



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

subdivisions from creating any new (post-June 30, 2007) "other postemployment benefit" (OPEB) plans or promises or to constrain the power of Minnesota political subdivisions in creating new OPEB plans or obligations by imposing various regulatory measures on new (post-July 1, 2007) OPEB promises. This would be analogous to the situation addressed by the Legislative Commission on Pensions and Retirement in 1971, when some local jurisdictions were creating employer-funded supplemental retirement plans to augment the retirement coverage of the statewide retirement plans and compete with each other for employees, and the Commission recommended Minnesota Statutes, Section 356.24 (Laws 1971, Chapter 222), which is a general ban on the creation of employer-funded supplemental pension plans that has some exceptions if some regulatory requirements are met. Thus, legislation (**Amendment H1160-1A**) could be enacted that would prohibit local government entities from creating a new OPEB plan for any employee group or class not currently (as of June 30, 2007) covered by an OPEB plan and would prohibit any increase in the level of OPEB coverage in an OPEB plan currently in force (on June 30, 2007).

2. Potential Need to Clarify the Other Postemployment Benefit Arrangements. H.F. 1160 (Hilstrom) does not address the policy issue, but there may be policy advantages in regulating the manner in which other postemployment benefit promises are made. It appears that the rights that public employees gain to non-pension forms of employment-related benefits after retirement are primarily obtained through collective bargaining agreements, personnel policy documents, or governmental policy making body enactments. The benefits might not be codified into one document rather than existing in multiple documents and covered individuals, policy makers, and taxpayers might not be on complete notice of the magnitude of the benefit coverage and the various applicable eligibility requirements. **Amendment H1160-2A** would address this issue of incomplete disclosure of OPEB plans by requiring the government entity to reduce the entirety of all pre-July 1, 2007, OPEB benefit provisions into a single document, the OPEB plan, and to make all post-June 30, 2007, changes in OPEB by amendments to that OPEB plan.
3. Potential Need to Clarify the Manner in which Other Postemployment Benefits Actuarial Liabilities are Calculated. H.F. 1160 (Hilstrom) does not address the policy issue of the advisability of regulating the manner in which other postemployment benefit liabilities are calculated. Other postemployment benefits (OPEB) are typically self-insured benefit obligations that are essentially identical to pension benefits from the standpoint of the determination of actuarial liabilities. With pension liabilities, the Legislature discerned the need to regulate the manner in which the actuarial liabilities will be calculated in 1965, with the enactment of Minnesota Statutes 2006, Section 356.215. Because other employment benefit funding costs are typically borne by the employer rather than jointly with the employees, some streamlining of or modifications to pension plan actuarial reporting requirements are possible. The topics that probably should be addressed with respect to OPEB liability determination and reporting are the academic, professional, or experiential requirements to be imposed in determining an actuary qualified to conduct the actuarial reporting, the actuarial method to be used in determining actuarial liabilities of the OPEB plan, the method for determining the actuarial value of plan assets, the actuarial assumptions used in OPEB actuarial valuations, the frequency of OPEB actuarial valuations, the filing requirements for OPEB actuarial valuations, the extent of funding requirements to be imposed for OPEB liabilities and the penalties for any failure of compliance, and the extent to which the Government Accounting Standards Board Statement 45 accommodations for liability and funding requirement determinations for small OPEB plans should be incorporated into Minnesota law. **Amendment H1160-3A** addresses those topics in order to prompt further discussion by interested parties.
4. Potential Need to Add Fiduciary Regulation. H.F. 1160 (Hilstrom) limits its scope to the manner in which other postemployment benefits (OPEB) amassed assets will be invested and what available investment mechanism may be utilized by an OPEB plan. It provides no guidance or regulation of the responsibility and liability for the manner in which the OPEB plan and amassed assets are administered. The policy issue is what fiduciary responsibility regulations should apply to OPEB plans. Absent any codified statutory fiduciary regulations for OPEB plans, to the extent that the litigants or the court find an analogous situation, the common law of private trusts or pension plan fiduciary responsibility likely will apply. To ensure consistent and pervasive application of fiduciary regulation, especially if outside investment vendors are permitted to operate or administer these OPEB plans, it may be optimal to bring OPEB administrations under the public pension plan fiduciary standards of Minnesota Statutes, Chapter 356A. **Amendment H1160-4A** extends Minnesota Statutes, Chapter 356A, to OPEB plans and arrangements.
5. Appropriateness of Utilizing Banks and Insurance Companies as Plan Administration and Investment Vehicles. (Section 1, Subdivision 3) The policy issue is the appropriateness of permitting banks and

insurance companies to administer the trusts permitted as vehicles for Other Postemployment Benefit (OPEB) plans or arrangements and to function as the investment vehicles for those trusts, rather than utilizing a local or statewide governmental plan administration. Representatives of the League of Minnesota Cities and of the Minnesota Inter-County Association, two proponents of the proposed legislation as drafter, indicated to the Commission staff that the inclusion of the banks and insurance companies was the result of the ability of banks and insurance companies to block similar 2006 proposed legislation that did not permit their involvement and of the preferences of school districts in benefit programs utilizing insurance companies. These reasons reflect practical and tactical considerations, but shed no light on policy reasons for the inclusions of banks and insurance companies to handle OPEB trusts on behalf of the public sector. The operation of these permitted trusts, where the governmental unit retains the power to create and amend the benefit plan, is limited to collecting money designated as an asset of the OPEB program, investing OPEB assets, and periodically returning amounts when benefits are due. There are approaches within the public sector to handle these OPEB assets, from having the State Board of Investment establish an investment mechanism akin to what it did in connection with the Lottery and with the Assigned Risk Pool for Workers Compensation, to utilizing the Health Savings Account Plan operated by the Minnesota State Retirement System (MSRS) if federal law permits, to utilizing the collection and disbursement functions of the Public Employees Retirement Association (PERA), a statewide retirement plan, to utilizing special administrative operations established within each county, to utilizing a special legislatively created nonprofit company for this purpose akin to the Workers Compensation Reinsurance Association. Amendment E eliminates the banks and insurance companies from the trust operation authority, leaving PERA as the sole administrative entity for OPEB trusts.

6. Appropriateness of Requiring More Qualified Banks and Insurance Companies to Serve OPEB Trusts. (Section 1, Subdivision 3) The policy issue is whether or not to require the banks and insurance companies that are permitted to serve Other Postemployment Benefits (OPEB) trusts to meet greater quality criteria than currently required by H.F. 1160 (Hilstrom). The proposed legislation simply requires that banks be incorporated under U.S. state or federal law and be organized to exercise corporate trust powers and that insurance companies or agencies be “qualified” to do business in Minnesota, have five-year group retirement investment products, and have a specialized retirement investment products department. The current requirements would not eliminate any but the smallest banks and any but those insurance companies without any advertising or marketing sense. None of the requirements actually speak to either quality investment performance or modest administrative expenses. The proposed legislation could be improved by requiring quality/efficiency. **Amendment H1160-6A** would require the bank or insurance company to demonstrate to the Commissioner of Commerce that its administrative expenses are lower than those charged by the Public Employees Retirement Association (PERA) for the Duluth OPEB account. **Amendment H1160-7A** would require any bank or insurance company engaging in the OPEB business to demonstrate to the Commissioner of Commerce that its investment performance for the past two, five, and ten year periods exceeded the investment performance of the Income Share Account of the Minnesota Supplemental Investment Fund operated by the State Board of Investment. **Amendment H1160-8A** would impose both requirements.
7. Appropriateness of Utilizing PERA to Administer OPEB Trusts. (Section 1, Subdivision 3) The policy issue is the appropriateness of utilizing the Public Employees Retirement Association (PERA) to administer the various local government other postemployment benefit (OPEB) trusts. The proposed legislation permits PERA to be an alternative administrative entity to operate OPEB trusts. The duties to be performed by PERA for the OPEB trusts are not set forth in any detail, although presumably PERA would be receiving OPEB contributions, keeping basic accounting records, and transfer portions of OPEB assets back to sponsoring employers when benefits are due. The proposed legislation also does not specify what would be reasonable administrative expenses for PERA in conducting its activities, although PERA is permitted to deduct its administrative charges from the OPEB trusts. The additional, but ill defined, duties to be expected of PERA under the proposed legislation may blur the mission of PERA to administer the various retirement plans it is primarily responsible for, similar to the way that the State Deferred Compensation Program has appeared to interfere with the Minnesota State Retirement System (MSRS) in administering its retirement plans. Also, the use of PERA to operate these OPEB trusts would seem to eliminate the possibility of utilizing the MSRS Health Savings Program as the vehicle through which to operate OPEB accounts if federal law is determined to permit its use.
8. Appropriateness of Utilizing Revocable and Irrevocable Trusts. (Section 1, Subdivision 2) The policy issue is the appropriateness of allowing the creation of either irrevocable trusts and revocable

trusts for other postemployment benefits (OPEB). The creation of a funded irrevocable OPEB trust allows the employing unit responsible for the OPEB program to basically ignore the OEPB liability in its regular financial reporting, while revocable OPEB trusts are not treated the same. The desire for revocable trust authority rather than the potentially more advantageous irrevocable trust authority is a concern by some employing units that federal or state law, demographics, or other factors are too fluid to permit the inflexibility of an irrevocable trust. It is not clear that the full policy argument for revocable trust authority has been presented to the appropriate legislative bodies to sufficiently convince policy makers of the wisdom of permitting anything but an irrevocable trust.

9. Appropriateness of the Lack of Required Minimum Contents Items for OPEB Trust Documents. The policy issue is the appropriateness of the proposed legislation when it does not specify any minimum requirements for the contents of an other postemployment benefits (OPEB) trust document. Trust documents can be very complicated and OEPB liabilities and assets can be very substantial, which are both factors arguing for a need for more specificity in the proposed trust creation authority. The proponents of the proposed legislation should be requested to provide some sample trust documents and the contents of the best drafted documents could be translated into minimum statutory trust document requirements.
10. Appropriateness of Including Municipal Investment Authority for OPEB Trusts. (Section 1, Subdivision 5, Paragraph (d)) The proposed legislation, for other postemployment benefits (OPEB) trusts not administered by the Public Employees Retirement Association (PERA), sets the trust investment authority as either the current local public funds investment authority, Minnesota Statutes, Chapter 118A, or the current larger local retirement plan investment authority, Minnesota Statutes, Section 356A.06, Subdivision 7. Since the problem underlying the proposed legislation is the need to utilize a trust that would permit OPEB assets to be invested in long-term, institutional investor-type investment securities, it is unclear why limiting investment authority to the current municipal investment authority law under Minnesota Statutes, Chapter 118A, makes any policy sense.
11. Appropriate Level of Risk Tolerance for OPEB Trust Assets. (Section 1, Subdivision 5, Paragraph (d)) The policy issue is the appropriateness of allowing all other postemployment benefits (OPEB) trusts, even the smallest trusts, the authority to invest in virtually the full spectrum of potential retirement plan investments. For smaller sized local Minnesota public pension plans, which may be appropriately risk-averse, and which are not professionally invested, Minnesota Statutes, Section 356A.06, Subdivision 6, restricts the plan's investment authority to more debt securities and less likely market volatility. It may be appropriate to also carry forward the small versus large asset investment authority provisions for OPEB trusts.
12. Appropriateness of the Vague Investment Authority for State Board of Investment Invested OEPB Trusts. (Section 1, Subdivision 5, Paragraph (d)) The policy issue is the appropriateness of the vague reference to "the investment restrictions shall be the same as those generally applicable to the State Board of Investment" when the actual State Board of Investment investment authority could be referenced. The primary "legal list" investment authority of the State Board of Investment is Minnesota Statutes, Section 11A.24. **Amendment H1160-9A** would replace the vague reference to the specific citation. It is undoubtedly appropriate to include vague drafting in proposed legislation where the precise intent is unclear or all of the relevant facts are unknown, but since that is not the case here, more precise drafting would be advisable.
13. Appropriateness of Omission of Any Requirement for Filing an Investment Policy Statement. The policy issue is the need for any other postemployment benefits (OPEB) trusts authorized for various political subdivisions to have a clear investment policy and to be required to file that statement with some central statewide clearinghouse. The Duluth Postemployment Benefit trust fund authorization required the City of Duluth to construct an investment policy statement and to file that investment policy statement with the State Auditor, which also functions as the repository and clearinghouse for local pension plan investment statements. A key argument for OPEB trusts is to allow for the actuarial pre-funding of OPEB liabilities and to gain the investment performance on the amassed assets. An actuarial pre-funded pension plan can have its investment portfolio provide two-thirds to three-quarters of the money disbursed as benefits and the same sort of investment advantage can be gained for OPEB trusts. A well operated institutional investment operation will have a clear policy on investment portfolio mix, investment time horizons, investment risk, and extent of active investment management permitted, although the investment policy statement does not substitute for its actual implementation. The only way to insure that OEPB trusts will be invested effectively is to require that OPEB trusts have investment policy statements from the start and then to monitor actual

