

City of Alexandria, Virginia

MEMORANDUM

DATE: MARCH 3, 2006

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT: BUDGET MEMO #8: ACCOUNTING FOR POST-EMPLOYMENT RETIREE BENEFITS NEW MANDATES FROM THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD (GASB 45)

In mid-2004, the Governmental Accounting Standards Board (GASB) issued new state and local government accounting and financial reporting requirements related to accounting for "Other Post-Employment Benefits (OPEB)." These new mandates require governments to measure, account for, and report the long-term liabilities related to post-employment promised and provided benefits (i.e., benefits for an organization's current and future retirees such as health and life insurance). Prior to the issuance of this new mandate (named "GASB 45"), in the employee benefit area state and local governments were only expected to measure, account for, report and fund long-term pension costs and liabilities.

Retiree health and life insurance costs have been simply reported on a pay-as-you-go cash basis by nearly all state and local governments in the United States. The City is projected to spend about \$2.1 million in retiree health and \$0.1 in retiree life insurance in FY 2006. The estimated long-term liability for the City government is over \$82 million (calculated much like an actuary calculates the long-term liability of pension costs). The City School system costs would be significant and in addition to that \$82 million. While these are large sums, because the City government's and City School's retirement health benefits are less than many of our neighboring jurisdictions in Northern Virginia, the liability in those other jurisdictions will likely be multiples of the City's. While the City government has measured its potential liability, many state and local governments have not yet taken any sort of measurement actions.

In following the lead of the Financial Accounting Standards Board (which required public corporations to account for OPEB starting in the 1990's), GASB has recently promulgated this new set of accounting standards which will have a major financial impact on all state and local governments in the years ahead. The City follows GASB accounting standards, as it is required to do so by the Virginia Auditor of Public Accounts, and it is expected to do so by the bond rating agencies in order to receive an investment grade rating on its bonds. While most of the GASB's various accounting mandate impacts relate to better financial reporting, GASB 45 will

have a widespread and material financial and policy impact on state and local governments -- as occurred 40 years ago when the national accounting standards first required pension costs and long-term liabilities to be fully accounted for. The following summarizes the issues related to GASB 45, and its impact on the City:

- How any liability is expected to be funded and over what time period is not absolutely clear, as this GASB regulation is new.
- This new GASB mandate (the reporting element and not the funding) needs to be implemented for cities our budget size in the audit and comprehensive annual financial report that is issued for FY 2008. GASB does not set funding requirements, but its reporting requirements sometimes trigger funding expectations.
- How much and over what period of time the current unfunded liabilities will need to become funded is not clear. However, it appears that ratcheting up the funding the liability in the budget over a number of years is a likely expectation.
- The bond rating agencies have recently sent the message to state and local governments that at the time of the ratings meeting (between the bond rating agencies and issuers), that the bond rating agencies will be looking for some sort of recognition of the OPEB issue and a start towards funding. Moody's has stated, "*In general a state or local government's effectiveness and initiative in OPEB liability management probably will influence our overall assessment of the government's management strength.*"
- A liability can be amortized over a 30-year period so that a sudden financial impact can be spread out over time.
- The combination of GASB 45, the expectations of the bond rating agencies (see Attachment I for the view of Standard & Poor's), the emerging expectations of Wall Street, and those of the Securities and Exchange Commission (see Attachment II for March 2, 2006, article) will result in state and local governments not only measuring and reporting OPEB but needing to start to fund these largely unmeasured and unfunded costs.
- While some of GASB mandates related to long-term liabilities have not triggered an expectation of action by the bond rating agencies and investors, it has become clear over the last few months that state and local governments will be expected to start to set monies aside and start to fund the long-term liabilities.
- The views of all the bond rating agencies (Standard & Poor's, Moody's Investors Service, Fitch Ratings) are all similar.

- The City's calculation of \$82 million reflects:

\$21 million	Retirees - health
45 million	Active employees - health
5 million	Retirees - life insurance
<u>10 million</u>	Active Employees - life insurance
\$82 million	Total Estimated "Unfunded Actuarial Liability"

- If that unfunded liability was amortized over a 30-year period, then the annual payment into such a fund by the City would be some \$8.4 million in FY 2007 and then gradually increase above that amount each year for 30 years.
- This \$82 million calculation is about a year old and is likely to be understated given recent trends in the cost to the City have exceeded the actuary's assumed 9.5% annual health care cost inflation rate.
- This \$82 million assumes that any set aside funds will be set up in a separate investment fund and that an assumed 6% rate of return would occur. If not set up in a separate investment fund, GASB 45 requires a lower discount rate such as 3% to be used. That use of a lower discount rate would raise the City's unfunded liability to over \$150 million.
- As a rule of thumb, any increase in annual costs above that assumed by the actuary when the \$82 million calculation was undertaken will have a 40/50 to 1 impact on the unfunded liability. So for example, if \$0.1 million in added retiree benefits above the 9.5% assumed growth rate occurred then the unfunded liability would jump \$4 million to \$5 million. Conversely, actions taken to reduce cost increases to less than 9.5% would have a similar but opposite positive effect.
- In recognition that there is an increasing expectation in the financial community that GASB 45 reported unfunded liabilities should be funded, the City's FY 2007 proposed budget reflects two items:
 1. The previously designated \$7.2 million for compensated absences in the City's General Fund fund balance has been re-designated for "Post Retirement Employee Benefits." The designation for compensated absences was initiated in 1990, to deal with a pending GASB 11 accounting requirement. While the accounting requirement for compensated absences on a budgeting basis did become effective, the expectation that it would need to be fully funded never came to fruition. As a result, changing it to cover a more serious long-term liability such as post retirement benefits is in the City's best interest
 2. An additional \$1.5 million from FY 2006 surplus revenues is proposed to be added to that designation bringing the total designation to \$8.7 million by the end

of FY 2006.

- During FY 2007 a more specific multi-year funding strategy will be developed, and would also need to be incorporated into the City's overall Financial Policy Guidelines. Also a review of the structure of the City's retiree health insurance program will need to occur.

Finally, I want to emphasize that the retiree health care issue in front of the City is not one of eliminating the program (as some corporations have done), but the issue is to fund a sound and reasonable retiree health program over the long-term.

Attachments:

- I. *"Funding OPEB Liabilities,"* Parry Young, Standard & Poor's, Government Finance Review, December 2005
- II. *"Disclosures on OPEB Needed,"* Lynn Hume, The Bond Buyer, March 2, 2006