

Issue: GASB 45 and Funding for Retiree Health Obligations

How should the City address the challenge of long-term funding for retiree health?

Background:

The City of Modesto currently provides a generous retiree health benefit to most employees who retire from City service. Since 1990, most employee bargaining agreements and Council adopted policies have enabled employees to convert their accumulated sick leave, upon retirement, to retiree health coverage with substantial part of the premium paid by the City. The long-term liability arising out of these types of retiree health benefits is now being formally recognized by the Government Accounting Standards Board (GASB), with their recently finalized GASB 45 statement, dealing with post-employment benefits.

The City's program for sick leave conversion to retiree health benefits is structured on a formula. In general, the number of months that the City contributes toward retiree premiums is a function of each employee's unused sick leave hours at retirement. The dollar cost to the City for each of those months is a function of each retiree's level of coverage (single, 2-party, family) and the then current City contribution toward health premiums for active employees. As the City's contribution toward active employees increases year by year, the retirees receive parallel increases in the City's contribution for the duration of the retiree's sick leave conversion period.

It should be noted that the formula is in no way tied to the employee's pay rate. Rather, the benefit is strictly a function of unused sick leave hours, the level of retiree coverage and the City's contribution to active employee health coverage. Generally, an employee retiring with no sick leave balance will not be part of the sick leave conversion program, (although there is a provision for converting limited vacation hours for employees with little or no sick leave balances). A retiree with maximum allowable sick leave balance at retirement will be eligible for an escalating City-paid health contribution for approximately 20 years, following retirement.

The final guidelines recently issued for GASB 45 will require government agencies to make disclosures starting with the 2007-2008 fiscal year that include the costs for providing retiree health care obligations to current and future retirees, the annual cost to fund both the current and long-term portions of the liability and the amortization period and interest assumptions used for determining the cost to pay the long-term portion of the liability. While GASB 45 does not require the City to actually fund the long-term liability, the adequacy of the City's plan to address the long-term liability will be reviewed by our bond underwriters at the time we propose issuing any new debt beginning with the 2007-2008 fiscal year. It is important to note that all of the City's programs that pay full-time employee salaries share in the cost of these retiree health benefits and the long-term liability that exists.

At issue is how the City of Modesto will comply with the GASB 45 guidelines and, most importantly, how the City will address the challenge of long-term funding for retiree health. While the City is not required to make financial statement disclosures regarding the long-term

liability for retiree health obligations until the 2007-2008 fiscal year, administration had previously directed that the Comprehensive Annual Financial Report (CAFR) should include disclosures on this liability. As a result, the CAFR has included this amount for the past several years.

The City's implementation of GASB 45 will include actuarial determinations of the long-term costs (amortized for a period of up to 30 years) with an actuarial valuation needed every two years, policy determination of whether to pre-fund this obligation and consideration of alternatives to minimize the obligation in the future.

The City undertook a professional actuarial valuation in FY04-05. Based on the study's recommendation, the City budgeted at the \$3.5 million level for FY05-06. For FY06-07, retiree health will be budgeted at \$3.6 million. A new actuarial valuation will be needed prior to FY07-08, which is the official implementation date for the City's GASB 45 compliance.

Recommendations:

Staff is working with the City's auditors and financial advisors to evaluate any changes that are needed to the City's existing financial statement disclosures and the options that are available to us with respect to pre-funding the liability (as opposed to pay-as-you-go), actuarial cost methods, and amortization periods. In addition, staff anticipates working with employee associations through the meet and confer process to negotiate alternatives to the current retiree health program. Alternatives could include programs that cap or limit the City's long-term liability such as individual retiree health savings accounts operating under a defined contribution model, as opposed to the current model that is similar to the defined benefit model. Alternative program designs could also address the growing needs of retirees for more portability in their retiree health coverage.

Finance Committee Action:

Committee concurs with current funding strategy and recommends continued work to identify changes to financial statement disclosures, pre-funding of liability, actuarial cost methods, and amortization periods with periodic reports to Council as needed.