News Scan
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Consultants & Actuaries

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The following news summaries were developed by Gabriel, Roeder, Smith & Company to inform clients and other benefit professionals of news in the benefits industry. Our thanks to Mary Ann Vitale for her diligent work on this issue. To receive this publication electronically, send an email to web.admin@gabrielroeder.com with "SUBSCRIBE NEWS SCAN" in the subject line. To stop receiving this publication electronically, send "UNSUBSCRIBE NEWS SCAN" in the same manner. Copies of this and other benefit-related publications are available on the GRS web site at www.gabrielroeder.com.

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IRS Posts FAQs Regarding Governmental Plan Determination Letters

On September 2, 2008, the Internal Revenue Service (IRS) posted frequently asked questions (FAQs) on its website for governmental plans submitting requests for determination letters. Earlier this year, the IRS's Tax Exempt and Government Entities (TE/GE) Division announced its intention to increase its oversight of governmental pension plans. The IRS has urged governmental plans to submit determination letter requests in order to ensure the plans satisfy applicable qualification requirements of the Internal Revenue Code. Under the IRS's new staggered determination letter process, governmental plans would generally file their determination letter requests during Cycle C, which began on February 1, 2008, and will end on January 31, 2009.

Among other items, the FAQs clarify that the plan documentation submitted with the determination letter request does not have to be in "restated form." Generally, the IRS requires a plan be submitted as a single, restated plan document in order to facilitate their review. However, in the FAQs, the IRS recognized governmental plans may not have a single document. Therefore, plan sponsors will be allowed to submit the applicable statutes and other relevant material, provided the information is organized in a way that allows IRS reviewers to determine whether plan provisions meet the qualification requirements.

In addition, the FAQs clarify that the determination letter request should also include a copy of plan amendments made as a result of qualification rule changes under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), demonstrating the amendments were made in a timely manner. Alternatively, the plan may submit a summary of the amendments, along with a certification that they were made in a timely manner. However, if a summary is submitted, the IRS may request some or all of the amendments for verification purposes. Governmental plans that have not been amended in a timely manner should make a submission under the IRS's Voluntary Correction Program (VCP).

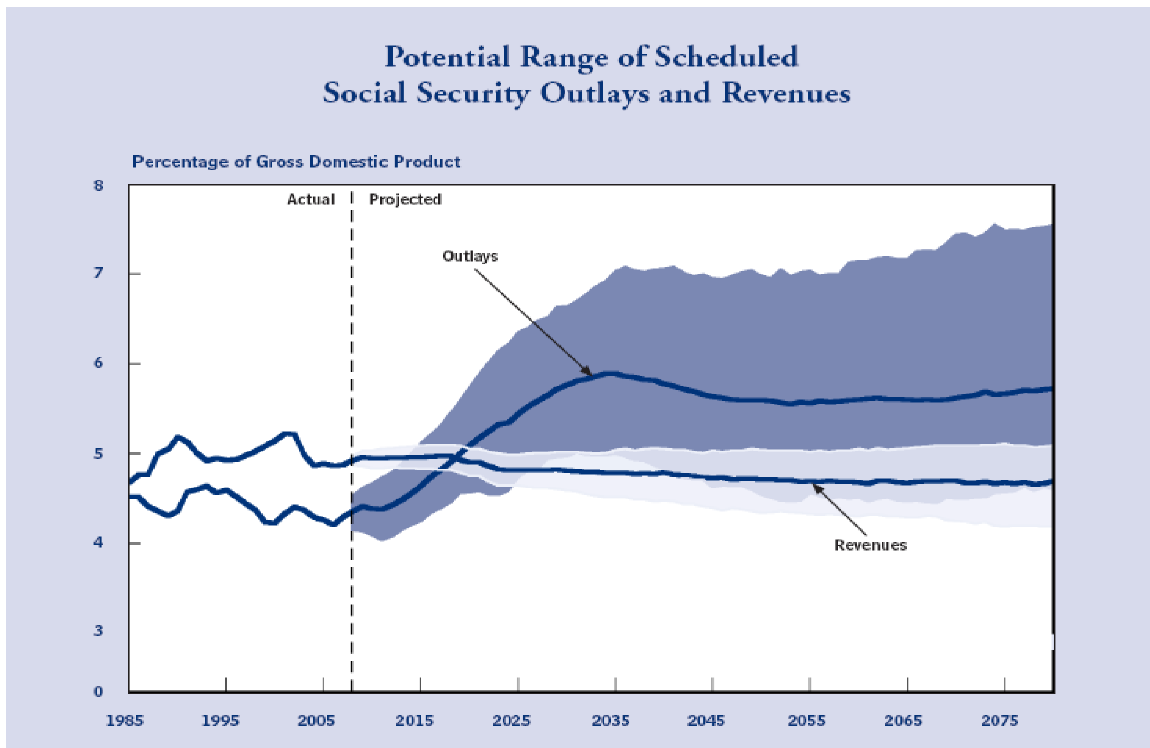
With regard to governmental plan amendments to comply with recent regulatory changes related to normal retirement age, the FAQs clarify that the IRS will not consider these changes in the Cycle C review. Since these changes are not applicable to governmental plans until plan years beginning on or after January 1, 2009, they fall outside the applicable qualification rules for Cycle C. However, the FAQs also note that governmental plans need to comply with the new regulations as of their future effective date.

The FAQs are available at: http://www.irs.gov/retirement/article/0,,id=184417,00.html

CBO Updates Social Security Long-Term Projections

On August 21, 2008, the Congressional Budget Office (CBO) released its report, *Updated Long-Term Projections for Social Security,* which forecasts the funding outlook for Social Security over the 75-year period ending in 2082. According to the report, Social Security's long-range projected status has improved from last year, principally due to improved modeling of immigration trends. The number of prime-age workers (ages 20-64) whose earnings will contribute to Social Security over the period is 11% greater than projected last year. According to CBO Director Peter Orszag, "these projections assume that future immigrants will be younger and more numerous than was assumed in 2007." As a result of this and other factors, CBO extended the projected date for depletion of Social Security's trust fund from 2043 to 2049. Once the trust fund is exhausted, CBO projects annual revenues would be sufficient to fund 84% of promised benefits, falling to 81% by 2082.

The figure below shows the potential ranges of scheduled Social Security outlays and revenues as a percentage of gross domestic product (GDP) from 2008 to 2082. As shown by the dark lines, the CBO projects that outlays will begin to exceed revenues in 2019. The shaded areas in the figure indicate the 80% range of uncertainty around projected outlays and revenues based on a distribution of 500 simulations. In addition, there is a 10% chance that expected outcomes will be above the range and a 10% chance they will be below the range.



Source: Congressional Budget Office

The CBO estimates that Social Security's 75-year shortfall will be 0.38% of GDP, or 1.06% of taxable payroll. If payroll taxes were increased immediately and permanently by 1.06%, from the current 12.40% of payroll to 13.46%, the program could remain solvent over the 75-year projection period. While these estimates are based on long-term projections that are necessarily uncertain, the report states the general conclusions would hold up under a broad range of assumptions.

The CBO report is available at: http://www.cbo.gov/ftpdocs/96xx/doc9649/08-20-SocialSecurityUpdate.pdf

GASB Issues Proposed Guidance for Determining the ARC Adjustment

On July 17, 2008, the Governmental Accounting Standards Board (GASB) issued a proposed technical bulletin, offering guidance on calculating the annual required contribution (ARC) adjustment for pensions and other postemployment benefits (OPEB).

Generally, GASB Statement No. 27 (GASB 27) requires governments that sponsor pension plans to report the annual pension cost (APC) in their annual financial report.[1] The APC is equal to the actuarially determined annual required contribution (ARC), if the government has contributed 100% of past ARCs. However, if the government has contributed less than 100% of past ARCs, the APC is increased to include one year's interest on the deficient contributions. In addition, an "ARC adjustment" is made to the APC in order to offset any adjustment to the current ARC made by the actuary to amortize the contribution deficiency (otherwise this would be double-counted in the APC). However, because the exact ARC adjustment may not be known, GASB 27 allows it to be approximated using amortization factors. Similar adjustments are required under GASB Statement No. 45 (GASB 45) related to OPEB costs for governments sponsoring OPEB plans.

The proposed technical bulletin clarifies the requirements of GASB 27 and 45 in situations where the actuary's calculation of the ARC adjustment is known. As explained in the technical bulletin, the ARC adjustment is intended to avoid misstating the annual pension (or OPEB) cost and maintain consistency between actuarial and accounting measurements presented in financial reports. According to the technical bulletin, when the actual ARC adjustment is known, rather than approximated, use of the actual amount is encouraged.

In a recent statement, GASB Chairman Robert Attmore urged state and local governments to accommodate the use of actual amounts. Since many governments are currently obtaining their first OPEB actuarial valuations in accordance with GASB 45, they have the opportunity to separately track the ARC adjustment. The technical bulletin will become effective for financial statements for periods ending after December 15, 2008.

The proposed technical bulletin is available at: http://www.gasb.org/exp/prop_tb_2008-a.pdf

CRR Posts State and Local Pension Data for Defined Benefit and Defined Contribution Plans

On August 4, 2008, the Center for Retirement Research (CRR) at Boston College posted two data sets related to state and local government retirement plans on its web site. The first data set, referred to as the Primary Defined Contribution Plan Database, provides data for 20 state-administered defined contribution plans and plans that combine both defined benefit and defined contribution components. It includes information about the number of plan members, types of covered employees, employer and employee contributions, asset values, and general asset distributions. It also includes a codebook defining the applicable variables, along with a section identifying inconsistencies in the data.

The second data set, covering Defined Benefit Plans, includes information on 126 defined benefit plans largely administered by individual states. It includes information on plan participants, governance, finance and investments. The pension data is coordinated with the NASRA/NCTR *Public Fund Survey* which is published separately. CRR expects to update both data sets on an annual basis. Later this year, CRR also expects to release data for a sample of municipal pension plans.

The data sets are available at: http://crr.bc.edu/frequently_requested_data/state_and_local_pension_data.html

[1] This discussion applies to state and local governments sponsoring single-employer or agent multiple-employer pension or OPEB plans. However, it does not apply to governments sponsoring cost-sharing multiple-employer pension or OPEB plans. Further information about plan definitions may be found in GASB 27 and 45.

Report Examines Issues Related to Measuring Retiree Health Care Liabilities

In July 2008, the Center for State and Local Government Excellence released its issue brief: *Financing Retiree Health Care: Assessing GASB 45 Estimates of Liabilities*, written by Dr. Robert L. Clark, Professor of Economics and of Management, Innovation and Entrepreneurship at North Carolina State University. As provided under Governmental Accounting Standards Board Statement No. 45 (GASB 45), public-sector employers that sponsor retiree health care plans are required to determine and disclose the associated actuarial accrued liabilities and required contributions in their financial reports. The brief examines a number of issues related to measuring these retiree health care liabilities including: potential changes in plan design, selecting an appropriate discount rate, and projecting health care cost trends.

Although GASB 45 requires the valuation of health care liabilities to be based on current plan provisions, a variety of possible future changes in plan design could affect future valuations. Clark points out that most health care plans are altered regularly to control costs by increasing premiums, deductibles, and co-pays. In addition, future federal changes in Medicare or the adoption of national health insurance could change the benefits provided by the plans. Clark suggests that state and local governments may be delaying major changes in retiree health plans due to these future uncertainties.

GASB 45 also requires state and local governments to calculate plan liabilities associated with the promised benefits using a discount rate consistent with the investments expected to finance the benefits. Consequently, if the benefits are paid from the government's general fund, the assumed discount rate would reflect the general fund's investments, which are typically in short-term, fixed-income securities (e.g., 4%). However, if the benefits are paid from a trust fund invested in a diversified portfolio (and all required contributions are made to the trust), the discount rate would reflect the returns of the diversified portfolio (e.g., 8%). Since state and local government retiree health care benefits have largely been paid from general funds, most actuarial valuations calculate liabilities using the lower discount rate assumption. In addition, the valuations also show what the liabilities would be if the larger discount rate assumption were used. The brief presents the resulting actuarial liabilities and discount rates for 18 state plans.

Health care cost inflation is another important assumption used to project the future benefit costs. The Bureau of Labor Statistics reports that medical care inflation has typically been about twice the annual increase in the general Consumer Price Index. Therefore, the cost of providing health benefits for workers and retirees has escalated significantly. The brief notes that almost all the available actuarial reports for state retiree health care plans assume medical inflation will decrease from the current 10-14% per year to about 5%. However, the brief points out that if the medical care inflation rate were to continue at the current rate, the projections of actuarial liabilities and required contributions would be significantly higher.

The issue brief is available at: http://www.slge.org/

Note: Clark also discusses the current debate between advocates of financial economics and conventional actuarial approaches for calculating plan liabilities. Proponents of financial economics argue that pension and retiree health liabilities should be calculated in a manner similar to bond pricing. See the April 2008 issue of *GRS Insight* for a more detailed comparison of financial economics and conventional valuation approaches at: http://www.gabrielroeder.com/news/pdf_insight/insight2008_04.pdf.

EBRI Finds HSAs Insufficient for Funding Individual Retiree Health Costs

On August 7, 2008, the Employee Benefit Research Institute (EBRI) published its report: *Saving for Health Care in Retirement: The Use of Health Savings Accounts.* Health savings accounts (HSAs) are tax-favored individual accounts that can be used to accumulate funds to cover health insurance premiums and out-of-pocket expenses for health care services. According to proponents of HSAs, such accounts can also serve as a vehicle for funding an individual's future retiree health care costs. However, according to EBRI, the maximum amount

that can accumulate in an HSA will likely be insufficient to fully cover retiree health insurance premiums and related out-of-pocket expenses.

The maximum annual HSA contribution in 2008 is $2,900 for individual coverage and $5,800 for family coverage, with future annual contributions indexed for inflation. Consequently, due to these statutory limits, HSAs will likely accumulate insufficient amounts to pay health care costs during retirement. For example, an individual age 55 who contributes $2,900 annually to an HSA could accumulate $59,000 after 10 years (assuming catch-up contributions are made). However, this is meager compared to the costs of individual health care premiums and expenses throughout retirement, estimated at about $376,000 on a present value basis.

The report also identifies other significant disadvantages related to HSAs including:

- **HSA qualification:** In 2008, to qualify for tax-free contributions to an HSA, individuals must be covered by a high-deductible health plan (HDHP) with an annual deductible of at least $1,100 for individual coverage and $2,200 for family coverage.
- **Distribution rules:** Distributions from HSAs cannot be used for employment-based retiree health insurance until an individual attains age 65. Therefore, early retirees may not use them to pay retiree health care premiums before age 65.
- **Use of HSA assets before retirement:** Individuals will likely use their HSA account to pay medical expenses during their working years, and may pay COBRA premiums and insurance premiums during periods of unemployment. These distributions will reduce the account's value and make it difficult to accumulate adequate savings for health expenses in retirement.

According to EBRI estimates, a 55-year old man in 2008 would need to save about $132,000 to $261,000 (depending on prescription drug utilization) when he retires at age 65 to have a 50% chance of accumulating sufficient assets to pay health insurance premiums and related out-of-pocket expenses throughout retirement. Using an HSA, he would only be able to save between 23% and 45% of the necessary amount. Moreover, if he wanted to have a 90% chance of having sufficient assets by age 65 to cover health care premiums and expenses, he would need to save between $266,000 and $555,000. An HSA would only allow him to save between 11% and 22% of the necessary amount.

In addition, since women live longer than men, they need even greater savings, but would be unable to save more in an HSA due to the statutory limits. According to EBRI, a 55-year old woman would need about $181,000 to $364,000 when she retires at age 65 to a have a 50% chance of paying for health care premiums and expenses throughout retirement. Her HSA would only allow her to save between 16% and 33% of the targeted amount. To have a 90% chance of saving sufficient assets to cover premiums and expenses, she would need between $308,000 and $654,000 by age 65. Her HSA would only allow her to save between 9% and 19% of the targeted amount.

The report is in the August 2008 *EBRI Notes* at: http://www.ebri.org/pdf/notespdf/EBRI_Notes_08b-20081.pdf

EBRI Studies Employer Incentives to Delay Retirement

On July 10, 2008, the Employee Benefit Research Institute (EBRI) released its *2008 Recent Retirees Survey Report*. The report identifies employer policies that may help to encourage employees to delay retirement. The study was conducted by EBRI in conjunction with Mathew Greenwald & Associates, Inc. using an online survey of over 5,000 aerospace and defense industry workers between the ages of 55 and 65 who retired in 2003 or later. Based on the interview responses, the most common reasons for retirement include:

1) Retirement becomes affordable;
2) Lack of job satisfaction;

3) Desire for more personal or family time; and
4) Personal health status.

According to EBRI, one of the most significant findings is that employers have only about two years before an employee's retirement to offer incentives that will delay retirement. About 63% of the surveyed retirees reported that such incentives would be most effective if offered within two years of the intended retirement date. Additionally, many retirees (61%) reported they would have favorably viewed their employer's request to postpone retirement. Interestingly, however, only 7% of the survey respondents who were actually asked to postpone retirement agreed.

In the study, EBRI examines 19 potential incentives for motivating retirees to postpone retirement. Of these, the following were rated as potentially "extremely" or "very effective" in delaying retirement by a large proportion of the respondents.

- Receiving a full pension while working part-time (50% of respondents);
- Feeling truly needed for an assignment (48%);
- Continuing full employer-subsidized health benefits while working part-time (46%);
- Receiving a partial pension while working part-time (44%);
- Being able to work seasonably or on a contract basis (38%);
- Doing more meaningful work such as teaching or mentoring (36%);
- Receiving an increased salary (33%).

The survey report is available on EBRI's web site by searching for *Issue Brief No. 319* at: www.ebri.com

Massachusetts Commission Recommends Funding the State's OPEB Liabilities

On August 5, 2008, a Massachusetts special commission issued its report on funding the state's retiree health liabilities, estimated to be $13.3 billion. The commission recommended that the state allocate an additional $200 million per year over 20 years, which would effectively reduce the liabilities to $7.5 billion. Currently, the state's retiree health benefits are financed on a pay-as-you-go basis, with the state paying approximately $400 million per year. Additionally, state employees who retired prior to 1994 are required to pay 10% of their health insurance costs, while those who retired after 1994 pay 15%.

The seven-member commission was established last year and consists of the state treasurer, the governor's budget chief, the chief of the state pension fund, and four state lawmakers. The panel warned of "an increasingly unsustainable financial burden" on taxpayers and a serious threat to the continuation of retiree benefits. They cautioned that funding retirees' health care benefits may require cuts in other programs or reductions in benefits for future retirees.

As a possible source of funds, the commission suggested using revenues from a 1998 multistate tobacco litigation settlement, which currently pays the state about $300 million annually. The panel suggested allocating 25% of the annual tobacco settlement to the OPEB liability in the first year, 50% in the second year, and 90% each year thereafter until the liability is fully funded or the tobacco settlement is exhausted. They also noted that, when the state pays off its pension costs in 2026, an additional $1 billion could be available.

Separately, the commission requested approval for legislation to protect teachers' benefits by allowing municipalities to create retiree health care trust funds without individual legislative approval.

Source: BNA *Pension & Benefits Reporter*, August 12, 2008.