



TO: Representative Phyllis Kahn
FROM: Lawrence A. Martin, Executive Director *LAM*
RE: Requested Analysis of H.F. 1160 (Hilstrom), General Regulation of OPEB Trusts
DATE: April 9, 2007

Summary of H.F. 1160 (Hilstrom), the First Engrossment

H.F. 1160 (Hilstrom), the first engrossment, allows a public entity with an actuarial liability for postemployment benefits to establish a trust to pay those benefits. It defines "postemployment benefits" to mean benefits that give rise to a liability under the Governmental Accounting Standards Board Statement 45 ("GASB 45") and it defines "trust" by reference to federal tax code. The proposed legislation permits the trust to be revocable or irrevocable and permits the trust administrator to be the Public Employees Retirement Association (PERA), a bank, or an insurance company. The trust administrator is required to set up a separate account for each political subdivision or public entity and the trust administrator is permitted to charge maintenance fees. The allowable investments by each of the authorized trust administrators are specified as the generally applicable authority for the State Board of Investment or alternatively the municipal investment authority under Minnesota Statutes, Chapter 118A, or the large local pension plan investment authority under Minnesota Statutes, Section 356A.06, Subdivision 7. The public entity may withdraw funds from a revocable trust only to pay benefits unless there are changes in law or there are changes in actuarially determined liability occur that result in more money in the trust than is needed. The public entity may withdraw funds from an irrevocable trust only to pay postemployment benefits or when the political subdivision's actuarial liability for the benefits is satisfied or defeased. The trust fund money is not subject to the public entity's creditor claims. Trust funds created before June 6, 2006, under a provision of the federal tax code are validated and funds in a validated trust or account to be invested as provided in the proposed legislation and the trust or account must be brought into compliance with the proposed legislation by January 1, 2008

Summary of GASB Statement No. 45*

The Government Accounting Standards Board Statement 45 requires employers that sponsor defined benefit plans other than pension benefits to measure and report their long-term "other postemployment benefit" (OPEB) costs and the extent to which the employer has contributed assets to meet those costs. For these purposes, the same actuarial methods and assumptions are to be used for both the OPEB plan and the participating employer.

Two key OPEB measures are required to be calculated and included in the employer's financial statements:

1. The "OPEB cost" is the annual required contribution (ARC), with certain adjustments, determined by an actuarial valuation conforming to GASB's parameters. The OPEB cost determines the employer's annual OPEB expense or expenditure shown in the employer's annual financial statements.
2. The "net OPEB obligation" is the difference between the employer's OPEB cost and actual annual employer contributions to the OPEB plan, accumulated from the effective date of the OPEB standards.

In addition to requiring that government employers measure and report the long-term costs of retiree health care and other OPEBs in their financial statements, the OPEB standards also require other disclosures in the employer's annual financial report, including:

- a. Notes to the Financial Statements: The disclosure item summarizes plan provisions, authority for plan changes, significant accounting policies, contributions, reserves, investment concentrations, funded status, funding progress, actuarial methods and actuarial assumptions.
- b. Schedule of Funding Progress: The disclosure item shows actuarial accrued liabilities, actuarial value of assets, unfunded accrued liabilities, funded ratio, covered payroll and unfunded liabilities as a percent of covered payroll for the three most recent actuarial valuations.

* This summary was drawn heavily from Murphy, Brian B., and Zorn, Paul, "Managing the Impact of GASB Statement 45," Benefits & Compensation Digest, Vol. 43, No. 5, May 2006.

- c. Schedule of Employer Contributions: The disclosure item shows the annual OPEB cost, the percent of the annual OPEB cost actually contributed by the employer, and the net OPEB obligation for the three most recent actuarial valuations.

The GASB OPEB standards do not require that OPEB benefits to be prefunded or accumulated OPEB funds be held in trust, but offer significant advantages for doing both. If OPEB assets are held in trust and the funding policy requires a contribution of 100 percent or more of the annual ARC, GASB Statement 45 allows the investment return assumption to reflect the diversified mix of stocks and bonds held by the trust, similar to that used by public pension plans. However, if OPEB assets are not held in trust, the assumed investment return may only reflect the return on investments available to the employer, which are typically short-term, fixed income securities. Consequently, OPEB costs are likely to be much higher in an unfunded plan than in a funded one, because investment return will be assumed to play a much smaller role in the funding.

The GASB OPEB standards provide incentives for governments to establish funding vehicles (trusts or equivalent arrangements) for OPEB benefits and to fund the OPEB costs at levels equal to the ARC. Even without such an incentive, funding OPEB benefits is a good idea. Income from investments can, in the long term, significantly offset future required contributions and can help ensure survival of the plan.

To qualify as a trust or an equivalent arrangement under the GASB standards, the arrangement must be established so that:

- (1) Contributions are irrevocable;
- (2) Assets are dedicated to providing OPEBs to retirees and beneficiaries in accordance with the terms of the plan; and
- (3) The assets are legally protected from creditors of the plan sponsor or administrator.

If the trust fund or equivalent arrangement meets these three conditions, contributions made by the employer can offset OPEB liabilities in the financial statements, and the actuary can use a higher rate of interest in the calculations, actually lowering the ARC.

In addition to satisfying GASB's requirements, other characteristics are desirable in a funding vehicle. It would be best if plan administration was not too complex, with minimal administrative filings. The vehicle should allow for a diversified portfolio while protecting the assets from creditors. To the extent possible, the vehicle should also provide tax advantages with regard to contributions, investment earnings and benefit payouts. Several funding vehicles are available to governments for funding retiree health care, including 401(h) accounts, voluntary employees' beneficiary associations (VEBAs) and governmental trusts.

Analysis and Discussion

H.F. 1160 (Hilstrom), the first engrossment, addresses a portion of the "Other Postemployment Benefit" (OPEB) issue that has been prompted by the promulgation and pending implementation of Government Accounting Standards Board (GASB) Statement No. 45, by permitting Minnesota governmental subdivisions to establish OPEB trusts and by providing some regulation of those trusts, principally their investment authority.

H.F. 1160 (Hilstrom) is not a general response to the broad situation of OPEB benefits grants, but is a response to the recognition by local government representatives and others that potential municipal debt issuance will be affected by OPEB concerns in the future, that municipal debt rating agency concerns and preferences argue for the creation of OPEB trusts, and that current Minnesota law has been interpreted by the Attorney General's Office (June 6, 2006, letter from Kenneth E. Raschke, Jr., to Patricia Anderson) as disallowing the establishment of OPEB trusts in Minnesota.

Your request was for my assessment of the problematic aspects of the proposed legislation. I have approached this request more generally than the proposed legislation, from both the perspective of identifying any potential shortcomings in the proposed legislation as well as the perspective of identifying policy issues not addressed by the proposed legislation.

The policy issues associated with H.F. 60 (Hilstrom) and the OPEB accounting change that I have identified for consideration and discussion are:

1. Potential Need to Disallow the Creation of Future OPEB Plans or to Regulate the Creation of Future OPEB Plans. H.F. 1160 (Hilstrom) does not address the policy issue, but it may be advantageous from a policy perspective that the Minnesota Legislature either disallow Minnesota political

