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GASB 45 and other post-employment benefit promises: The fog is clearing

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It is often said that you won't get rich working for the government, but you can't beat the benefits. One form of these benefits is "Other Post-Employment Benefits" (OPEB), which represent government promises to employees to provide health care and other non-pension benefits after retirement. Government employers commonly use these benefits to attract talent in lieu of large salaries or bonuses and to provide future security to employees. Until now, governments have also been able to apply preferential accounting treatment to OPEB plans, which allowed deferral of the costs of today's promises into the future.

However, due to a standard issued by the Governmental Accounting Standards Board (GASB) in June 2004, this is about to change. This standard, GASB 45, requires clear and transparent reporting of the current value of OPEB promises in state and local government financial statements. For New England state governments, this total value will be in the tens of billions of dollars. While implementation of GASB 45 may cause the financial picture of some governments to suddenly appear dim, the standard is in fact only illuminating an existing situation.

The way things were

In the world before GASB 45, governments were not required to measure and report the long-term implications of OPEB promises. Related expenses were recognized when retirees received benefits, not when benefits were granted and earned. Under this system, commonly referred to as "pay-as-you-go," the government recorded an expense each year equal to the annual premium or benefit payments made to retirees. Given the continuing trend of growing retiree pools and rising health care costs, this practice resulted in a reported cost that was lower than if benefit expenses had been recorded as earned.

Because this accounting method provided no incentive to set aside current funds to meet the growing demands of these benefits, it quietly shifted the true burden of payment to future generations. This burden would rest not only with future employees, who might see reduced benefits, but also with communities, which could see services cut or taxes increased to cover growing benefit payments. Allowing tomorrow's citizens to pay for the retirement of today's workers is inconsistent with the GASB concept of inter-period, or inter-generational, equity. By changing the accounting for these plans, GASB hopes to "foster improved accountability and a better foundation for informed policy decisions."[1]

Learning to speak the language

GASB 45 is an accounting standard, not a law, and does not mandate how a government conducts its operations. However, by changing the way OPEB plans are reported, it provides new and valuable information to decision-makers. A few concepts are helpful to understand the newly provided information and the influence it might have.

The Unfunded Actuarial Liability

Prior to the issuance of GASB 45, many governments did not know the value of the OPEB promises they had made to their

employees. Future costs may have been only roughly estimated or not calculated at all, resulting in a foggy picture of the value of benefit promises. That fog is gradually clearing as governments take the first required step to comply with the standard, which is to hire an actuary to calculate the cost of benefits that have been promised to and earned by employees to date.

The actuarial calculation factors in, among other things, participant characteristics, plan provisions, and assumptions regarding health care cost increases, retirement age, and life expectancy. After factoring in the many variables, the calculation applies a discount rate to the future costs in order to determine their value in today's dollars. Their present value is then reduced by the actuarial value of any plan assets that have been legally segregated for plan use.

The Annual Required Contribution (ARC)

While the Unfunded Actuarial Liability must be disclosed, the standard does not require that it be immediately recognized as a liability and expense in the financial statements. Instead, the liability is recognized gradually, over a period not to exceed 30 years. In each year following implementation, an allocation of the Unfunded Actuarial Liability for that year, combined with the additional actuarially determined incremental cost for maintaining the plan provisions for that year, will comprise the ARC. Despite the use of the term "required," the standard does not actually require funding of the ARC; it is required only if a plan wishes to be considered fully funded for the plan year.

The ARC, which will drive the annual cost recorded on government-wide financial statements, will be significantly higher than the current annual cost. Consider the example of Maine, which, under the current pay-as-you-go method, has recorded an average annual increase of 16 percent in OPEB costs over the five-year period ending June 30, 2006. If the state were to implement GASB 45 for fiscal year 2007, the state's additional reported cost increase from 2006 to 2007 could be anywhere from 302 percent to 569 percent.[2] While this increase may seem severe, the range is not atypical of reported OPEB cost increases that states all across the nation are expected to face.

The Net OPEB Obligation

For each year that a government fails to make contributions that are at least equal to the ARC, the Net OPEB Obligation will increase by the shortfall. The growth of this obligation on government balance sheets will be a clear indicator to users of financial statements that the government is not keeping up with what the GASB has deemed to be an appropriate funding schedule for these benefits.

Picking up the pieces

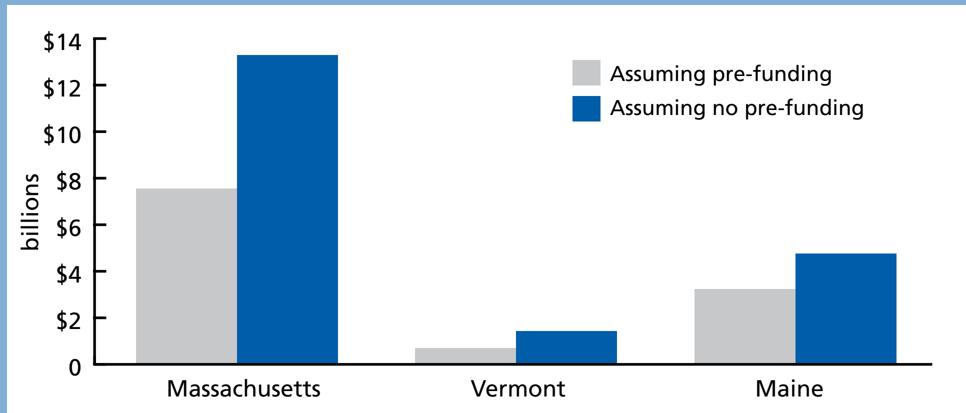
Since the amount of the Unfunded Actuarial Liability depends upon both promises to employees and assets designated to fund these promises, governments have a variety of options to manage the liability. These options include changing the benefits provided to retirees, pre-funding with additional asset contributions, and utilizing a combined approach. Of course, governments could also operate as if nothing has changed, although ignoring the liability will only facilitate its growth.

Can you take it back?

The liabilities now being determined are large because the promises made have been large and have only been exacerbated by medical inflation and longer retirement periods. Among the New England states alone, benefit payments per eligible retiree in 2006, recorded on a pay-as-you-go basis, ranged from approximately $3,300 for Maine to $11,000 for Connecticut, according to the states' Comprehensive Annual Financial Reports. These reported figures, which are representative of current health care costs and retiree pools, are only expected to increase under the new standard.

Attempting to scale back these promises may prove difficult or even illegal, since post-retirement benefit modifications may be prohibited by state constitutions or statutes, as is the case for Connecticut, Massachusetts, and Maine. Benefit promises also may be supported by employment contracts or case law, and even absent legal enforceability, governments will still need to be sensitive to obligations to employees. The Executive Director of the Government Finance Officers Association has noted that it "would be inequitable to expect hard-working government employees alone to shoulder the full burden of potential changes in plan design in the form of decreased or eliminated benefits."[3]

Figure 1. Current value of projected unfunded actuarial liability



Note: Calculations use the following discount rates for unfunded and funded plans, respectively: 4.5% and 8.25.% for Massachusetts, 3.75% and 8.0% for Vermont, 4.5% and 7.5% for Maine
Source: 2006 Massachusetts Comprehensive Annual Financial Report; State of Vermont BuckConsultants Presentation, March 2006; Bartel Associates LLC and Glicksman Consulting, LLC, "State of Maine Retiree Healthcare Plan Actuarial Valuation," June 2006

If allowable, governments may consider some forms of benefit modification, including reducing overall benefit levels, increasing the threshold for employees to qualify for benefits, increasing retiree contribution rates, or reconsidering spousal coverage. Some may even consider discontinuing coverage for incoming employees, discontinuing coverage entirely, or converting the plans to defined contribution plans.

To fund or not to fund

Given the difficulties in attempting to reduce benefits, governments may instead look at funding possibilities to manage their Unfunded Actuarial Liability. While legally segregating assets sufficient to cover future plan obligations would eliminate the Unfunded Actuarial Liability entirely, governments are more likely to take a gradual approach. When a government commits to making scheduled contributions at least equal to the ARC each year, the plan is considered pre-funded under GASB 45. While pre-funding will mean an additional strain on current resources as payments are made, contributions in excess of annual benefit payments can be invested in order to fund future liabilities. Actuarial calculations for plans that meet annual funding targets will use a discount rate based on the long term investment rate, which is higher than the short-term discount rate used for plans without pre-funding. This will result in a smaller Unfunded Actuarial Liability and calculated ARC. Figure 1 shows the impact of pre-funding for three New England states that have made publicly available the actuarial calculations of their liability under various funding scenarios.

In an environment where expendable resources are already scarce, finding assets to pre-fund these plans may be difficult or require especially creative thinking. Massachusetts has proposed using a portion of its tobacco settlement proceeds to reduce its liability. Other states could consider funding options that might be less obvious and could include more drastic policy changes, such as selling or leasing assets or privatizing certain government functions to raise funds. Governments with limited assets may also explore the possibility of issuing taxable bonds to fund the liabilities. However, in doing so, they should carefully consider any associated risks, including whether the returns obtained on bond proceeds exceed the interest paid and keep pace with rising plan costs.

When a government is unable to commit to meeting annual funding targets equal to the ARC, partial contributions or contributions that gradually approach the ARC can offer some benefit, in the form of a blended discount rate, without overextending the government's resources. A government may also decide that pre-funding at any level is not a feasible option in light of other demands on limited resources. Rhode Island, for example, has decided to apply funds from pending to-

bacco settlement bond issuances towards a 2008 budget deficit rather than previously planned OPEB contributions. While a government can choose not to pre-fund, that decision will yield a growing liability under GASB 45, as the unfunded portion of the ARC is added to the balance sheet liability each year. Those governments will need to keep a close watch on the size of the liability and develop a sustainable plan to meet the cash obligations as they come due.

Moving forward

With no clearly preferable method of dealing with OPEB liabilities, the key for decision-makers is to consider the needs of all interested parties, the availability of resources, and potential areas for negotiation. This will not be easy. Employees are counting on receiving promised benefits, government agencies may resist budget cuts, and citizens will likely be reluctant to pay increased taxes to cover these costs. Given the importance of bond issuances for funding, governments should also consider how credit agencies will react to their chosen approach. While credit agencies are unlikely to ignore the absolute size of the liabilities, it has been emphasized that "how the liability is managed, along with a government's capacity to fund these obligations on an annual basis—either on a pay-as-you-go or an accrual basis—will be an important element of the credit review."[4]

In anticipation of its 2007-2008 fiscal year effective date for the largest governments, New England states are taking action to prepare for implementation of GASB 45. However, the challenges related to OPEB plans span beyond simply complying with the standard's reporting and disclosure requirements. In the nearly three years since it was issued, GASB 45 has placed pressure on governments to re-evaluate OPEB plans and to identify resources that can be set aside to fund them. While this process has begun, additional discussions and many difficult choices still lie ahead and will likely continue well into the future.

Suggested reading:

Eric S. Berman and Elizabeth K. Keating. "Unfunded Public Employee Health Care Benefits and GASB 45." August 2006.

Martin Feldman and Roscoe Haynes. "Effect of New GASB 45 Accounting Rules: What We Can Learn From FAS 106." *Benefits and Compensation Digest*. March 2007.

Endnotes

[1] Governmental Accounting Standards Board, "GASB Statement 45 on OPEB Accounting by Governments: A Few Basic Questions and Answers." www.gasb.org/project_pages/gasb_st45_basic_q&a.pdf

[2] Author's calculation based on costs and projections reported in the state's 2006 Comprehensive Annual Financial Report; and the Bartel Associates LLC and Glicksman Consulting, LLC, "State of Maine Retiree Healthcare Plan Actuarial Valuation." June 2006

[3] Jeffrey L. Esser. "Coming to Grips with Other Post-Employment Benefits." *Government Finance Review*. August 2006.

[4] Robin Prunty, et al. Standard & Poor's Ratings Direct, "OPEB Liabilities Pose Minimal Near-Term Rating Risk for Public Finance Credits." December 2006

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