

# Establishing an investment trust for OPEB only makes sense with accumulated assets



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Investment trusts are coming into vogue as a way for government employers to prefund other post-employment benefits (OPEB) and manage the long-term costs of these benefits. (See Milliman white paper: *Investment trusts for OPEB: The right thing at a better price*). But before establishing an OPEB trust, employers must first consider the amount of money available for funding the trust. For an OPEB fund to make sense, contributions to the trust must be significant enough to allow for sufficient accumulation of assets. Only then can the employer benefit from a higher discount rate when valuing liabilities and higher returns on investment to help finance the cost of retiree health benefits.

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**Simply establishing an OPEB trust is not enough. Contributions to the trust must be significant enough to accumulate assets. GASB 43 and 45 allow for a higher discount rate only if the retiree benefits are paid by assets that have been invested in such a way as to achieve a higher long-term rate of return. Otherwise, the existence of the fund will have little effect on your OPEB cost and liability.**

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## **THE PRIMARY BENEFIT OF AN OPEB TRUST: REDUCING THE OPEB COST AND LIABILITY**

GASB 43 and 45 require government employers to recognize the cost of their post-employment benefits during an employee's period of employment. The difference between the accrual cost of the retiree benefits within a given year and the amount paid out during that year (in the form of benefit payments, insurance premiums, or payments to a trust) is known as the net OPEB obligation, or balance sheet liability. If an employer does not fund the accrual cost of benefits, this balance sheet liability would grow over time.

One of the principal assumptions used for determining the accrual cost, called the annual required contribution (ARC), is the discount rate. This rate, also known as the investment return assumption, is calculated based on the estimated long-term yield on investments used to finance the employer's retiree benefits. The primary benefit

of establishing an OPEB trust is that GASB 43 and 45 allow the employer to invest assets long-term to earn a rate of return higher than the return on general operating funds. This allows the employer to use a higher discount rate to calculate the ARC and, thus, the balance sheet liability. A higher discount rate translates into lower accounting costs and reduced liability for retiree benefits.

But simply establishing an OPEB trust is not enough. Contributions to the trust must be significant enough to accumulate assets. GASB 43 and 45 allow for a higher discount rate *only if* the retiree benefits are paid by assets that have been invested in such a way as to achieve a higher long-term rate of return. Otherwise, the existence of the fund will have little effect on your OPEB cost and liability.

## **POSSIBLE ADVANTAGES OF A TRUST WITH NO ASSETS**

There are two potential advantages to establishing an OPEB trust without significant funding.

### **Transferring the OPEB obligation to the trust**

If you have a cost-sharing multiple-employer plan,<sup>1</sup> the contractually required contribution for the trust might be set lower than the GASB 43 and 45 actuarially determined amount; therefore, you could satisfy your OPEB obligation by paying the lower rate. You would then refer to the financial statement of the trust when addressing your OPEB obligation.

### **Preparedness for future funding**

Establishing the trust and putting procedures in place for managing the trust in the long-term might allow you to act more quickly once funds do become available.

## **POTENTIAL RISKS OF A TRUST WITH NO ASSETS**

Establishing an OPEB trust with no intention to accumulate assets would also expose you to the following risks:

### **High administrative costs**

Establishing an OPEB trust involves additional accounting procedures along with the added time, effort, and costs associated with these procedures. Without the benefit of the trust accumulating assets with returns to help offset these expenses, the administrative costs might outweigh any potential benefits.

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<sup>1</sup> A cost-sharing multiple-employer plan is a plan with a pooling arrangement for participating employers. All risks, rewards, and costs, including benefit costs, are shared and are not attributed individually to the employers. A single actuarial valuation covers all plan members, and the same contribution rate applies for each employer.

### Reaction of credit-rating agencies

Credit-rating agencies are most concerned with an employer's ability to manage OPEB costs and liabilities. On the one hand, the creation of an OPEB trust could be a positive sign to rating agencies that you are actively seeking ways to manage costs associated with your OPEB obligation. On the other hand, an unfunded trust might signal to the rating agency an inability to follow through on funds and do little to demonstrate effective cost-management of retiree benefits.

### Low commitment from trustees

It may be difficult to find responsible trustees for a trust with few or no assets. Their duties and actions would have more form than substance.

### Implicit subsidy more visible

The implicit subsidy is the true cost of retiree healthcare benefits above and beyond the premium (average cost) paid for healthcare benefits for retirees not currently eligible for Medicare. A portion of the premium for active employees would be allocated to the trust for the payment of retiree benefits. This would make it easier for current employees to see how much of the premium rate is being used to pay the medical costs of these retirees.

## IMPORTANT CONSIDERATIONS WHEN ESTABLISHING AN OPEB TRUST

In addition to making sure you have sufficient funds available to begin an accumulation of assets, the decision to establish an OPEB trust involves a number of other important considerations.

### Qualifying as a formal trust

You can look to your pension plan or the pension plan in which you participate as a model for understanding the workings of an OPEB trust. Much like pension plans, to qualify as a formal trust:

- Contributions to the trust must be irrevocable.
- Assets must be dedicated to providing plan benefits to retirees and their beneficiaries.
- Assets must be protected from creditors.

### Tax-exempt status

Ideally, you would want your OPEB trust to qualify for tax exemption under the Internal Revenue Code. This would allow for earnings to accumulate tax free. Contributions made to the trust and benefits paid out of the trust would also be tax exempt.

The following funding vehicles may be established with tax-exempt status under different sections of the Internal Revenue Code:

- Special-purpose government trust: IRC Section 115
- Voluntary employee beneficiary association (VEBA): IRC Section 501(c)(9)
- Sub-account of a pension trust: IRC Section 401(h)

Each of these options has a unique set of requirements and limitations. Determining the most appropriate one would require a more thorough analysis based on your current accounting practices and OPEB obligations.

### Management of the trust

The terms of the trust would be formalized in a trust agreement. This trust agreement would establish a board of trustees and specify the number of trustees, the composition of the board, member terms, board powers and duties, uses of the funds, and procedures related to the administration and oversight of the trust.

The board of trustees may select an investment advisor and establish an investment policy. It may retain a separate custodian of the funds. It may determine the employer contribution, which could be lower than or as high as the full accounting cost of the benefits based on an actuarial valuation using GASB 43 and 45 guidelines.

### Ongoing administrative considerations

The board of trustees would oversee the trust and meet regularly to handle administrative policies and procedures. Your own retirement system provides a good example of the administrative responsibilities that would be involved in the management of an OPEB trust.

A comprehensive annual financial report (CAFR) would be developed for the trust, and the government employer's financial statement would refer to the fund's CAFR with relevant information extracted.

The trust would also require an annual audit by an outside party with the findings reported in the CAFR.

### Changes in accounting procedure

If you participate in a cost-sharing multiple-employer OPEB trust, different accounting procedures would apply under GASB 43 and 45. These differences would involve the following:

- The primary reporting and disclosure requirements would pass from you, the employer, to the trust.
- The trust would determine the accounting cost, which would not have to be the actuarially determined amount.
- The trust could potentially charge a premium rate that is less than the actuarially determined amount for retirees. If you paid this premium, you would have no additional accounting liability for retiree benefits. The accounting liability would, however, be a liability of the trust.
- Information about the trust and the liabilities of the trust would appear in the footnotes of your financial statement.

GASB 43 and 45 are solely concerned with an employer's retiree benefits. Establishing an OPEB trust would also involve the separation of funds between retiree benefits and active employee benefits.

FIGURE 1

	PER MONTH
<b>TOTAL AVERAGE PREMIUM (BASED ON COSTS FOR ACTIVES AND RETIREES)</b>	<b>\$450</b>
<b>MONTHLY EMPLOYEE CONTRIBUTION</b>	<b>50</b>
<b>EMPLOYER CONTRIBUTION (REMAINDER OF PREMIUM AFTER EMPLOYEE CONTRIBUTION)</b>	<b>400</b>
<b>AVERAGE HEALTHCARE COST PER EMPLOYEE (ESTIMATED BY ACTUARY)</b>	<b>350</b>
<b>COST PAID BY EMPLOYEE</b>	<b>50</b>
<b>EMPLOYER COST (REMAINDER OF COST AFTER EMPLOYEE PAYMENT)</b>	<b>300</b>
<b>AMOUNT ALLOCATED TO TRUST OR IMPLICIT SUBSIDY (EMPLOYER CONTRIBUTION - EMPLOYER COST)</b>	<b>100</b>

- A portion of your employer premium would need to be allocated for the payment of retiree benefits. This presents a challenge because employer premiums are usually based on an average of active employee and retiree costs, rather than calculated separately. A portion of the premium paid for active employees would, therefore, need to be allocated explicitly for the payment of retiree benefits. See Figure 1.
- The assets attributable to contributions and benefits for retirees would need to be separated from assets attributable to contributions and benefits of active employees.
- Administrative costs associated with each group's benefits would also need to be properly allocated.
- Payments for retiree benefits could come from three sources: the implicit subsidy allocated to the trust, employer contributions for retirees, and premium payments from retirees. The premium payments from retirees would have to be tracked separately because GASB 43 and 45 are only concerned with the employer-paid portion of retiree benefits. Retiree premium payments could

be used to pay benefits directly or passed through a separate sub-account of the trust and withdrawn immediately to pay benefits.

### Conclusion

Establishing an OPEB trust is certainly not required by government employers under GASB 45 rules; however, if you have the means to make regular contributions to a trust that leads to accumulated assets, you gain the advantage of using a higher discount rate allowed for those who fund their liabilities as they accrue. This could result in significantly lower liabilities and accounting costs for your OPEB obligation in addition to several other non-financial benefits as discussed in *Investment trusts for OPEB*. Otherwise, setting up a trust without sufficient funding or the near-term potential for such funding provides little advantage and would not be recommended.

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