

**MINNESOTA STATE COLLEGES AND UNIVERSITIES
BOARD OF TRUSTEES**

Agenda Item Summary Sheet

Committee: Finance, Facilities and Technology

Date of Meeting: July 15, 2008

Agenda Item: FY2008 Financial Statement Issue Discussion

Proposed Policy Change Approvals Required by Policy Other Approvals Monitoring

Information

Cite policy requirement, or explain why item is on the Board agenda: The purpose of this Board report is to provide to the Finance, Facilities and Technology committee of the Board of Trustees background for a discussion about the FY2008 adoption of Standard 45 of the Governmental Accounting Standards Board (GASB 45) by Minnesota State Colleges and Universities, the liabilities prescribed by the standard, and a recommendation to defer establishment of a trust for OPEB liabilities.

Scheduled Presenter(s): Tim Stoddard, Associate Vice Chancellor Financial Reporting
William O'Brien, Finance Division Project Manager

Outline of Key Points/Policy Issues: Minnesota State Colleges and Universities (the System), as a governmental entity is subject to Governmental Accounting Standards Board (GASB) standards for financial accounting and reporting. GASB Standard 45 requires reporting the accrual for Other Postemployment Benefits (OPEB) expense over the working career of a plan member, rather than on a pay-as-you-go basis.

GASB 45 applies to implicit rate subsidies to retirees participating in the state health plan until they reach the age of 65. The standard does not require that the System switch from pay-as-you-go to an advanced funding approach, but relates only to how obligations are reported on the financial statements.

The report describes the OPEB liabilities for the System, for comparable higher education institutions, and for selected state governments. Included is a discussion of strategies to set aside assets for OPEB liabilities, ending with a recommendation to defer establishing a trust for OPEB liabilities.

Background Information: The liability calculations were made by Deloitte Consulting LLP under contract with the Minnesota Department of Employee Relations (DOER), based on early retiree health plan provisions, participant data, and input on actuarial assumptions provided by the System, DOER and Minnesota Department of Finance (DOF) staff.

**BOARD OF TRUSTEES
MINNESOTA STATE COLLEGES AND UNIVERSITIES**

INFORMATION ITEM

FY2008 Financial Statement Issue Discussion

BACKGROUND

The purpose of this Board report is to provide to the Finance, Facilities and Technology committee of the Board of Trustees background for a discussion about the FY2008 adoption of Standard 45 of the Governmental Accounting Standards Board (GASB 45) by Minnesota State Colleges and Universities (the System), the liabilities prescribed by the standard, and a recommendation to defer establishment of a trust for OPEB liabilities.

The liability calculations were made by Deloitte Consulting LLP under contract with the Minnesota Department of Employee Relations (DOER), based on early retiree health plan provisions, participant data, and input on actuarial assumptions provided by the System, DOER and Minnesota Department of Finance (DOF) staff.

A committee presentation will be made by Tim Stoddard, Associate Vice Chancellor of Financial Reporting, and William O'Brien, Finance Division Project Manager. The Board report and presentation were prepared with input from Tim Stoddard, William O'Brien, Denise Kirkeby (System Director, Financial Reporting) and her staff.

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1. Executive Summary

- GASB 45, a financial accounting standard effective FY2008, establishes reporting requirements for other post employment benefits (not pension benefits), primarily for retiree health benefits (OPEB).
- An actuarial consulting firm makes all liability and expense calculations.
- For financial reporting purposes:
 - Record a liability (or asset) for a FY2008 amount (\$6 million for the System),
 - Include required footnote disclosure, including unfunded liability (\$94 million for the System).
- **Key question:** Should MnSCU establish segregated assets for OPEB liabilities?
- **Recommendation:** Defer establishment of a trust due to uncertainties regarding actuarial assumptions, drawbacks of a GASB defined funding vehicle (i.e., irrevocable trust), low materiality.

2. Introduction

- Minnesota State Colleges and Universities (the System) as a governmental entity is subject to Governmental Accounting Standards Board (GASB) standards for financial accounting and reporting.
- GASB Standard 45 requires reporting the accrual for Other Postemployment Benefits (OPEB) expense over the working career of a plan member, rather than on a pay-as-you-go basis.
- For institutions with total annual revenues > \$100,000, the pronouncement is effective starting in FY2008.
- For institutions with a membership of 200 or more, the actuarial valuation of liability related to OPEB should be done at least biennially.

3. What is OPEB?

- Considered a benefit earned by employee during his/her active years of employment.
- Includes:
 - Any benefits not provided under a pension plan,
 - Healthcare benefits even if provided through a defined benefit pension plan,
 - Life insurance,
 - Disability and long-term benefit care when provided separately from a defined benefit pension plan.

4. Why GASB 45?

- The pay-as-you-go approach to accounting for OPEB's was not sufficient to reflect obligations incurred while retirees were still active employees.
- OPEB's should be reported using the same approach as pension plan benefits, since both are benefits earned through active employment.
- To provide disclosure as to OPEB related obligations and current funded status of those obligations to financial statement users.

5. How GASB 45 Applies to the System

- Applies to implicit rate subsidies to retirees participating in the state health plan until they reach the age of 65.
- Does not require that the System switch from pay-as-you-go to an advanced funding approach, but relates only to how obligations are reported on the financial statements.

7. Actuarial Assumptions

- Liability calculations are based on 2006 fiscal yearend demographics, historical trend and Minnesota State Retirement System (MSRS) defined pension benefit plan actuarial assumptions.
- Demographic assumptions
 - Withdrawal (ending employment prior to retirement)
 - Mortality
 - Early retirement (Rule-of-90 eligible and other-eligible)
 - Percentage of early retirees electing medical coverage and type of coverage selected (utilization rate).
- Economic Assumptions
 - Medical Inflation Rate
 - Discount Rate (for present value calculation)

8. Liability Calculations - Summary

- | | | |
|--|--------------------|------------------------------------|
| a. Unfunded Actuarial Accrued Liability: (UAAL) as of July 1, 2007 | \$94 million | (footnote disclosure only) |
| b. FY2008 Annual Required Contribution: (ARC) | \$10 million | |
| c. Net Unfunded ARC as of June 30, 2008: | \$6 million | |
| • Detail: | | |
| Annual Required Contribution (ARC) | \$10 million | |
| Annual Implicit Rate Subsidy | <u>(4 million)</u> | |
| Net Unfunded ARC: | \$6 million | (additional expense and liability) |

9. Peer GASB 45 Adoptions and Liabilities

- a. State of Minnesota
- Unfunded OPEB UAAL: \$565 million as of July 1, 2006
 - Limited explicit benefits, implicit rate subsidy
 - No immediate plans to fund net unfunded ARC
- GASB 45 Valuation Report, Deloitte Consulting LLP
- b. Other States with largest unfunded OPEB UAAL's
- New York: \$49 billion (excluding SUNY)
 - California: \$48 billion
 - Illinois: \$48 billion
 - Connecticut: \$22 billion
 - New Jersey: \$22 billion
- *Promises With A Price: Public Sector Retirement Benefits*, The Pew Charitable Trusts, 2008

- c. University of Minnesota
 - Unfunded OPEB UAAL: \$72 million as of July 1, 2007
 - Limited explicit benefits, implicit rate subsidy
 - No immediate plans to fund net unfunded ARC
 - Phone Survey, June 26, 2008

- d. Large State College and University Systems and their unfunded UAAL's
 - State University of New York (SUNY): \$747 million
 - City University of New York (CUNY): \$108 million
 - University System of Georgia: \$2.1 billion
 - Massachusetts System of Higher Public Education (includes Univ. of MA): not separately available
(Part of Commonwealth of Massachusetts: \$13 billion)
 - Internet Document Search, June 17-26, 2008, and Phone Survey, June 26, 2008

10. Financial Markets Assessment

Note: The following rating agency comments are primarily directed towards government entities that have explicitly subsidized OPEB promises (specific health plan provisions). For government entities with OPEB liabilities generated only by implicit rate subsidies, the OPEB liabilities tend to be far less material, with little or no financial market impact expected for decisions not to fund such liabilities.

- a. Standard and Poors
 - “OPEB obligations, which are primarily centered on health care coverage, represent a significant expense for public sector employers.
 - The current level of OPEB promises are primarily the result of employment contracts entered into by governmental entities.
 - The funding of these obligations is of an increasing credit concern, exacerbated by the rapid cost acceleration in many health-related areas.
 - Government jurisdictions have a wide range of OPEB liabilities in terms of absolute size and relationship to budget resources, depending on how generous they have been in awarding benefits.
 - The disparities between employers will now be made more apparent under the new GASB 45 reporting. In some instances, the new reporting may reveal cases in which the actuarial funding of OPEB obligations would seriously strain operations, or, further, may uncover conditions under which employers are unable or unwilling to fulfill these obligations. In such cases, OPEB liabilities may adversely affect the employers’ creditworthiness, in that overall liabilities, including debt-like obligations such as OPEB, would be increased and future expenditure flexibility reduced.”
 - *Commentary Published on Reporting & Credit Implications of GASB 45 on OPEB*, Standard & Poors, December 1, 2004

b. Fitch Rating Service

- “Initially, Fitch’s credit focus will be on understanding each issuer’s liability and its plans for addressing it.
- Fitch also will review an entity’s reasoning in developing its plan. An absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor...
- Fitch does not expect OPEB plan funding ratios to reach the generally high levels of pension systems for many years, but steady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality.”

- *The Not So Golden Years: Credit Implications of GASB 45*, Fitch Rating Service, June 22, 2005.

c. Moody’s Investor Service

- Moody's does not anticipate that the liability disclosures will cause immediate rating adjustments on a broad scale.
- In fact, certain positive long-term effects seem likely to stem from the new requirements. This special comment describes the GASB statements and how they may affect the state and local government credit rating process.
- For municipal issuers, the credit impact of the new statements probably will depend on the following factors:
 - The absolute size of unfunded actuarial accrued liability (UAAL) and UAAL size relative to key financial measures such as size of payroll, budget and tax base
 - The plan for UAAL amortization as well as ongoing funding of new OPEB costs as incurred, on an accrual basis
 - Actuarial assumptions, including discount and medical cost inflation rates, used to determine values of liability and pledged assets
 - Retirement benefits promised to current workers and retirees as well as the ability (under contract or statute) to modify benefit offerings
 - The impact of full funding on the issuer's financial flexibility and strength, based on measures such as debt or reserve levels
 - The current credit assessment of the issuer and other factors affecting financial flexibility

- *Other Postemployment Benefits: New Accounting Requirements to Shed Light on Cost of State and Local Retiree Health Benefits; Funding Pressures Expected to Vary Widely*, Moody’s Investor Service, July 2005

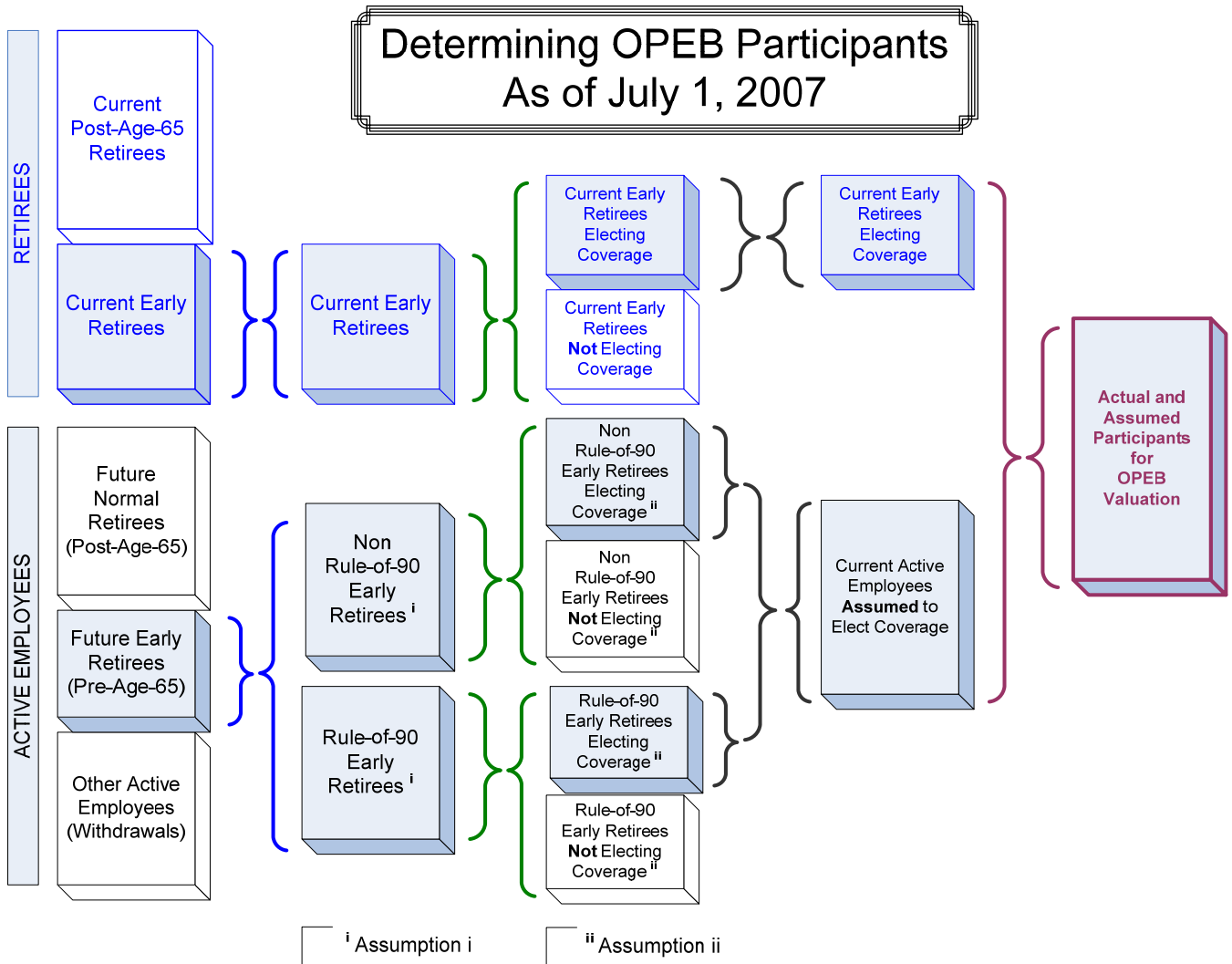
11. Recommendation: Defer establishment of a trust

- Uncertainties regarding actuarial assumptions.
- Drawbacks of a GASB defined funding vehicle (i.e., irrevocable trust).
- Relatively small size of OPEB liability for the System - low materiality.
- No discernable financial impact (rating agencies) for not funding an OPEB liability due only to an implicit rate subsidy.
- State of Minnesota and University of Minnesota are holding off funding net unfunded ARC.
- Financial market may respond with development of viable funding vehicles that would:
 - a. offset a net recorded OPEB liability, and
 - b. allow more System control over assets than an irrevocable trust.
- Industry response may result in future modifications to GASB 45.
- Decision to fund or not fund should be revisited as circumstances merit.

A1. Actuarial Computations

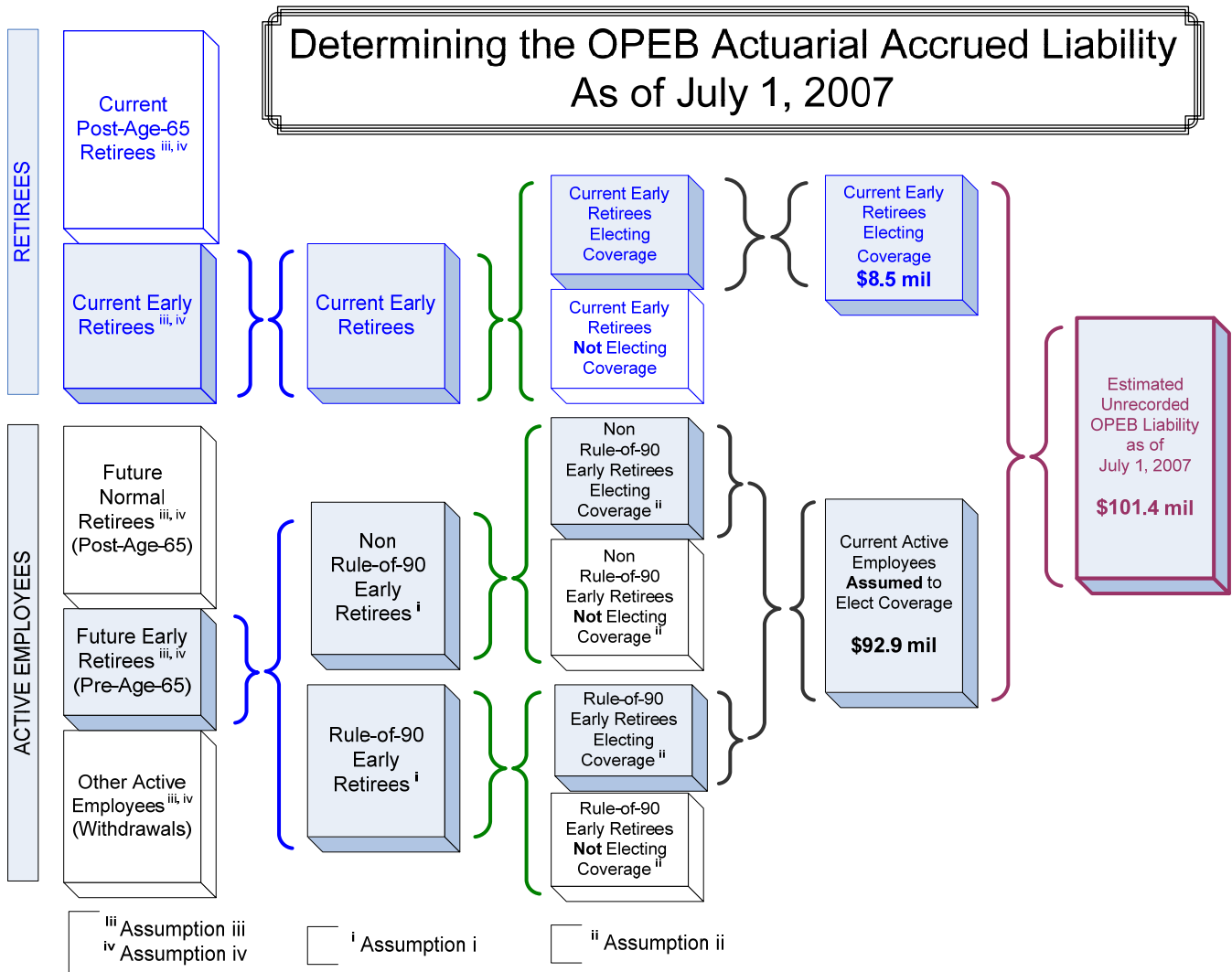
a. Development of Participants

- o Key Demographic Assumptions:
 - i. Early retirement rates of current employees (Rule-of-90 eligible and other-eligible),
 - ii. Percentage of future early retirees electing medical coverage and type of coverage selected (utilization rate),
- o Graphic:



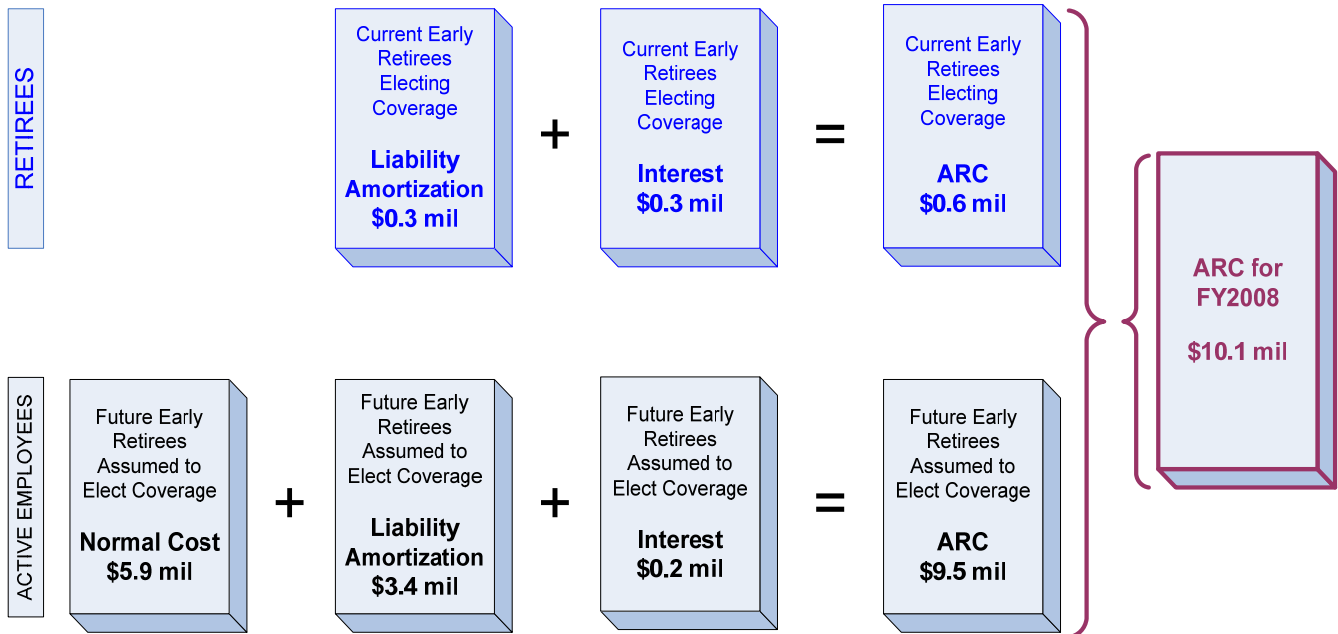
b. Development of Liability

- o Key Demographic Assumptions:
 - i. Early retirement rates of current employees (Rule-of-90 eligible and other-eligible),
 - ii. Percentage of future early retirees electing medical coverage and type of coverage selected (utilization rate).
- o Key Economic Assumptions
 - iii. Medical Inflation Rate
 - iv. Discount Rate (for present value calculation)
- o Graphic:



- c. Calculation of Annual Required Contribution (ARC)
 - o Components:
 - i. Normal Cost: additional liability due to one more year of age and service for future early retirees
 - ii. Amortization (30 years) of pre-July 1, 2008 Unfunded Accrued Liability (UAL)
 - iii. Annual Interest (on items a and b above)
 - o Graphic:

Determining the Annual Required Contribution (ARC) for FY2008



Normal Cost	+	Amortization	+	Interest	=	ARC
\$5.9		\$3.7		\$0.5		\$10.1
(Millions)						

A2. Financial Statements Impact / Sample Statement & Accounting Entry

- OPEB liability to be recorded in the financial statements is the “unfunded” Annual Required Contribution (net unfunded ARC).
- The recorded liability is reduced by the annual amount that early retiree medical premiums are subsidized by active employees due to rate blending. The annual amount of this subsidy for FY 2008 is approximately \$4.1 million.

- The resulting balance sheet liability of the net unfunded ARC for FY2008 is:

\$10.1 million ARC
 (4.1 million) Annual Rate Subsidy
(0.0 million) “Qualified” Annual Funding (see item #A4 below)
 \$ 6.0 million Net Unfunded ARC

- The net unfunded ARC will roll together with compensated absences/workers comp/early termination line on financial statements
- Sample Statement:

Other Post Employment Benefits- Other post employment benefits are health insurance benefits for certain retired employees under a single-employer fully-insured plan. Under the health benefits program retirees are required to pay 100% of the total premium cost. Since the premium is a blended rate determined on the entire active and retiree population, the retirees are receiving an implicit rate subsidy. See note XX for further details.

- Sample Accounting Entry (System-wide)

Dr	Expense (Benefits)	\$6 million
Cr	Liability (OPEB Liability-noncurrent)	\$6 million

A3. Notes to the Financial Statements / Sample Note

- An OPEB note is added to the notes to the financial statements, which should include:
 - Plan description
 - Funding policy
 - Information regarding the actuarial valuation
 - Information related to the current cost and funding progress of the plan
- Sample Note:

XX. OTHER EMPLOYEE BENEFITS

Minnesota State Colleges and Universities provides health insurance benefits for certain retired employees under a single-employer fully-insured plan, as required by Minnesota Statute §471.61 subdivision 2b. Active employees who retire when eligible to receive a retirement benefit from a Minnesota public pension plan and do not participate in any other health benefits program providing coverage similar to that herein described, will be eligible to continue coverage with respect to both themselves and their eligible dependent(s) under the health benefits program. Retirees are required to pay 100% of the total premium cost. Since the premium is a blended rate determined on the entire active and retiree population, the retirees are receiving an implicit rate subsidy. As of July 1, 2006 there were approximately 741 retirees receiving health benefits from the health plan.

Annual OPEB Cost and Net OPEB Obligation

The annual other post employment benefit (OPEB) cost is calculated based on the annual required contribution (ARC) of the employer, an amount actuarially determined in accordance with the parameters of GASB Statement No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years. The following table shows the

components of the annual OPEB cost for 2007, the amount actually contributed to the plan, and changes in the net OPEB obligation:

Components Of The Annual OPEB Cost (In Thousands)	
Annual required contribution (ARC)	\$ 10,096
Interest on net OPEB obligation	0
Adjustment to ARC	<u>0</u>
Annual OPEB Cost	10,096
Contributions during the year	<u>(4,088)</u>
Increase in net OPEB obligation	6,008
Net OPEB-beginning of year	<u>0</u>
Net OPEB-End of year	<u>\$ 6,008</u>

Minnesota State Colleges and Universities annual OPEB cost, the percentage of annual OPEB cost contributed to the plan and the net OPEB obligation for fiscal year 2008 were as follows:

(In Thousands)				
<u>Fiscal Year</u> <u>Ended</u>	<u>Annual</u> <u>OPEB Cost</u>	<u>Employer</u> <u>Contribution</u>	<u>Net OPEB</u> <u>Obligation</u>	<u>Percentage</u> <u>Contributed</u>
June 30, 2008	\$ 10,096	\$ 4,088	\$ 6,008	40.49%

Funding Status

There are currently no assets that have been irrevocably deposited in a trust for future health benefits. Therefore, the actuarial value of assets is zero.

(In Thousands)						
<u>Actuarial</u> <u>Valuation</u> <u>Date</u>	<u>Actuarial</u> <u>Value of</u> <u>Assets</u> <u>(a)</u>	<u>Actuarial</u> <u>Accrued</u> <u>Liability</u> <u>(b)</u>	<u>Unfunded</u> <u>Actuarial</u> <u>Accrued</u> <u>Liability</u> <u>(b - a)</u>	<u>Funded</u> <u>Ratio</u> <u>(a/b)</u>	<u>Covered</u> <u>Payroll</u> <u>(c)</u>	<u>UAAL as a</u> <u>Percentage of</u> <u>Covered Payroll</u> <u>((b - a)/c)</u>
July 1, 2006	\$0	\$94,235	\$94,235	0.00%	\$876,585	10.75%

Actuarial Methods and Assumptions

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and healthcare cost trends. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future.

Projections of benefits for financial reporting purposes are based on the substantive plan (as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities, consistent with the long-term perspective of the calculations.

In the July 1, 2006 actuarial valuation, the entry age normal actuarial cost method was used. The actuarial assumptions included a 4.75% discount rate, which is based on the estimated long-term

investment yield on the general assets, using an underlying long-term inflation assumption of 3.00%. The annual healthcare cost trend rate is 9.13% initially, reduced incrementally to an ultimate rate of 5.00% after twenty years. The unfunded actuarial accrued liability is being amortized as a level dollar amount over an open 30-year period.

A4. Funding Vehicle Comparison: Segregated Assets / Revocable Trust versus Irrevocable Trust

- The decision to advance fund any portion of the Annual Required Contribution or higher amounts is dependent on a number of factors.
- In order for funding to qualify as an offset to recorded and unrecorded OPEB liabilities, assets must be legally segregated from the general assets of the reporting entity, as are the assets in an irrevocable trust.
- Non-legally-segregated assets for advance funding OPEB liabilities (e.g., a revocable trust) are not considered as qualified funding in the accounting treatment for GASB 45. Board designation of net assets for some portion of unfunded OPEB liabilities may be worth considering but provides no specific GASB 45 impact.
- At least 13 states have set up irrevocable trusts to pay for retirement benefits in years to come, ensuring that none of the funds are diverted to other purposes.
- Promises With A Price: Public Sector Retirement Benefits, The Pew Charitable Trusts, 2008

Segregated Assets / Revocable Trust		Irrevocable Trust	
Pros	Cons	Pros	Cons
Assets provide for early retiree OPEB liability		Assets provide for early retiree OPEB liability	
Assets remain on MnSCU balance sheet			Assets are not on MnSCU balance sheet
Segregation of assets does not involve a cash outlay	Contributions to a revocable trust would represent a cash outlay		Contributions represent a cash outlay
	Assets cannot be used to offset OPEB accounting liability in financial statement disclosure.	Assets do offset OPEB accounting liability in financial statement disclosure.	
Ownership and future control of assets is retained by MnSCU management if OPEB liability is otherwise mitigated or eliminated			Ownership and/or recapture of assets is uncertain if OPEB liability is otherwise mitigated or eliminated

Date Presented to the Board of Trustees: July 16, 2008