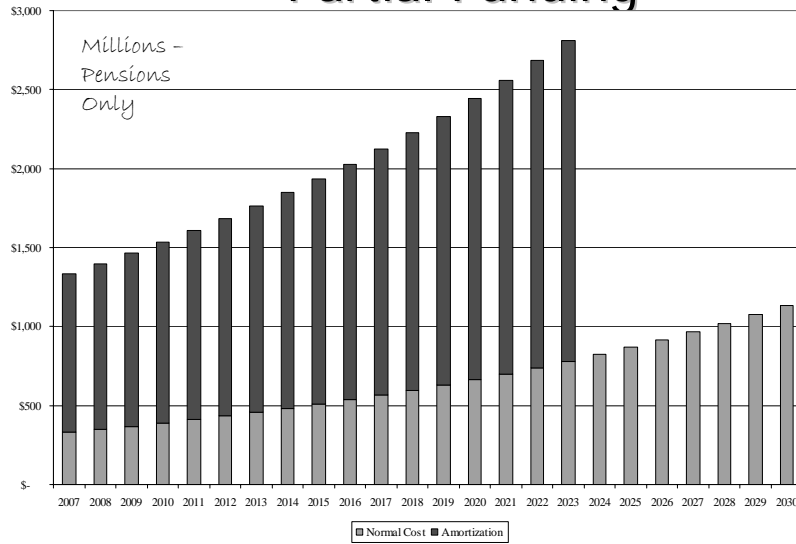
– *Pros*

- Follows the spirit of GASB 45
- Shows management is taking action
 - Massachusetts has proposed taking this approach using up to 90% of MSA payments

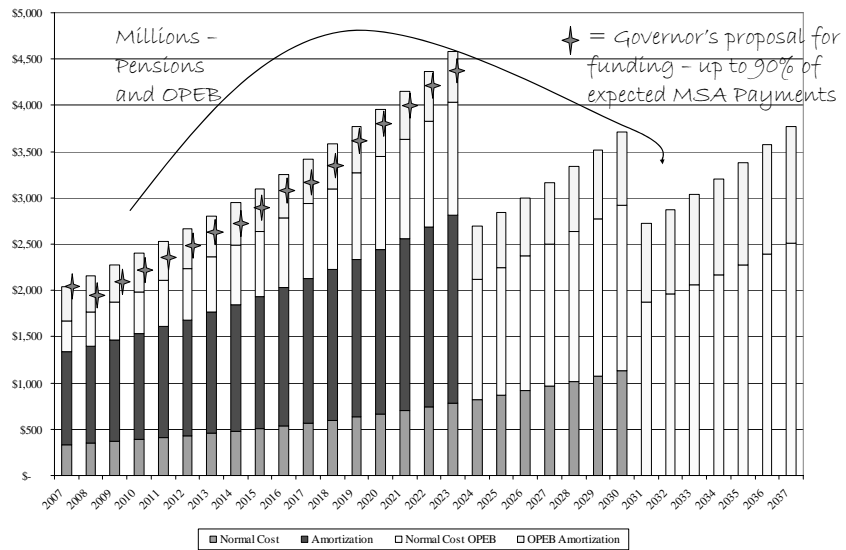
– *Cons*

- Cannot use highest interest rates, thereby lowering liability considerably
- Cash flow drain, though not as much as full funding

Funding Strategies – Pros and Cons – Partial Funding



Funding Strategies – Pros and Cons – Partial Funding



Other Strategies for Dealing with OPEB that Governments have Done or are Considering

- Change the health benefit structure
- Increase cost sharing
- Think outside the box –
 - Employee actions
 - OPEB Bonds
 - Insurance vehicles

Funding Strategies – Pros and Cons

- Increase Employee Contributions
 - *Pros*
 - Directly lowers employer obligations
 - Employees have more of a stake in government's health care decisions
 - *Cons*
 - May trigger contractual issues with unions
 - May not have an immediate affect as current employees and retirees may not be effected

Funding Strategies – Pros and Cons

- Allow greater employee options
 - VEBA trusts, IRC 401(h) after tax contribution accounts, HSAs, Defined Contribution (DC), Retirement Medical Benefit Accounts
 - *Pros*
 - Employees have more of a stake in government's health care decisions
 - Potential Tax Benefits for employees depending on vehicle
 - *Cons*
 - Need to be careful with DC accounts as it creates classes of employees

Funding Strategies – Pros and Cons

- Using one-time revenues, surpluses, MSA payments
 - *Pros*
 - Gives a quick jolt of funding with minimal pain on taxpayers
 - *Cons*
 - May be one time only – true funding needs to be sustained

Funding Strategies – Pros and Cons

■ Using bonds and insurance vehicles

– *Pros*

- Gives a quick jolt of funding with minimal immediate pain on taxpayers

– *Cons*

- Bonds – trades a variable liability to a fixed liability
- Insurance products need to defease the liability to be effective

Funding Strategies – Pros and Cons

■ The elephant in the room –

- Control health care costs through consolidation and aggressive management

– *Pros*

- Combined with other strategies has the greatest effect

– *Cons*

- May require legislation and breaking down age-old barriers

Quick Comparison of Funding Vehicles

Funding Vehicle	Available for Gov'ts?	Creates an Asset?	Tax Treatment for Employee Contributions	Limits on Funding?	Possible Asset Reversion to Gov't?
VEBA (IRC 501(c)(9))	Yes	Yes	After tax	None except for higher ed may be limited due to UBI Tax ¹	No – excess assets used to provide other benefits
IRC 115 integral part trust	Gov'ts Only	Yes	After tax – pre tax uncertain	No	Yes if all benefits paid
IRC 501(c)(3) trust	NO	Yes	After tax	No	Yes if all benefits paid

Source – TIAA CREF –
"The Retiree Health
Care Challenge" Page
16 – November 2006

¹ IRS PLR 200610025

Quick Comparison of Funding Vehicles

Funding Vehicle	Available for Gov'ts?	Creates an Asset?	Tax Treatment for Employee Contributions	Limits on Funding?	Possible Asset Reversion to Gov't?
IRC 401(h) medical sub account in pensions	Yes	Yes	Depends on structure	Yes – $\leq 1/3$ of total contributions – can be greater if pension is overfunded	Yes if all benefits paid
Individual accounts - HRA's / HSA's	Yes	Yes – if HRA is funded through other vehicle – No for HSA – employee's account	Employer contributions only for HRA's – Pre tax HSA subject to limits – MediGap not covered	Yes	Yes – some HRAs can be portable HSA's immediately 100% vested

Source – TIAA CREF –
"The Retiree Health
Care Challenge" Page
16 – November 2006

Massachusetts' Next Steps in GASB 45 Implementation

- Legislation needs to be passed on trust and initial funding model
- If funding is similar to Commonwealth's pension model, get Federal approval
- Work with 60+ separate auditees to get implemented
- Commission to explore future funding

Questions