Retiree contributions can be structured on a completely different basis, including linking the level of subsidy to the retiree's length of service, such that only retirees with full service accrual can receive the full retiree health subsidy. The plan sponsor can place a cap on the amount or percentage that active employees can accrue toward retiree health coverage and adjust that cap, or the service accrual schedule, for future generations of employees.

- ***Eliminate Coverage*** Some jurisdictions may take a position that retiree health costs are not manageable and, therefore, terminate the benefits. There is significant risk in cutting off current and future retirees from these benefits upon which they depend. For the many retirees from public employment who have modest financial means, a reduction or elimination of health benefits may prove disastrous to their financial security in retirement. Some portion of the retiree population could become eligible for Medicaid benefits, which would result in these individuals receiving benefits supported by state and local tax revenues. Finally, the unexpected elimination of retiree health benefits sends a message to current and future employees that the balance between salary and benefits is shifting. The result may be higher salary costs, hampered ability to attract and retain qualified workers and reduction in the value of the overall employment package.

When weighing these options, public sector employers should factor in the value that these benefits have in the total compensation arrangement.

"Plan sponsors have a spectrum of options to consider for managing OPEB liabilities... Most jurisdictions are likely to structure solutions that include a combination of approaches."

Employers should keep in mind that they need to offer a total rewards package that differentiates them from private sector employers in order to continue to attract and retain qualified employees. Retiree health benefits may be their competitive advantage.

Developing a Strategy

Plan sponsors have a spectrum of options to consider for managing OPEB liabilities, ranging from full funding of current benefits to benefit reductions (or, theoretically, even elimination). Most jurisdictions are likely to structure solutions that include a combination of approaches.[5] For larger jurisdictions already beginning to report GASB OPEB liabilities, the strategy needs to be in place and operational now. Smaller jurisdictions preparing for their phase-in date should already be reviewing costs and planning strategy.

Conclusion

With any approach, an employer should be mindful of the impact that a single action can have on the relationship among funding, cost, workforce management and overall wellness of its population. The most important outcome is that there be consensus on a strategy for managing OPEB costs and liabilities that is understood and supported by all stakeholders.

[5] A case study in which this multifaceted approach was used is available as an online supplement to this *Public Sector Letter*: http://www.segalco.com/publications/publicsectorletters/nov07supp3.pdf

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Public Sector Letter

Benefits, Compensation and HR Consulting AUGUST 2007

Retiree Health Care: Implications of OPEB Liabilities

As the effective date approaches for complying with Statements No. 43 and No. 45, the new financial reporting requirements of the Governmental Accounting Standards Board (GASB) to account for retiree health and other non-pension benefits,[1] these benefits are on public sector employers' radar screens. GASB Statements No. 43 and No. 45 set governmental retiree benefits on a par with the reporting for governmental pensions already in place under GASB 25 and 27 — and create a common standard for understanding the liabilities for other post-employment benefits (OPEB) promised by governments.

This *Public Sector Letter*, the first of two issues on OPEB, discusses why GASB's new reporting requirements matter. The next issue, which will be published next month, will discuss options for managing the costs of OPEB liabilities, including prefunding vehicles and plan design changes.

Why Accounting for OPEB Matters

GASB's requirement to account for OPEB liabilities has financial and human resources implications for all governmental entities that provide retiree health coverage and life insurance. This section addresses both types of implications.

Budget Implications

GASB does not require advance funding of OPEB liabilities. It only requires that certain additional values be recognized in financial reports. However, given how large these values are likely to be (as well as the fact they are likely to be growing in most instances), their inclusion on financial reports will raise questions about prefunding. The issue of financing large and growing OPEB liabilities will have implications for most jurisdictions' budgeting. Once an entity includes these values on financial reports, it will likely be faced eventually with tough choices between financing those benefits and financing essential government services.

It is important for each public sector entity to address the merits of different approaches to managing OPEB liabilities based on its unique facts and circumstances for the reasons noted in this *Public Sector Letter*. A strategic review of alternatives is a critical aspect of these reporting requirements.

Effect of the Bond Rating Agencies' Review

One reason to adopt a strategy for financing OPEB benefits is that bond rating agencies and bond underwriters are paying close attention to how a jurisdiction manages those liabilities. A bond ratings downgrade — or lack of an expected upgrade — can result in a higher interest rate the jurisdiction must pay to borrow money through issuance of bonds, and thereby cause pressure on the allocation of resources for government services. Although bond rating agencies acknowledge that most plans have a distance to cover from the current "pay-as-you-go" financing to full actuarial reserve prefunding, they are looking for a financing plan that will manage the risk. Questions posed by the agencies are summarized in the box on page 2. The U.S. Securities and Exchange Commission (SEC) has advised bond issuers to include material information about their OPEB liabilities in their issuance statements.

One possible outcome in the marketplace is that the overall bond rating of a jurisdiction may not be affected by recognition of OPEB liabilities and expenses, but the underwriters who bid on and purchase the jurisdiction's bond issues may bid less for the next bond issue, raising the rate of interest the jurisdiction must pay to obtain capital in the marketplace. Investors in municipal bonds may want to know more about how entities are managing their OPEB liabilities. As bond rating agencies and underwriters fine-tune the process of evaluating how jurisdictions are managing their OPEB liabilities, public employers will place increasing importance on this issue.

"As bond rating agencies and underwriters fine-tune the process of evaluating how jurisdictions are managing their OPEB liabilities, public employers will place increasing importance on this issue."

IN THIS ISSUE:

> Why Accounting for OPEB Matters
> Assessing the Impact of GASB's New Requirements
> The Decision: To Prefund or Not to Prefund?
> Conclusion

[1] The effective date for complying with Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, varies depending on the employer's annual revenue. It began as early as fiscal years commencing after December 15, 2005 for plans and after December 15, 2006 for employers. For more information, see The Segal Company's October 2005 *Bulletin*, "GASB Issues Long-Awaited OPEB Implementation Guide": http://www.segalco.com/publications/bulletins/oct05OPEBguide.pdf

Reaction of Citizens, Including Employees and Potential Recruits

Because public financing takes place in public meetings, the issue of whether to prefund the liabilities for retiree benefits or to use money for infrastructure improvements or repair projects for the jurisdiction will increasingly be at the forefront of taxpayers' attention. Elected officials may find it difficult to commit hard-won tax revenues toward prefunding liabilities for current and future retirees.

Balanced against that position is the realization that employees and retirees of the jurisdiction are also taxpayers and constituents. As a representative of the people, how does an elected official decide between replacing an aging bridge or taking care of an aging former employee? Former employees view OPEB as a form of deferred compensation, a benefit paid for with foregone wages, and they expect the employer to honor the terms of the bargain.

Recruiting may also be affected by the pressures building on retiree health obligations. If a jurisdiction provides a lesser retiree health benefit or pays considerably lower contributions for that coverage than a neighboring jurisdiction, then that employer may have more difficulty in recruiting and retaining qualified workers.

Assessing the Impact of GASB's New Requirements

Public sector retiree benefit plan sponsors must look at the big picture in examining the impact of the new reporting demands on their accounting and operation. The key questions to address are:

- What promises have been made to employees that must now be honored?

"Whether to fund the liability for retiree benefits or to use that money for infrastructure improvements or repair projects for the jurisdiction will increasingly be at the forefront of the taxpayers' attention."

- How will the retiree population change in the coming years as more and more Baby Boomers join its ranks?
- What level of benefit is affordable?
- What future capital decisions may be altered?
- What is the likely impact on bond ratings and the cost of capital?

Plan sponsors will need to look at the expected growth in total liabilities compared to total revenue growth and review OPEB annual costs against offsets like tax revenue and payroll growth. The relative value of OPEB within the total wage package will need to be determined because paying for OPEB may displace other benefit programs or pay increases. After reviewing all the costs and offsetting revenues, the entity needs to develop an approach to manage future costs and the associated liabilities.

Questions Posed by Rating Agencies

Various bond rating agencies are looking for a plan sponsor's short-term and long-term plans for managing OPEB liabilities. They are asking questions such as the following:

Management

- What are the jurisdiction's plans to manage OPEB liabilities?
- Has an action plan been established?
- What retiree benefits have been "promised," and what is the jurisdiction's ability to modify that benefits promise?

Financial

- Can the jurisdiction's budget afford the cost of OPEB liabilities?
- Will OPEB liabilities be prefunded?
- Are there other areas to secure funding (*e.g.*, unused taxing power)?
- Is the plan for managing OPEB liabilities a viable long-term plan or merely a quick fix?

Debt

- How does the OPEB liability alter the jurisdiction's long-term debt picture?
- Is the jurisdiction comparable to its peer group?
- What is the relative size of Unfunded Actuarial Accrued Liability (UAAL)* compared to payroll, to budget and to the tax base?
- Are the actuarial assumptions reasonable?

* The UAAL is the excess of the Actuarial Accrued Liability (AAL) over the actuarial value of plan assets. The AAL is the portion of the actuarial present value of total projected benefits allocated to years of employment prior to the measurement date, calculated using one of five acceptable actuarial cost methods, or calculated with the entry age normal method if the aggregate method is used for the ARC calculation.

The Decision: To Prefund or Not to Prefund?

As noted, there is no requirement to prefund retiree health benefits. Nevertheless, jurisdictions will feel increasing pressure from citizens, employees, retirees and investors to manage the level of OPEB liabilities, and prefunding is a proven management tool.

The annual cash amount required to fully fund the annual required contribution (ARC) for OPEB liabilities may be as much as 10 times the current pay-as-you-go amount. Although continuing the typical pay-as-you-go approach to paying for OPEB (*i.e.*, paying only the claims or premiums for retirees for that year) is less costly than prefunding from a cash standpoint and more controllable for current budget purposes, it can have negative consequences over time. Each year of continued pay-as-you-go financing results in a larger gap to be made up on the overall actuarial funding of the liabilities, and therefore a larger net OPEB obligation.

GASB requires the actuary to use an appropriate discount rate for calculating OPEB liabilities. If the jurisdiction is using the pay-as-you-go approach, the actuary will base the interest rate assumption on the actual return on investment that the jurisdiction is getting on its short-term assets, typically a lower rate than would be chosen for a funded trust with longer-term investments. The lower interest rate results in a considerably higher liability amount and a higher ARC for the financial reports.

"Although continuing the typical pay-as-you-go approach to paying for OPEB...is less costly than prefunding from a cash standpoint and more controllable for current budget purposes, it can have negative consequences over time."

"When deciding whether to continue pay-as-you-go financing of OPEB or to introduce prefunding, jurisdictions should project the costs associated with both approaches, ideally with a number of intermediate approaches."

If the employer is prefunding liabilities on an actuarial basis, the actuary will use an interest assumption that takes into account actual and projected earnings on the trust. This higher interest assumption results in a lower liability amount and a lower ARC. However, costs will still exceed the current pay-as-you-go costs.

Guidance from GASB[2] may allow a higher discount rate if a government establishes, as part of *its own assets*, an investment fund for the designated purpose of accumulating employer assets to pay for retiree health care. If the fund is invested like a pension fund, the higher expected return can affect the determination of the discount rate.

Continuing with pay-as-you-go financing may also raise questions at the bond rating agencies, which will want to see evidence that the jurisdiction has a plan in place to manage costs over time within the jurisdiction's revenue structure.

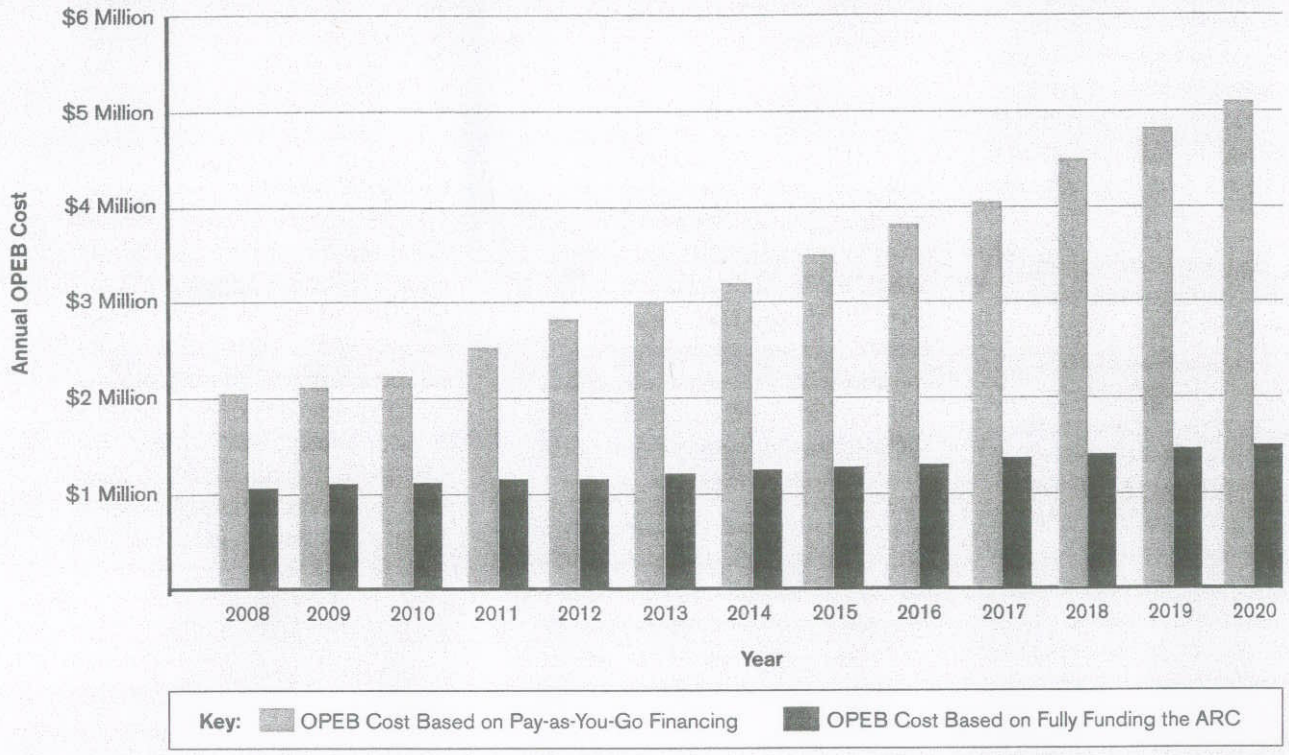
The decision to continue pay-as-you-go financing should be made after considering the jurisdiction's entire situation. For example, it may be advantageous for the jurisdiction to fund less than the full ARC in order to allow spending on infrastructure improvement or development of new sources of revenue. If the jurisdiction is secure in its bond ratings and not over-financed generally, use of available cash flow for the most immediate public needs prior to fully prefunding the retiree OPEB liabilities might be appropriate. If retiree subsidy levels are contained (*e.g.*, the jurisdiction provides only a finite dollar contribution per month for retiree health benefits regardless of cost of the benefit program), the jurisdiction may decide it has more latitude to fund the retiree benefits at a rate less than the full ARC. Whatever the rationale for a less aggressive funding approach, an accelerated payment schedule that funds faster than the pay-as-you-go costs will demonstrate an approach to funding the benefit.

On the other hand, advantages of prefunding include longer-term savings, higher interest rate assumptions with correspondingly lower annual required contribution levels and lower total liability amounts.

When deciding whether to continue pay-as-you-go financing of OPEB or to introduce prefunding, jurisdictions should project the costs associated with both approaches, ideally with a number of intermediate approaches. The graph on the last page illustrates sample projections.

[2] This guidance is in Q&A 8.26.6 of GASB's *Comprehensive Implementation Guide: Guides Issued through June 30, 2006: Questions and Answers.* The guide can be ordered from GASB's Web site: http://www.gasb.org

Comparison of GASB Statement No. 45 Annual OPEB Cost



Source: The Segal Company, 2007.

Conclusion

With the implementation of GASB Statements No. 43 and No. 45, jurisdictions will have to disclose their future OPEB liabilities as they accrue over an employee's working lifetime. For many employers, the ARC associated with pre-funding these liabilities on an actuarial basis may be significantly larger than the current pay-as-you-go cash cost for the benefits paid each year, but may have other benefits that justify the cost. Employers should consider how the new accounting rules affect not only the funding of their retiree benefits, but also their overall fiscal stability and ability to provide essential services.

The Segal Company's next *Public Sector Letter* will discuss funding vehicles and plan design options available to help public employers manage their OPEB liabilities.

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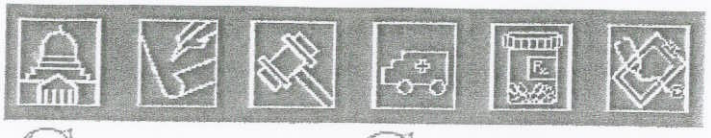

CAPITAL CHECKUP

January 16, 2008

MEDICARE, MEDICAID, AND SCHIP EXTENSION ACT OF 2007

On December 29, 2007, President Bush signed into law the Medicare, Medicaid, and SCHIP Extension Act of 2007 (Public Law No: 110-173).[1] The new law:

- Extends the State Children's Health Insurance Program (SCHIP), which otherwise would have ended on December 31, 2007, through March 31, 2009, and
- Introduces new Medicare Secondary Payer (MSP) data-reporting requirements that will affect employer-sponsored group health plans.

This *Capital Checkup* summarizes the new MSP data-reporting requirements.

Background on MSP

The MSP law and regulations address which payer pays primary when a person is covered by Medicare and also by a group health plan. Generally, group health plans must pay primary to Medicare (thus making Medicare the secondary payer) when the participant is an active employee, while Medicare pays primary when retirees have both Medicare and group health plan coverage.

Under current MSP law,[2] employers are required to respond to MSP-related inquiries from Medicare carriers seeking to determine who should pay primary.

The New MSP Data-Reporting Requirements

Starting January 1, 2009, the new MSP data-reporting requirements will require insurers, third party administrators (TPAs) and a plan administrator or fiduciary of a self-insured/self-administered group health plan to:

- Collect from the plan sponsor and plan participants information, as required by the Secretary of Health and Human Services (HHS), to identify where the group health plan is or should be paying primary for medical care, and
- Submit such information to HHS in a form and manner specified by them.[3]

The penalty for noncompliance will be $1,000 per day for each day of noncompliance for each individual for whom information should have been submitted. Any other applicable MSP penalties would continue to apply.

The Centers for Medicare and Medicaid Services (CMS) continues to work on Medicaid-related data reporting requirements applicable to group health plans under the Deficit Reduction Act of 2005 (DRA), and it is possible that those efforts will be combined with efforts to implement the new MSP-related requirements. Work on the DRA reporting requirements has been slow due to conflicts about how much information is necessary and what format it should take.

Implications for Health Plan Sponsors

Plan sponsors will not be able to comply with these new reporting requirements until HHS issues implementing regulations or other guidance specifying the data elements to be provided and the manner of data submission. As with the proposed reporting under the DRA, it may be difficult to agree on standards and data for reporting, so it may take CMS some time to implement the new law.

Under the new law, the Secretary is also required to share information on entitlement under Medicare Part A and enrollment under Part B with insurers, TPAs and plan administrators/fiduciaries. This aspect of the new law could actually make it easier for plan sponsors to coordinate benefits with Medicare and facilitate retiree enrollment into private Medicare plans (*e.g.*, Prescription Drug Plans and Medicare Advantage plans).

Outlook: Policy Changes for SCHIP Possible

In August 2007, HHS announced controversial policy changes to SCHIP that primarily address efforts to limit SCHIP eligibility to children in families with income below 250 percent of the poverty level and to prevent substitution of SCHIP coverage for private coverage.[4] As part of the fall legislative process, Congress attempted to respond to and counteract some of the administration's policy changes. Nevertheless, despite months of negotiations and two presidential vetoes, Congress' recent extension of SCHIP did *not* address any of these policy issues.