

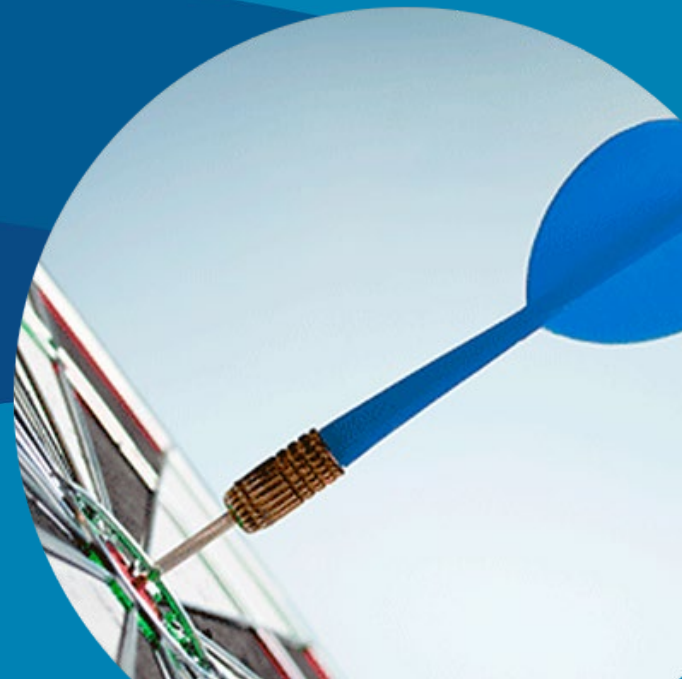


# ***Funding Considerations for Pensions & OPEBs***

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# Agenda Topics

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- The 40,000-foot perspective
- A written pension funding policy statement
- Funding using reasonable/mainstream investment return assumptions
- Considerations unique to OPEBs

# Polling Question 1

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Are you a pension trustee or pension administrator for your government?

- A. Yes
- B. No

# Polling Question 2

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Are you involved in the preparation or the audit of a government's ACFR?

- A. Yes
- B. No

# The 40,000-foot Perspective

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- Types of retirement plans
- Defined contribution plans (401(k), 457, and 401(a) plans)
  - The employer contribution is defined in advance
  - For example, 7.5% of pay deposited into an account in the name of each employee
  - But the ultimate benefit payable to the retiring employee is unknown and depends on the investment performance over the years
  - Employee bears the investment risk (and longevity risk)
- Defined benefit promises (“pension plans”)
  - The benefit amount is defined in advance by the formula
  - A formula determines the monthly benefits payable for life at age X
  - For example,  $2.7\% \times \text{Final Average Pay} \times \text{Years of Service}$
  - But the employer contribution to fund it is actuarially determined each year
  - Employer bears the investment risk

# The 40,000-foot Perspective

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- Pension Plan “Equation of Balance” over Time:

$$\begin{array}{ccccccc} \mathbf{C} & + & \mathbf{I} & = & \mathbf{B} & + & \mathbf{E} \\ \text{Ultimate} & & \text{Actual} & & \text{Actual} & & \text{Actual Adm} \\ \text{Cost} & & \text{Net Interest} & & \text{Benefits} & & \text{Expenses} \end{array}$$

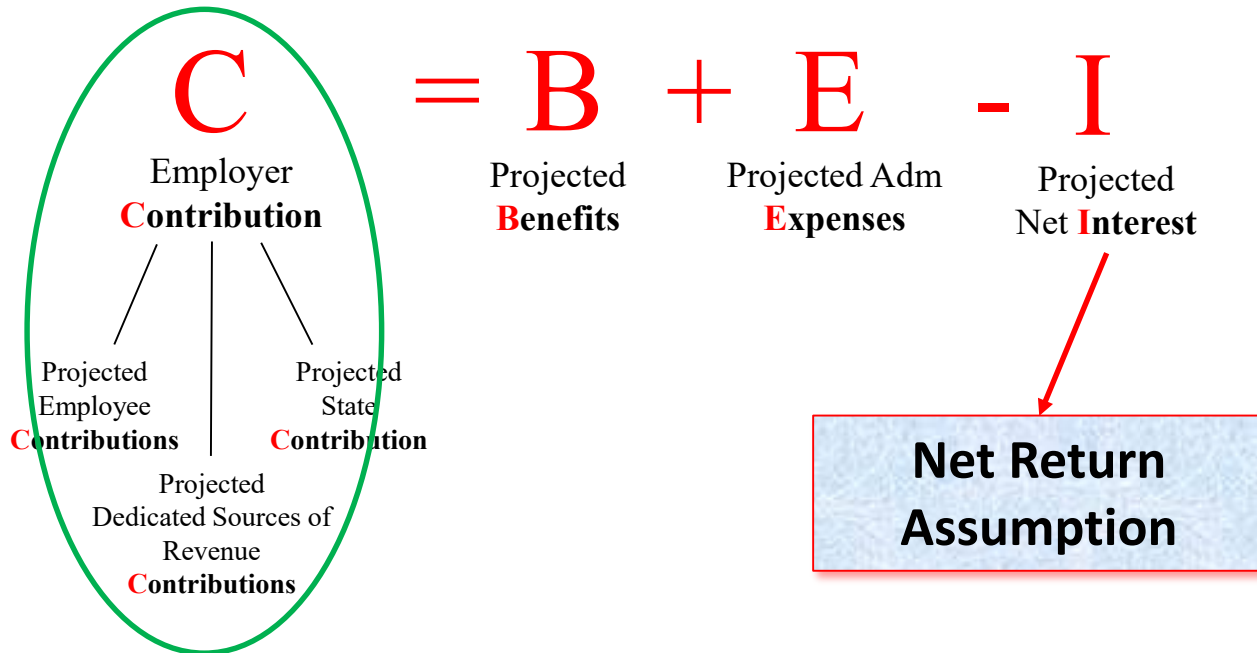
Net investment income funds a majority of benefits and administrative expenses over the life of a plan

Solve for **C** (the ultimate **C**ost to taxpayers) . . .

$$\mathbf{C} = \mathbf{B} + \mathbf{E} - \mathbf{I}$$

# The 40,000-foot Perspective

- Pension Plan “Equation of Balance” in an Actuarial Valuation:



# The 40,000-foot Perspective

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- A duty in financial reporting (esp. for local pension plans)
  - A duty owed to the state, to the public, to other users of financial statements
  - Reasonable best estimates for balance sheet liabilities
- A duty to adequate funding (esp. for local pension plans)
  - A duty owed to current retirees and current employees, both of whom have been promised a secure pension benefit for life
  - Actuarial pension benefit security (the #1 Funding Objective)
  - Less of a funding duty on OPEBs that have no direct subsidy

# The 40,000-foot Perspective

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What's the rationale for pre-funding?

What's the value proposition?

Why pre-fund the obligation? Why not just pay-as-you-go?

1. Pre-funding gives employees and retirees benefit security, knowing there is a large reserve fund dedicated to, and backing, the benefit promise; hopefully an “actuarially sound” reserve
2. Pre-funding substantially reduces cost to taxpayers in the long run; a substantial majority (near 70%) of the pension benefits are funded with investment earnings
  - Followed by employer contributions from taxes, employee contributions from payroll, and state contributions from insurance policyholders

# The Written Funding Policy

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- All pension boards have a written Investment Policy –  
It is also important to have a written Funding Policy as well
  - *Don't leave important policies decisions to the actuary's discretion –  
The actuary is an advisor, not a policy-maker.*
  - *Leave only mathematical/actuarial techniques to the actuary's discretion.*
  - *Prevents important policy matters from being changed –  
willy-nilly, on-the-fly.*
  - *Reminds trustees and vendors of the rules –  
actuary, atty, auditor, inv firms.*
  - *Documents and discloses your policies to the public –  
accountability and transparency.*
  - *Includes a procedure for amending the funding policy document.*

# The Written Funding Policy

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- In a written Funding Policy,
  - Include: Legal and ethical **duties** of pre-funding
  - Include: The five **objectives** of pre-funding
  - Include: The five core **elements** of a written funding policy
- Sample Funding Policy

# Legal and Ethical Duties of Pension Funding

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*§112.61, F.S. Legislative Intent (excerpts) –*

- “It is the intent of the Legislature in implementing the provisions of s. 14, Art. X of the State Constitution, relating to governmental retirement systems, that such retirement systems or plans be managed, administered, operated, and funded in such a manner as to maximize the protection of public employee retirement benefits.”*
- “Inherent in this intent is the recognition that the pension liabilities attributable to the benefits promised public employees be fairly, orderly, and equitably funded by the current, as well as future, taxpayers. Accordingly, except as herein provided, it is the intent of this act to prohibit the use of any procedure, methodology, or assumptions the effect of which is to transfer to future taxpayers any portion of the costs which may reasonably have been expected to be paid by the current taxpayers.”*

# Legal and Ethical Duties of Pension Funding

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§112.656(1) –

- *“A fiduciary shall discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan.”*

§112.64(1) –

- *“Employee contributions shall be deposited in the retirement system or plan at least monthly. Employer contributions shall be deposited at least quarterly; . . .”*

# The Written Funding Policy

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- In a written Funding Policy,
  - Include: Legal and ethical ***duties*** of pre-funding
  - Include: The five ***objectives*** of pre-funding
  - Include: The five core ***elements*** of a written funding policy

# Objectives of Pre-Funding

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Five objectives taken from “*Actuarial Funding Policies and Practices for Public Pension Plans*”, published by the Public Plans Community of the Conference of Consulting Actuaries

## **1. Actuarial Benefit Security:**

*Future contributions and current plan assets should be sufficient to provide for all benefits expected to be paid to members and their beneficiaries when due. To secure that objective on a sound actuarial basis requires building up and maintaining a reserve backing the benefit promise as described in the Actuarial Standards of Practice and other actuarial literature.*

# Objectives of Pre-Funding

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## 2. Inter-period Equity:

*Seek a reasonable and equitable allocation of the cost of benefits and the required funding between current and future taxpayers.*

## 3. Volatility Control:

*Seek to manage and control future employer contribution volatility to the extent reasonably possible, consistent with other Funding Objectives.*

## 4. Accountability and Transparency:

*Support the employer's general public policy goals of transparency and accountability.*

## 5. Avoidance of Agency Risk:

*Avoid undue influence from outside non-fiduciary concerns that may undermine other Funding Objectives and the financial stability of the Plan; commonly an issue when adopting actuarial assumptions.*

# Polling Question 3

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Which answer is NOT an objective of pre-funding pension plans:

- A. Actuarial benefit security (build up actuarial reserves)?
- B. Inter-period Equity (fairness between generations of taxpayers)?
- C. Cost control (keep contributions down)?
- D. Accountability and Transparency? or
- E. Avoidance of Agency Risk (avoid non-fiduciary concerns)?

# The Written Funding Policy

---

- In a written Funding Policy,
  - Include: Legal and ethical ***duties*** of pre-funding
  - Include: The five ***objectives*** of pre-funding
  - Include: The five core ***elements*** of a written funding policy

# Elements of a Written Funding Policy

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Build Policies on these topics right into your written funding policy:

1. Actuarial Cost Method
2. Actuarial Value of Assets
3. Amortization Methods
4. Actuarial Assumptions Procedure
5. Enterprise Risk Management Process

# Elements of a Written Funding Policy

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Build Policies on these topics right into your written funding policy :

## **1. Actuarial Cost Method**

- Usually, it is the Entry Age actuarial cost method; but might be different due to actuary's recommendation and justification
- Adjustments for timing of contributions in relation to valuation date
- Treatment of employee and state contributions
- Treatment of excess contributions (above the minimum)
- Special provisions for closed and frozen plans
- Cite/refer to relevant portions of Actuarial Standards of Practice (ASOP) No. 4

# Elements of a Written Funding Policy

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## 2. Actuarial Value of Assets

- Describe plan assets (for legal and accounting purposes)
- Describe the asset smoothing method in sufficient detail
- Set forth rationales for when and why to *change* the asset smoothing method
- Describe how to transition to a different asset smoothing method
- Describe the effect of excess contributions and DROP assets on plan funding
- Cite/refer to compliance with ASOP No. 44

# Elements of a Written Funding Policy

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## 3. Amortization Methods

- Define the unfunded actuarial liability (UAL) in detail
- Contribution usually = normal cost plus amortization payments
- Amortization policy sets the parameters for paying off each component source of the UAL: (a) length of time and (b) the pattern of payment (level dollar or percent of pay)
- Effect of changing return assumption on UAL payments
- Set forth rules for how contributions are applied to paying down each amortization base
- Set forth in advance what to do when UAL goes negative (i.e., surplus)
- Never pay less than the normal cost

# Elements of a Written Funding Policy

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## 4. Actuarial Assumption Procedure

- Document a robust process and frequency for your actuary's recommendations for economic assumptions
  - Hold your actuary to account for professional research
  - Adopt an inflation assumption by **researching several professional inflation forecasters' unbiased mainstream opinions** (consensus average)
  - Obtain capital market assumptions (CMAs) from **several professional investment return forecasters' unbiased mainstream CMAs**
  - Reflect your own asset allocation, cash flow, and investment expenses
  - Final assumptions should be based on a blend of mid-term and long-term time horizons for the forecasts (not only long-term) and average over 3-5 yrs
- Document frequency of experience studies for demographic assumptions
- Avoid non-fiduciary reasons for adopting certain assumptions!!

# Elements of a Written Funding Policy

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## 5. Enterprise Risk Management Process

- Incorporate enterprise-wide considerations encompassing the risk appetite of the party bearing the risk (employer)
- Require actuary's advice concerning ASOP No. 51
- Require periodic open group asset/liability modeling forecasts to measure the volatility in key risk metrics:
  1. Funding liability (UAL) or balance sheet liability (NPL)
  2. Funded ratio
  3. Employer contribution requirement as a percent of pay
- Every three years, or when asset allocation is changed, or when economy or investment landscape changes sufficiently
- Examine baseline version of the future, compared to sensitivity testing, and/or stress-testing, and/or stochastic simulations, to see if the volatility is tolerable

# The Written Funding Policy

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  - *Don't leave important policies decisions to the actuary's discretion –  
The actuary is an advisor, not a policy-maker.*
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  - *Prevents important policy matters from being changed –  
willy-nilly, on-the-fly.*
  - *Reminds trustees and vendors of the rules –  
actuary, atty, auditor, inv firms.*
  - *Documents and discloses your policies to the public –  
accountability and transparency.*
  - *Includes a procedure for amending the funding policy document.*

# The Written Funding Policy

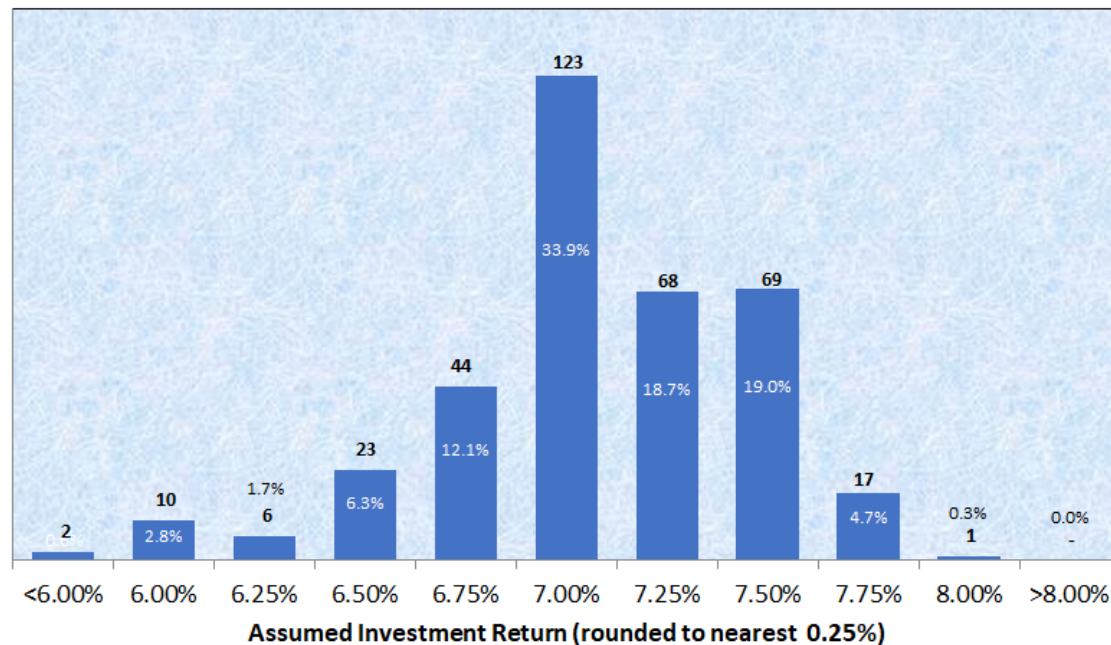
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For a sample written Funding Policy Statement:

- Click on [GRS Advantage™](https://advantage.gabrielroeder.com)  
(or copy/paste: <https://advantage.gabrielroeder.com>)
- Look for:  
[Click here for the Sample-Template Funding Policy Statement \(Local Florida Plans\)](#)

# Investment Rate of Return Assumptions

**Pension Boards' Adopted Return Assumptions for 2021**  
**Among 363 Local Florida Public Pension Plans**

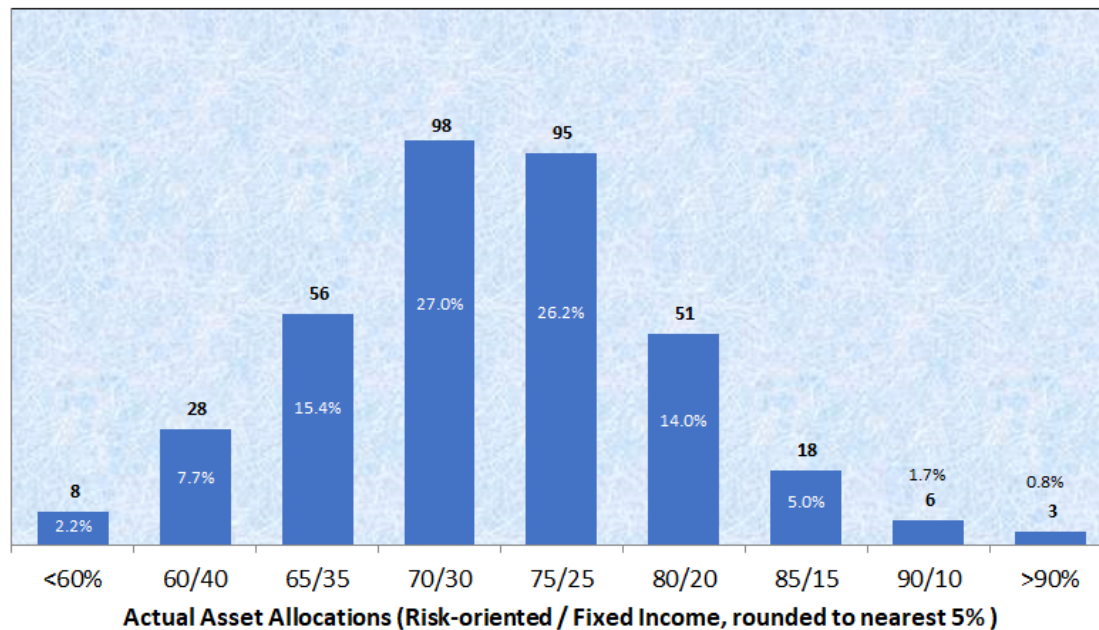


Source: Florida Department of Management Services Database (including 2021 valuation data submissions rec'd through October 31, 2022; excluding plans having low asset values or high non-classified assets).

■ Number (and %) of Pension Boards with the given return assumption.

# Investment Rate of Return Assumptions

**Pension Funds' Actual Asset Allocations for 2021**  
Among 363 Local Florida Public Pension Plans



Source: Florida Department of Management Services Database (including 2021 valuation data submissions rec'd through October 31, 2022; excluding plans having low asset values or high non-classified assets).

■ Number (and %) of Pension Funds with the given asset allocation.

# Investment Rate of Return Assumptions

## Assumed Investment Return $\times$ Actual Asset Allocation Among 363 Local Florida Plans (2021 Valuations)

	Actual Asset Allocation (Rounded to Nearest 5%)									Total Plans
	<60%	60/40	65/35	70/30	75/25	80/20	85/15	90/10	>90%	
>8.00%	-	-	-	-	-	-	-	-	-	-
8.00%	-	-	-	-	-	1	-	-	-	1
7.75%	1	1	2	3	3	5	1	1	-	17
7.50%	3	5	8	20	25	5	2	1	-	69
7.25%	-	5	13	14	19	9	6	2	-	68
7.00%	1	10	18	40	29	18	4	2	1	123
6.75%	1	4	8	10	12	6	3	-	-	44
6.50%	-	1	5	5	6	4	2	-	-	23
6.25%	1	-	2	2	-	1	-	-	-	6
6.00%	-	2	-	3	1	2	-	-	2	10
<6.00%	1	-	-	1	-	-	-	-	-	2
<b>Total Plans</b>	<b>8</b>	<b>28</b>	<b>56</b>	<b>98</b>	<b>95</b>	<b>51</b>	<b>18</b>	<b>6</b>	<b>3</b>	<b>363</b>

Number of Plans. Source: Florida Department of Management Services Database (2021 valuation data submissions rec'd thru October 31, 2022; excluding plans having low asset values or high non-classified assets).

# Elements of a Written Funding Policy

---

## 4. Actuarial Assumption Procedure


- Document a robust process and frequency for your actuary's recommendations for economic assumptions
  - Hold your actuary to account for professional research
  - Adopt an inflation assumption by **researching several professional inflation forecasters' unbiased mainstream opinions** (consensus average)
  - Obtain capital market assumptions (CMAs) from **several professional investment return forecasters' unbiased mainstream CMAs**
  - Reflect your own asset allocation, cash flow, and investment expenses
  - Final assumptions should be based on a blend of mid-term and long-term time horizons for the forecasts (not only long-term) and average over 3-5 yrs
- Document frequency of experience studies for demographic assumptions
- Avoid non-fiduciary reasons for adopting certain assumptions!!

# Investment Rate of Return Assumptions

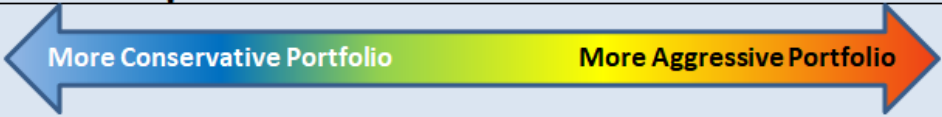
Professional Inflation Forecasters	
Congressional Budget Office	Federal Reserve Bank of Cleveland
Federal Reserve Bank of New York Surveys (2)	Federal Reserve Bank of Philadelphia Surveys (2)
Federal Reserve Bank of St. Louis (FRED)	Federal Reserve Board (Open Market Committee)
Investment Forecaster Survey (GRS)	Social Security Trustees Report
U.S. Department of the Treasury	
State of Florida Office of Economic & Demographic Research	

Participating Professional Investment Forecasters			
Aon/Hewitt	Blackrock	BNY/Mellon	Callan
Cambridge	J.P. Morgan	Meketa	Mercer
RVK	NEPC	Verus	Wilshire


# Investment Rate of Return Assumptions

A Spectrum of Sample Asset Allocations							
							
Risk/Fixed Assets	60/40	65/35	70/30	75/25	80/20	85/15	90/10
Large Cap Equity	35%	35%	30%	25%	20%	15%	15%
Sm/Md Cap Equity	15%	15%	15%	10%	10%	10%	10%
Developed Intl Equity	10%	10%	10%	10%	15%	15%	15%
Emerging Mkt Equity			5%	10%	10%	10%	15%
Real Estate		5%	5%	10%	10%	10%	10%
Private Equity			5%	10%	10%	15%	15%
Hedge Funds					5%	5%	5%
Other Alternatives						5%	5%
<b>Total Risk-oriented</b>	<b>60%</b>	<b>65%</b>	<b>70%</b>	<b>75%</b>	<b>80%</b>	<b>85%</b>	<b>90%</b>
Govt Fixed Income	20%	15%	10%	5%			
Corporate Fixed Income	15%	15%	10%	10%	10%	5%	
High Yield	5%	5%	10%	5%	5%	5%	5%
International Debt				5%	5%	5%	5%
<b>Total Fixed Income</b>	<b>40%</b>	<b>35%</b>	<b>30%</b>	<b>25%</b>	<b>20%</b>	<b>15%</b>	<b>10%</b>

# Investment Rate of Return Assumptions


<b>50<sup>th</sup> Percentile (50-50 Probability of Achieving) 2021 Expected Compound Return Over Next 10 Years</b>							
							
Investment Forecasters*	60/40	65/35	70/30	75/25	80/20	85/15	90/10
1	3.62%	3.87%	4.56%	5.00%	5.27%	5.52%	5.74%
2	3.70%	3.91%	4.68%	5.09%	5.44%	5.77%	6.06%
3	3.95%	4.16%	4.82%	5.39%	5.49%	5.80%	6.08%
4	4.07%	4.29%	4.91%	5.40%	5.56%	5.85%	6.11%
5	4.10%	4.31%	4.94%	5.40%	5.56%	5.86%	6.14%
6	4.11%	4.35%	4.95%	5.44%	5.59%	5.90%	6.18%
7	4.17%	4.36%	5.00%	5.48%	5.59%	6.00%	6.26%
8	4.31%	4.49%	5.02%	5.68%	5.79%	6.14%	6.43%
9	4.32%	4.51%	5.07%	5.70%	5.85%	6.17%	6.44%
10	4.48%	4.71%	5.23%	5.81%	6.08%	6.30%	6.52%
11	5.04%	5.26%	5.78%	6.04%	6.14%	6.77%	7.07%
12	5.21%	5.41%	5.98%	6.49%	6.46%	6.94%	7.22%
<b>2021 Consensus Average</b>	<b>4.26%</b>	<b>4.47%</b>	<b>5.08%</b>	<b>5.58%</b>	<b>5.74%</b>	<b>6.08%</b>	<b>6.35%</b>
<small>* Investment Forecasters' expectations published for 2021. Investment Forecasters do not rank the same across all asset allocations. Some rank a little higher in some asset allocations than they do in others. Nevertheless, they are listed from 1 through 12.</small>							

# Investment Rate of Return Assumptions

50 <sup>th</sup> Percentile (50-50 Probability of Achieving) Expected Compound Return Over Next 10 Years							
							
	60/40	65/35	70/30	75/25	80/20	85/15	90/10
2021 Consensus Average	4.26%	4.47%	5.08%	5.58%	5.74%	6.08%	6.35%
2020 Consensus Average	4.65%	4.83%	5.40%	5.84%	5.98%	6.25%	6.49%
2019 Consensus Average	5.40%	5.58%	6.09%	6.41%	6.55%	6.78%	6.99%
2018 Consensus Average	5.08%	5.23%	5.69%	5.95%	6.12%	6.34%	6.55%
2010 Consensus Average	7.21%	7.36%	7.78%	7.94%	8.06%	8.21%	8.37%

# Investment Rate of Return Assumptions

**50<sup>th</sup> Percentile (50-50 Probability of Achieving)**  
**Expected Compound Return Over Benefit Horizon**  
*Single Equivalent BenefitFlow-Adjusted Expected Return Between*  
*Mid-Term and Longer-Term Forecasts (Rounded to Nearest 0.25%)*

							
	60/40	65/35	70/30	75/25	80/20	85/15	90/10
<b>2021 Consensus Average</b>	4.75%	5.00%	5.50%	6.00%	6.25%	6.50%	6.75%
<b>2020 Consensus Average</b>	5.25%	5.25%	5.75%	6.25%	6.25%	6.50%	6.75%
<b>2019 Consensus Average</b>	5.75%	6.00%	6.50%	6.75%	7.00%	7.25%	7.25%
<b>Three-year Average Expected Return</b>	5.25%	5.50%	6.00%	6.25%	6.50%	6.75%	7.00%

# Investment Rate of Return Assumptions

## Assumed Investment Return $\times$ Actual Asset Allocation Among 363 Local Florida Plans (2021 Valuations)

	Actual Asset Allocation (Rounded to Nearest 5%)									Total Plans
	<60%	60/40	65/35	70/30	75/25	80/20	85/15	90/10	>90%	
>8.00%	-	-	-	-	-	-	-	-	-	-
8.00%	-	-	-	-	-	1	-	-	-	1
7.75%	1	1	2	3	3	5	1	1	-	17
7.50%	3	5	8	20	25	5	2	1	-	69
7.25%	-	5	13	14	19	9	6	2	-	68
7.00%	1	10	18	40	29	18	4	2	1	123
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<b>Total Plans</b>	<b>8</b>	<b>28</b>	<b>56</b>	<b>98</b>	<b>95</b>	<b>51</b>	<b>18</b>	<b>6</b>	<b>3</b>	<b>363</b>

Number of Plans. Source: Florida Department of Management Services Database (2021 valuation data submissions rec'd thru October 31, 2022; excluding plans having low asset values or high non-classified assets).

# Investment Rate of Return Assumptions

## Assumed Investment Return $\times$ Actual Asset Allocation Among 363 Local Florida Plans (2021 Valuations)

		Actual Asset Allocation (Rounded to Nearest 5%)								Total Plans
		<60%	60/40	65/35	70/30	75/25	80/20	85/15	90/10	
Assumed Investment Return (Rounded to Nearest 0.25%)	>8.00%	-	-	-	-	-	-	-	-	-
	8.00%	-	-	-	-	-	1	-	-	1
	7.75%	1	1	2	3	3	5	1	1	17
	7.50%	3	5	8	20	25	5	2	1	69
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	6.50%	-	1	5	5	6	6.50% 4	2	-	23
	6.25%	1	-	2	2	6.25% 1	-	-	-	6
	6.00%	-	2	-	6.00% 3	1	2	-	-	10
	<6.00%	1	5.25%	5.50%	1	-	-	-	-	2
Total Plans		8	28	56	98	95	51	18	6	363

Number of Plans. Source: Florida Department of Management Services Database (2020 valuation data submissions rec'd thru September 17, 2021; excluding 50 plans having low asset values or high non-classified assets).

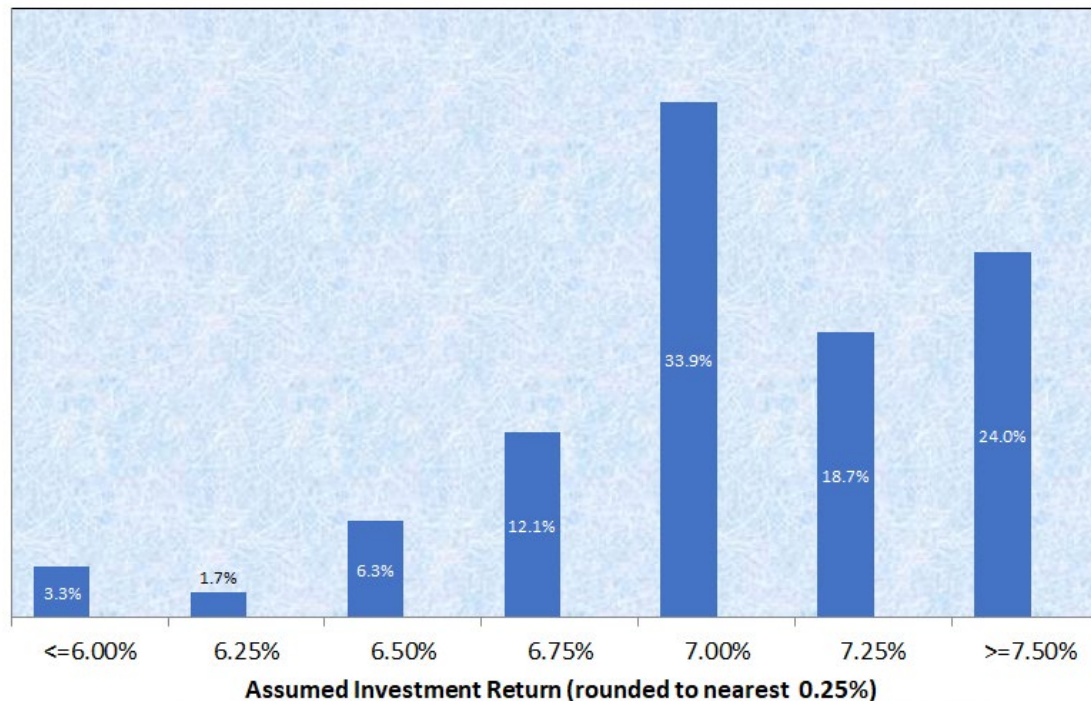
# Have Overly Optimistic Return Assumptions?

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- Overly optimistic return assumptions –
  - Understate balance sheet liabilities,
  - Decrease contribution requirements,
  - Undermine actuarial benefit security,
  - Kicks the can down the road and
  - Fails fiduciary duty.

# Investment Rate of Return Assumptions

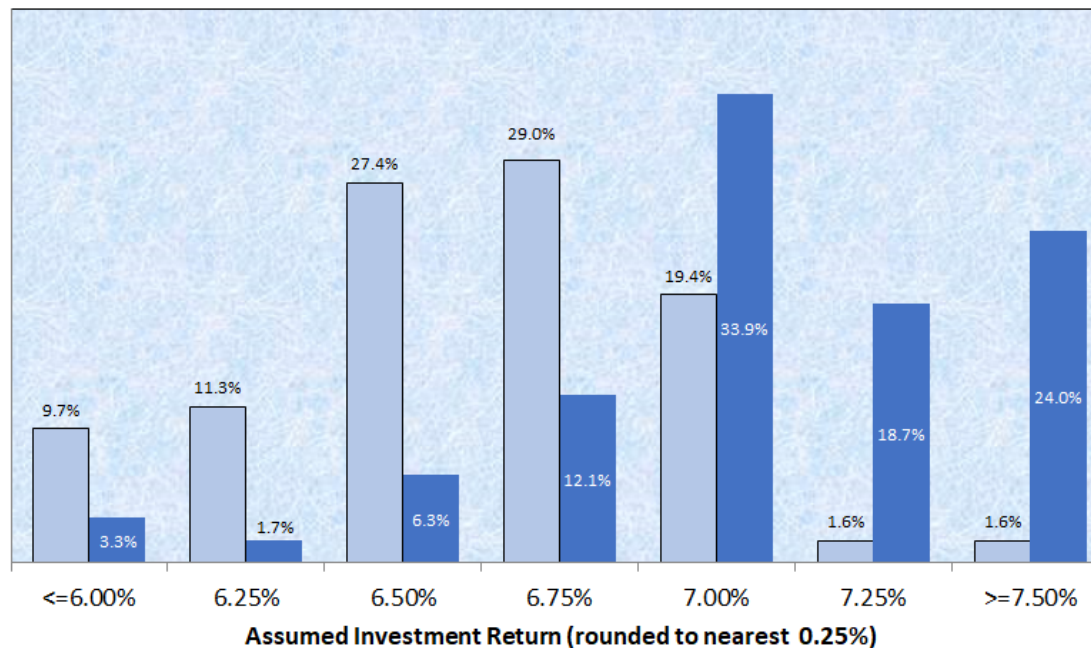
**Pension Boards' Adopted Return Assumptions for 2021**  
Among 363 Local Florida Public Pension Boards



■ Percent of 363 Local Florida Pension Boards adopting a given return assumption for 2021 actuarial valuations, as downloaded from Florida DMS database October 31, 20221.

# Investment Rate of Return Assumptions

## Comparison of Actuaries' Preferred Return Assumptions with Florida Local Pension Boards' Adopted Assumptions




■ Percent of 62 public sector pension actuaries (from many different firms around the country) preferring a given return assumption, as surveyed at the national Enrolled Actuaries Conference in May 2021.

■ Percent of 363 Local Florida Pension Boards adopting a given return assumption for 2021 actuarial valuations, as downloaded from Florida DMS database October 31, 20221.

# Investment Rate of Return Assumptions

**50<sup>th</sup> Percentile (50-50 Probability of Achieving)**  
**Expected Compound Return Over Benefit Horizon**  
*Single Equivalent BenefitFlow-Adjusted Expected Return Between*  
*Mid-Term and Longer-Term Forecasts (Rounded to Nearest 0.25%)*

							
	60/40	65/35	70/30	75/25	80/20	85/15	90/10
2022 Consensus Average	4.50%	4.75%	5.25%	5.75%	6.00%	6.25%	6.50%
2021 Consensus Average	4.75%	5.00%	5.50%	6.00%	6.25%	6.50%	6.75%
2020 Consensus Average	5.25%	5.25%	5.75%	6.25%	6.25%	6.50%	6.75%
2019 Consensus Average	5.75%	6.00%	6.50%	6.75%	7.00%	7.25%	7.25%
<b>Three-year Average Expected Return (for 2022)</b>	<b>4.75%</b>	<b>5.00%</b>	<b>5.50%</b>	<b>6.00%</b>	<b>6.25%</b>	<b>6.50%</b>	<b>6.75%</b>

# Polling Question 4

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Do overly optimistic return assumptions:

- A. Overstate balance sheet liabilities? or
- B. Understate balance sheet liabilities?

# Polling Question 5

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Do overly optimistic return assumptions:

- A. Increase funding requirements? or
- B. Decrease funding requirements?

# Have Overly Optimistic Return Assumptions?

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- So, what can you do about it?
- In order of pain level ---
  1. Ask for your GASB 67/68 numbers using a more mainstream return assumption
  2. Put on your most diplomatic hat and suggest to the chair or the City-appointed members that they consider lowering the return assumption
  3. Ask your board to obtain professional research about mainstream return forecasts (as described above) – or just go out and engage that for yourself (City ends up paying for it either way)
  4. Ask for your actuarially determined contribution (ADC) to be based on a more mainstream return assumption (causing a higher ADC)
  5. Opportunistic reductions (e.g., when ADC would otherwise be lower for a given year)

# Have Overly Optimistic Return Assumptions?

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- So, what can you do about it? (continued)
  6. If choosing between amortization periods/methods and mainstream return assumption, choose mainstream return assumptions; in fact, consider extending your amortization period (subject to ASOPs) coupled with a more mainstream return assumption
  7. Don't resist your board's desire (or actuary's recommendation) to reduce the return assumption – you might be tempted to resist, on account of an increase in ADC
  8. “If you cannot afford the contributions (using mainstream assumptions), you cannot afford the benefits.”
  9. Roll back certain benefit provisions (subject to collective bargaining), so that you can use a more mainstream return assumption; benefit roll-backs can offset the higher ADC of lower return assumption . . .  
*It's better to have a healthy plan with slightly lower benefits than to over-promise and under-deliver.*

# Other Post-Employment Benefits (OPEBs)

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## OPEB vs pension benefits - Similarities

1. Benefits are paid after retirement/separation from employment
2. Benefits are accrued during employment  
(part of exchange transaction)

# Polling Question 6

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Is your organization prefunding its OPEB program?

- A. Yes, full actuarially determined amount,
- B. Sort of; we have a trust but we are not funding on actuarial basis,
- C. No, we have no trust,
- D. None of the above.

# Other Post-Employment Benefits (OPEBs)

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## OPEB vs pension benefits - Differences

1. OPEB benefit value can change over time more easily than for pension
2. OPEB benefits have less protection than pensions
3. Deferred OPEB benefits not always available/utilized
4. Pension benefits often accrue uniformly during working career, many OPEB benefits are all-or-nothing
5. Unlike pensions, OPEB benefits are often conditional on retiree contributions
6. Unlike pensions, OPEB benefits often stop (or decrease in value) when retiree attains 65

# Other Post-Employment Benefits (OPEBs)

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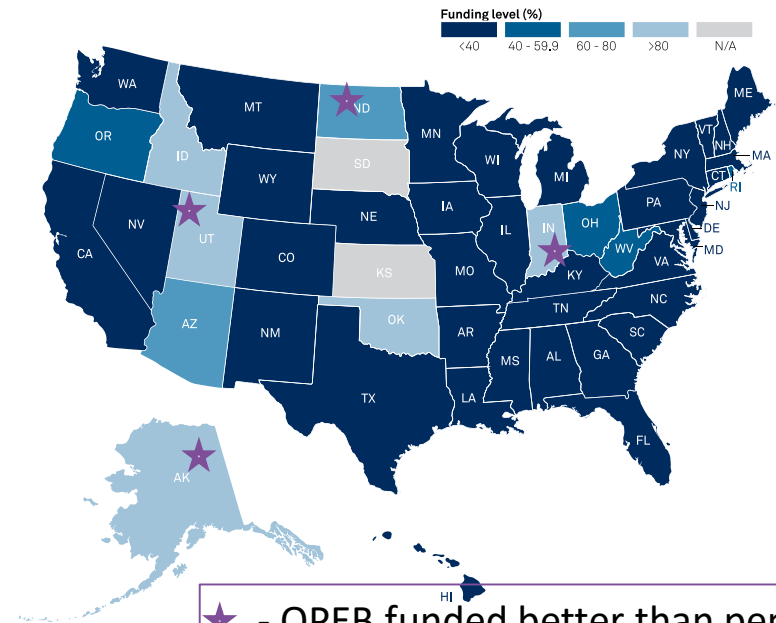
## OPEB Funding

1. Implementation of GASB Statement 75 sparked interest in establishing OPEB trusts
2. Not always followed with funding
3. Employers often look at OPEB funding differently than pension funding
4. In some jurisdictions, accounting gets more attention than funding

## Disparity in US funded levels between OPEB and pensions

OPEB

### Aggregate U.S. State Funded Ratios For 2020 - OPEB



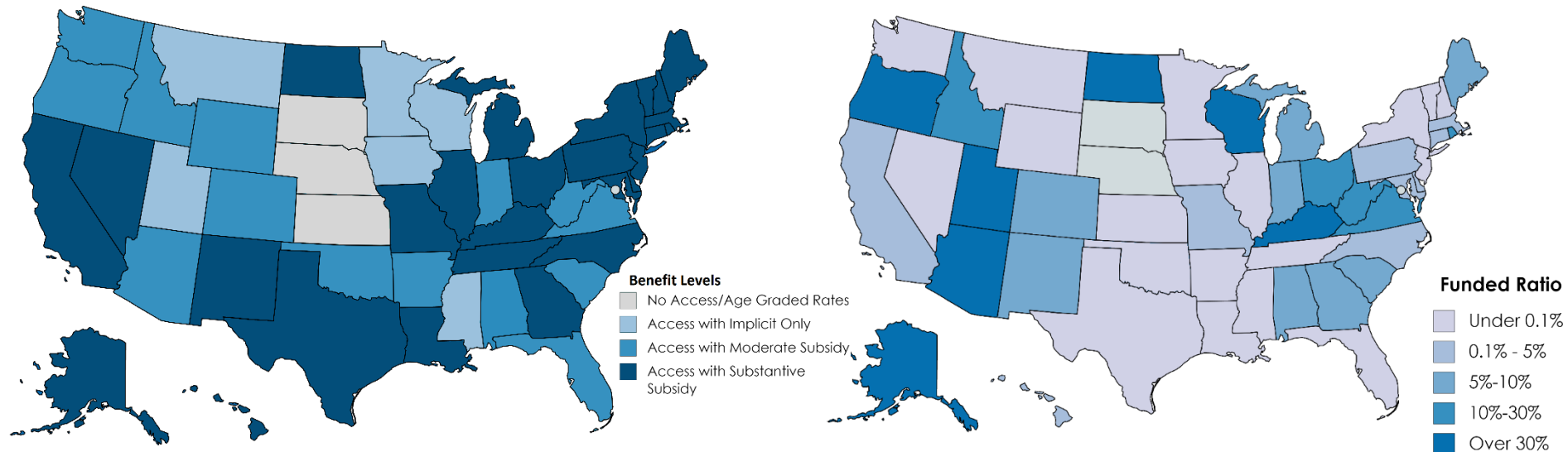
Note: Kansas and South Dakota do not report even an implicit liability for retiree health care benefits so are excluded from this chart.  
Source: S&P Global Ratings.  
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# Other Post-Employment Benefits (OPEBs)

Low correlation between benefit level and funded status

Pre-65 Benefit  
Levels

Funded Levels

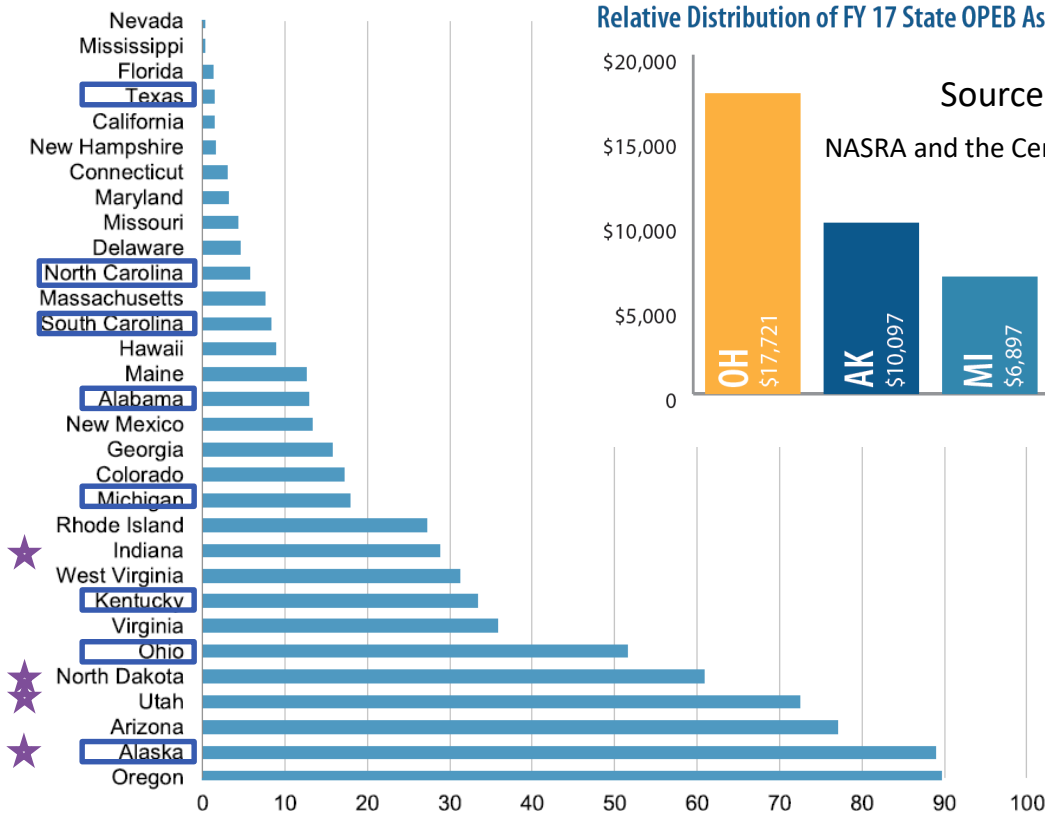


Source: Pew, State Retiree Health Plan Spending

# Other Post-Employment Benefits (OPEBs)

## OPEB funding trends in US

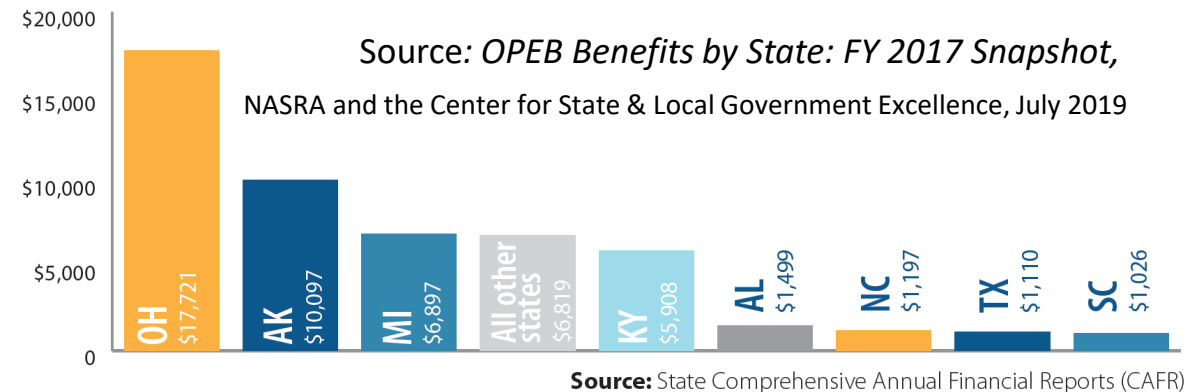
Combined Funded Ratio For OPEB Funds\*



## Largest OPEB trusts

Relative Distribution of FY 17 State OPEB Assets for States with Over \$1 Billion in Assets (in millions)

Figure 3



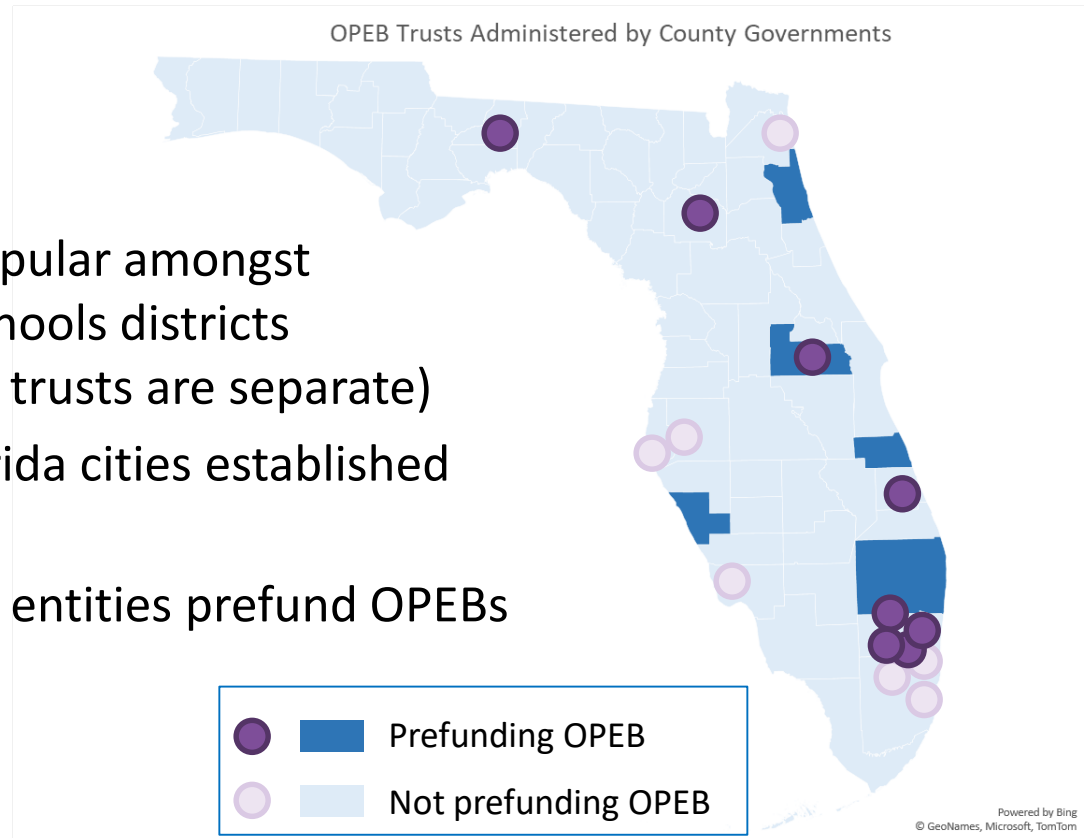
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# Other Post-Employment Benefits (OPEBs)

## OPEB funding trends in Florida

- OPEB prefunding is not popular amongst county governments or schools districts (union administered VEBA trusts are separate)
- Eight out of 15 largest Florida cities established OPEB trusts
- Many other governmental entities prefund OPEBs



# Other Post-Employment Benefits (OPEBs)

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## Advantages of prefunding OPEBs

1. Benefit security
2. Investment returns will help paying for benefits
3. Allows to use a higher discount rate (and lower balance sheet liabilities)
4. Shows responsible financial management and stability
5. Enhances inter-generational equity
6. Secures assets from creditors

# Other Post-Employment Benefits (OPEBs)

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## Disadvantages of prefunding OPEBs

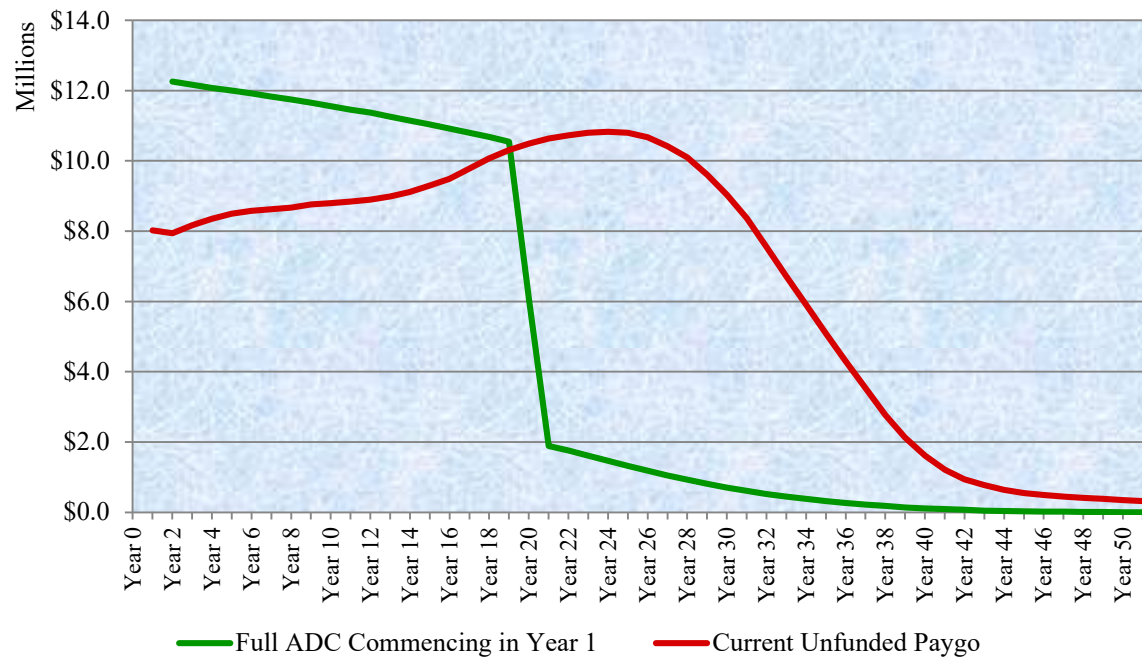
1. Funds may only be used for OPEB
2. High initial cost
3. Requires governance efforts

# Other Post-Employment Benefits (OPEBs)

## Case Study

1. Employer has a very generous, unfunded OPEB program.
2. Benefits offered only to non-Medicare retirees.
3. A new OPEB trust fund is being established.
4. Plan is closed to new members shortly before funding commencement.

**Total Expected Employer Contribution  
(Pre-funded Options and Current Unfunded Policy)**

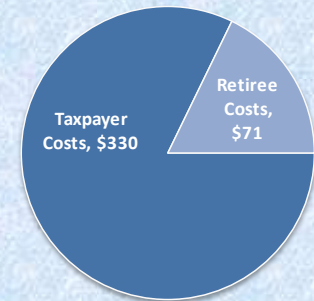


# Other Post-Employment Benefits (OPEBs)

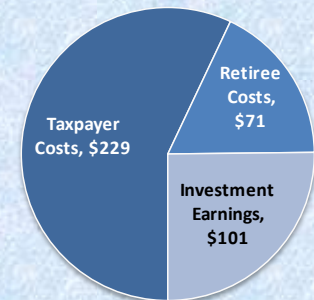
## Case Study

1. Prefunding offers benefit security
2. Prefunding provides for investment earnings to pay for a significant portion of benefits over time
3. Proportion of benefits paid from investment income not as high as seen for long established pension funds

**Sources of Funding for Total Expected  
Pay-As-You-Go Costs**  
(50 Years from Inception - in Millions)



**Sources of Funding for Total Expected  
Actuarial Pre-funding Costs**  
(50 Years from Inception - in Millions)



# Other Post-Employment Benefits (OPEBs)

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## Common OPEB funding vehicles

1. Voluntary Employee Beneficiary Association (VEBA) trust  
Established under section 501(c)(9) of the Internal Revenue Code (IRC)
2. Section 115 trust  
Established under IRC section 115
3. Separate account within your pension fund  
Established under IRC section 401(h)

# Other Post-Employment Benefits (OPEBs)

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## Similarities between Sec 115 or VEBA trusts

1. Assets protected from creditors
2. May be established by multiple employers
3. Benefits paid by the trust are generally tax free
4. Trust income not taxed (when contributions are made by tax-exempt employers)

# Other Post-Employment Benefits (OPEBs)

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## Differences between Sec 115 or VEBA trusts

1. VEBA trust generally controlled by members (or members elected trustees), Sec 115 trust generally controlled by the employer
2. VEBA trust generally not subject to state investment regulations, Sec 115 trust may need to comply with F. S. 218.415
3. VEBA trust will likely require IRS ruling, Sec 115 trust may not need one
4. VEBA trust assets may not revert to the employer, it may be possible to allow for asset reversion from Sec 115 trust, but it may jeopardize GASB qualification

# Other Post-Employment Benefits (OPEBs)

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## OPEB trust and benefit payments

1. Employer pays benefits from own resources in addition to a smaller contribution the trust
2. Employer makes full contributions to the trust, pays benefits from resources and gets reimbursed by the trust
3. Employer makes full contributions to the trust, trust pays benefits (may be difficult when health benefits provided through a fully insured plan)

# Other Post-Employment Benefits (OPEBs)

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Challenges when the trust does not pay benefits

1. IRS compliance  
IRS audits are rare but happen. They will check if the trust operated according to the trust document.
2. Payments of benefits outside the trust may complicate determination of the GASB expected rate of return

# Other Post-Employment Benefits (OPEBs)

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Do we need a funding policy for OPEB?

1. OPEB plans are less common to have a robust funding policy than pension plans
2. It is equally important to have a funding policy for OPEB plan.
  - Defines a clear plan to accumulating sufficient assets to pay promised benefits
  - Helps with budgeting
  - Demonstrates prudent financial management practices
  - Reassures bond rating agencies
  - Shows members and tax payers just how OPEB benefits will be funded.
3. OPEB funding policy objectives are the same as for pensions
  - Actuarial Benefit Security
  - Inter-period Equity
  - Volatility Control
  - Accountability and Transparency
  - Avoidance of Agency Risk

# Other Post-Employment Benefits (OPEBs)

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## Rate of Return Assumption for an OPEB

Developed with the same rigor as for a pension plan

- Collect forward looking market forecasts from multiple sources
- Resulting expected returns are likely to cover a wide range
- No single forecast is guaranteed to be correct
- Although the consensus is not guaranteed to be correct either, it's often more reliable than any individual forecast
- Apply capital market assumptions from multiple sources to plan's own asset allocation
- Adjust for inflation
- Adjust for plan's investment expenses
- Adjust for cash-flow timing

# Other Post-Employment Benefits (OPEBs)

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## Special considerations for OPEB funding policy

1. OPEB benefits have less protection than pensions
  - Benefits may be rolled back in the future
  - It may be beneficial to fund toward a target lower than 100%
2. OPEB benefits are likely to have a different cash-flow patterns
  - Benefits often get reduced (or disappear) at age 65
  - Greater reduction in benefits between tiers of employees than with pensions
  - Resulting contribution pattern different than for pension plans
3. Funding policy will likely need to be different than for pension plans

# Other Post-Employment Benefits (OPEBs)

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## OPEB Funding Summary

1. Government created an OPEB trust with an intention to fund it
  - More governments opted to continue pay as you go
  - In some cases funding stalled or was dramatically reduced over time
2. Same rigor needs to be applied to funding OPEB as for pension
3. Rate of return assumed for OPEB valuations should be evaluated independently from pension plan
  - Differences in investment policies
  - Differences in benefit duration
  - Differences in investment expenses

# Polling Question 7

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Do you think there is place for subsidized retiree health care in public sector?

- A. Yes,
- B. Yes, but not before age 62,
- C. No, we can all work until we qualify for Medicare,
- D. None of the above.

# Disclaimers

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- This presentation shall not be construed to provide tax advice, legal advice or investment advice.
- Examine original source materials and consult with subject matter experts before making decisions related to the subject matter of this presentation.
- This presentation does not necessarily express the views of the FGFOA or of Gabriel, Roeder, Smith & Company. It may not even constitute the opinions of the presenters at times.

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