



Under pressure

New accounting standards force local governments to treat their ailing retiree health care benefit plans

By Robert Barkin

under pressure

New accounting standards force local governments to treat their ailing retiree health care benefit plans.

The day of reckoning for reporting projected future retiree health care costs is growing nearer for municipalities. Governments with more than \$100 million in annual revenues will be required to implement new Government Accounting Standards Board (GASB) rules for the fiscal year beginning after Dec. 15, 2006.

Two new GASB standards will require governments to report accrued liabilities for other post-employment benefits (OPEB) similar to the way pension plans are reported. The new accounting rules, which the private sector adopted in 1992, are likely to have a significant impact on governments' financial outlook. Large unfunded liabilities may raise the borrowing costs for them, and funding the accruing liabilities will increase current budget expenditures. (See "New accounting rules may tip over the balance sheet," p. 38.)

Although accounting for any OPEB is being required, retiree health benefits remain the new accounting rules' primary focus — and with good reason. Rising health care costs affect state and local governments more than private sector employers, according to the Menlo Park, Calif.-based Kaiser Family Foundation. A recent foundation survey found that 77 percent of governments with more than 200 workers offer retiree health care benefits compared with 36 percent for all similarly sized employers. Additionally, the cost for single employee coverage is 8 percent higher for government employers than for all industries, according to the survey.

Health care also has become governments' fastest growing area of expense. According to a 2004 study of government employers by New York-based Fitch Ratings, the cost of providing employee health care increased an average of 14.2 percent per year from 2000 to 2004 vs. overall annual expenditure growth of 5.5 percent and an inflation rate of 2.4 percent. Also, health insurance costs made up 5.4 percent of the surveyed governments' operating expenses, up from 3.4 percent in 2000 — a 63 percent increase. Longer life expectancies and early retirement incentives are increasing the benefits' duration as well.

Given those factors and governments' diminishing ability to increase revenues, municipal officials are seeking a variety of solutions to meet the retiree health care demand. They are finding that solutions require creativity, tough decisions and long-term thinking.

Affordable commitments

Rochester Hills, Mich., is a suburban community near Detroit of about 71,000 residents with a strong mayoral system and 233 full-time employees. Incorporated in 1984, Rochester has not assumed the legacy or risk from traditional pension and retirement health plans, which gives it flexibility that other municipalities do not enjoy.

In fact, the city did not have a post-retiree-

ment health benefit plan for its employees until 2001, according to Pamela Lee, the city's director of human resources. Since then, it has been trying to make its benefits more attractive.

The city's post-retirement health benefit centers around a retirement health savings (RHS) plan, which is based on an integral part trust that allows its employees to save money tax free while they are working, pay no taxes on trust earnings and pay no taxes when the money is used for qualified expenses. The program has evolved over the last several years to include an employer contribution as a key feature.

While employees have accepted the benefit, Lee says that the program is not what every employee had in mind. Some were asking for a defined benefit that would pay for health insurance based on years of service. "We have to be realistic," she says. "Employers have to be able to control costs."

In early 2000, the city began evaluating the best way to provide the promised benefits at a cost it could afford. Rochester Hills decided to use a defined contribution plan, which commits to the current year's funding, rather than a defined benefit plan with its promise of benefits in retirement. The original defined contribution plan implemented in 2001 called for a maximum employer contribution of 4 percent.

It includes a mandatory 3 percent from the employer, and a 1 percent match based on a mandatory employee contribution of 16 hours of annual leave pay (which amounted to 0.8 percent contribution of pay). All three employee unions agreed to the plan.

In 2003, the unions were offered more flexible options in an updated version of the RHS plan that were eventually given to non-union employees. The new non-union plan eliminated the mandatory employee requirement and substituted a 3 percent employer contribution and a 1 percent employer match of a voluntary employee contribution of either earned income or prospective leave. Employees also could phase in a plan where they could schedule an increase in their contribution closer to retirement. All pre-tax election decisions are irrevocable.

The supervisory employees' union negotiated a straight 4 percent employer contribution, a 1 percent mandatory employee contribution with an additional 1 percent employee contribution of available annual leave that was matched by the employer. The employee could make additional voluntary contributions from earned income or prospective leave. The qualifying expenses definition was made more flexible for supervisory employees and non-union employees to include all qualified medical expenses as defined by the IRS.

Two other unions stayed with the original plan. "They would like to see a defined benefit," Lee says, "but that is unrealistic in the current medical care, health care cost arena." She says the unions are pushing for employee benefits similar to those of other, older communities', but she feels that is unlikely, especially given the new GASB rules.

One concession was made for retired employees and those close to retirement. The city gives a defined supplemental sum toward the health care premium based on years of service and age. Because the amount is specified and tied directly to

New accounting rules may tip over the balance sheet

The new standards issued in 2004 by the Governmental Accounting Standards Board (GASB) that are shaking up the balance sheets of some municipalities will begin to affect the budget process of the largest government entities (those with gross receipts over \$100 million) for fiscal years beginning after December 15, 2006. The first date with major year-end reporting will be June 30, 2008.

The new rules will require governments to report annually in their financial statements both the accruing cost of retiree health benefits being earned by active employees in the current year, and a portion of the unfunded liability earned in prior years, thus formally recognizing the unfunded liabilities phenomenon. Governments will be able to spread the unfunded liability over as long as 30 years.

That means that the cost of the benefits has to be shown on current balance sheets, even though they will not be paid out until some time in the future. If the promised costs are large enough, they could affect the credit rating of the municipality and, therefore, the rate it pays on its bonds. Previously, those costs were only reflected in footnotes.

While some governments may be waiting to see what happens with the pending implementation of the GASB statement, any change in the underlying benefits will be difficult to achieve. Governments with collective bargaining agreements must pay particular attention to the GASB deadlines, as current benefit negotiations are likely to affect the calculations for reporting the liability from the first year the standard is in effect.

— Robert Barkin

contributions rather than a promised level of benefit, it is a more manageable expense for the city, Lee says. "We recognized that those who were already retired or close to retirement did not have time to build up a benefit through the retirement health care savings plan," she says.

While not all of the employees have the benefit they envisioned, the city feels it fulfills its commitment to employees at a cost it can afford. Because its basic retirement plan also is a defined contribution plan, the RHS plan continues to require employees to manage and plan their retirement security. The vesting schedule also is faster (five years) than a traditional defined benefit plan.

With its new plan, the city enters the GASB era with a balance sheet unburdened with a legacy of pledged,

but unfunded, retirement health commitments. It also has a benefit plan to help recruit new employees. "We now have a benefit that will assist our employees with retirement health costs — and a commitment we can fulfill," Lee says.

Adapting changes

Arlington, Texas' employee and retiree demographics are extremely different from Rochester Hills'. With a population of 354,000, the city employs 2,200 full-time workers. It has an aging workforce, including 400 employees who are eligible to retire today and 400 who will be eligible within five years. Currently, the city has over 500 retirees. "The retiree population is large and getting larger," says Dal Anderson, the city's director of human resources. "There are lots of baby boomers preparing to retire."

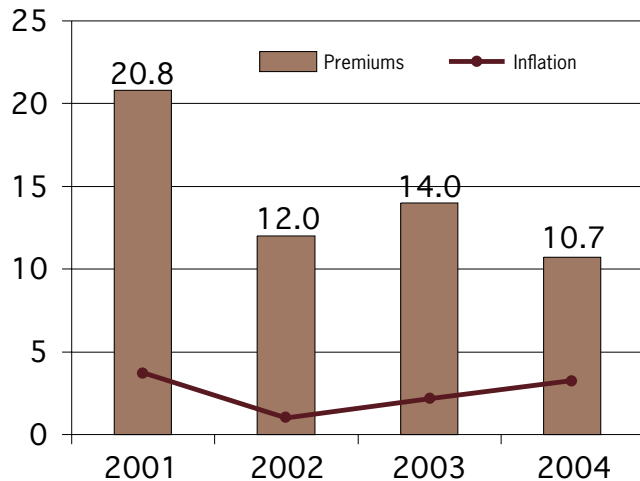
Unions do not represent city employees, but active employee associations represent their positions on employee issues. So, while the city's benefits are not negotiated or contractual, employees and retirees are encouraged to voice their concerns. That has been the case in recent months as the city has considered its retirement health benefit plan and the pending GASB requirements, Anderson says.

Arlington has a retiree health program that exceeds many other cities'. The city

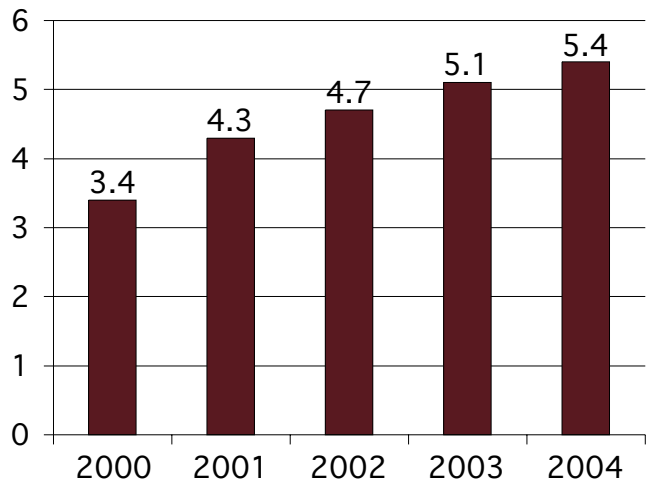
Actions taken or planned to control costs	% of respondents
Increase employee premium contribution, copay, and/or deductible.....	61
Shop for providers.....	57
Switch to self insurance for some services.....	35
Offer lower cost plan option.....	35
Wellness/disease management programs.....	30
Tiered prescription drug coverage	26
Join with other entities.....	9
Provide consumer information on health care	4

SOURCE: "Local Governments Pressured by Rising Employee Health Care Costs," December 2004, New York-based Fitch Ratings

Health insurance premium growth vs. general inflation (annual % change)



Health insurance premium expense (as % of total operating expenses)



SOURCES: "Local Governments Pressured by Rising Employee Health Care Costs," December 2004, New York-based Fitch Ratings; and Bureau of Labor Statistics' consumer price index for all urban consumers

pays 100 percent of the premium and 70 percent of the dependent's premium for a retiree with 30 years of service. The percentage decreases with years of service to 60 percent for retirees with 10 years of service. With employees retiring early and living longer, the city faces a liability of millions of dollars under the new GASB standards.

In January 2004, the city council reviewed the potential impact of the GASB rules on future budget and balance sheets. Over the next several months, an actuarial study projecting long-term liabilities was completed, and city staff considered possible solutions with a consultant. Anderson and the city manager held group meetings with employees and retirees to discuss the issue and prepare them for the likelihood of change. Additionally, a newsletter series was created to help regularly communicate with employees.

By June, the council considered proposed revisions, which resulted in several changes, including a voluntary movement of older retirees from the city's plan to an American Association of Retired Persons Medicare supplement. For employees with less than

five years of service, the council lengthened the retirement eligibility standards to a combination of 55 years of age and a minimum of 15 years of service. For that group of employees, the city plans to pay 50 percent of their health benefits once the employees retire, with no subsidy for their dependents. That adjustment affects less than half of the workforce, most of whom have a greater opportunity to prepare for future retirement medical expenses.

Additionally, a task force was asked to consider city subsidy, rate structure and GASB implications relative to the remaining employees and existing retirees. "Some of the task force members had difficulty breaking out of the respective interests of their stakeholder groups," Anderson says. "The issue is so big — has so many tentacles — it became difficult to reach consensus in dealing with [it]." Their experiences are indicative of the issue's complexity. It is a matter of fiscal impact vs. human impact, he says.

While Arlington's consideration of benefits is not concluded, its approach represents sound fiscal management and sensitivity to the changes that affect employees and retir-

ees. Arlington appears to be committed to assisting employees in preparing for increasing medical expenses in retirement.

In January 2004, the city was among the first government entities in Texas to initiate an RHS plan for retiring employees, allowing them to contribute all, or a portion, of their accrued vacation and sick leave to the plan and draw from those funds to pay for medical expenses in retirement. Arlington plans to expand the RHS plan to include other types of contributions from employees and/or the employer.

For two cities facing a similar issue with significantly different demographic circumstances, alternative defined contribution retirementsavingsplansrepresentacommon tool that has been proven strategically valuable. In Rochester Hills and Arlington, the plans allow the cities and the employees to set aside accrued vacation and sick pay tax free to help pay for qualified medical expenses.

ACC

Robert Barkin is vice president of corporate communications for Washington-based ICMA Retirement Corp.

Reprinted with permission from the February 2005 issue of *American City & County*.® (www.americacityandcounty.com)

Copyright 2005, PRIMEDIA Business Magazines & Media Inc. All rights reserved.

AMC-81-CU



This presentation is intended as educational advice and is not to be construed as investment advice or the solicitation for a specific product or service. ICMA Retirement Corporation does not render specific legal or tax advice.