WEDNESDAY'S
News You Can Use

All the Right Reasons *to* Fund OPEB

Presented by
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Today’s Presenters

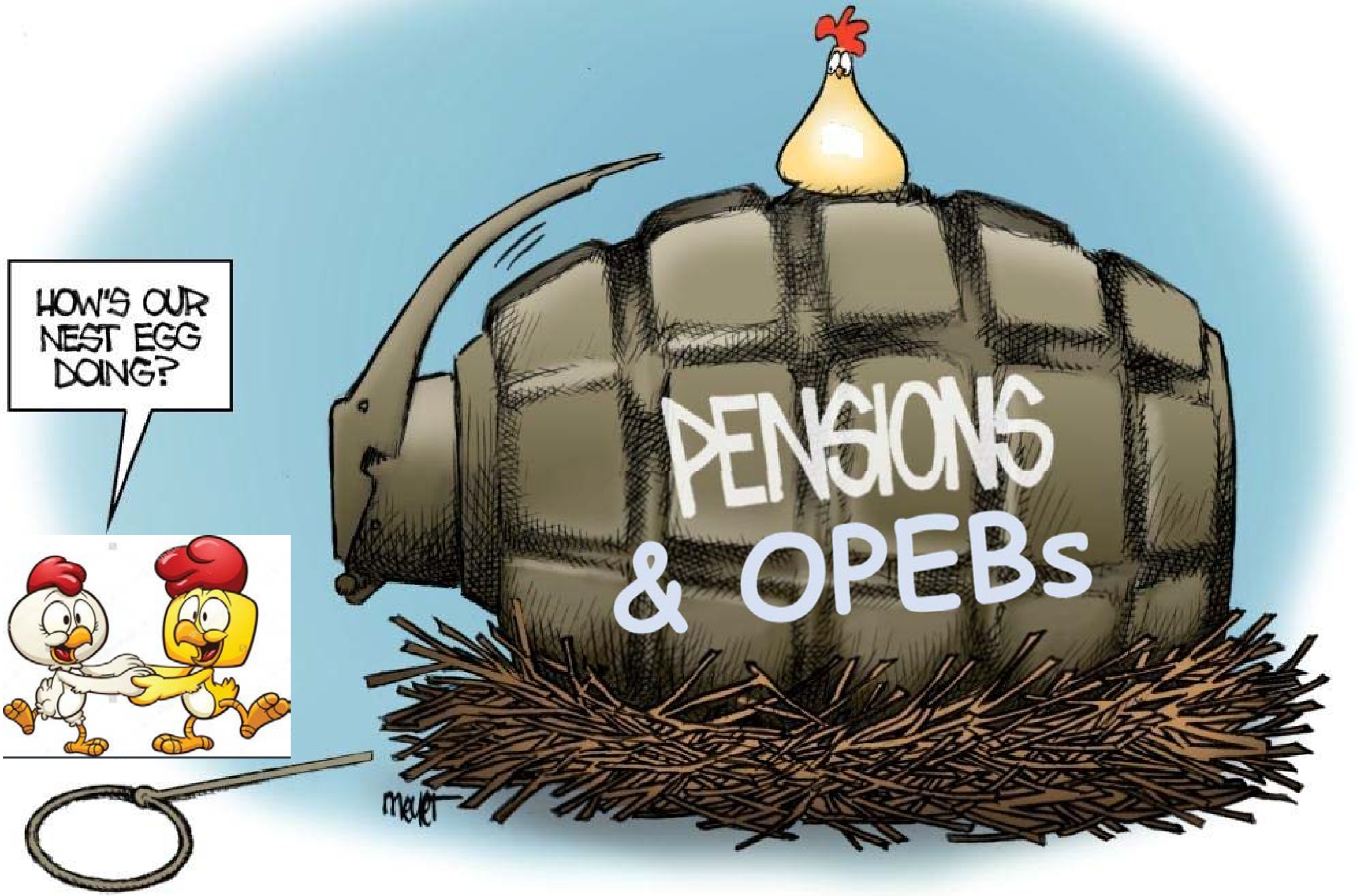
Allison Corbally is a Director with PFM Asset Management LLC. Allison joined PFM in 2017 and focuses on new business development for PFM’s multi-asset class management capabilities. Her primary focus is introducing public retirement systems, endowments, foundations, healthcare organizations and other institutions in the South region to the benefits of PFM’s multi-asset class management capabilities.

Scott Stitcher, CFA, is a Director in the Orlando office of PFM Asset Management LLC. Scott focuses primarily on providing a broad range of investment advisory and consulting services, including developing portfolio strategies; modeling cash flows; and reviewing portfolio performance and investment policy development for operating, reserve, and other post-employment benefits (OPEB) funds for local government and non-profit entities. Additionally, he shares PFM’s multi-asset class manager knowledge with hospital, higher education, endowment and foundation, and corporate clients.

Learning Objectives

At the end of this session, you should be able to:

- Define OPEB and recognize what constitutes a guaranteed benefit
- Discuss the risks of not setting dollars aside for OPEB
- Recall the differences between pay as you go funding and pre-funding an OPEB trust
- Identify trust types
- Recall methods of funding an OPEB trust
- Discuss investment considerations, equity and fixed income


HOW'S OUR NEST EGG DOING?
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Background/Impact of New GASB Rules

What is OPEB?

- Other *(than pension)* Post-Employment Benefits
  - Retiree medical, dental, vision, prescription drug, life, and long-term disability and care
- Deemed a form of deferred compensation
- Promise to provide retiree benefits *must* be accrued during the working years of employees

Background of GASB Rules

- Prior to 2004, OPEB liabilities were grossly understated on financial reports of public employers
- Purpose of GASB rules is to give a more accurate picture of the true cost of benefits promised to retirees
- "Improves transparency and comparability of state and local governments' reporting."[1]

[1] Moody's, GASB's Proposed Accounting Changes For Retiree Health Benefits Will Improve Transparency and Comparability, September 24, 2014

GASB 43/45 (2004)*

- Requirement to measure, recognize and report OPEB expenses and liabilities in a (limited) manner
- Move from **cash basis** of accounting (Pay-As-You-Go) to **accrual** (of OPEB expense over the working career)
- Measure the actuarial accrued liability (PV future benefits promised)
- Full liability is addressed in the notes and as supplemental information

* Effective dates: Phase 1: December 15, 2006. Phase 2: December 15, 2007. Phase 3: December 15, 2008.

GASB 74/75 (June 2015)*

- Replaces GASB 43/45 starting with 2018 annual financial reports
- Requires reporting net liability on financial statements
  - Plans *not* administered as a trust or equivalent arrangement – Employer reports a total OPEB liability
- OPEB expense will recognize asset and liability changes over a shorter time period
- No more "ARC." Employers must consider developing a new OPEB funding policy
- Discount rate based on a projection of how funding will cover future benefit payments of current members

*GASB 74/75 effective: June 15, 2016 for OPEB plans and for fiscal years beginning after June 15, 2017 for participating employers. RSI: Required Supplementary Information.

GASB 74/75 Impact on Financials

GASB Change	Expense Volatility	Impact on Liabilities
Unfunded liability moved from notes to balance sheet	–	↑
Accrued unfunded liability recognized immediately, not amortized	–	↑
Lower discount rate mandated for projected unfunded benefits	↑	↑
Shorter, closed amortization periods	↑	–
Pooled cost-sharing plans report allocated liabilities, expenses	–	↑
ARC requirement eliminated, funding & accounting separated	?	?

Knowledge Check

OPEB includes all but which of the following:

A. Retiree medical

B. Retiree dental and vision

C. Pensions

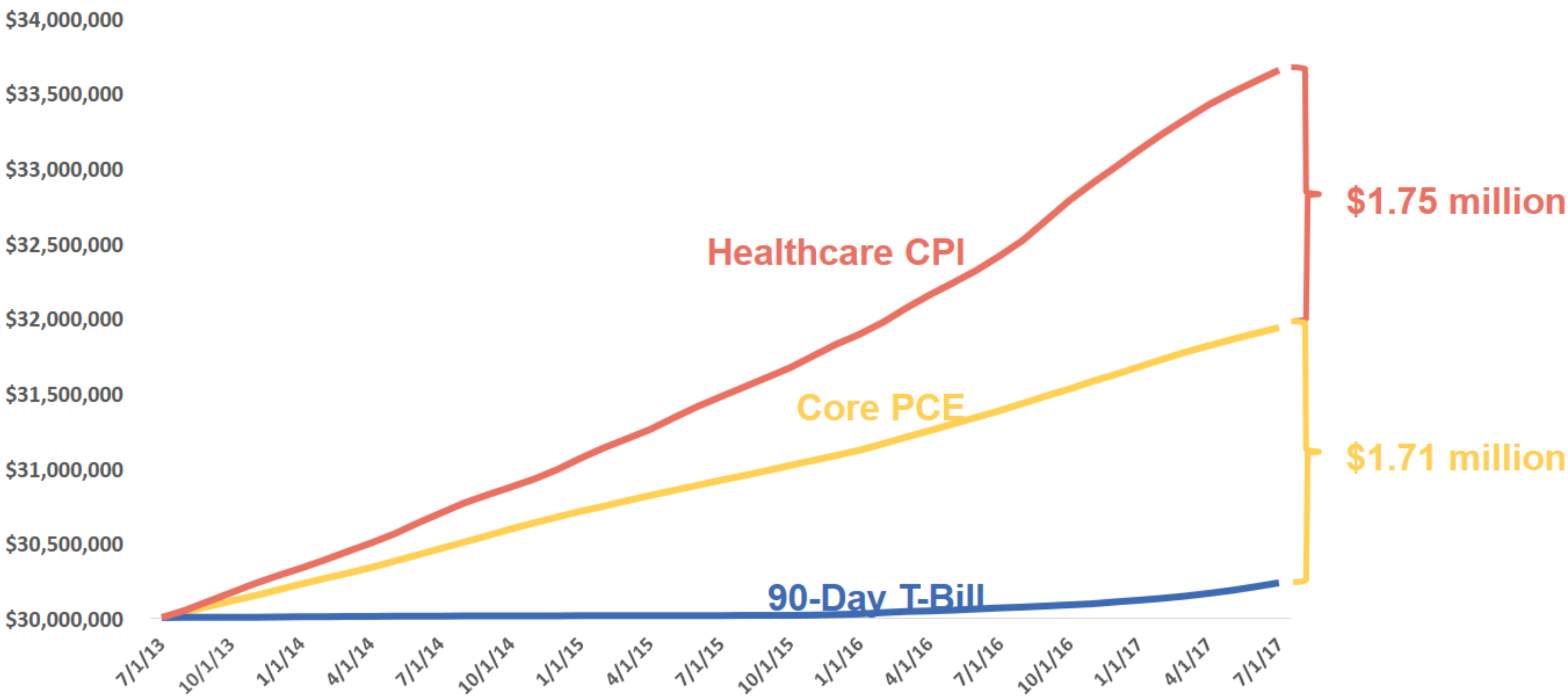
D. Long-term disability and care

Benefits of Pre-funding an OPEB Trust and Maximizing Investment Earnings

Challenges and Risks

- Healthcare inflation is higher than CPI
- Employers have no control over rising costs, future borrowing ability, overall fiscal health
- Upward revisions in Medicare age, assumed medical costs or life expectancy increases liabilities
- Pay as you go (“PayGo”) creates the highest possible liability and out-of-pocket costs
- New GASB accounting rules have increased the visibility and impact of OPEB liabilities

OPEB Liabilities Grow at Faster Rate than General Funds



Source: Bureau of Labor Statistics, Bloomberg
Calculations are based on an initial investment of $30,000,000.

Benefits of Pre-funding an OPEB Trust

- Sound and sustainable financial planning
- Outpace inflation
- Minimize total costs and liabilities over time
- Credit rating agency positive move
- No downside (other than short term market volatility)
- Access funds any time to pay OPEB benefits or expenses
- GFOA best practice[1]

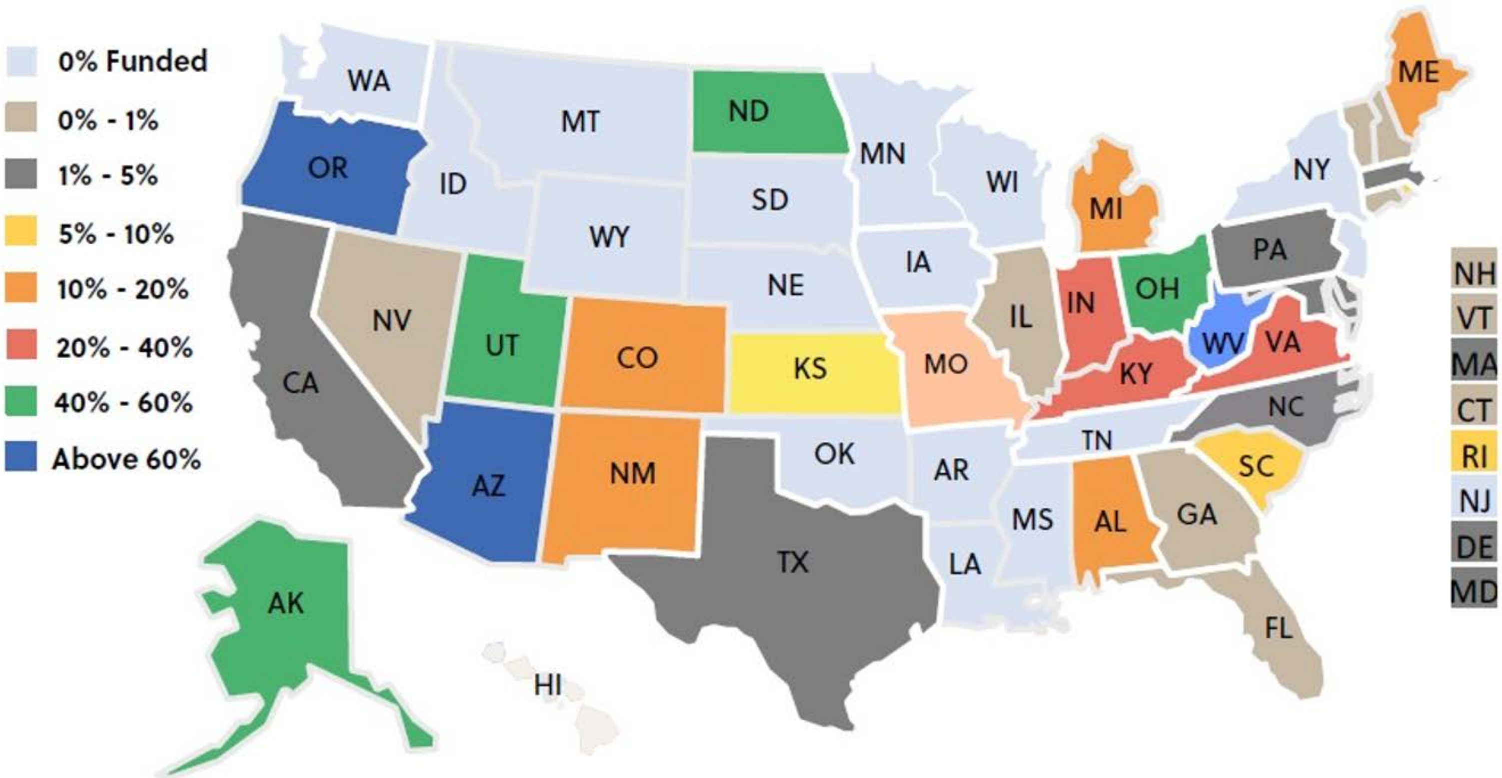
[1] http://www.gfoa.org/establishing-and-administering-opeb-trust

OPEB Funding Road Map

Determine Funding Policy → Establish Irrevocable Trust → Create Investment Fund → Ongoing Management

Determine Funding Policy

National OPEB Funding Status – State Plans



Source: Standard & Poor's 2016

Common Funding Options

- Annual budget appropriation
- Strategic funding allocation from the general fund investment portfolio
- Appropriation of a funding amount from a one-time revenue source (initial funding amount)
- A percentage of debt service savings from general fund

Pros and Cons of Common Funding Options

PAY-AS-YOU-GO

- Convenient/ low upfront costs
- Potential unsustainable liability
- Red flag to credit raters
- Concerns from constituents
- Guaranteed loss of inflation

PRE-FUNDING OPEB TRUST

- Sustainable solution
- GFOA best practice
- Lower long-term spending
- Appealing to credit raters
- Addressing inflation
- Access funds at any time
- GASB reporting benefits
- Budget commitment upfront

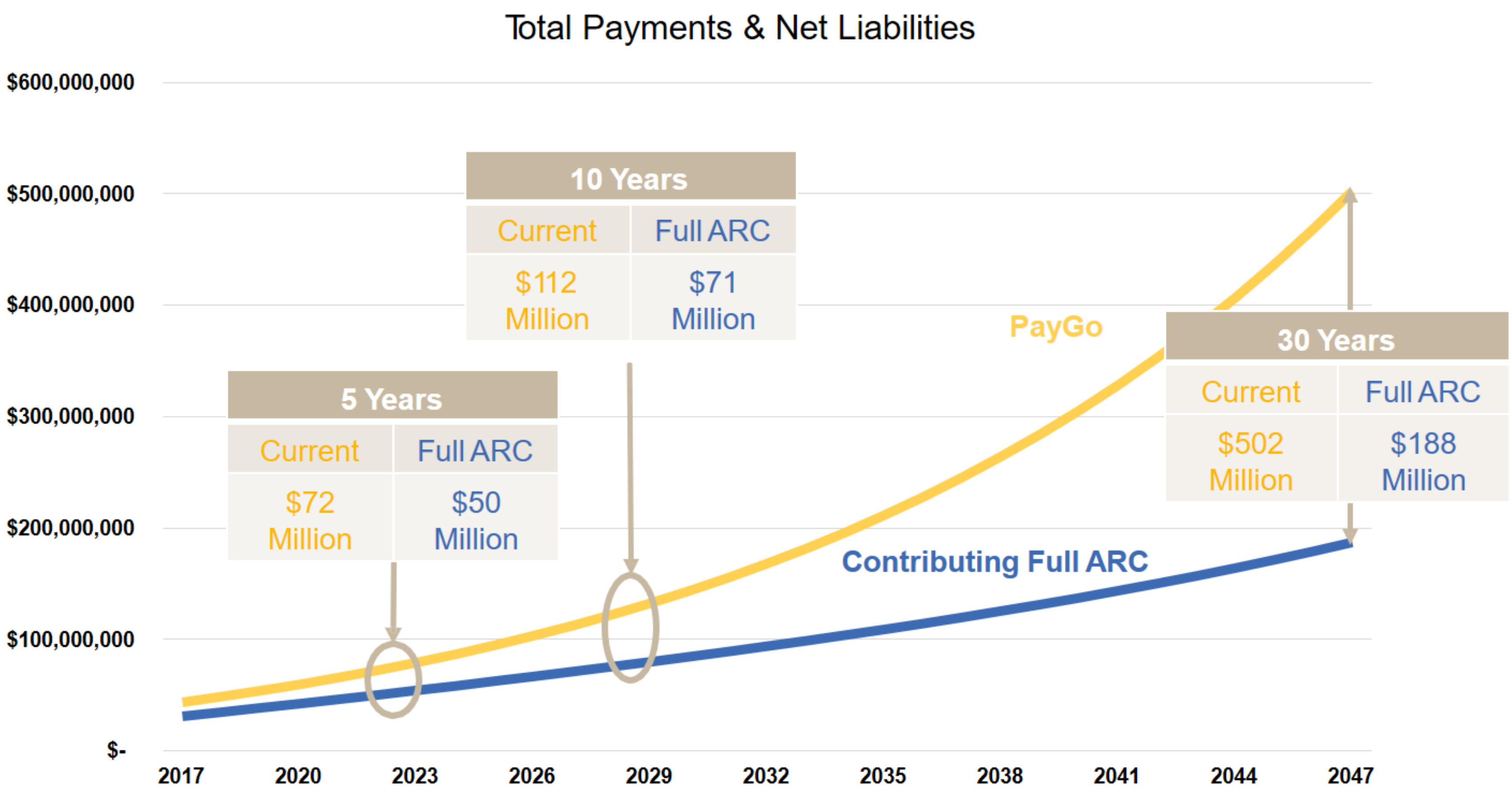
A Illustrative Example on Reporting Implications

Ex: Employer with $30 million OPEB liability and $12 million in funds to pay benefits

	Scenario 1: PayGo	Scenario 2: OPEB Trust	
Discount Rate	4.0%	7.0 %	
Actuarial Accrued Liability	$30 million	$20 million	
Market Value of Assets	$0	$12 million	
Net OPEB Liability	$30 million	$8 million	Balance Sheet
Funded Ratio	0.0%	60.0%	
Normal Cost	$1 million	$600,000	Income Statement

For illustrative purposes only. The assumed illustrative discount rates are based on GASB Statement No. 45 guidance, which ties discount rate to the source of funds used to pay benefits. The pay-go 4.0% discount rates assumes money-market type funds held by the plan sponsor. For the OPEB Trust's 7.0% discount rate, the funding source is assumed to be a mix of equities/fixed income securities

Current Plan versus Contributing Full Annual Required Payment (ARC)



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Case Study: Florida County OPEB

- County funded an OPEB Trust in 2008 and made total contributions of $21.6 million since
- Investing in a balanced multi-asset class portfolio provided an additional $15.7 million in returns

Cash Flows Since Funding
June 1, 2008 to December 31, 2017

Cumulative Contributions	Distributions	Return On Investment	Market Value As of 03/31/2017
$21.6 million	-$6.0 million	$15.7 million	$31.3 million

Assuming the difference in returns between the OPEB Trust's actual returns and an annualized rate of return of 1.39% for the 1-3 Year US Treasury Index from 07/01/2008 to 03/31/2017.

Knowledge Check

Benefits of prefunding an OPEB trust include all but which of the following:

A. Lower long-term spending

B. Addressing inflation

C. Guaranteed loss of inflation

D. Sustainable solution

Establish an Irrevocable Trust

OPEB Trust Types

	VEBA	401(h)	Section 115
Structure	Voluntary adoption by employers	Separate account under pension trust	Integral Part Trust - Governmental
No IRS Approval Required	✗	✗	✓
No IRS Annual Filings	✗	✗	✓
No Contribution Caps	✗	✗	✓
Accounting and Non-discrimination Flexibility	✗	✗	✓
Investment Earnings Non-taxable	✓	✓	✓
Benefits Non-taxable	✓	✓	✓

VEBA: Voluntary Employees' Beneficiary Association

Employer Trusts – Single vs. Multi

Single-Employer

- May be set up to accept:
  - OPEB contributions
  - Pension contributions
- Sponsored by the employer
- Offers greater customization and control:
  - Documents
  - Legal provisions
  - Distributions
- Requires creation of new trust (Trust agreement, documents

Multi-Employer

- May be set up to accept:
  - OPEB contributions
  - Pension contributions
- Sponsored by Plan Administrator and a Trustee Bank, or by two or more governments (IG coop)
- Multiple employers adopt the same trust
  - Each signs an adoption agreement to participate
  - Each has a unique account
- Offers a simplified, quick process

Create Investment Fund

Considerations for Investing the OPEB Trust Portfolio

- Operating funds are typically invested for safety, liquidity, and yield with a short-term horizon because the liquidity is needed in the short term
- Core funds can be invested longer-term for higher yield and return
- OPEB, pension, and pension related funds are at risk of losing purchasing power due to inflation and have much longer time horizons
- Equity investments provide a much better ability to beat inflation in the long-term beyond (10-years or longer)

Determining a Customized Asset Allocation

- Asset allocation is the most important investment decision and has the largest impact on performance
- When determining an appropriate asset allocation, the Entity should consider:
  - Discount rate
  - Funded status
  - Expected risk/return of asset classes
  - Governing body risk tolerances
  - Liquidity needs
  - Potential changes to benefit level

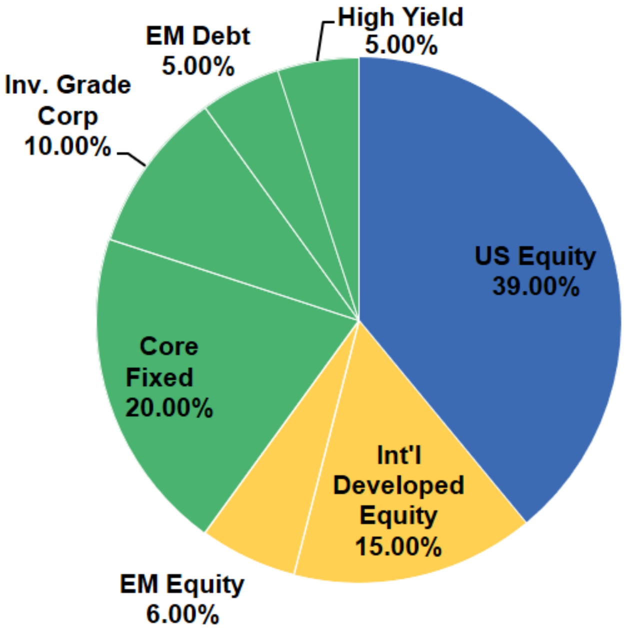
Expected Portfolio Returns – PFM 60/40 Model

Based on PFM's Capital Market Assumptions

PFM 60/40 Model Expected Return		
	Intermediate-Term Projections	Long-Term Projections
Standard Deviation	11.2%	10.6%
Return Variance	**5 Year**	**30 Year**
95th Percentile	13.9%	10.7%
75th Percentile	9.0%	8.8%
50th Percentile	5.6%	7.5%
25th Percentile	2.2%	6.2%
5th Percentile	-2.8%	4.2%
Probability of Achieving 7.0% Return	**39.4%**	**60.2%**

All returns are annualized

PFM 60/40 Model Allocation

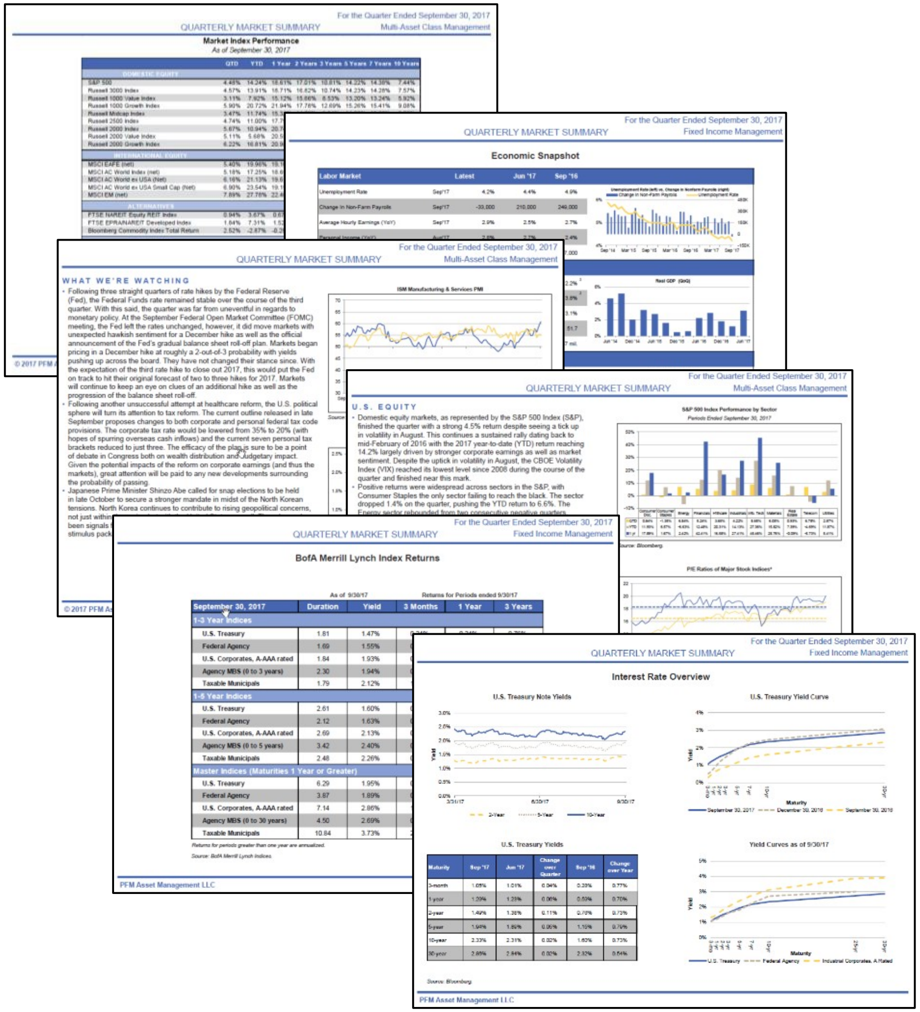


**The information provided reflects standard risk and return metrics for the portfolio depicted and are derived by running Monte Carlo simulations using PFM's Capital Market Assumptions and the strategic target asset class allocations as of the presentation date. Please refer to PFM's Capital Market Assumptions presentation for key assumptions and the methodology utilized. The "Probability of Achieving" rate of return represents the client's portfolio discount rate or target rate of return as articulated by the client. The return data is hypothetical in nature and should not be relied upon as independently verifiable information. There is no guarantee that the projected returns can or will be achieved. Results may vary with each use and over time. This material does not purport to contain all of the information that a prospective investor may wish to consider and is not to be relied upon or used in substitution for the exercise of independent judgment. Past performance is not a guarantee of future results. Prior to investing, you should consult your accounting, tax, and legal advisors to understand the implications of such investment.*

Ongoing Management

Regular Portfolio Monitoring

- **Monthly statement**
- **Monthly market review**
- **Preliminary quarterly investment report**
  - Summarizes the portfolio composition, strategy, and performance of the Pension plan
- **Quarterly investment report**
  - Financial markets review
  - Investment strategy review and plan performance summary
  - Investment manager review
- **Real-time manager and portfolio alerts**
- **Education**
  - Ongoing education for staff, board, and Trustees
  - Educational workshops and seminars
  - Timely publications covering relevant economic developments



OPEB Funding Roadmap

Determine Funding Policy	Establish Irrevocable Trust	Create Investment Fund	Ongoing Management
Determine initial funding amount Make annual required contribution each year Add in annual surpluses if available Target 60%-80% Funding Ratio	Governing body resolution / ordinance Trust administrator Trustee (bank)	Fund Oversight Committee (Investment Committee) Investment policy Asset allocation	Compliance Reporting (daily, monthly, quarterly, annually) Portfolio Rebalancing

Knowledge Check

When determining an appropriate asset allocation, you should consider.....

A. Liquidity needs

B. Funded status

C. Discount rate

D. Expected risk/return of asset classes

E. All of the above

Important OPEB Definitions

(will change with new standards)

- Pay As You Go (PAYGO)
  - Current year out of pocket claims and insurance premiums payable
- Actuarial Accrued Liability (AAL)
  - The existing liability for OPEB
- Unfunded Actuarial Accrued Liability (UAAL)
  - The existing unfunded liability for OPEB which is amortized over a period of years
- Normal Cost
  - The cost of future benefits earned by employees in the current year. Annual Required Contribution (ARC)
  - Amortized Unfunded Actuarial Accrued Liability + Normal Cost
- Net OPEB Obligation (NOO)
  - OPEB amount stated on balance sheet, cumulative ARC less qualifying OPEB assets

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QUESTIONS?

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