PROTECTING YOUR RETIREE HEALTH BENEFITS

A Brief Explanation of the New Accounting Rules Affecting Post-Retirement Health Plans

GASB Reporting Requirements

The Governmental Accounting Standards Board (GASB) recently released financial statements No. 43 and No. 45. These rules will require governmental employers to calculate and report the funding status of postemployment benefits other than pensions (OPEB). Public employers are currently required to include a note in their annual financial statements that retiree health insurance is provided to qualifying retirees. The new GASB rules will require these employers to perform an actuarial valuation to determine the cost of the promised benefit and then include this financial liability in their annual reports.

Retiree health coverage is usually provided on a pay-as-you-go basis. Employers pay the costs as they are incurred. From an accounting standpoint, however, the benefit is earned during employees' working careers. So, the costs are also incurred during employees' working careers. The GASB rules essentially require that the cost for retiree health coverage (and other non-pension retiree benefits) be reported in a manner similar to defined benefit pension plans. If sufficient assets are not set aside to pay for such benefits, the employer or plan must report the unfunded liability.

Effective Date(s)

Generally the new GASB reporting and disclosure requirements will become effective in 2007 for governments with annual revenues in excess of $100 million, 2008 for those with annual revenues of $10 to $100 million, and 2009 for those with revenues of less than $10 million.

Implications

GASB does not require any employer funding. Providing retiree coverage on a pay-as-you-go basis is totally acceptable. However, GASB will require employers to calculate and publish the cost of these benefits, which will show up as a liability on the employer's financial statements. If assets have not been set aside to offset the liability, an "unfunded liability" will be displayed. This undoubtedly will put great pressure on employers to pre-fund the benefit over employees' working careers, and will induce employers to reduce or eliminate this liability and/or require employees to pay more for the benefit. When private employers were faced with a similar change in accounting rules years ago, many of them simply eliminated the benefit or capped the dollar amount of the benefit available to retirees.

Many believe the GASB methodology is flawed. While requiring employers to display the long term liability associated with employee retirement benefits, GASB does not authorize governments to display the value of all of their assets (such as real estate and other infrastructure) on their balance sheets. Such assets are displayed on the balance sheets of private sector entities. Moreover, GASB has singled out employee based benefits for accrual-based accounting. Many other governmental functions necessarily incur long term liabilities including

incarceration, medical assistance and education program, yet those liabilities are not reported under GASB requirements. Finally, the actuarial methodology used to develop the liability estimates are little more than educated guesses. Healthcare inflation, which is a cornerstone assumption in the methodology, has been extremely volatile over the past decade and actuarial methodologies are prone to overstating inflation based on very recent trends. This has the effect of vastly overstating the liability associated with retiree health benefits.

Bond Rating

Undoubtedly, the bond rating agencies will take any unfunded liability into account when assessing the financial condition of a government entity. Fitch Ratings, one of the largest bond raters, issued a report in June 2005 stating: "For issuers choosing to ramp up annual contributions to reach full funding of actuarially determined levels, Fitch recognizes that a rising net OPEB obligation in the short term may be a by-product. Such an increase, taken in the context of a sound OPEB funding plan, will not by itself affect credit ratings. Fitch does not expect OPEB plan funding ratios to reach the generally high levels of pension systems for many years, but steady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality." In other words, a bond rating agency will not downgrade the rating of a government solely because a new reporting requirement reveals an unfunded liability. Budgetary decisions that result in an increase or decrease of the liability over time, and the jurisdiction's overall ability to manage the liability, will be considered as a more significant factor when a jurisdiction's financial condition is assessed. Regardless, a benefit gained in place of income should not be eliminated or decreased because of management decisions on how to pay for the benefit. Retiree health benefits are an integral part of employee compensation and the promise of the benefit must be honored by the government.

Offsetting Funds

Ideally, employers will accumulate funds to pay the future cost of retiree health insurance coverage. These funds will offset the present value of the future liability dollar-for-dollar. Funding decisions can also result in a change in the basis on which the benefit is provided. Like pension benefits, retiree health benefits can be provided on a "defined contribution" or "defined benefit" basis. Defined benefit arrangements, which are common under most pay-as-you-go systems and are most often preferred, involve an employer commitment to pay, in whole or in part, for an eligible retiree's health benefits regardless of the total cost of the benefit or the lifespan of the employee. The employer commitment is most often to pay the entire cost, or a percentage of the entire cost, of the benefit and the percentage contribution is often based on a longevity based formula. Under a defined contribution arrangement, an employer commits to a specific sum of money that the retiree uses to defray all or part of the costs of the benefit. Typically, employees who retire with more years of service (and/or a greater annual salary) can accumulate more in their defined contribution account. When the funds are exhausted, the retiree must fund the benefit on his/her own. There are a variety of mechanisms to pre-fund benefits under both arrangements:

Special Purpose Governmental Trust

A special purpose trust can be used to designate funds for retiree health insurance. The trust can be funded and operated similar to a pension or health benefit trust fund. Unfortunately, this type of trust fund is considered as part of the general assets of the employer, and, as such, the sponsoring governmental entity can terminate the trust and use the assets for any other legitimate purpose. However, the creation and disciplined operation of a trust fund may be the most preferable way of offsetting the cost of retiree health benefits. Trust funds most commonly serve as the funding method for a defined benefit but can be used as the source of funds in a defined contribution arrangement.

Health Reimbursement Account (HRA)

Sometimes referred to as a Health Retirement Account, HRAs are accounts maintained by the employer on behalf of an employee. The federal tax code does not allow HRAs to receive employee contributions, but mandatory employee contributions can be reclassified as employer contributions under certain circumstances. In all circumstances, the employer maintains ownership of the funds in the accounts. HRAs can serve as the source of funds in a defined contribution retiree health benefit plan.

Voluntary Employee Benefit Association (VEBA)

VEBAs provide for tax deferred contributions to a trust account on behalf of an employee, similar to a deferred compensation or 401(k) arrangement. Often, VEBAs are funded by "cashing out" an employee's accumulated leave or other severance payments upon retirement but VEBAs may be funded throughout an employee's working career. VEBAs are already in use in many jurisdictions and many benefit consultants are promoting them to public employers as a method to deal with the issues presented by the GASB requirements. VEBAs typically play a role in defined contribution methods of funding retiree health care.

Health Savings Account (HSA)

An HSA is an individual health spending account that is owned by the employee and may be used for the payment of current and future medical expenses, or as retirement income. One major problem with HSAs is that they must be coupled with High Deductible Health Plans which shift costs and risks to employees. HSAs are a defined contribution method of funding for retiree health benefits and benefit experts have concluded that HSAs are ineffective vehicles for funding retiree health care.

Section 401(h) Pension Funds

Some public employers fund retiree health benefits using a 401(h) plan, which is a separate account under the employer's pension plan. Although the account is separate from the pension plan, all administration, investment management and recordkeeping is done by the pension plan, thereby avoiding the need to create and administer a separate retiree health plan. Up to 25% of an

employer's pension contribution can be designated for the retiree health benefit account.

The 25% limitation is further limited in two ways. First, the 25% applies to the pension plan's "normal cost," which does not include amortization of the actuarial unfunded liability. If the normal cost is $3, the employer can contribute $4, designating $1 for the 401(h) separate account. The 25% is also limited to actual payments made by the employer. If the employer in the above example pays less than the $3 normal cost, then the contribution into the 401(h) plan is reduced accordingly. However, the 25% ratio is cumulative. That is, an employer who underpays the maximum allowance in any year can carry the unused balance into future fiscal years, catching up when the financial position improves. 401(h) funding is typically associated with a defined benefit retiree health plan but can be used as the source of funds in a defined contribution arrangement.