BEST PRACTICE

Ensuring the Sustainability of Other Postemployment Benefits (2007) (CORBA & BUDGET)

Background. Employee compensation packages for active workers often include healthcare and similar benefits following the completion of active service. Generically, such benefits are described as *other* postemployment benefits (OPEB) to distinguish them from pensions.[1] For many years, employers have been required to recognize expenses for the cost of pension benefits as those benefits are earned by employees during their active service life. The Governmental Accounting Standards Board (GASB) has now extended this same requirement to OPEB.[2] The change in accounting standards has focused attention as never before on the costs of OPEB. These concerns are exacerbated by rising healthcare costs and an aging public-sector workforce. The real issue is not the new accounting for OPEB, as such, but rather the underlying *budgetary and funding* challenge that those accounting standards highlight. Meeting this challenge will require that government finance officers ensure that any such benefits they offer are *sustainable* over the long term (i.e., benefits *are, and reasonably may be expected to remain,* affordable to the government, competitive and sufficient to meet employee needs).

Recommendation. Governments should develop a deliberative process to ensure the sustainability of any OPEB they offer to their employees. These steps should include:

1) Developing principles and priorities to guide decision-making for OPEB that considers benefit design, funding approaches, and the needs of all stakeholders. (Because OPEB are a form of employee compensation, they should always be considered as an integral part of an employee's total compensation package. Likewise, governments should strive to avoid benefit reductions that place an undue burden on employees, or that risk making the government uncompetitive as an employer).

2) Carefully evaluating and designing benefits to ensure they are sustainable. In doing so, a government may wish to consider the following possibilities of enhancing sustainability:

   a) implementing healthcare cost containment measures[3]
   b) improving coordination with Medicare benefits
   c) establishing vesting rules that provide levels of benefits that are commensurate with years of service
   d) establishing eligibility rules that avoid including retirees, dependents, and spouses who are otherwise insured
   e) creating a tiered system of benefits based on hiring dates
   f) replacing defined benefits with a defined contribution or hybrid model[4]

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[1] Some government employers choose to augment other elements of employee compensation rather than providing OPEB.
[2] See GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (2004). The Financial Accounting Standards Board (FASB) has required the same of private-sector employers since the implementation of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, which was released in 1990 and first took effect for calendar fiscal year 1993.
[3] See the GFOA Best Practice, *Health Care Cost Containment*, 2004.
[4] A *hybrid* model combines elements of a defined *benefit* plan with elements of a defined contribution plan--for example, fixed employer payments (i.e., a defined *contribution*) combined with a guaranteed minimum earnings rate on the resources accumulated (i.e., a defined *benefit*).

g) considering whether to continue using the same blended or common premium to both retirees and active employees (i.e., the *implicit rate subsidy*).

3) Once a government has satisfied itself that its plan design for OPEB is sustainable, it should intentionally select an appropriate funding approach.

   a) The government should refrain from offering incentive packages for early separation without first considering their impact on the cost of OPEB[5];
   b) The government should decide whether it will fund benefits as they are being earned over an employee's active service life (i.e., *advance funding*) or only as benefit payments come due (i.e., *pay-as-you-go* or *pay-go* funding)[6];
   c) If the government elects to advance fund benefits it should decide:

      i) which actuarial cost allocation method is most appropriate to its objectives and circumstances,
      ii) whether to do so for all OPEB, or to exclude the implicit rate subsidy for healthcare,
      iii) whether to fully pre-fund benefits or only partially pre-fund benefits, and
      iv) whether to establish a separate trust fund for the purpose or earmark resources that remain in the government's control (e.g., a separate fund or account).

4) If the government elects to establish a trust fund, it should consider all of the following:

   a) potential need to seek new legislation to allow appropriate trust arrangements and investment guidelines
   b) impact on annual required contribution of prompt implementation and funding[7]
   c) possibility of collaborating with others including pension plans to lower administrative costs and leverage investing expertise
   d) advantages and disadvantages of each trust option
   e) administrative and reporting requirements (including the need for a private letter ruling from the IRS in certain circumstances)
   f) governance structure (oversight board, investment policy, investing infrastructure)
   g) appropriate flexibility (e.g., appropriate adjustments if a form of state or national universal health care is adopted) without compromising compliance with GASB requirements to qualify as a "trust" for accounting and financial reporting purposes.

5) Governments should exercise considerable caution before issuing debt to fund their unfunded actuarial accrued liability.[8]
6) Governments should consider how to most effectively communicate with and educate affected stakeholders on the impact of the decisions made regarding OPEB.

Approved by the GFOA's Executive Board, October 19, 2007.

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[5] See GFOA's Best Practice, *Evaluating the Use of Early Retirement Incentives,* 2004.
[6] One clear benefit of advance funding over pay-as-you-go funding is that amounts accumulated for future benefits partially offset their cost.
[7] As already noted, earnings on amounts accumulated for future benefits help to offset the cost of these benefits. Thus, the sooner the trust is funded, the greater the impact on the cost of the OPEB. This fact needs to be considered when a government considers an OPEB funding strategy.
[8] See GFOA's Advisory, Need for Considerable Caution in Regard to OPEB Bonds, 2007.