

## May 2006\*

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](mailto:web.admin@gabrielroeder.com) with the message "SUBSCRIBE NEWS SCAN" in the subject line. To stop receiving this publication electronically, send the message "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](http://www.gabrielroeder.com).

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### **GASB Publishes Preliminary Views Document on Accounting for Derivatives**

On April 28, 2006, the Governmental Accounting Standards Board (GASB) released its Preliminary Views (PV) document regarding proposed new accounting and financial reporting standards for derivative securities. Typically, the GASB issues a PV when the topic is sufficiently complicated to warrant additional discussion before the proposed standards are presented in an Exposure Draft. Public hearings on the PV have been set for June 21, 2006 in San Diego and July 10, 2006 in New York City.

The PV reflects the GASB's concerns about the increasing use of derivatives by state and local governments, the complexity of these transactions, and their relatively limited disclosure. While derivatives can be useful financial tools, they can also expose the government to significant risks. Although the definition of derivatives varies, the GASB defines them as financial arrangements that (1) require little or no initial payment from a government, (2) can be settled early with a cash payment or the transfer of an equivalent asset, and (3) are based on an entirely separate transaction, agreement, or rate. Derivatives can be used as an investment, as a way to lower borrowing costs, or as a way to reduce (or "hedge") the financial risk of outstanding assets, liabilities, or expected transactions. Examples of derivatives include, but are not limited to:

- **Interest rate locks** – agreements allowing a borrower to issue debt at a specific interest rate on a future date;
- **Futures contracts** – agreements to buy or sell a commodity or product at a specific price on a future date;
- **Interest rate swaps** – such as agreements allowing a borrower to effectively obtain a fixed interest rate on variable rate debt by paying a third party to absorb the risk of rising interest rates.

The PV extends a 2003 GASB technical bulletin that required governments to disclose the value of their derivatives in the notes to their financial statements. In the PV, the GASB now proposes:

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- The fair value of derivatives be reported as assets or liabilities on the government's balance sheet (e.g., the statement of net assets). Fair value would be measured either as the derivative's price on the open market or the present value of its future cash flows.
- The change in the fair value of derivatives be reported as an increase or decrease in investment income on the government's change statements (e.g., the statement of revenues, expenditures, and changes in fund balances), except when the derivative is effectively used to hedge financial risk.
- If the derivative effectively hedges the risk it was created to address, then the annual changes in the derivative's fair value would be deferred and reported in the government's balance sheet as deferred increases or decreases in fair value until the derivative ends or ceases to be an effective hedge.

In addition, the GASB proposes extensive disclosures regarding the derivatives in the notes to the financial statements, including: (1) the types of derivatives held by the government and purposes they serve, (2) their significant terms, (3) their fair value, (4) explanations of any significant assumptions, (5) methods for determining the derivative's effectiveness, and (6) disclosure of the various associated risks (e.g., credit risk, interest rate risk, termination risk, market-rate risk, etc.)

The PV is available on the GASB's web site at: [http://www.gasb.org/exp/pv\\_derivatives.pdf](http://www.gasb.org/exp/pv_derivatives.pdf)

The GASB's plain-language summary is at: [http://www.gasb.org/exp/derivatives\\_plain-language.pdf](http://www.gasb.org/exp/derivatives_plain-language.pdf)

### **Public Pension Financial Forum Announces October Conference**

The Public Pension Financial Forum (P<sup>2</sup>F<sup>2</sup>) has announced that its 2006 Annual Professional Development Conference will be held October 8-11 at the Hyatt Regency Savannah hotel in Savannah, Georgia. P<sup>2</sup>F<sup>2</sup> is an organization of public finance professionals dedicated to promoting excellence in the financial operations of public pension plans, providing educational programs for members, and promoting the exchange of ideas regarding current financial issues affecting governments.

Conference speakers will address a variety of topics, including: (1) new accounting rules related to governmental pensions, other postemployment benefits and investments; (2) internal controls and audits, (3) changes to federal tax laws and regulations, (4) actuarial methods and assumptions, and (5) methods for stabilizing pension plan contribution rates, among others.

Additional information about the conference is available on the P<sup>2</sup>F<sup>2</sup> web site at: <http://p2f2.org>.

### **CBO Reports New Government Withholding Requirement Is an Unfunded Mandate**

On May 17, 2006, President Bush signed into law the Tax Increase Prevention and Reconciliation Act of 2005 (H.R. 4297, P.L. 109-222). The Act includes a little-known "Government Withholding Provision" (Section 511) requiring federal, state, and local governments to withhold, for federal tax purposes, 3 percent of their payments to contractors for property and services purchased by the government. The provision is intended to reduce the extent to which government contractors are able to avoid federal taxes. The provision becomes effective January 1, 2011.

Payments subject to the 3 percent withholding include all payments by governments to any person providing property or services to the government, with certain exceptions. Payments **not subject to the new withholding provision** include:

- Payments made through a federal, state, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test;

- Wages or any other payment with respect to which mandatory or voluntary withholding applies under present law (with limited exceptions); and
- Certain other payments (e.g., payments of interest, payments for real property, and payments to tax-exempt entities, foreign governments, or pursuant to classified or confidential contracts).

The provision exempts political subdivisions and instrumentalities of States with less than \$100 million in annual expenditures for property and services that would otherwise be subject to withholding under this provision.

The provision was not included in the House or Senate versions of the Act and was inserted during the conference agreement negotiations. The Congressional Budget Office (CBO) reports that the new withholding requirement constitutes an unfunded mandate on state and local governments under the Uniform Mandates Reform Act. Senator Larry Craig (R-ID) has introduced legislation to repeal the provision (S. 2821) stating: "Reporting requirements are already in place for government contractors. All this does is buck the IRS's collection responsibilities to the taxpayers." The provision is estimated to raise federal tax revenues by \$7 billion over 10 years.

The Senate Finance Committee's description of the provision is at:  
<http://finance.senate.gov/press/Gpress/2005/prg052506c.pdf>

The CBO's analysis is at: <http://www.cbo.gov/ftpdocs/71xx/doc7198/hr4297conf.pdf>

### **Social Security Trustees Release 2006 Report on Program's Financial Condition**

On May 1, 2006, the Social Security Board of Trustees issued their annual report on the program's financial and actuarial status. The trustees announced that in 2017 benefit payments and administrative expenses are expected to exceed Social Security's tax revenue. This will mainly be due to the rapid increase in the number of baby boomers who will leave the workforce and begin receiving benefits. Initially, interest on the trust fund assets will be sufficient to cover the shortfall, but beginning in 2027, government securities held by the trust funds would need to be redeemed to generate sufficient cash to pay benefits. The report projects that Social Security's trust fund reserves will be exhausted by 2040, one year earlier than indicated in the 2005 report. After 2040, Social Security will be able to pay only 74 percent of scheduled annual benefits.

The Trustees' Report presents Social Security's financing shortfall in dollar terms, as well as a percent of either taxable payroll or gross domestic product (GDP). Traditionally, Social Security's unfunded obligation has been measured over a 75-year period. The projected actuarial deficit in Social Security's trust funds is \$4.6 trillion (\$600 billion higher than estimated last year) when measured over the next 75 years and \$13.4 trillion when measured on a perpetual basis. Expressed in relation to the GDP, the annual cost of Social Security benefits is projected to increase from 4.3 percent of GDP in 2006 to 6.2 percent in 2030, and 6.3 percent in 2080.

In the 2006 report, several assumptions were revised reflecting economic and demographic factors that affect Social Security's financial condition. First, the ultimate real interest rate (excluding inflation) assumed for investments was lowered from 3.0 percent to 2.9 percent. Typically, the lower the interest rate, the less income the Trust Fund will earn on its bonds. This change increased the program's actuarial deficit and unfunded obligations. Second, the projections also reflect a slightly higher assumed birth rate (increased from 1.95 children per woman in 2005 to 2.00 in 2006). This results in a projection of slightly more workers whose payroll taxes would help to support Social Security beneficiaries. Third, the projections reflect a slight rise in the assumed ultimate productivity growth (increased from 1.6 percent per year to 1.7 percent). The net result of the changes in assumptions, methods, and long-range valuation period increased the 75-year actuarial deficit from 1.92 percent of taxable payroll in 2005 to 2.02 percent in 2006.

Under current law, Social Security's annual cost will likely grow faster than the program's income due to the aging of the baby-boom generation, expected continuing low fertility, and increasing life expectancy. In order for Social Security to remain solvent throughout the 75-year projection period, the trustees indicated that some alternative changes to the program may include:

- Raising the combined employee-employer payroll tax rate immediately by 2.02 percentage points from the current 12.40 percent to 14.42 percent;
- Reducing benefits for all current and future recipients immediately by 13.3 percent on a permanent basis;
- Transferring general revenues equivalent to \$4.6 trillion (in present value) during the period; or
- Adopting some combination of approaches.

The trustees urged that the trust fund deficits be addressed soon in order to gradually phase-in the necessary changes and protect future generations.

The 2006 Social Security Trustees' Report is available at: <http://www.ssa.gov/OACT/TR/TR06/tr06.pdf>

### **Medicare Trustees Release 2006 Report on Financial Status of Medicare Funds**

On May 1, 2006, the Medicare Trustees released their annual report on the financial status of the Medicare funds. According to the trustees, Medicare's long-term liability, based on a 75-year actuarial projection, is estimated to be \$32.4 trillion. Of that amount, \$8 trillion is directly attributable to the Medicare prescription drug benefit, (reduced from the 2005 estimate of \$8.7 trillion due to lower than projected drug costs and slower rates of enrollment). Total annual Medicare expenditures, which were \$336 billion in 2005 or 2.7 percent of Gross Domestic Product (GDP), are expected to grow to 3.2 percent of GDP in 2006, 6.5 percent in 2030, and 11.0 percent in 2080.

The Medicare program consists of two component programs for the elderly and disabled: Hospital Insurance (HI) and Supplementary Medical Insurance (SMI). The HI program (Medicare Part A) pays primarily for inpatient hospital care and is financed by a payroll tax of 1.45 percent of taxable earnings. The SMI program consists of Medicare Parts B and D. Part B is a voluntary program that pays for physician, outpatient hospital, home health, and other services. Part D is a voluntary program providing access to outpatient prescription drug benefits. Approximately one-quarter of the SMI program is financed by beneficiary premiums, with the remainder financed by transfers from the U.S. Treasury's general fund.

According to the Trustee's report, the financial status of the HI Trust Fund has deteriorated significantly, and is projected to be insolvent in 2018, two years earlier than projected in 2005. After the HI Trust Fund is exhausted, payroll tax revenues would cover only 80 percent of projected HI expenses in 2018. The drop in solvency is due to:

- Slightly higher hospital costs in 2005 than previously estimated; and
- Upward revisions in the short-range assumptions regarding the utilization of HI services.

The financial outlook for the SMI program is better than for the HI program, although rapid expenditure growth remains a serious issue. For both Part B and Part D, revenues are projected to equal expenditures for all future years, but only because beneficiary premiums and general revenue transfers must, by statute, be increased to meet expected costs for each year. However, the rapid growth of health care costs is expected to greatly accelerate the need to finance these benefits.

In an effort to address Medicare's long-term financial challenges, the Medicare Modernization Act created new tools to monitor the program, such as the "45-percent threshold." Under this provision, the annual trustees' report is required to include an estimate of the year in which general revenues will account for more than 45 percent of Medicare funding. If the projections in two consecutive trustees' reports indicate that general revenue financing will exceed 45 percent of total Medicare expenditures within the next seven years, the President is required to propose legislation in the next budget to address the issue by recommending options to reduce this percentage.<sup>1</sup> Some of the options would include decreasing expenditures (e.g., cutting benefits, delaying eligibility, or reducing provider payments), increasing revenues (e.g., raising payroll taxes, or raising beneficiary premiums), or some combination of the two. Congress could then implement the administration's recommendations, but it not required to do so.

The 2006 Trustees' Report is the first that projects the 45-percent threshold will be reached within the next seven years, i.e., 2012. A second such finding in next year's report would trigger a "Medicare funding warning" and require the President to respond with proposed legislation.

The report is available on the CMS web site at:

<http://www.cms.hhs.gov/ReportsTrustFunds/downloads/tr2006.pdf>

### **CMS Publishes Medicare Rights and Protections Booklet**

On May 8, 2006, the Centers for Medicare and Medicaid Services released an online publication titled *Your Medicare Rights and Protections*. The booklet outlines various Medicare programs such as the traditional plan, health plans, supplemental insurance policies, and new prescription drug benefit. Information is also provided about obtaining emergency care, discrimination protections, and instructions for filing a complaint or appealing a decision on benefit claims.

The booklet is available at: <http://www.medicare.gov/Publications/Pubs/pdf/10112.pdf>

### **NCSL Reports on 2005 State Pension and Retirement Plan Legislation**

The National Conference of State Legislatures (NCSL) issued a report on the major state pension and retirement plan legislation enacted in 2005. The summary focuses on all states that held regular legislative sessions. In 2005, the broadest concern for state legislatures was the long-term security of defined benefit plans which resulted in various issues being covered including:

- Increases in employer and employee contribution levels;
- Reductions in benefits; and
- Modification of service purchase provisions to ensure purchasers bear the full cost.

Other policy issues that were frequently addressed included early retirement incentives, funding, governance and investment policy, and re-employment after retirement. The report, prepared by Ronald Snell of NCSL, is organized by topics and summarizes the legislation enacted by state. A copy of the report is available at the NCSL website at: <http://www.ncsl.org/programs/fiscal/pensun05.htm>.

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<sup>1</sup> A determination of "excess general funding" is triggered when two consecutive trustees' reports indicate that the difference between Medicare expenditures and dedicated financing sources (HI payroll taxes, HI share of income taxes on Social Security benefits, Part D state transfers and beneficiary premiums) exceeds 45 percent of Medicare expenditures within seven years of the projection.

## **Maryland Governor Signs Bill to Increase State Employees' Retirement Benefits**

On April 25, 2006, Maryland Governor Robert L. Ehrlich, Jr. signed legislation (H.B. 1737) to enhance retirement benefits for members of the Employees' Pension System and Teachers' Pension System who will retire on or after July 1, 2006. Under the new Alternative Contributory Benefit Selection, the law increases the normal service retirement benefit multiplier from 1.4 percent to 1.8 percent of an employee's average final compensation for service credited from July 1, 1998 forward. Participation in the new benefit is automatic for state employees and teachers. Participation may be elected by the local governmental units that participate in the state pension plans, provided the election is made prior to June 30, 2007. The state's estimated cost for the benefit increase is \$120 million in fiscal year (FY) 2007. To help pay for the expanded benefits, the law increases employee contributions by one percent of pay per year, from 2 percent in FY 2006 to 5 percent after FY 2008, for employees receiving the enhanced benefits.

H.B. 1737 is available at: <http://mlis.state.md.us/2006rs/billfile/HB1737.htm>

## **Michigan Governor Unveils Major Health Care Initiative**

On May 11, 2006, Michigan Governor Jennifer Granholm discussed the details of a proposed state health care plan designed to cover 1.1 million residents who are currently uninsured. The Michigan First Health Care Plan is intended to expand health care coverage at more affordable costs by:

- Creating a private market health care product for individuals and businesses;
- Subsidizing care for low-income citizens;
- Creating incentives for businesses to offer coverage for employees; and
- Reducing the overall cost of health care by expanding technology and promoting healthy lifestyles.

The program would require legislative approval and be funded with \$400 million in community mental health money and a \$600 million federal match. To implement the program by April 2007, the state will apply for a federal Medicaid waiver by year end which would allow redirecting existing state resources and new federal money to provide residents with health care premium assistance based on family income.

More information is available in the Health section of the State of Michigan's portal (<http://www.michigan.gov>) by selecting "Making Health Care Affordable and Accessible."