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FACT SHEET

California's Obligation for Retired State Workers' Health Benefits

What is the Governmental Standards Accounting Board?
Created in 1984, the non-profit, independent Governmental Accounting Standards Board establishes standards for accounting and reporting by state and local governments. Generally, these are the accounting standards that governmental entities use when preparing their financial statements.

The GASB comprises seven members, representing preparers and auditors of financial statements, users of financial statement, and academicians. It is an independent, private sector, not-for-profit organization whose budget is supported by contributions from states and local governments.

What is GASB 45?
GASB Statement 45 is an accounting rule released in 2004 that significantly increases the information included in government financial reports with respect to the cost of retiree health and other non-pension retiree benefits. The new accounting standard imposes rules similar to the rules that apply to reporting of liabilities for public employee pension programs.

What are Other Postemployment Benefits?
Other post-employment benefits (OPEB) are benefits other than pensions, like health and dental coverage, that are provided to retired employees, including retired public employees. State retirees can also get long-term care coverage and vision care, however, retirees pay the full cost of these benefits so they are not included in the GASB 45 requirement.

When is the disclosure requirement imposed?
Depending on their size, public entities are required to start providing the information specified by GASB 45 in financial reports for fiscal years 2007-08 through 2009-10. The State of California is required to include the information in its 2007-08 financial reports, expected in March 2009.

To whom does the disclosure requirement apply?
The requirement applies to state and local governments including school districts, as well as related entities, such as public universities and retirement plans that offer non-pension retirement benefits.

When did the state start providing health care benefits to state retirees?

- Health benefits were first provided to state employees and retirees in 1961 – the employee contribution was set at $5 per month.

- 1974 – State contribution set at 80% (employees/retirees) and 60% (dependents)
- 1978 – State contribution increased to 100% and 90% (100/90 percent amounts are based on a weighted average of premium costs for the four basic health plans with the largest employee enrollment in prior year)
- 1984 – State imposes a vesting period for eligibility for benefits for retirees
- 1989 – Vesting period extended to 20 years of service, prorated between 10 years (50%) and 20 years (100%).
- 1991 – 100/90 formula maintained for retirees, but modified for active employees to reduce the state's contribution.

Generally, employees are eligible for retirement health and dental benefits as long as they retire within 120 days of separation from state service.

How are retiree health and dental benefits paid for currently?
Currently, state retiree health benefits are paid for on a "pay-as-you-go" basis where the cost of retirees' benefits are paid as they come due. The state is expected to make payments of about $1.36 billion from direct and indirect sources (including the General Fund) for these costs in 2007-08.

What is the state's financial obligation for health and dental benefits for retirees?
The state's actuary made three estimates of the state's obligation for retiree health and dental benefits based on three different funding scenarios:

- A <u>pay-as-you-go</u> policy results in an actuarial liability of $47.88 billion, which represents the total present value of future retiree health benefits for retirees and current state employees, earned to date. Based on this liability the state has an "annual required contribution" of $3.59 billion for 2007-08. This represents the amount the state should pay annually to fund these benefits. Because the state is currently funding $1.36 billion of this annual "requirement," the state's net accounting liability for 2007-08 is $2.23 billion.

- A <u>full-funding</u> policy results in an actuarial liability of $31.28 billion. This amount is lower than the actuarial liability under the pay-as-you-go scenario because under a full-funding approach the cost of future benefits are fully prefunded. Prefunding permits the state to earn investment income on the amounts set aside to fund future benefits; these investment earnings help offset the cost of paying for future benefits. The "annual required contribution" under this approach is $2.59 billion. Because this approach would fully fund the state's obligation, there would be no accounting liability for 2007-08.

- A <u>partial-funding</u> policy results in an actuarial liability of $38.24 billion. This amount is higher than the actuarial liability under the full funding scenario because investment earnings are lower due to the lower level of annual payments, which reduces portfolio growth. This results in a smaller offset against the cost of future benefits. The "annual required contribution" under this approach is $2.98 billion. After accounting for the state's current payment plus another $620 million to achieve partial funding, this approach results in an accounting liability of $1 billion.

Note that for purposes of the actuary's estimate of the state's liability, state employee retirees include employees of the California State University system, but not employees of the University of California. UC is required to conduct its own actuarial valuation in compliance with GASB 45.

What happens if the state doesn't make the full annual required contribution?
GASB 45 does not require the state to make the full "annual required contribution." However, to the extent that the state does not make the full contribution, the amount by which the contribution falls short must be accounted for a liability in the state's financial statements. In addition, the difference between current assets available to pay these benefits and what will be needed in the future to pay for benefits is required to be disclosed in the Notes to the Financial Statements in the state's financial reporting, and used for purposes of rating the state's credit.

Moreover, to the extent that the state does not begin to set aside funds to pay for future benefits, the annual cost of these benefits will rise dramatically and consume a significantly larger percentage of available General Fund resources.

How did the actuary make the estimate of the state's liability?
The actuary used data from CalPERS to identify the relevant population of employees and retirees eligible to receive benefits. The actuary also made estimates of the number of retirees who would chose to receive benefits and per-retiree claim costs. The estimate also incorporates an assumption with respect to the trend of health care costs over time. Finally, the estimate uses different rates of return, or discount rates, to reflect the annual yield that assets used to pay for benefits will earn over time.

Is this the only estimate the state will have of its cost for these benefits?
GASB 45 requires the state to obtain an actuarial valuation of the cost of these non-pension post-retirement benefits every two years. However, the Controller intends to request another estimate to be prepared next year.

What are the advantages to prefunding these benefits?
Pre-funding sets aside funds to pay these benefits and permits these funds to generate income to help pay benefits by being invested in long-term, higher-yield strategies.

Unlike most health plans, most pension plans are prefunded. CalPERS has been prefunding pension benefits for state retirees since the program was initiated in 1932. As a result, approximately 75 percent of the current cost of pension benefits paid to retirees is now funded from earnings on the pension fund, as opposed to employee or employer contributions.

Shouldn't the state simply reduce health benefits to reduce its liability?
Even though the law in this area is developing, the state likely has limited legal flexibility to change benefits for retirees and current state employees. Any changes to benefits for new employees need to be considered through the collective bargaining process and with a view toward the impact of any changes on the state's ability to attract a qualified workforce. Moreover, any reduction in the state's cost for future benefits as a result of benefit changes for new employees would take a long time to be realized because it will be decades before these newly hired employees replace the existing and near-term population of retirees.

What is the status of other governmental entities' valuation and funding efforts?

As a result of the issuance of the GASB 45 Statement, local jurisdictions in California are generally in the process of obtaining estimates of their retiree health benefit obligations. Unlike pension benefits, which are generally prefunded, most entities have been funding health care benefits for retirees on a pay-as-you-go basis. Other states are in a similar position; many have recently received or are about to receive at least preliminary estimates of their retiree health care liabilities and are considering a variety of measures in response to these estimates.

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