

**CITY OF DURHAM, NORTH CAROLINA**

February 5, 2008

Memo To: Patrick W. Baker, City Manager

Through: Wanda S. Page, Deputy City Manager

From: Keith R. Herrmann, Interim Director of Finance

Subject: Implementation of a Retirement Health Savings (RHS) Plan

**Executive Summary**

New accounting rules for Other Post Employment Benefits (OPEB), effective for the fiscal year beginning July 1, 2007, require the City to acknowledge health care and life insurance benefits that will be provided to current and future retirees in a manner similar to a pension obligation. This change creates impetus for pre-funding the liability to reduce the impact of the rise in annual cost of the benefits and to make changes to the benefits structure to reduce the growth of the liability.

These new rules, also known as GASB 45, will significantly change the City's financial statements as we account for and report the liability for the future cost of providing these benefits. Based on a recent actuarial study the City's current liability, discounted at 4%, is \$137,317,913. In order to fully fund this liability on an actuarially sound basis the City would need to make an annual required contribution (ARC) of \$12.9 million. Assuming a higher discount rate of 7% based on participation in the State Treasurer's Investment Trust for OPEB funds, yields a liability of \$80,840,632 and an ARC of \$8.1 million.

In order to address the growing OPEB liability and the resulting potential long-term impact on the City's credit worthiness, we are recommending the following three phase strategy:

- Participate in the State Treasurer's investment trust for local government OPEB funds thereby increasing the estimated return on OPEB funds and reducing the ARC.
- Reduce Benefits and/or change eligibility requirements for existing employees.
- Replace existing benefit for new employees with a defined contribution post-employment health benefit.

This agenda item deals with the third bullet point: establishment of a defined contribution post employment benefits plan. The adoption of a retirement health savings plan would work in the same manner as other defined contribution retirement plans. As proposed for new City employees, participants would make tax-free contributions of a portion of their salary to an individual account held in trust. The funds in trust can be invested in the various funds available through ICMA RC. The City would make a flat rate contribution each pay period for participating employees. Contributions can be used for qualified

medical expenses as defined by IRS Code Section 213 on a reimbursement basis. The employee's contribution would be portable and the employer's contribution would vest after separation with 20 years of service.

### **Recommendations**

To authorize the City Manager to take the following steps to establish a Retirement health Savings Plan with ICMA Retirement Corporation:

- Establish a retiree welfare benefits plan identifying the benefits available to retirees.
- Execute a plan adoption agreement that describes the details of how the plan works. The basics of our plan are as follows:
  - All employees hired after 6/30/08 are eligible (mandatory)
  - Employer contributes \$25 per pay period for each participating employee
  - Participating employees contribute 1% of pay deducted each pay period
  - Participating Employees are vested after 20 years and separation of service
- Complete all appropriate administrative tasks to establish the plan.
- Execute the Administrative Services Agreement between the City and ICMA RC for plan administration.

In addition, the Administration recommends that Council take the following actions necessary to establish the RHS plan:

- Make a declaration of trust establishing the legal entity to hold assets and establishing the duties of the City (employer) and the trustee.
- Adopt the Plan Adoption Resolution.

### **Background**

GASB 45 provides new accounting and reporting rules for benefits provided to retirees by state and local governments. The new standards are being phased in, with the largest units over 100,000 in population having to implement the new requirements in fiscal year 2007-08. These benefits for the City of Durham are mostly related to health care benefits, but also include the life insurance program. Under GASB 45, governments are required to account for these benefits much like a pension plan where the cost of the benefits are recognized as expenses over the course of active employment as compared to the current practice of cash funding of claims benefits after retirement. Depending on the demographics of an employee base, funding for OPEB can increase annual budget requirements a significant amount over the pay-as-you-go (PAYGO) method. Because these are not new benefits, just existing ones accounted for differently; the future accounting for OPEB has components that reflect both the post employment benefits already earned by current employees and the amount of benefits yet to be earned by employees. Typically, the prior earned benefits are amortized over a period as long as 30 years.

Implementation of GASB 45 requires ongoing actuarial studies much like we do with the Law Enforcement Separation Allowance program. To provide a planning tool for implementing GASB 45 and to assist us in budgeting for any impacts in our annual budget for 2007-08, the City engaged the consulting firm Cavanaugh Macdonald to do such an actuarial review. Our analysis and discussion of OPEB is based on that study.

It is important to note that GASB 45 does not require “funding” of the new accounting standards. As such, a local government could continue cash funding of post employment benefits, with appropriate reporting of annual and future liabilities and related expense amounts. Under GASB 45, a liability would have to be set up and expensed, reflecting the difference between the amount cash funded and the actuarial annual cost. For a growing government, this liability would generally continue to grow as the variance accumulated. This could cause some credit rating issues as that liability grew.

The use of a defined contribution plan has several benefits over the current defined benefit plan. Foremost, the defined contribution plan limits the cost to the City for providing post employment health benefits. The shocking size of the actuarially calculated liability is due in large part to the assumption of continuing health care cost escalation that will be paid entirely by the City for existing employees if there are no changes to the plan. The defined contribution plan also has benefits for the employee; most significant of which is the portability of the employee’s contributions. With the current benefit employees that leave employment with the City prior to retirement will receive no OPEB benefits from the City. Also, employees will have control over how contributions to their account are invested through the ICMARC family of funds. The receipt of periodic account statements and the ability to manage their own funds provides greater opportunity for employees to be directly involved in planning for their post employment health care. Currently, OPEB benefits are usually “out of sight, out of mind” until an employee approaches retirement, which is not conducive to sound retirement planning.

### **Issues**

Similar to the experience of the private sector when they experienced similar accounting changes, several key decisions have to be dealt with:

- Do we fund the new requirements of GASB 45 versus continuing to budget on a PAYGO basis?
- Does our retiree benefits package need to be changed due to the escalating cost of retiree expense compounded by this new accounting requirement?

The Finance Department has received a comprehensive review of GASB 45 implications from Standard & Poor’s (attached). Their current focus is on getting information from governments on how they are “managing” this new set of requirements. While not indicating that funding the plan is the only course of action, AAA quality credits could not over time continue to cash fund those benefits without feeling some stress on its credit worthiness because of the increasing nature of the unfunded liability. The Finance

Department, therefore, recommends that the City adopt a strategy to eventually fully fund this program.

A key part of the actuarial calculation is the interest rate discount factor used. That factor is basically the interest rate projection that represents what we could earn on invested OPEB funds. Our Cavanaugh Macdonald study used a 4% rate (approximate City rate over time). Currently, the State Treasurer's Office is establishing a trust to manage OPEB funds for local governments using investment authority that they presently have for investing state pension funds.

Based on a 4% discount factor, the Cavanaugh Macdonald study shows a \$137,317,913 liability for OPEB. The study shows an annual required contribution (ARC) of \$12.9 million, representing \$8.2 million for "normal" future cost and \$4.7 million for amortizing the prior amount. Using the past year, the approximate "cash" cost of that was approximately \$1.8 million. To fund the OPEB requirement, assuming this scenario stayed constant, would take approximately \$11.1 million more in City budget for 2007-08. At this time, it is unknown whether local governments will be able to invest any part of their OPEB funds in equities without special authority from the legislature to do so. Participation in the State Treasurer's OPEB investment trust, that is currently being established, would provide equity exposure; increasing the rate of return on invested funds. This will significantly reduce the OPEB liability number and the ARC.

As pointed out in the Standard & Poor's report, governments "may want to take a step back and look at the entire slate of post-employment benefits to see if there are ways to lower the total liability and, further, the unfunded liability." The establishment of a RHS plan for new employees will reduce the growth in the liability, however, in order to reduce the existing liability, changes to the benefit for existing employees must be addressed.

### **Budgetary/Financial Impact**

The adoption of the RHS plan for new employees will have no immediate effect on the existing OPEB liability. By moving new employees to a defined contribution type plan the growth in our liability will be significantly reduced and will eventually decline over time given the normal rate of employee turnover.

In order to determine the impact of changes to the benefits for existing employees the actuary ran several scenarios using benefit levels currently provided at other jurisdictions. Each scenario was run with the current actuarial valuation assumption for the long term interest rate of return of 4% and using the State Treasurer's OPEB Investment Trust the assumed interest rate will be 7%.

Plan descriptions:

- **Alternative I** – Eliminate health insurance coverage for all members once they reach age 65 for both future retirees and current retirees.

- **Alternative II** – Eliminate health insurance coverage for all members once they reach age 65 for both future retirees and current retirees and eliminate dependant coverage.
- **Alternative III** – Extend the time necessary for an active member to become eligible for subsidized health care under the plan from ten years to 20 years for future retirees only. Upon attaining 20 years of service prior to retirement the City will contribute 50% of the required premium. Upon attaining 25 years of service prior to retirement the City will contribute 75% of the required premium. Upon the completion of 30 years of service prior to retirement the City will contribute 100% of the required premium.
- **Alternative IV** – Replace existing benefit structure for future retirees to provide \$250 per month for members who retire with ten or more years of service to be used toward the purchase of health care coverage in the City’s group health insurance plan. No future increases are assumed in the future.

		<b>Annual Required Contribution (ARC)</b>	<b>Accrued Liability</b>
Current Benefits	4%	\$12,921,658	\$137,317,913
Current Benefits	7%	8,123,375	80,840,632
Alternative I	4%	5,995,902	66,172,111
Alternative I	7%	3,027,931	34,819,765
Alternative II	4%	4,311,562	49,874,180
Alternative II	7%	2,177,339	26,243,794
Alternative III	4%	9,734,560	118,391,808
Alternative III	7%	4,915,953	62,297,769
Alternative IV	4%	3,158,365	62,120,248
Alternative IV	7%	1,594,974	32,687,674

As indicated in the preceding table, significant reductions in the City’s OPEB liability and ARC can be achieved by changing the benefit for existing employees. Due to the potential impact on employees, reduction in benefits should be carefully managed, so that employees have ample opportunity to plan for their post employment health care.

**SDBE Issues**

There are no SDBE issues concerning this item.

- Attachments: Standard & Poor’s report entitled “OPEB Liabilities Pose Minimal Near-Term Rating Risk for Public Finance Credits”  
Descriptions of OPEB Benefits from other NC Municipalities  
ICMA RC – VantageCare Retirement Health Savings Plan, Questions and Answers for Employers  
ICMA RC VantageCare RHS Plan Adoption Documents:
- City of Durham Retiree Welfare Benefits Plan
  - Plan Adoption Agreement
  - Administrative Services Agreement between the City and ICMA RC
  - Declaration of Trust
  - Plan Adoption Resolution.