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GRS Insight

February 2004 • Volume 2004, Number 1

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Questions to Consider Before Issuing Pension Obligation Bonds

Interest in Pension Obligation Bonds (POBs) has grown among state and local governments in recent years, primarily due to historically low interest rates, the budgetary problems that many jurisdictions currently face, and declines in pension plans' funded ratios.

POBs are financing instruments intended to relieve the issuer of some of the annual pension contribution. POB proceeds are typically used to pay some or all of the pension plan's unfunded accrued liability (UAL) and may also include funds to pay the plan's normal costs for two or three years into the future.

In order to achieve the expected budgetary relief, the issuer hopes to invest the bond proceeds at a rate higher than the total cost of borrowing. The desired result is that the transaction reduces the annual pension contribution required to fund the plan by more than the total cost of borrowing.

POBs were originally tax-exempt borrowings. But today, due to certain provisions of the Tax Reform Act of 1986, they must be issued at taxable rates. Therefore, governments usually issue POBs at higher interest rates than they would pay for tax-exempt borrowing, making it more difficult to produce the desired result.

Some borrowers reason that issuing a POB is similar to refinancing a debt that bears a high interest rate (the pension plan's UAL) with one that bears a lower interest rate (the POB).

However, the long-term, actual investment performance of the retirement plan is what determines the final savings or cost of issuing the POB. Issuing a POB will usually produce a near-term reduction in contributions to the retirement plan, but it is not possible to know in advance whether the POB will produce any long-term savings at all.

Issuing a POB is a financial investment, and like any other, it involves investment risk. The following issues, grouped by related topics, should be considered before issuing Pension Obligation Bonds.

Investment Market Issues

1) To achieve any real saving from issuing a Pension Obligation Bond, the issuer needs to earn an investment return that exceeds the total cost of borrowing during the period the POB is outstanding. Two questions arise: Is the POB period sufficiently long to earn such an excess return? Further, what level of risk can the pension plan tolerate over this period to earn the desired return?

2) How will market performance, particularly in the short-term, affect the funded ratio of the plan? Even after issuing the POB, short-term market declines producing low or negative investment returns can cause the UAL to rise to the pre-POB level or higher.

Therefore, an employer hoping to reduce or eliminate its UAL amortization payment by using a POB may still find it owes a pension contribution (including UAL amortization payment) at the same time the POB debt payments are due. Issuing a POB does not insulate the plan

or the plan sponsor from the effects of market declines. A POB issued in January of 2000 could have looked like a losing investment by March of 2003 due to the downturn in the investment markets.

Credit Rating Issues

3) Will using POBs to pay annual pension contributions signal financial distress? In a special report issued by FitchRatings titled *Reversal of Fortune: The Rising Costs of Public Sector Pensions and Other Post-Employment Benefits,* the credit rating agency indicated it regards this use of bond proceeds as a form of deficit financing. Therefore, using POBs to pay annual pension contributions could have a negative impact on a government's credit rating.

4) Is the issuer's financial position strong enough to service the debt if the expected budget relief does not materialize? For example, budget relief may not materialize if the pension plan experiences large investment losses and/or the plan sponsor grants benefit increases while the POB is outstanding. Under these scenarios, a financially weak issuer may not be able to pay both the debt service payments and increased pension contributions.

Other Policy Issues

5) Can similar budget relief be achieved within the plan's present funding policy? If actuarially reasonable funding policy alternatives are available, such as modifying the UAL amortization period, the plan sponsor may want to investigate this option before issuing debt.

6) How does the planned amortization schedule in the pension plan compare year-by-year with the sequence of debt payments on the POB? Remember that in governmental retirement systems, unfunded accrued liabilities are most commonly amortized as level percents of payroll, and not level dollar amounts.

7) Issuers should consider how POB borrowing might affect the government's debt capacity, since POB debt could constrain borrowing for traditional governmental purposes.

8) Plan sponsors must recognize that the long-term solvency of the plan will ultimately depend upon systematic contributions, not on POB borrowing.

   Plan sponsors should not forget the basic funding equation: C+I=B+E. Both contributions (C) and investment returns (I) are needed to pay benefits (B) and expenses (E). At some point in the future, pension contributions may have to be paid from the government's general revenues.

9) Would issuing a POB encourage plan members to expect benefit increases, especially if the employer reduces or stops making pension contributions? Such benefit increases could increase employer contributions on top of required POB debt service payments, potentially eliminating any budgetary relief expected from the POB.

   Plan sponsors should also be aware that issuing a POB could result in additional contingent benefits payments (e.g., COLAs or post-retirement health care benefits), if they are granted on the basis of the plan's funded ratio.

Conclusion

While a POB can be a tool to manage pension fund obligations, plan sponsors will be well served by recognizing that POBs involve assuming additional risk. Although state and local governments cannot control market volatility and investment losses, open discussion of the issues raised above may help them issue POBs that are better suited to their overall financial condition and fiscal outlook.

To quote Gary Findlay, Executive Director of the Missouri State Employees' Retirement System, if POBs are issued "it should be done with full disclosure of the potential downside, so policy makers are conversant with the risks involved."

Structuring a POB.

A Pension Obligation Bond issued by a financially sound borrower and properly structured may help plan sponsors manage pension plan obligations. The following offers added guidance on structuring a POB.

The points are drawn from James Burnham's article "Risky Business" published in the Government Finance Officers Association (GFOA) monthly magazine, *Government Finance Review*, June 2003.

1) **The issuer should have above average financial strength in terms of the balance sheet and fiscal forecast.**
2) **The size of a single borrowing should be limited to avoid high financial leverage for the plan sponsor or fund. This also reduces the effect of poor market timing.**
3) **The issue should be callable.**
4) **The scheduled debt service arrangement should be structured with relatively equal annual payments. Artificial deferral of debt service on the POB should be avoided.**

The GFOA recommends that state and local governments use caution in issuing POBs and that they "not be used as a substitute for the prudent funding of pension plans."

Actuarial Standards Guiding Investment Return Assumptions. ***Actuarial Standard of Practice No. 27, Selection of Economic Assumptions for Measuring Pension Obligations*** **guides actuaries in setting investment assumptions.**

Generally, the investment return assumption should reflect the "anticipated returns on the plan's current and future assets."

Anticipated returns are based on a review of appropriate investment data, such as historical returns, forecasts of inflation, and expectations of investment returns for the major investment classes.

An assumption's purpose should play a role in how it is determined. For example, an investment return assumption used to determine the liabilities of an ongoing plan will be different than one used to determine the liabilities of a plan that is terminating.

One of the key guidelines in selecting the investment return assumption is that it be consistent with the other economic assumptions used in the valuation.

Often this involves applying the same underlying price inflation assumption to develop both the wage inflation assumption and the investment return assumption.

Is It Time to Change Your Investment Return Assumption?

The investment return assumption is arguably the most influential assumption (or method) used in a defined benefit plan's actuarial valuations. It is intended to reflect the best estimate of the plan's long-term investment returns. However, investment experience between 2000 and 2003 raises the question of whether current investment return assumptions are still reasonable.

One might think that an immediate reduction in the investment assumption will offer a quick solution for maintaining the plan's financial objective and at the same time will quell any detractors who may say the rate is too aggressive or optimistic.

In examining this question, it would be good to first step back and consider the two choices: reducing the investment return assumption or keeping it the same. In doing so, it is important to remember that there is no single "best choice" for the return assumption. Only in hindsight will we be able to determine which choice would have been best. This point is necessary for any further discussion.

If the investment return assumption is reduced from 8% to 7%, the expected increase in liabilities is about 25%. Using very broad approximations, this could make a 10% of payroll contribution rate go instantly to 17% in the absence of any other changes and before recognition of any losses.

What would have happened if the assumptions had been changed several years ago? There would still have been the same upward pressure on the contribution rate, only it would have been slightly less and started from a much higher rate!

The second point is that before making a decision the Board should discuss it with their investment consultant, money managers and actuary in light of their investment policy, risk tolerance and asset allocation. Here are some other points to keep in mind while discussing the investment return assumption:

- Ongoing retirement systems have investment horizons of over 50 years.
- The investment return assumption really should be called the "long-term investment return assumption" meaning at least 30 years.
- In the 1980's and 1990's, investment results exceeded investment return assumptions for most pension plans. Recent results should be viewed through that historical lens.
- Few people believe diversified investment returns will be negative over periods of 10 years or more.
- The investment return assumption affects the timing of contributions, not the actual cost of the retirement benefits.
- Due diligence requires that the Board review any assumption that is not being met on a consistent basis.
- Consider revising the asset valuation method and monitoring the ratio of the funding/actuarial value of assets to the market value of assets. If it is above 120%, the Board may wish to impose a corridor that caps the funding/actuarial value of assets at 120%. This will increase the current contribution rate, but generally nothing like lowering the return assumption by 0.5% to 1.0%.
- If the long-term business prospect of a firm or the credit rating of a particular security are similar to what they were in 2000, then is the investment opportunity over the long-term any less viable?
- Changing the investment return assumption cannot be solely based on the experience of the last three to four years, because doing so could eliminate prefunding. Remember that the assumption is prospective and can no longer effect what has already happened. Good questions are: "Does it continue to reflect what will likely happen?" and,

"Are we getting a little too precise for a measure that has defied accurate prediction in the past?"

- If long-term average investment returns are to be positive, at some future point investments will 'outperform' to offset the experience of the last few years. Consider 2003.

- Changing the investment return assumption downward may appear to increase the cost of benefit changes and vice versa.

- It is possible to change the short-term investment return assumption without changing the long-term investment return assumption, but this is equivalent to recognizing losses before they happen. This is inconsistent with the financial objective and past practice for most pension plans, disrupts the funding mechanisms put in place to soundly finance the plan, and may give the appearance of predicting or timing future investment markets.

- There are presently no prudent methods to postpone recognition of extremely poor investment performance indefinitely.

- For retirement plans with statutory investment assumptions, remember that the purpose of the valuation is to enable the plan to meet the projected cash flows. If the statutory investment return assumption provides contributions that meet these cash flows, the plan is not in short-term jeopardy. However, it would still be important to monitor plan funding with a long-term perspective.

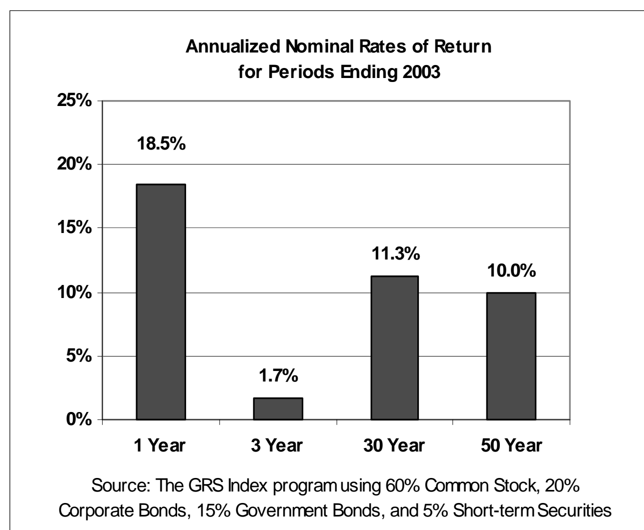
- Review the amortization periods for the unfunded actuarial accrued liability. Shortening a period will increase current contributions, lengthening a period will decrease current contributions. Even if there has always been only one amortization base, many Boards and plan sponsors have the latitude to separately amortize the different components of the unfunded actuarial liability.

- Do not lose sight of the primary focus of the pension plan – to fulfill the benefit promises being made to the members. Concern for relieving external budget pressures does not absolve the Board of its fiduciary responsibility to the members.

- Be careful of benefit provisions that are linked to the investment return assumption and be certain that any effect on benefits, contracts, or even statutes are known and reviewed by legal counsel before a change in the assumption is made.

Considering these points should help prepare retirement system administrative staff, Boards, and plan sponsors to ask the right questions of the right professionals, and determine whether it's time to change the investment return assumption.

The following chart shows annualized rates of return for various periods ending December 31, 2003, calculated using the GRS Index program. It assumes a portfolio with 60% invested in common stock, 20% in corporate bonds, 15% in government bonds, and 5% in short-term Treasury securities.



Source: The GRS Index program using 60% Common Stock, 20% Corporate Bonds, 15% Government Bonds, and 5% Short-term Securities

Investment Returns in 2003. After three years of some of the lowest investment returns in history, 2003 resulted in excellent rates of return for many public employee retirement systems. Here are just a few examples:

- **On January 5, 2004, the Ohio Public Employees Retirement System announced its preliminary investment returns for 2003, with assets growing $11.2 billion to $58.7 billion - the largest dollar increase in the System's history.**

- **On January 8, 2004, the State of Wisconsin Investment Board (SWIB) announced a 24.1% return on its Fixed Fund, the second highest rate in 20 years. The Fixed Fund is a balanced fund with diversified holding in stocks, bonds, real estate, and other investments.**

- **In addition, SWIB's Variable Fund, consisting entirely of stocks, returned 32.7% in 2003, the highest in 20 years.**

- **On January 9, 2004, the Pennsylvania State Employees' Retirement System estimated investment returns in 2003 of more than 24% on its diversified portfolio, resulting in a year-end market value of approximately $24.6 billion.**

Kaiser Releases 2003 Retiree Health Care Survey. **On January 14, 2004, the Kaiser Family Foundation released the results of its latest survey on retiree health care, done in conjunction with Hewitt Associates. The survey covered 408 large private firms, including 30% of the Fortune 500 companies.**

The survey found that large private-sector employers (with 1,000 or more workers) continued to "scale back their retiree health care benefits in 2003, in response to rising health care costs, shifting demographics, global competition, and other pressures."

The percent offering retiree health care fell from 66% in 1988 to 38% in 2003. Of those offering retiree coverage:

- **46% have capped the employer's future retiree health care costs;**
- **33% have either hit their caps or expect to reach their caps within the next one to three years;**
- **71% increased retiree contributions for premiums last year;**
- **86% are likely to increase retiree contributions within the next three years; and,**
- **10% eliminated subsidized health benefits for retirees in 2003.**

The survey is available at: http://www.kff.org/

Medicare Subsidies for Employer-Sponsored Retiree Drug Coverage

On December 8, 2003, President Bush signed the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, enacting a new prescription drug benefit for individuals eligible for Medicare Part A or enrolled in Part B.

Starting January 1, 2006, Medicare eligible individuals may voluntarily enroll in Medicare Part D. In return for an estimated $35 monthly premium and a $250 deductible, Medicare will pay 75% of the enrollees' outpatient prescription drug costs between $250 and $2,250. Enrollees will then pay 100% of drug costs above $2,250 until their out-of-pocket costs (excluding premiums) reach $3,600. After that, Medicare will pay 95% of additional prescription drug costs for the year, possibly with nominal co-payments. This is referred to as the "standard plan."

The prescription drug benefits under the standard plan will be provided through private, risk-bearing, stand-alone plans that will bid to provide prescription drug coverage in different regions of the country. People enrolled in Medicare Advantage (MA) plans (formerly referred to as Medicare+Choice plans) could receive comparable coverage through the MA plan.

Nothing in the legislation prevents an employer or other health care plan sponsor from providing coverage that is at least actuarially equivalent to coverage under Part D.

Retiree Drug Coverage Before the Act

According to the U.S. Congressional Budget Office (CBO), total outpatient prescription drug spending for Medicare beneficiaries, including out-of-pocket costs and costs covered by prescription drug plans, amounted to about $90 billion in 2002, and averaged about $2,500 per beneficiary.

Total annual outpatient drug costs are less than $1,000 for about one-third of the beneficiaries, between $1,000 and $3,000 for another third, and over $3,000 for the remainder. Seventeen percent have total outpatient drug costs over $5,000, with the amount spent making up 54 percent of total outpatient prescription drug spending.

In analyzing early versions of the Medicare reform legislation, the CBO estimated that approximately one-third of Medicare's 40 million beneficiaries could lose their employer-sponsored health care coverage as a result of the Medicare prescription drug benefit. In order to encourage employers to continue providing prescription drug coverage to retirees through their health care plans, Congress added employer subsidies to the final legislation.

Medicare Subsidies for Employers

Under the Act, Medicare will pay employers (and other sponsors of retiree health care plans) 28 percent of a member's allowable costs between $250 and $5,000 (up to $1,330 per member). The plan member must be eligible for Part D coverage, but have elected to receive their prescription drug benefit through the employer. In return for the subsidy, the employer must certify that the plan's prescription drug coverage is at least actuarially equivalent to that offered under Part D.

Allowable costs are those paid by the plan sponsor and the retiree under the plan – including dispensing costs, but excluding administrative costs, discounts, chargebacks, and rebates.

Interestingly, inclusion of retiree-paid drug costs among allowable costs prompted some to suggest that employers might be subsidized for providing drug plans where retirees pay most or all of the costs. However, Bill Thomas, a chief architect of the Act, responded that such a plan would not be actuarially equivalent to Medicare Part D, and so would not be eligible for the subsidy.

The subsidy is not taxable to the employer, and the employer may also take a tax deduction for the cost of providing the prescription drug plan. State and local governments

that sponsor retiree health care plans are eligible to receive the 28 percent subsidy but do not benefit from the tax advantages, since they are already tax-exempt entities.

Employer-Sponsored Supplemental Coverage

The Act also allows retiree health care plan sponsors to offer coverage that supplements Part D. For example, if a member elects Part D coverage, the plan sponsor may offer to pay the member's Part D premiums, and some portion of the out-of-pocket costs. Although the plan sponsor would not receive a subsidy from Medicare under this approach, Medicare would become the primary payer for prescription drug coverage. This would limit the plan sponsor's liability for the coverage and possibly lower the sponsor's long-term costs.

However, it is important to note that employer payments do not count toward the member's out-of-pocket costs. Under the Act, Medicare does not pay 95% of prescription drug costs until the member has paid $3,600 out-of-pocket. Consequently, while supplemental employer payments can help reduce a member's prescription drug costs, they do not move the member closer to catastrophic coverage under Medicare Part D. To be eligible for this catastrophic coverage, the member must ultimately pay the full $3,600 out-of-pocket.

Next Steps

Considerable uncertainty still surrounds implementation of the Act. The Department of Health and Human Services (HHS) has yet to write the regulations needed to implement these provisions, and many of the details must still be resolved. For example, the definition of "actuarially equivalent" benefit has yet to be determined.

Moreover, it is unclear how the Medicare changes will affect the use of prescription drugs. On the one hand, Medicare Part D could lower the costs of providing prescription drugs through prescription drug plans, Medicare Advantage plans, and employer subsidies. This, in turn, could increase the supply. On the other hand, if employer-sponsored prescription drug benefits were abandoned, the cost of prescription drugs for many retirees would increase substantially. This could reduce demand.

Even with these uncertainties, employers who currently sponsor prescription drug coverage for retirees should begin to examine the potential effect of the Medicare changes on their plans and plan members. This will involve understanding the effects of the different options on the costs borne by the plan sponsor and by retirees; the sustainability of the resulting plans; and members' access to quality prescription drugs.

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