Other Post Employment Benefits (OPEB) – Future Impacts

Texas Association of County Auditors
"On the Road Area Training"

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PFM Asset Management LLC

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I. Creating an OPEB Trust

OPEB in the Media

"School districts struggle to pay retirees' health benefits"

"The next retirement time bomb"

"Officials continue to grapple with liability issue"

"District is stretching out OPEB burden"

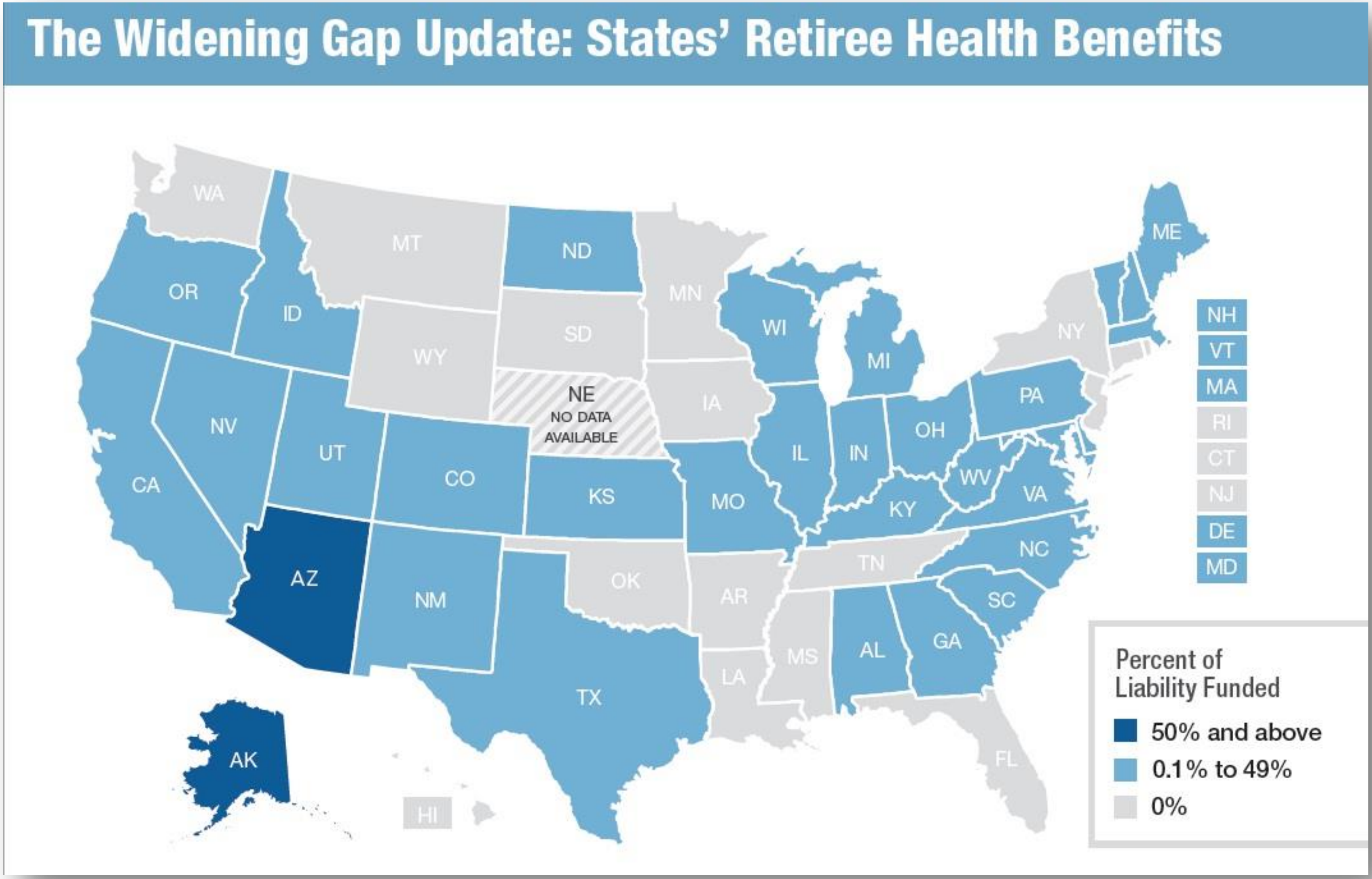
What is an OPEB?

- Form of deferred compensation
- Promise to provide retiree benefits must now be accrued during the working years of employees
- Post-retirement benefit <u>other than pension</u>
  - Including:
    - Retiree medical, life, vision, dental, prescription
    - Implicit retiree medical subsidy
  - Not Including:
    - Early retirement incentives, severance based on unused sick pay, vacation and compensated absences
- Multiple funding options

General OPEB Observations

- The liability of every OPEB fund is different in its construction
  - Different benefits (health, dental, life, etc.)
  - Inconsistent vesting and retirement ages
  - Employer payment structures (explicit/implicit)
- Healthcare inflation has far outstripped CPI
- National healthcare as passed in recent legislation does not relieve employers of their liabilities
- OPEB bonds have not been widely used to fund liabilities, except where taxing authority has been expanded
- OPEB asset management remains relatively unsophisticated

Funding Levels by State



Source: 2012 The Pew Charitable Trusts.

Danger in “Playing it Safe”

- Fiduciary duty to be prudent
  - Safe does not automatically mean “prudent”
- Not keeping up with growth in liabilities
- Less money for county operations
- Lost opportunity cost
- Headline risk

GASB 43/45

- In the past, OPEB liabilities were understated on financial reports of public entities
  - Only reported current cash payments each year;
  - Did not report the full cost of benefits earned by employees
- Purpose to accurately measure, recognize and report the costs and liabilities of providing OPEB
- GASB 45: requires all public plan sponsors that provide OPEB to measure, recognize and report their OPEB expenses, expenditures and liabilities in a new manner.
- GASB 43: (only for separately funded trust) requires trustee or administrator to provide financial reports describing the plan's assets, liabilities and net assets at the end of fiscal year.

GASB 67/68

Currently applies to Pensions, not OPEBs. But it seems OPEB application may be imminent.

- Reporting of net pension liability on financial statements
- Recognize pension expense on income statement
- Reduction of amortization periods from 30 years
- Use of blended discount rate when plan is expected to deplete its assets while still owing benefits
- Disconnection of accounting and funding calculations
- Reduced use of multi-year smoothing in reporting of assets
- Enhanced disclosures

Funded vs. Unfunded OPEB

- **Unfunded:**
  All benefits are paid out of the general operating funds

- **Funded (or partially funded):**
  All or some of the assets needed to pay OPEB have been irrevocably set aside in a trust, or trust equivalent such as a custodial arrangement or certain types of insurance arrangements.

Funding Option #1: PAYGO

- Not really a funding option
- Retiree benefits are paid for as an annual budget item
- Need a coherent story for rating agencies and financial statement users about use of this strategy

Pros	Cons
• Minimizes current year expenditures throughout the life of the benefits • Requires minimal outside professional assistance – Actuary every other year – Auditor • Operationally simple, requires no changes to current processes	• Creates largest possible Unfunded Actuarial Accrued Liability (“UAAL”) and Annual Required Contribution (“ARC”) • Does not address rising cost of providing retiree benefits • No assets to invest, so no mitigation of future liabilities • For actuarial valuation and financial reporting – Must use lower discount rate – Have no assets to offset liabilities

Funding Option #2: Internal Service Fund

- Minimalist funding option
- Retiree benefits may be paid from the fund or may reimburse the employer for costs
- Might create a “better” story for rating agencies and financial statement users

Pros

- Begins to provide funding for future benefits that begins to address intergenerational equity
- Earns a return on assets that can help mitigate future cost increases
- Operationally similar to other Internal Service Funds, requires only minimal changes to current processes
- Assets can revert to General Fund (revocable)

Cons

- Does not qualify for GASB 45 treatments, so structure does not improve UAAL or ARC over PAYGO due to lower discount rate and lack of assets to offset liabilities
- More expensive than PAYGO but addresses rising cost of providing retiree benefits in only a limited manner
- **Typically must be invested according to governmental investment statutes**
- Likely requires additional outside professional assistance of an investment advisor and custodial bank

Funding Option #3: Irrevocable Trust

- **Best of the 3 funding options**
- Retiree benefits may be paid from Trust or may reimburse the employer for costs
- Creates the best funding story for rating agencies and financial statement users
- Only way to receive and invest employee contributions

Pros	Cons
• Provides funding for future benefits in a formal, segregate manner addressing intergenerational equity • Generally, trust assets allowed to invested in "prudent person" investments which can improve returns over the long-term helping to mitigate future cost increases • Structure improves UAAL and ARC reporting using higher discount rate and having Trust assets directly offset liabilities on balance sheet	• Significantly higher costs than PAYGO on a year to year basis to provide full funding, but may limit total future costs • Likely requires changes to current operational processes • Will require additional external professional assistance

Why Fund an OPEB Trust?

- Provide systematic long term funding for retiree medical benefits
- Good funding story for credit rating agencies and financial statement users
- Take advantage of actuarial rules permitting use of a higher discount rate for determining the present value of OPEB obligations
- Improve the balance sheet impact of GASB 45 and reduce your ARC
- Receive employee contributions to mitigate employer costs
- Legal protection from creditors of the employer and plan administrator

Why Fund an OPEB Trust? (cont'd.)

- Increases returns on assets set aside in Trust vs. General Operating Funds
- Keep pace with healthcare inflation rate (which has outpaced CPI), and other risks such as increases in Medicare age
- Leads to lower actuarial plan costs over long-run
- Immediately reduces the accounting liability
- Reduces annual expense
- Improves financial statement quality
- Lowers borrowing costs

OPEB Trust

For Trust assets to be considered as directly offsetting the OPEB liability:

- Assets must be remote from creditors
- Assets must be for the exclusive benefit of participants and beneficiaries

Implications on Trust Governance Models

- Generally, it is expected that assets will be deemed to be remote from creditors if they are controlled by someone other than the governmental entity. Generally, two options are most prevalent in fulfilling this goal:
  - Trust asset investment is directed by a trust board with substantial representation of outside or unaffiliated members—not commonly used
  - Trust assets are held by a bank trustee and managed by a discretionary manager or at direction of an oversight body—most common option

OPEB Trust Structures

- The three trust types listed are among the most common structures for employer funded OPEB trusts

	VEBA	401(h)	Section 115
Structure	Voluntary adoption by employers	Separate account under pension trust	Integral Part Trust - Governmental
No IRS Approval Required	✗	✗	✓
No IRS Annual Filings	✗	✗	✓
No Contribution Caps	✗	✗	✓
Accounting and Non-discrimination Flexibility	✗	✗	✓
Investment Earnings Non-taxable	✓	✓	✓
Benefits Non-taxable	✓	✓	✓

OPEB Trust Governance Approaches

Association Model	Board Model	Employer Model

Group or Multi-Employer Trust

Individual Trust

GASB Requirements

- No direct employer control of assets, thus remote from creditors
- For exclusive benefit of participants and beneficiaries
- Irrevocable

Association Model

- Necessitates IRS Private Letter Ruling to ensure tax-exemption
- Requires a sponsoring body to oversee Trust
- Restrictions are developed by the Sponsor
- Can be low cost
- No ability to customize by client

Board Model

- Requires constitution of a Board to oversee Trust
- Restrictions are developed by the Board
- Some ability to customize by employer

Employer Model

- Requires development of an individual Trust
- No specific investment or withdrawal restrictions
- Full ability to customize by employer

OPEB Obligation Management Process

1. Complete an Actuarial Study — Defined by GASB
2. Develop implementation plan
   -Develop an action plan and communicate with governing body
3. Adjust on-going benefits structure
   -Identify benefit structure and contribution change opportunities
4. Define implications of potential funding choices
   - Budgeted cash flow funding, OPEB Bonds, etc.
5. Develop vehicle(s) for OPEB assets
   -Funding Device including accounting, governance, and legal structures
6. Create plan to invest OPEB assets
   -Identify optimal asset allocation, create investment policy and select manager
7. Implement plan and oversee OPEB assets

II. OPEB Implementation Process

What Are the Basic Steps?

- Work with an investment advisor
  - Approval of contract
- Select a bank custodian/trustee
  - Directed versus Discretionary
- Designate a trust administrator
  - Usually the investment advisor

- Approve trust documents
- Designate oversight official(s) and plan administrator
- Approve investment policy and initial asset allocation

Governance Structure and Documentation

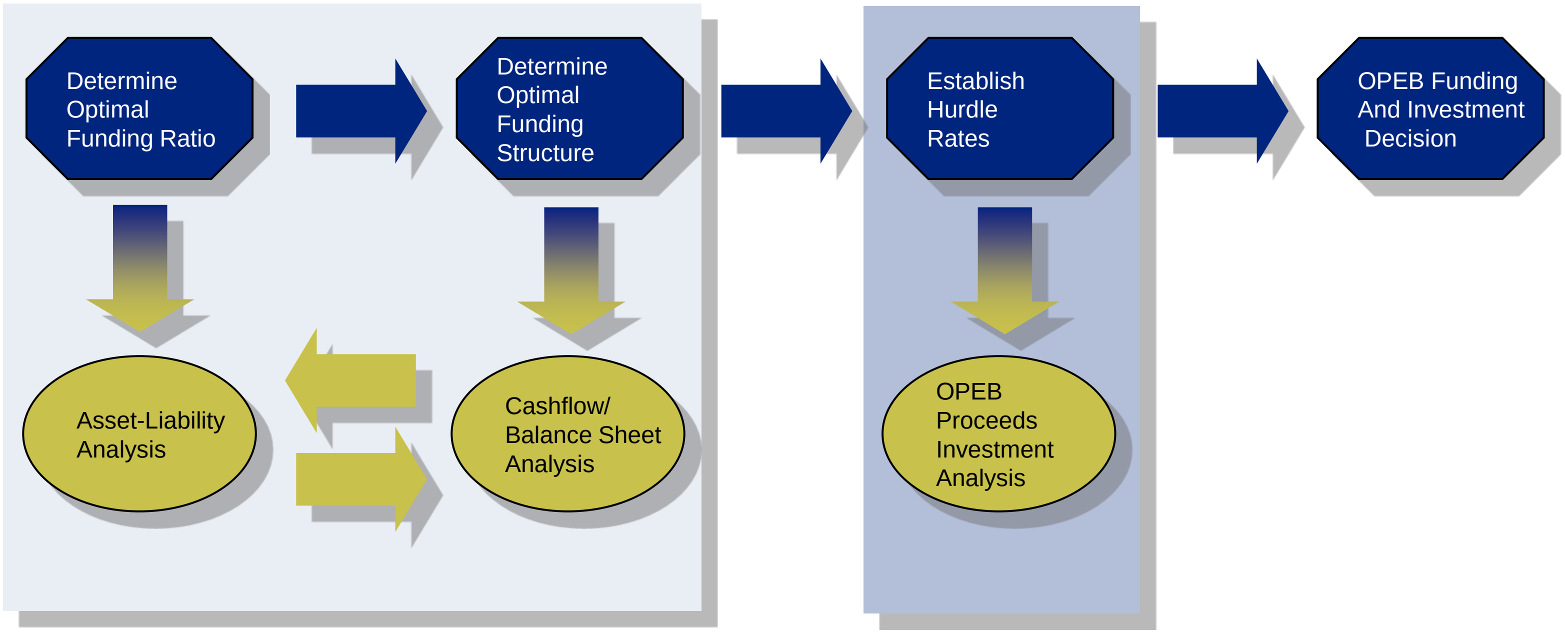
- **Form of Trust**
  - Single Employer Trust
  - Multi-Employer Trust
- **Oversight Committee Charter and Bylaws**
  - Organizes the oversight committee
  - Outlines meeting and decision-making roles and requirements
- **Funding Policy**
  - Outlines general parameters for funding
- **Investment Policy**
  - Outlines parameters of investment including asset class targets and ranges
  - Describes assets classes to be used

OPEB Management Program Financial Analysis

Once an account structure is determined, the financial analysis of an OPEB program typically utilizes a two-step approach:

❶ **Funding Analysis:** Determine the funding plan for the OPEB program based, in part on the program's account structure

❷ **Asset Allocation/Hurdle Rate Analysis:** Assess the probability that various asset allocations will meet or exceed various hurdle rates of return to be earned by the investment portfolio based, in part, on the funding plan



Funding Analysis

Types of Funding

- Cash Flow Funding
- OPEB Bonds
- Reserves
- Budget Surplus

Levels of Funding

- Ramp up to ARC
- ARC
- Lump sum plus ARC
- Fully Fund

Bond Considerations

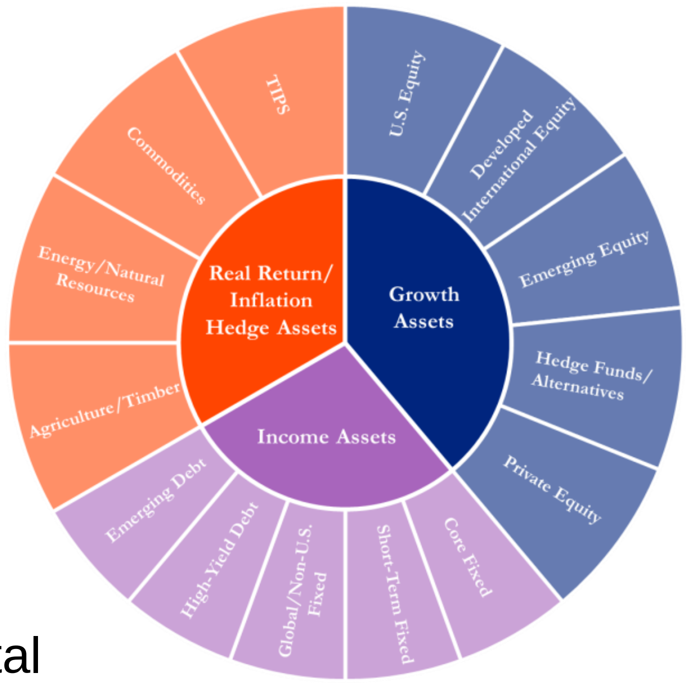
- Only if closing OPEB plan
- Issue in tranches, during recessionary cycles

Level Considerations

- Achieve ARC as soon as practical
- Fund only to maximum of ~80% if benefit changes possible

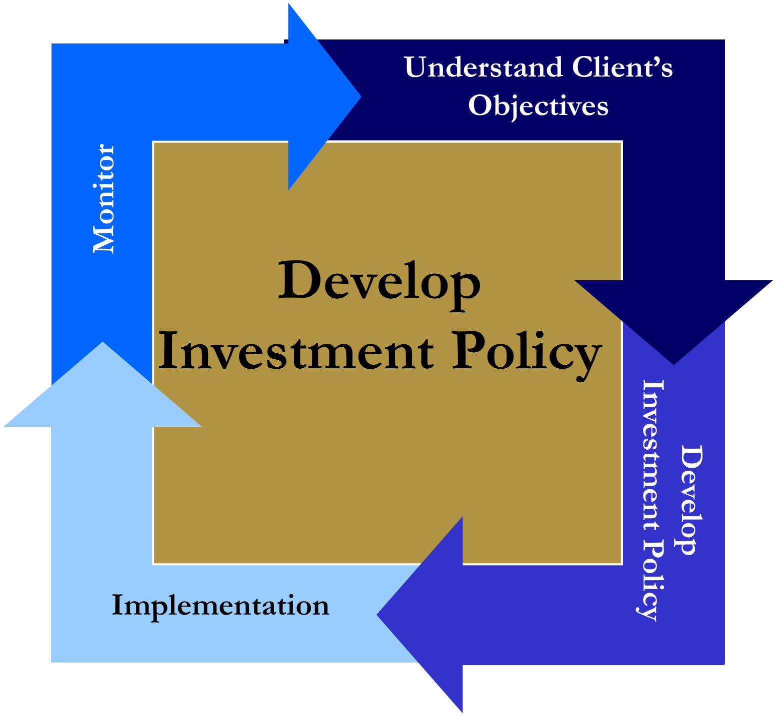
Building a Sound Asset Allocation

- **Funding Plan**
- **Asset / Liability Analysis**
  - Retirees/near-retirees liabilities versus Active liabilities
- **Portfolio Planning**
  - Analyze Detailed Cash Flow Analysis
  - Develop Investment Policy
  - Asset Classes and Styles and Risk Tolerance
  - Target Rate of Return
- **Structuring Asset Allocation Models**
  - View using historical and projected capital market assumptions
  - Develop several risk/reward or stress test scenarios



Documentation as a result of Portfolio Planning

- Liability
- Liquidity
- Risk Tolerance
- Time Horizon
- Target Rate of Return
- Acceptable Allocation Ranges
- Prohibited Investments
- Asset Safekeeping



Texas PFIA & OPEB

- **Does the Texas Public Funds Investment Act apply to (1) the transfer of funds into the OPEB trust, and/or (2) the funds once they are in the OPEB trust?**
  - *Short answer, "yes and no". PFIA is not exclusive authority of OPEB Trust funds.*
  - *PFIA provides that it is not exclusive authority for the investment of public funds. Section 2256.024*
  - *Texas Benefits Act, Chapter 172, Local Government Code*
    - *Allows for creation of Risk Pools, which are treated as Trust.*
    - *Provides the "trustees of a pool may invest the pool's money in any investment authorized by the Texas Trust Code (Subtitle B, Title 9, Property Code)"*

III. Other Considerations – Rating Agencies

Rating Agencies' Heightened Focus on Pension Funding

- Numerous rating agency metrics explicitly factor in pension liabilities, and incorporate current and potential future burden of benefits into their process.

- Although annual pension payments can be temporarily underfunded, policies that risk unsustainable future payments or lack a responsible long-term approach to an appropriate funding level will be viewed as credit negatives.

- National pension fund performance, budgetary limitations, and current funding levels have caused rating agencies to take a closer look at how these metrics impact an issuer's credit worthiness.

- The heightened focus of rating agencies on pension funding and funding levels have created downward pressure on the ratings of many issuers – large and small.

Rating Agency Views on Pensions & POBs

- **Moody's**
  - "…pension obligations are a significant source of credit pressure for governments and warrant a more conservative view of the potential size of the obligations."[1]
  - "Issuance of pension bonds could be part of a broader credit positive effort aimed at restoring a balance between the pension's actuarial liabilities and asset values and achieving affordability. "[2]
- **Standard and Poor's**
  - "…a very high debt, pension and OPEB burden can lead to a management score of 4, which caps the final rating at the lower of 'A' and one notch lower than suggested by [the indicative rating outcomes resulting from the weighted average of seven factors]…"[3]
  - "Standard & Poor's generally considers the issuance of POBs as the swapping of an existing liability for another, with generally neutral credit implications. The difference is that POBs are a 'hard' liability with specific repayment dates, and pension contributions are 'soft' in the sense that they only need to be adequate to keep a pension fund from insolvency."[4]
- **Fitch**
  - "The ability to manage pension costs, as well as all other cost pressures, is a factor in our analysis of management... Fitch's ratings have reflected the degree to which local governments have an ability and willingness to pursue possible changes in order to make their pension burdens more sustainable."[5]
  - "Fitch believes that POBs, if used moderately and in conjunction with a prudent approach to investing the proceeds and other pension assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices with respect to POB proceeds could expose the sponsor to market losses."[6]

1. Moody's Investor Service: Moody's announces new approach to analyzing state, local government pensions; 29 local governments placed under review, April 17, 2013
2. Moody's Investor Service: US State and Local Governments Face Risks with Pension Funding Bonds, December 11, 2012
3. Standard & Poor's: U.S. Local Governments G.O. Ratings: Methodology and Assumptions, September 12, 2013
4. Standard & Poor's: No Immediate Pension Hardship For State And Local Governments, But Plenty Of Long-Term Worries, June 8, 2009
5. Fitch Ratings: Local Government Pension Analysis, April 8, 2013
6. Fitch Ratings: Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits, September 18, 2003

Rating Agency Pressure

Recent Ratings Commentary on a Selected Client

- **Moody's**
  - "The ** rating reflects *CLIENT's* below average financial position and the continued expectation that large and growing pension liabilities and moderate economic growth will challenge its return to structural budget balance."
  - "What could make the rating go down: Growth in long term liabilities, increase in fixed cost pressures, or additional deferral of pension costs."
- **Standard & Poor's**
  - Offsetting factors: "The growing state unfunded pension liability and increased funding costs, which are likely to stress *CLIENT's* budget."
  - "Despite gradual improvement in *CLIENT's* economy, the state still faces significant fiscal pressures tied to growing pension cost."
  - "We believe *CLIENT's* pension and other postemployment benefit (OPEB) liabilities will be a very significant source of pressure for the state in the foreseeable future."
  - Negative outlook: "The outlook also reflects the potential for Standard & Poor's to lower the state rating to '***' in the next year in the absence of meaningful pension reform efforts or significant economic growth that would help mitigate the impact of growing pension costs on *CLIENT*."
- **Fitch**
  - "Maintenance of the '**' rating will require action over the next one to two years to make substantive progress towards addressing the state's structurally unbalanced budget, restoring reserves, and addressing the rapid growth of fixed costs, including for pension funding."
  - "*CLIENT* faces fiscal pressures in the form of a structurally unbalanced budget, depleted reserves, and a rapidly growing pension cost burden following years of underfunding and market-driven investment declines."

IV. Appendix

The PFM Group: A Strategic Partner

- The PFM Group is a leading provider of independent financial and investment advisory services to the public sector.
- Since our inception, the PFM Group's primary focus has been serving the distinct needs of state and local governments and authorities across the nation.

The PFM Group

PFM Asset Management LLC (PFMAM)

- Manages $50 billion in AUM and consults on an additional $41.8 billion as of 12/31/13
- Specializes in public funds, including pension funds and other post-employment benefits (OPEB) total assets advised over $11 billion.

Public Financial Management, Inc. (PFMI)

- Ranked the top financial advisor to governments for the past 15 years[1]
- Advised on over $46 billion in bond issuance for 2013

The combined strengths of the PFM Group of companies support a comprehensive view that considers both sides of the balance sheet; our 35-year focus on the public sector has helped us develop specialized expertise in the management of investments.

[1]*Ranked by Thomson Reuters, based on principal amount and number of transactions for calendar year 2013.*

PFMAM's OPEB Expertise

- Provide both discretionary and non-discretionary investment advisory services to 195 retirement plans with assets over $11 billion (including 81 OPEBs with assets of $2.6 billion, as of December 31, 2013).
- Work with clients' actuaries to understand benefit streams and liability obligations of clients, which helps us craft customized investment solutions.
- Coordinate the establishment of and transactions under OPEB trusts with client custodians. We have extensive experience in providing investment management services to this unique sector.
- PFM Staff includes OPEB experts who are consulted by the Government Accounting Standards Board (GASB) staff periodically as they promulgate new accounting rules.
- PFM Staff speak about OPEB benefits, trusts and management at industry conferences, regularly meet with actuaries and auditors to support the setting of discount rates, the compiling of capital market assumptions, and documenting of information for financial statements.

Disclosure

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