MEMORANDUM

TO: Roger L. Stancil, Town Manager

FROM: Kenneth C. Pennoyer, Director of Business Management
Valerie Meicher, Human Resources Development Director

SUBJECT: Implementation of a Retirement Health Savings (RHS) Plan for New Employees

DATE: October 28, 2009

PURPOSE

One of the Council's adopted goals is to *develop strategies for sustainability of the Town retiree health-care program*. The attached resolution would:

- Adopt the ICMA RC's VantageCare Retirement Health Savings Plan.
- Authorize the Town Manager to execute documents required to establish the Plan, including the following:
  - Retiree Welfare Benefits plan identifying the benefits available to retirees.
  - Plan Adoption Agreement that describes the details of how the plan works.
  - Administrative Services Agreement between the Town and ICMA RC for plan administration.
  - Declaration of trust establishing the legal entity to hold assets and establishing the duties of the Town (employer) and the trustee.
- Specify that the assets of the plan will be held in trust for the exclusive benefit of plan participants and their survivors.

The attached ordinance, amending Section 14-59.1 Group Medical Insurance for Retiring Employees revision, would:

- Establish a defined contribution post employment benefits plan for employees hired after June 30, 2010.
- Set the contributions to the plan at 1% of pre-tax pay for the employee portion and a flat rate payment of $35 per bi-weekly payroll for the Town's contribution.
- Specify that accumulated funds in employee accounts may be used for reimbursement of qualified medical expenses and that employee contributions will accrue to the employee upon termination of employment, whereas Town contributions will be vested based on years of employment.

BACKGROUND AND DISCUSSION

New accounting rules for Other Post Employment Benefits (OPEB), effective for the fiscal year beginning July 1, 2008, required the Town to acknowledge health care and life insurance benefits that will be provided to current and future retirees, in a manner similar to a pension obligation. The future cost obligation is, in effect, a liability that the Town will need to address. To the extent that we can provide funding to address the liability, we will reduce the impact of the rise in the annual cost of benefits., We also have the opportunity to make changes to the benefits structure to reduce the growth of the liability.

These new accounting rules, also known as Government Accounting Standards Board Statement 45 (GASB 45), have significantly changed the Town's financial statements as we account for and report the liability for the future cost of providing these benefits. Based on the most recent actuarial study the Town's current unfunded liability, discounted at 4%, is $32.4 million. In order to fully fund this liability on an actuarially sound basis the Town would need to make an annual required contribution (ARC) of $3.0 million.

In order to address the growing OPEB liability and the resulting potential long-term impact on the Town's credit worthiness and financial sustainability we are recommending the following three phase strategy:

- Participate in the State Treasurer's investment trust for local government OPEB funds beginning with the FY2008-09 budgeted contribution of $400,000. *This step was approved by Council at the June 22, 2009 meeting and the OPEB funding contributions for FY2009 and 2010 will be transferred to the State OPEB Funding Investment Trust.*
- Replace the existing benefit for new employees with a defined contribution post-employment health benefit.
- Evaluate changes to benefits and/or changes in eligibility requirements for existing employees.

This memorandum addresses the second bullet point; establishment of a defined contribution post employment benefits plan. The adoption of a retirement health savings plan would work in the same manner as other defined contribution retirement plans. As proposed for new Town employees, participants would make tax-free contributions of a portion of their salary to an individual account held in trust. The funds in trust can be invested in the various funds available through ICMA RC. The Town would make a flat rate contribution each pay period for participating employees. Contributions can be used for qualified medical expenses including the cost of health insurance premiums for the employee and dependents.

Participation in the Retirement Health Savings plan would be mandatory for all employees in the defined participant group. In other words, as proposed, all employees hired after 6/30/10 would be required to participate and there would be no ability to "opt-out." The employee's contribution would be portable (if the employee left Town employment, he or she could take a portion of the accumulated benefit to his or her next job) and the employer's contribution would vest on the following schedule:

25%	After 5 Years
50%	After 10 Years
75%	After 15 Years
100%	After 20 Years

In order to establish a Retirement Health Savings Plan with ICMA Retirement Corporation the following steps must be completed:

- Establish a retiree welfare benefits plan identifying the benefits available to retirees.
- Execute a plan adoption agreement that describes the details of how the plan: works. The basics of our plan are as follows:
  - All employees hired after 6/30/10 are eligible (mandatory participation)
  - Employer contributes $35 per bi-weekly pay period ($910 annually) for each participating employee
  - Participating employees contribute 1% of their pre-tax pay deducted each pay period
  - Participating employees will be vested in the Town's contribution based on years of service according to the following schedule:
    - 25% after 5 years
    - 50% after 10 years
    - 75% after 15 years
    - 100% after 20 years
- Execute Administrative Services Agreement between the Town and ICMA RC for plan administration.
- Make a declaration of trust establishing the legal entity to hold assets and establishing the duties of the Town (employer) and the trustee.
- Adopt the Plan Adoption Resolution

Background

Current Town Code and Policy provides for continuation of healthcare coverage at the Town's expense for employees who retire from Town employment. This benefit is prorated based on years of service with 20 years required for the full benefit. As an alternative for all employees that begin employment after June 30, 2010, we are proposing a defined contribution plan that will allow employees to accumulate funds for future health care costs from contributions made by the Town and the employee.

GASB 45 provides new accounting and reporting rules for benefits provided to retirees by state and local governments. The new standards are being phased in, with units with revenues between $10 million and $100 million required to implement the new standards in fiscal year 2008-09. These benefits for the Town of Chapel Hill are mostly related to health care benefits, but also include the life insurance program. Under GASB 45, governments are required to account for these benefits much like a pension plan where the cost of the benefits are recognized as expenses over the course of active employment as compared to the current practice of cash funding of claims benefits after retirement. Depending on the demographics of an employee base, funding for OPEB can increase annual budget requirements a significant amount over the pay-as-you-go (PAYGO) method. Because these are not new benefits, just existing ones accounted for differently, the future accounting for OPEB has components that reflect both the post employment benefits already earned by current employees and the amount of benefits yet to be earned by employees. Typically, the prior earned benefits are amortized over a period as long as 30 years.

Implementation of GASB 45 will require ongoing actuarial studies much like we do with the Law Enforcement Separation Allowance program. To provide a planning tool for the Town in implementing GASB 45 and to assist us in budgeting for any impacts in our annual budget for 2008-09, the Town engaged the consulting firm Cavanaugh Macdonald to do an actuarial review. Our analysis and discussion of OPEB is based on that study which is currently being updated in preparation of our first OPEB reporting year.

It is important to note that GASB 45 does not require "funding" of the new accounting standards. As such, a local government could continue cash funding of post employment benefits, with appropriate reporting of annual and future liabilities and related expense amounts. Under GASB 45, a liability would have to be set up and expensed, reflecting the difference between the amount cash funded and the actuarial annual cost. For most government units, this liability would generally continue to grow as the variance accumulated. This could cause some credit rating issues as that liability grew.

Issues

There are some key decisions for the Council to consider:

- Do we fund the new requirements of GASB 45 versus continuing to budget on a PAYGO basis?
- Do we need to change our retiree benefits package due to the escalating cost of retiree expense compounded by this new accounting requirement?

The credit rating agencies are currently focusing on getting information from governments concerning how they are "managing" this new set of requirements. While not indicating that funding the plan is the only course of action, it is implied that AAA quality credits could not over time continue to cash fund those benefits without feeling some stress on its credit worthiness because of the increasing unfunded liability. The Business Management Department therefore, recommends that we fund this program.

A key part of the actuarial calculation is the interest rate discount factor used. That factor is basically the interest rate projection that represents what we could earn on invested OPEB funds. Our initial Cavanaugh Macdonald study used a 4% rate (approximate Town rate over time). As an alternative to the Town investing OPEB funds itself, we will be participating in the Local Government Other Post-employment Benefits Fund (OPEB Fund). The OPEB Fund has the same investment authority as the state pension funds, which provides equity exposure and higher expected long-term return.

Similar to a 457 or 401K plan the ICMA RHS charges fees to participant to cover the costs of administering the program and managing the various investment options. The fees applicable to each employees account would be as follows:

- $25 per year account maintenance fee (paid quarterly at $6.25 once funding into the account begins).
- 30 basis point annual asset management fee (30 basis points is $3 per $1,000 of assets).

The ICMA RC Retiree Health Savings Plan is a "self-directed" program that gives plan participants a variety of investment options available for their plan assets. These options include funds that have exposure to equity markets and therefore are subject to fluctuations in earnings, including the potential for losses. New plan participants will be provided information that will help them to make informed decisions about how they can match their investment strategy with their goals.

FISCAL NOTE

The estimated FY2010-11 budget impact of implementing an RHS as described above is approximately $30,000. This amount reflects the estimated Town contributions to individual employee health savings accounts. This amount will increase in future budget years as more new employees join the program. The increase in the Town contribution over time will eventually be off-set by a reduction in OPEB liability. The employee contribution will be budgeted based on estimated turn-over. The contribution rate will be reviewed as part of the annual budget process.

RECOMMENDATION

That the Council adopt the Plan Adoption Resolution and authorize the Town Manager to take the following steps to establish a Retirement Health Savings Plan with ICMA Retirement Corporation.

- Establish a retiree welfare benefits plan identifying the benefits available to retirees.
- Execute a plan adoption agreement that describes the details of how the plan works.
- Execute an Administrative Services Agreement between the Town and ICMA RC for plan administration.
- Make a declaration of trust establishing the legal entity to hold assets and establishing the duties of the Town (employer) and the trustee.

In addition, we recommend that Council enact an ordinance amending the Town Code Section 14-59.1 Group Medical Insurance for Retiring Employees.

ATTACHMENTS

1. Plan Adoption Agreement (p. 9).
2. Declaration of Trust (p. 15).