Are California community college districts prepared for GASB's new retiree health benefit cost accounting standards?

And how districts can prepare themselves for the new standards and maximize return on investments

Including results of a statewide survey

A special report prepared by

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COMMUNITY COLLEGE LEAGUE
OF CALIFORNIA

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EXECUTIVE SUMMARY

The year 2004 brings increasing fiscal challenges for California community college districts. It is unclear when these fiscal pressures will ebb. And in the midst of this indefinite stormy fiscal environment, all public employers – including community college districts – will be faced with a new fiscal challenge. The Governmental Accounting Standards Board (GASB) this year will issue new accounting standards that will require public employers to accrue retiree health benefit costs over employees' working lifetimes.

All California community college districts will need to assess their retiree health benefit plans and make any needed changes well in advance of the effective date of the new GASB accounting standards.

In helping member districts formulate a compliance plan, it is essential to get a good snapshot of where they currently are in terms of being prepared to respond to the new GASB standards. To that end, the League surveyed all member districts in November and December, 2003. The Community College League is extremely gratified that 61 of the 72 districts responded.

The new GASB accounting standards will require districts to accelerate recognition of retiree health expenses. This will result in a dramatic increase in retiree health plan expenses. Of the 33 districts that provided the League copies of their most recent actuarial valuation report, we determined that only 13 of the valuations comply with the upcoming GASB standards. For these 13 districts, retiree health expenses under the GASB standards will, on average, more than double when compared to *"pay-as-you-go"* (cash basis) accounting. The average increase was 162% with a median increase of 140%. The increases would have been larger had it not been for the fact that four of the 13 districts have funded a substantial part of their liability (ranging from 27.7% to 62.4%).

The League's survey determined that the districts have at least $257 million already set aside for retiree health benefits. However, the 33 districts that provided a copy of their most recent actuarial valuation are estimated to have funded only about 15% of their collective $1.5 billion past service liability (the value of benefits already earned by employees) as of June 30, 2003. Only 11 districts are funding their retiree health benefit costs at a level that meets the new GASB standards.

The League survey (complete results are found on pages 11-13) also found that most districts are holding reserves explicitly for retiree health benefits with amounts ranging from $65,000 to $49 million. Twenty-one districts reported that they expected to add to this fund in the current year but only 11 indicated it will be the full actuarially required contribution.

The new standards will be phased in over a three-year period, paralleling GASB 34. Most college districts will have to comply with the new GASB standards in advance of the 2008-09 fiscal year. A smaller number will have to comply for the 2007-08 year, and a few will have until 2009-10.

Although the effective dates of the GASB standards are still a few years away, it is important to evaluate the extent to which districts are prepared for the standards. To that end, our analysis indicates that a district that is fully prepared meets the following five criteria. (After each criterion we indicated the extent to which survey respondents meet that criterion.)

1) The district has had an actuarial valuation; (42 out of 59, or 71.2%)
2) The actuarial valuation should be less than two years old for districts with more than 200 participants and less than three years old for districts with fewer than 200 participants; (19 out of 33, or 57.6% – *Note*: 9 of 42 districts reported they had actuarial valuations but did not submit a copy. As a result, we were unable to determine the timing of the most recent valuation.)
3) The actuarial valuation should use assumptions and methodology that are consistent with the new GASB accounting standards. (13 out of 33, or 39.4%)
4) The District should be recognizing an expense for retiree health benefits that exceeds the amount necessary to cover only employer premiums for retiree coverage; (21 out of 59, or 35.6%)
5) The amount of excess expenses in #4 should be equal to the amount required by a compliant actuarial valuation (#1, #2 and #3 above). (11 out of 59, or 18.6%)

Of the 59 responding districts with district-paid retiree health benefits, at least seven (or 11.9%) are in compliance with all five of the above criteria. (Four of the districts that did not submit an actuarial valuation report would be in compliance if their valuation complies with criteria #2 and #3 above). Another 15 (or 25.4%) of the districts have not complied with *any* of the five criteria. Two of the 15 have set aside reserve funds for retiree health benefits, so they are prepared for the upcoming GASB standards to some extent.

The majority of districts (at least 33, or 55.9%) satisfy some but not all of the criteria. In a few cases this is because the last valuation was conducted before mid-2002 when the content of the new GASB accounting standards became known in detail. Consequently, a few districts may meet all five criteria when their next valuation is performed.

Even districts that meet all five compliance criteria may have more to do. In the long run, districts can minimize their retiree benefit costs by investing retiree health funds in suitable long-term investments. Currently, suitable investment vehicles do not exist. The survey shows that only one district has any funds invested outside of a county investment pool or the Local Agency Investment Fund (LAIF). With more than $250 million already reserved for retiree health benefits, surveyed districts certainly have enough funds to justify a pooled investment fund dedicated solely to retiree health benefits for California community colleges.

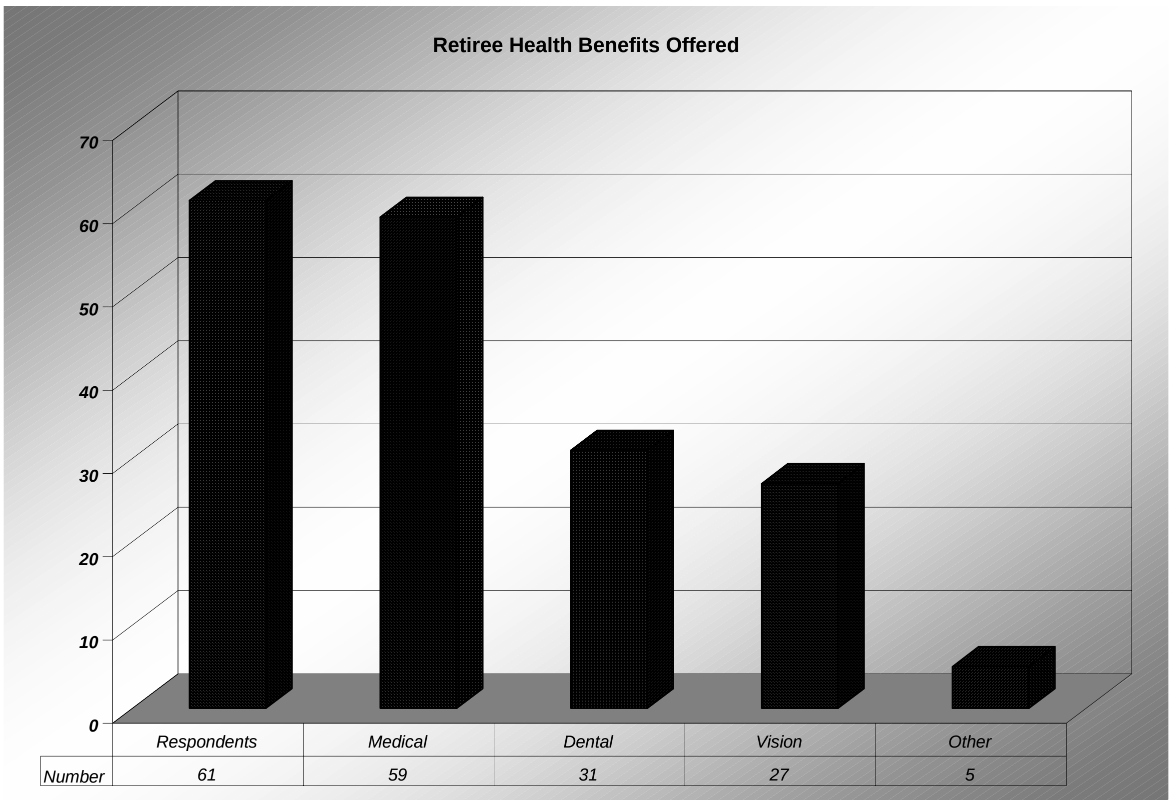
The League has called a meeting of Chief Business Officials to review this report and discuss possible solutions to the related fiscal challenge facing all districts. One objective is to investigate formation of a statewide investment pool to improve returns on accumulated funds thereby lowering district retiree health benefit costs.

The League thanks all those who took time to respond to its survey. The overwhelming response provides a solid base for evaluating the current situation and investigating alternatives that will be of value to our member districts.

The League would also like to thank Geoffrey Kischuk, FSA, FCA, MAAA of Total Compensation Systems, Inc. (TCS) for his assistance in preparing this study. Mr. Kischuk's extensive experience performing retiree health valuations for California community college districts and his experience working with GASB as the accounting standards were developed has been invaluable.

BACKGROUND

New Governmental Accounting Standards Board (GASB) accounting standards will fundamentally change how public employers – including community college districts – account for retiree health benefits. This change will affect the vast majority of California community college districts. Of the 61 districts responding to the Community College League's survey, 59 – or 97% – pay at least part of the cost of retiree health benefits for current and/or future retirees (see Table I).



The new GASB standards will require districts to treat retiree health expenses just as pension expenses have been treated – i.e. the benefits should be accrued over the working lifetime of employees. Districts will be required to have an actuarial valuation every two or three years (depending on the number of participants). The actuarial valuation will determine the value of retiree health benefits earned in the coming year. This figure is often referred to as the *"normal cost."* If a district had been accruing the normal cost since the first eligible employee was hired, a substantial fund would have built. This theoretical fund is called the *"past service liability (PSL)."* To the extent the District has not recognized a liability equal to the PSL, GASB will allow the unrecognized PSL to be amortized over a period not to exceed 30 years. The GASB standard will allow both the normal cost and PSL amortization to be calculated as a level percentage of payroll. Doing so will dramatically reduce the first year cost of compliance.

Recognizing retiree health expenses during employees' working lifetimes will dramatically accelerate expense recognition. Particularly because of the amortization of the unfunded PSL, these new accounting standards will increase the cost of providing retiree health benefits for most, if not all, districts. To assess the likely impact of the new GASB standards, we reviewed actuarial valuation reports provided to the League by 33 responding districts. Of the 33 districts, all would experience an increase in cost. The increases ranged from 24% to 733%, with a mean increase of 225% (i.e.more than triple “pay-as-you-go” costs) and a median increase of 170% (i.e. more than double).

While the above figures are alarming, the true impact may be more or less than indicated above for individual districts. In our evaluation of submitted actuarial valuation reports, we noted several issues that could result in lower costs than shown in a particular district’s actuarial valuation report:

- Several reports used Financial Accounting Standards Board SFAS 106 methodology to estimate accrual costs and liabilities. SFAS 106 methodology was used in several cases despite the fact that GASB decided as early as September 1995 to follow the structure of GASB 25 and 27 rather than SFAS 106. For several reasons, GASB methodology will allow substantially lower retiree health accrual costs than required under SFAS 106.
- Several reports used methodology that is not allowable under either SFAS 106 or the pending GASB accounting standards. GASB will allow lower accrual costs than these studies.
- In some cases, districts may have made progress reducing the unfunded “past service liability” (PSL) since the report was prepared.
- In some cases, districts may have made benefit modifications which have reduced costs and liabilities (About one-third of districts made material changes to their retiree health benefit plan since the last actuarial valuation.)

In addition to issues that may cause the last actuarial valuation to overstate the impact of the upcoming GASB accounting standards, our analysis of the submitted actuarial valuation reports indicates there are also issues that may cause individual district reports to *under*state the likely impact. These issues include:

- Several actuarial valuations were based on interest rates that are higher than what is reasonably attainable over the long run when funds are invested as surplus funds pursuant to California Government Code Sections 53601 and related sections. For districts not intending to fund retiree health plans at all, it would not be appropriate to assume any investment income (i.e. an interest rate of 0%).
- Many districts will not have made progress in reducing the unfunded PSL. Over time, this will most likely increase the required accrual cost.
- Some districts may have recently liberalized benefits resulting in higher costs and liabilities.
- Districts providing benefits through CalPERS are now subject to increasing minimum contribution rates due to SB1464. If the prior valuation did not reflect this, costs and liabilities will be substantially understated. (Even districts with contribution caps in excess of new CalPERS minimums will be affected due to the indexing provisions of SB1464.)

To better assess the likely impact of the new GASB accounting standards, we analyzed the recent actuarial valuations of 13 districts which appear to meet the new GASB accounting standards. For these 13 districts, retiree health expenses under the GASB standards will, on average, more than double when compared to *"pay-as-you-go"* (cash basis) accounting! The average increase was 162% with a median increase of 140%. The increases would have been larger had it not been for the fact that four of the 13 districts have funded a substantial part of their liability (ranging from 27.7% to 62.4%).

PLANNING

It is critical for all districts offering retiree health benefits to establish a plan that will enable the district to offer competitive retiree health benefits at a cost that is fiscally viable. To that end, we recommend the following process.

Step 1: Determine the latest date the district should address retiree health benefit issues in collective bargaining taking into consideration the effective date of the upcoming GASB accounting standards.
Step2: Determine how much *as a percentage of payroll* the District can afford to pay over the long run for retiree health benefits.
Step 3: Obtain an actuarial valuation of the current retiree health benefit plan using methods allowable under the upcoming GASB standards; and using realistic actuarial assumptions. Districts should actively participate in discussions with the actuary regarding key actuarial assumptions.
Step 4: If the cost of the current benefit plan exceeds what has been determined to be affordable, investigate changes necessary to achieve an affordable plan.
Step 5: Negotiate plan changes, as necessary during next collective bargaining cycle.
Step 6: If plan changes are implemented, obtain another actuarial valuation to assure costs are in line with expectations.
Step 7: Well in advance of the implementation date of the new GASB standards, districts should arrange for all premiums, claims and related expenses to be separated for retirees under 65 and, if applicable, over age 65.
Step 8: If the League establishes a statewide investment pool to maximize return on funds, consider participating in program.

HEALTH CARE COST TRENDS

Health costs have been increasing at double-digit rates for several years now. Prescription drug costs, in particular, have been increasing rapidly. Since Medicare supplement benefits are disproportionately comprised of prescription drugs, medical benefit costs for Medicare-eligible retirees have been increasing much faster than for other employees and retirees.

In addition, the ultimate trend rate used in an actuarial valuation should bear a reasonable relationship to the assumed underlying inflation rate. Many actuarial valuations don't implicitly state the assumed long-term inflation rate. However, 3% is commonly assumed.

Of 18 retiree health valuations done in 2002 or 2003 for which we had valuation reports, three used an ultimate trend rate of 5% to 6%. Particularly for districts that do not have district contribution caps, it is extremely important for districts to examine and discuss the assumed ultimate trend rate and how it relates to other economic assumptions (i.e. inflation and interest) before a valuation is begun.

The new GASB accounting standards will allow districts to establish retiree health accrual expenses based on a level percentage of payroll (subject to certain limitations). This is an option that is not available to private employers under SFAS 106. Expressing retiree health costs as a level percentage of payroll is important for two reasons. First, it dramatically reduces first year accrual costs from what they would be under SFAS 106. Second, in establishing a pattern of retiree health accrual expenses that track with payroll expenses, costs will more closely track revenue and be more fiscally manageable.

However, if medical expenses increase much faster than the rate assumed in the retiree health valuation over an extended period –as they have recently – the percentage of payroll could increase substantially from valuation to valuation. Under the new GASB standards, districts with at least 200 participants (including active, benefit-eligible employees) will be required to have an actuarial study done at least every two years. Smaller districts will be on a three-year cycle. A district cannot predict when there will be an extended period of high health claim increases. Districts should, therefore, consider whether it is necessary to take action to limit the impact of health claim increases.

INVESTMENT INCOME

Once the new GASB accounting standards take effect, districts will have three basic funding options:

1) No funding
2) Funding using investment vehicles that comply with California Government Code provisions related to surplus funds; or
3) Funding using a trust or similar vehicle that allows more investment latitude as provided under California Government Code Sections 53620-53622.

GASB will require districts that don’t fund their liabilities to accumulate a balance-sheet liability. Furthermore, expenses for an unfunded plan will be much higher than for a funded plan. Every dollar of investment income earned on plan assets reduces expenses by a dollar. The following example taken from a California school district illustrates this.

<u>Example</u>: District A (provides retiree health benefits only to age 65):

Current:
    "Pay-as-you-go" cost is $936,000
Option 1: No funding
    Accrual Cost at 0% interest: $2,661,000 (184% increase over "pay-as-you-go")
Option 2: Funding as "surplus funds"
    Accrual Cost at 5% interest: $1,667,000 (78% increase over "pay-as-you-go")
Option 3: Funding through trust or similar arrangement
    Accrual Cost at 6% interest: $1,555,000 (66% increase over "pay-as-you-go")

For District A, the new GASB accounting standard will substantially increase the district's cost of providing retiree health benefits. Should the district choose not to fund the plan, the cost will almost triple because there will be no investment income (i.e. 0% interest assumed). Should the district choose to set funds aside but not encumber the funds, the district will be limited by the Government Code in the way funds are invested. The Local Agency Investment Fund (LAIF) has achieved an annual return of about 5% over the ten-year period ending June 30, 2003. Using a 5% valuation interest rate would dramatically reduce the accrual cost.

Under the third option, a long-term return of as little as 1% over LAIF would generate significant savings. It is likely that a well-managed fund could achieve even better long-term results.

The above example would be even more dramatic if the district provided lifetime benefits. Lifetime benefits extend the period over which interest is earned by as much as 20 years, which increases the differences between the three options.

Of 59 California community college districts providing retiree health benefits, 36 (or 61%) are holding reserves. The 35 districts that provided their June 30, 2003 reserve balance are holding, in aggregate, $257.3 million. The average reserve balance is $7.4 million and the median is $2.7 million. All but one district has the entire balance deposited in LAIF and/or the County investment pool.

While the survey did not ask why funds are being invested almost exclusively in local agency investment pools, experience suggests the main reason is because the funds have not been irrevocably committed to retiree health benefits. Indeed, one district expects to withdraw funds from retiree health reserves in the current fiscal year. About one-third of districts with retiree health funds expect to suspend contributions in the current fiscal year.

Once the new GASB accounting standards take effect, it will not be possible to reverse or suspend expense accruals. For districts that choose to fund their plans, there will be little benefit from keeping the funding commitment revocable. Accessing these funds for purposes other than retiree health benefits could provide cash flow but could not be used to reduce an operating deficit.

While there will be little to gain from keeping retiree health reserves revocable, there is a lot to lose. Irrevocably committing retiree health reserves allows broader investment discretion under

Government Code Sections 53620-53622. There is no question that access to longer-term investments and access to much more broadly diversified asset classes as allowed under Government Code Sections 53620-53622 would enable substantially higher long-term investment returns. Holding retiree health reserves in local agency investment pools will sacrifice significant retiree health benefit cost savings that can be achieved if investments are more appropriate for the long-term liabilities created by retiree health benefits.

RETIREE HEALTH INVESTMENT JPA

County investment pools can do an excellent job of providing good returns for surplus funds where short-term, liquid investments are appropriate. However, these pools are unlikely to provide the optimal return for assets dedicated to long-term liabilities such as retiree health plan liabilities. Once a district is prepared to irrevocably commit funds to retiree health benefits, the Government Code provides a large number of opportunities for diversifying investments across asset classes and by duration. The best possible fit for community college districts could be a fund dedicated exclusively to retiree health funds for community college districts. A ready way to accomplish this would be through a retiree health investment JPA.

In establishing a retiree health investment JPA, the JPA agreement would incorporate all key safeguards now included in the Government Code, as well as additional safeguards deemed prudent. In considering appropriate safeguards, it is important to recognize that some of the statutory restrictions that apply to surplus funds are necessary because of high liquidity needs of surplus funds.

There are several advantages of pooling retiree health funds.

- Expertise. Availability of a wide range of asset classes for investment dramatically increases the investment expertise needed to manage a fund. Pooling funds makes it possible to obtain this expertise.
- Expenses. Many investment expenses do not increase materially as transaction size increases. As a result, pooling funds can dramatically reduce investment expenses.
- Diversification of investment portfolio options. Maximizing the benefits of broad diversification can require a minimum of $40 to $50 million.
- Liquidity of funds. A steady inflow of funds from a large number of districts can provide liquidity above and beyond what is available through investment maturity and marketability.

While maximum benefits can be obtained from a large fund, benefits of pooling arise from the outset. With at least $257 million already set aside for retiree health benefits, California community colleges clearly have sufficient funds to gain maximal benefits from pooling. And the potential is even greater. The 33 districts that provided a copy of their most recent actuarial valuation are estimated to have funded only about 15% of their collective $1.5 billion past service liability as of June 30, 2003.

(The $1.5 billion past service liability estimate results from factoring in the interest rate, normal cost and projected retiree health premiums taken from the actuarial reports plus the estimated premium increases since the last valuation as reflected in Survey Question #4.)

CONCLUSION

More than 75% of surveyed districts with district-paid retiree health benefits have taken at least some steps toward recognizing the associated long-term costs and liabilities. While this is a promising start in preparing for upcoming GASB accounting standards, much more needs to be done. We recommend the following:

- All districts should determine how much they can afford to pay as a percentage of payroll over the long run for retiree health benefits;
- All districts that have not had a compliant actuarial valuation within the last two to three years should obtain one as soon as possible; and
- Districts with substantial retiree health funds that are prepared to irrevocably commit the funds should assist the League in establishing a retiree health funding JPA.

Retire Health Benefit Funding Survey
61 Districts Responded

1. Please check the district-paid retiree health benefits offered to some or all current and future retires:

Benefit	Total
Medical	58
Dental	30
Vision	26
Other	9
None	3

2. Has your district ever had an actuarial valuation of its retiree health plan?

	Districts
Yes	40
No	18

3. Have there been any material changes to the retiree benefit plan since this report was issued?

Yes	No
9	19

4. What is your best estimate of the percentage increase in retiree health premiums per retiree since the above actuarial report was issued?

District Total	1	2	3	4	5	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24
Percentage	0	15	5	20	5.7	16	65	5	50	0	12	50	15	8	12	2.3	20	1.5	0	20	25	15	50

District Total	25	26	27	28	29	30
Percentage	0	17-31	15-20	20	34	35

5. Is your district currently holding any reserves explicitly for retiree health benefits?

	Total
Yes	36
No	23

6. What is the actual or estimated balance of this reserve as of June 30, 2003?

District	1	2	3	4	5	6	7	8	9	10	11
Dollar amount	720,212	6,495,473	4,751,933	1,792,286	2,075,000	24,356,355	3,045,617	506,423	497,000	1.3 M	49 M

District	12	13	14	15	16	17	18	19	20	21	22	23
Dollar amount	780,000	1.3 M	2,583,504	173,000	45 M	679,035	32,400,000	191,000	8.7 M	150 M	12,074,200	3,646,750

District	24	25	26	27	28	29	30	31	32	33	34	35	36
Dollar amount	2,680,624	6,700,000	7 M	622,124	2 M	576,505	4,900,000	3.1M	16,106,851	Don't Know	65,000	5.3M	6 M

7. *Exclusive* of investment income, how much does your district expect to add to this fund during the 2003-04 fiscal year?

District	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Dollar amount	0	150,000	1,200,000	0	0	200,000	0	0	143,927	0	1.6M	1.4M	0	0	0	0	0	400,000

District	19	20	21	22	23	24	25	26	27	28	29	30	31
Dollar amount	0	80,544	500,000	109,000	500,000	699,153	60,000	0	450,000	240,000	0	755,000	0

District	32	33	34	35	36	37	38	39
Dollar amount	200,000	1.2M	2,819,497	0	0	15,000	-1.2M	1,200,000

8. Is the amount in Question 6 intended to be the full actuarially required contribution based on the most recent actuarial study?

	Total
Yes	11
No	10

9. Where are retiree health reserve funds currently held?

	Total
i.e. county treasurer	27
LAIF	3

10. What is your best estimate of the rate of investment return on your retiree health fund for the year ending June 30, 2003?

District	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21
Percentage	2.9	4	2	2.6	1.2	3.0	1.5	2	1.6	3	3	1.5	2.65	1.7	4	1 ¾	4	2	2	2.5	1.74

District	22	23	24	25	26	27	28	29
Percentage	4.5	2.3	3	2.15	1-2	3	1.5	3.5

11. What was the district's total revenue for the 1998 - 99 fiscal year?

2	Under $10 million (Accrual accounting will be required by GASB for 2009-10)
33	$10 million to $100 million (Accrual accounting will be required by GASB for 2008-09)
10	Over $100 million (Accrual accounting will be required by GASB for 2007-08)

12. When do you expect to begin funding retiree health benefits on a full accrual (actuarial) basis?

	Total
We already are	8
Don't intend to	4
2004-05	1
2005-06	3
2006-07	3
2007-08	6
2008-09 or later	16

California Government Code Sections 53620-53622 allows greater investment latitude for retiree health funds, but only if those funds are irrevocably committed to retiree health benefits. Once GASB begins requiring full accrual of retiree health benefit costs, irrevocably committing these funds will be advantageous under the new accounting rules. With that in mind, please answer the following:

13. Do you believe your district would be willing to irrevocably commit funds to retiree health benefits if it enabled your district to lower the cost of retiree health benefits by achieving higher investment returns?

	Total
Yes	15
No	7
I need more info.	23

14. Would your district consider irrevocably committing retiree health funds *prior* to the effective date of the new GASB standards (see Question 11)?

Yes	18
No	20

15. If a retiree health JPA could safely provide better investment returns and lower investment expenses than a district could achieve on its own, would your district consider joining?

Yes	36
No	3

16. Would you be willing to participate in a task force to investigate formation of a retiree health investment JPA for California Community College Districts?

Yes	22
No	24