

## Financial Planning For Pension and OPEB Obligations

By Carlos Diaz and Molly McGee

The screenshot shows the CSMFO News website homepage. At the top, there is a navigation bar with links for Home, Articles, CSMFO News, Advertising, and CSMFO. Below the navigation bar is a large banner for MGO Client Training. The banner features a background image of a waterfall and contains the following text: "ENHANCING ORGANIZATIONAL STRENGTH, CAPACITY & RESILIENCE", "MGO CLIENT TRAINING JULY 9TH 2020", "GASB 87 Forensic Accounting Internal Audit CARES Act / COVID-19", and the MGO logo with the tagline "THE ATYPICAL".

Below the banner, there are three main article sections:

- Diversity and Inclusion – For Finance Officers**: A featured article from June 3rd, 2020. The text discusses a discussion with a panel of professionals at the 2020 CSMFO Conference regarding diversity and inclusion (D&I).
- Where Do You Stand?**: A featured article from June 5th, 2020. The text discusses the impact of COVID-19 on pension and OPEB plans and the need for a comprehensive framework for addressing these concerns.
- President-Elect Message | May 2020**: A featured article from May 26th, 2020. The text discusses how CSMFO will adapt to the impacts of COVID-19 through 2021 and the balance between the burden of COVID-19 responses and the benefits from it.

At the bottom of the page, there are two more article sections:

- The Editor's Alley | June 2020**: A featured article from June 3rd, 2020. The text discusses the transition back to some or increased face-to-face communication and the return of CSMFO News to production starting in June.
- President's Message | May 2020**: A featured article from May 19th, 2020. The text discusses a COVID-19 Solidarity Happy Hour held on Thursday, May 14th.

## **FINANCIAL PLANNING FOR PENSION AND OPEB OBLIGATIONS**

By Carlos Diaz, ASA, EA, MAAA & Molly McGee, ASA, MAAA

Tomorrow, a year from now, or further into the future, as a financial professional, you will be questioned about the funded status of your pension and OPEB plans. How will you respond? What measures will you have taken to maintain fiscal sustainability?

In this article, we examine a comprehensive framework for addressing the increasing concerns of governmental plan sponsors in a post-COVID-19 time. Specifically, what is the potential impact on decision making given the changing nature of work, revenue and long-term investment returns? In a curious way the Michigan Public Act 202, Protecting Local Government Retirement and Benefits Act, which was signed into law in December 2017 addresses those issues.

While it remains to be seen if and how other states or local governments will adopt laws like Michigan Public Act 202 (Act), it provides a strong framework for addressing increasing concerns related to rising long-term costs, recent transparency requirements, and fulfilling benefit promises.

This article provides a brief historical context and an overview of the Act and concludes with a list of helpful considerations for all governmental plan sponsors.

### **Learning from History – Unfunded and Hidden Promises**

Studebaker of South Bend, Indiana ceased operations at the end of 1963. The defined benefit pension plan, seriously underfunded, was terminated. This may have been the signal event leading to the Employee Retirement Income Security Act of 1974 (ERISA). The tax and labor laws were promulgated at that time to establish minimum standards for pension plans in private industry.

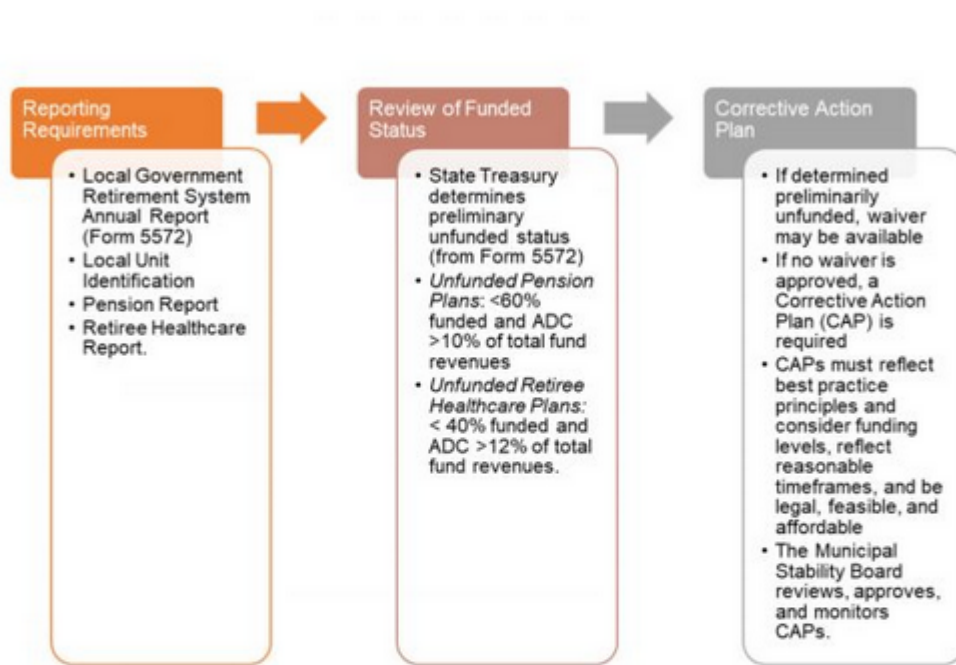
Fast forward 50 years to 2013. The City of Detroit filed for bankruptcy having amassed \$20 billion of debt. The bankruptcy was the leverage used to substantially reduced pension and postemployment benefits. Riding the wake of the bankruptcy was the creation of Michigan's Public Act 202.

And today, in the aftermath of COVID-19, the financial market indices are down 20% or more.

Considering also the recent implementation of GASB 68 and 75, which moved liabilities from the small print of footnotes to the body of your balance sheet, we highlight a changing landscape for governmental sponsored plans.

## Michigan's Public Act 202

The basic framework under Michigan's Public Act 202 includes three stages:



### Reporting Requirements

Governments that offer a retirement pension benefit plan and/or a retirement health benefit plan must file an annual report no later than six months after the end of the entity's fiscal year.

The form is completed using information from audit reports, actuarial funding valuations, system investment provider reports, and accounting records.

## Review of Funded Status

Pension Plans – A preliminary determination of underfunded status is made if:

- The plan's total assets are less than 60% of the plan's total liabilities, and
- The actuarially determined contribution (ADC) exceeds 10% of total governmental fund revenues.

Retirement Health Care Plans (OPEB) – A preliminary determination of underfunded status is made if:

- The plan's total assets are less than 40% of the plan's total liabilities; and
- The ADC is greater than 12% of total governmental fund revenues.

## Corrective Action Plan – Waivers

A local government that has been determined to be preliminary underfunded may apply for a waiver and must submit a plan approved by its governing body indicating the underfunded status is being addressed (for example, reduced benefits and/or adding additional contributions).

## Corrective Action Plan – Municipal Stability Board

A local government whose pension and OPEB plans are deemed to be underfunded (no approved waiver) are required to submit a corrective action plan (CAP) for each underfunded plan and CAP's are due within 180 days of a determination letter.

CAPs must follow best practices to sustain fiscally stable retirement programs, protect benefits for retirees, and provide high-quality public services to residents. Best practice principles include efforts to improve plan funding, reflect modern plan design, and adopt effective plan administration. These guidelines can serve as a model for all agencies to assess and strengthen retiree pension and health plans.

Plan Funding	Modern Plan Design – Pension	Modern Plan Design – Retiree Health	Effective Plan Administration
<ul style="list-style-type: none"><li>• Fund an ADC</li><li>• Fund in excess of ADC</li><li>• Transfer funds from reserves</li><li>• Establish irrevocable trust (for OPEB)</li><li>• Others.</li></ul>	<ul style="list-style-type: none"><li>• Bridged multiplier for actives</li><li>• Bridged cost of living adjustment</li><li>• Final average compensation standards</li><li>• Replace future accruals with defined contribution (DC) or hybrid</li><li>• Limit dual payment of pension and salary.</li></ul>	<ul style="list-style-type: none"><li>• Cost sharing</li><li>• Cap on employer portion</li><li>• Coordination with Medicare (65+)</li><li>• DC for new hires</li><li>• Raise eligibility age and or service</li><li>• Vesting based on service</li><li>• Others.</li></ul>	<ul style="list-style-type: none"><li>• Annual actuarial valuations</li><li>• Experience study (every five years)</li><li>• Actuarial audit by independent actuary</li><li>• Financial projections within annual valuations</li><li>• Others.</li></ul>

In addition, an approved CAP shall meet the following criteria:

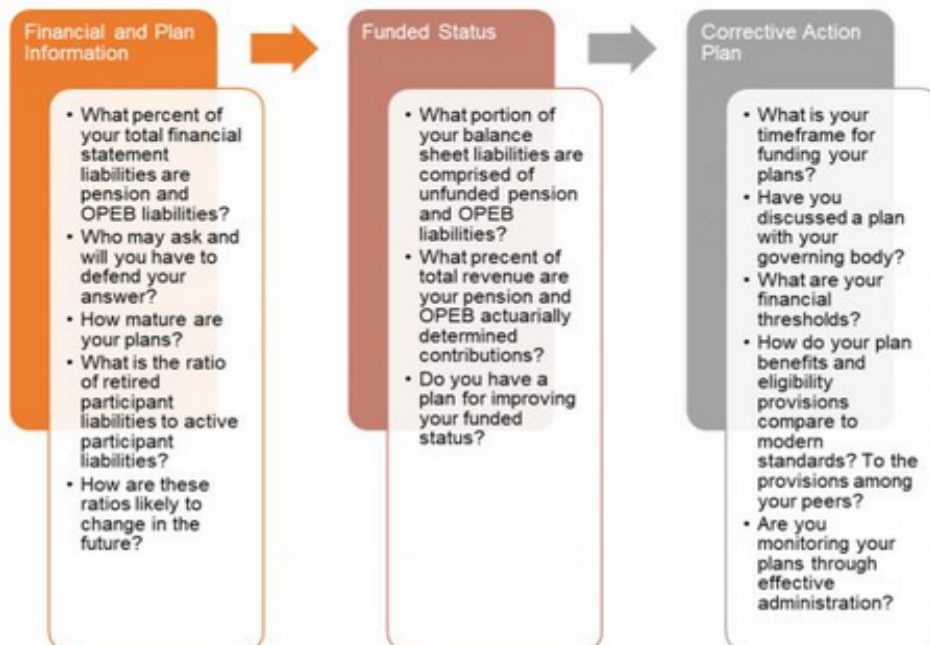
Funding Ratio	Reasonable Timeframe	Legal and Feasible	Affordability
<ul style="list-style-type: none"> <li>• Must show when Pension will attaining 60% funded status</li> <li>• When OPEB plan will attain 40% funded status.</li> </ul>	<ul style="list-style-type: none"> <li>• Pension &lt; 45% funded should reach 60% within 20 years</li> <li>• OPEB &lt; 25% funded should reach 40% within 30 years.</li> </ul>	<ul style="list-style-type: none"> <li>• Follow all local, state, and federal laws</li> <li>• Are reasonable achievable.</li> </ul>	<ul style="list-style-type: none"> <li>• Must certify that local government can continue to fund ADC</li> <li>• Meet current/future obligation without using significant portion of budget &lt;12%.</li> </ul>

## Where do you stand?

While the Michigan Public Act 202 does not apply to California agencies, it presents a comprehensive list of considerations in order to address the increasing concerns of governmental pension and retiree medical health care benefits during the changing landscape.

Be prepared for tomorrow, a year from now, or further into the future when you are asked about the funded status of your pension and OPEB plans. As Benjamin Franklin said, "By failing to prepare, you are preparing to fail." Don't fail, prepare today.

For your consideration, we pose the following questions.



## CalPERS COVID Podcast April 8, 2020

Staff carefully illustrated the 20-year employer contribution curve with various projected investment returns. Gains/losses from investments and other sources are amortized over a twenty-year period which smooths the curve.

While there is a possibility of returning to 'normal' in the near future, you may wish to be prepared with a CAP (corrective action plan) for your plans.



The authors of this work are Carlos Diaz and Molly McGee, both actuaries with DFA, LLC. They would like to hear from you regarding any questions about this article.

### **Carlos Diaz, ASA, EA, MAAA**

Mr. Diaz started his actuarial career in 1987 and joined DFA in 2017 as a senior actuary specializing in pensions and other employee benefits. He has 32 years of actuarial consulting experience serving as client manager, project manager, and actuary. His experience includes nine years with Foster Higgins and 20 years at Buck Consultants. Mr. Diaz is an applied mathematics graduate of the University of California, Los Angeles. He is an Associate of the Society of Actuaries (1993), an Enrolled Actuary (1996), and a Member of the American Academy of Actuaries (1998). He has spoken at the Western Pension & Benefits in Los Angeles and Phoenix. In his spare time, Mr. Diaz enjoys listening to music, reading and traveling.

### **Molly McGee, ASA, MAAA**

Ms. McGee started her actuarial career in 2009 working on the valuation of other post-employment benefits for a variety of public employers. Over the years she has expanded her skill set to include pension plan valuations and administration. She is an Associate in the Society of Actuaries and a Member of the American Academy of Actuaries. She enjoys consulting and learning her client's specific needs so that she can deliver the best service and product for them. When she isn't working with numbers, she enjoys spending time with family and friends in the beautiful Pacific Northwest.

Carlos and Molly may be reached at [CDiaz@dfa-actuaries.com](mailto:CDiaz@dfa-actuaries.com) and [MMcgee@dfa-actuaries.com](mailto:MMcgee@dfa-actuaries.com), respectively.

