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Evaluation Report Summary / January 2007

Postemployment Benefits for Public Employees

Some government entities in Minnesota have accumulated large post-employment benefit obligations that are not adequately funded.

Major Findings:

- Twenty-four public employers in Minnesota have accumulated $1.5 billion in liabilities from promises to pay for retiree benefits (excluding pension obligations) over the next 30 years. This estimate could grow significantly as additional jurisdictions have actuarial studies completed.
- The principal postemployment benefit public employers pay for—other than pensions—is health care insurance. Currently, significant spending on this and similar postemployment benefits is concentrated in a small number of jurisdictions. In 2005, 11 cities and school districts spent more than 5 percent of their annual operating budgets on these retiree benefits.
- Most local governments are not setting aside money to fund liabilities for nonpension post-employment benefits that will come due in the future as employees retire.
- Widely reported funding ratios make statewide pension plans appear better funded than they really are because they do not reflect a $4 billion deficit in the Postretirement Fund used to pay benefits to retirees.
- Recent legislative changes will help statewide pension funds become fully funded and have improved the Postretirement Fund's formula for increasing benefits; but they will not solve the Postretirement Fund's deficit or eliminate risk of future deficits.
- Among the major local pension plans, the St. Paul Teachers' Retirement Fund currently is the most at risk of serious future funding problems.

Recommendations:

- The Legislature should allow local governments to establish irrevocable trusts to fund postemployment benefits other than pensions.
- The Legislature should require statewide pension plans' funding ratios to reflect the actual market-related value of the Postretirement Fund.
- The Legislature should fully fund the Postretirement Fund and change the benefit formula to protect against future deficits, treat retirees equitably, and better protect pension benefits against inflation.
- The Legislature should disallow certain benefit increases when local teacher pension funds have large deficits. It should consider changing the formulas used to increase postretirement benefits, and it should consider increasing contributions for the St. Paul Teachers' Retirement Fund.

The full evaluation report, *Postemployment Benefits for Public Employees*, is available at 651-296-4708 or:

www.auditor.leg.state.mn.us/ped/2007/postemployment.htm

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In some communities, rising medical costs and extensive retiree health benefits have created large liabilities for "other post-employment benefits."

Report Summary

Postemployment benefits—pensions and other retiree benefits such as health care insurance—are a form of compensation employees receive in exchange for their work. Unlike wages, though, post-employment benefits are paid when workers reach retirement. The compensation is deferred, but it is earned based on services provided today.

Recent changes to accounting standards require public employers to account for "other post-employment benefits"—health care and other insurance benefits for retirees—in the same time period that employees work. Until now, most employers have accounted for these benefits when they were paid out (at retirement), not when they were earned. The changes align accounting procedures with those in place for pensions.

The health care postemployment benefit is of particular concern because of rising medical costs. Many public employers promised the benefits years ago when health insurance cost far less than today. In addition to medical inflation, demographic trends suggest that large shares of employees are nearing retirement ages. Retirees are also living longer than in the past, meaning employers could be paying for the benefits for longer periods.

About 1 in 5 Minnesota public employers (excluding small townships) reported paying for other postemployment benefits, and a few offer extensive benefits.

A study by the State Auditor estimated that 21 percent of 1,730 local governments and school districts pay for other postemployment benefits. Most school districts and counties, in contrast with cities and special districts, pay for these benefits. We found that health care coverage is the most common retiree benefit, although some also offer dental or life insurance. Few state employees qualify. In fiscal year 2006, about 5 percent of state pensioners received employer-paid health care.

Most local jurisdictions that pay for retiree health care provide a limited set of benefits. Seventeen jurisdictions pay for retiree health care for all employee groups, cover spouses or dependents, provide benefits for the retiree's lifetime, and pay all or nearly all of the premium. Most of them, however, have cut-off dates by which new hires no longer qualify, or in some other way have limited the scope of the benefit package.

Known liabilities total $1.5 billion, but they could reach $3.3 billion.

Accounting standards will begin requiring most public employers to conduct actuarial studies at least every two years to estimate their liabilities for other postemployment benefits. Among 24 Minnesota jurisdictions that have already conducted studies, the liability totals $1.5 billion over the next 30 years. Duluth accounts for $280 million of that liability, and the Metropolitan Council, $275 million.

Because most jurisdictions have not completed actuarial studies, the total liability statewide is unknown. In lieu of actuarial estimates, we made a rough estimate based on the amount of spending in fiscal year 2005 for postemployment health care benefits. Although this method does not provide precise estimates of individual jurisdictions' liabilities, it indicates that statewide liabilities could reach $3.3 billion when all jurisdictions have actuarial studies completed.

All governments offering health insurance have at least some liability for other postemployment benefits.

State statutes require public employers to allow employees to continue indefinitely in their employer-sponsored medical and dental insurance groups. Coverage is at employees' expense unless otherwise provided for in bargaining agreements or personnel

The Legislature should allow local governments to establish trust funds to pay for retiree benefits, and it should set standards for those trust funds.

policies. In addition, for the purpose of setting health care premiums, statutes require employers to pool retirees to age 65 together with active employees. Because retirees typically consume more health care than younger employees, they cost more, yet their premiums are the same as for active employees. Accounting standards say that this so-called "implicit rate subsidy" must be accounted for as a liability for other postemployment benefits.

High spending on retiree benefits in fiscal year 2005 was concentrated in a few localities.

Lacking actuarial data for most jurisdictions' liabilities, we analyzed spending on retiree benefits. We identified 11 jurisdictions that spent more than 5 percent of their operating expenditures in fiscal year 2005 on other postemployment benefits. All were located in northeastern Minnesota. Most jurisdictions that pay for other postemployment benefits spent less than 1 percent that year.

In addition, employers who have not capped their contributions to premiums can expect higher costs. This is particularly true if the price of health care continues growing above inflation, as has been the trend.

Controls on spending for other postemployment benefits are limited.

Among jurisdictions that pay for other postemployment benefits, 54 percent have reduced or eliminated retiree health care for at least some employee groups. Most of them have discontinued offering the benefit to newly hired employees, however some did this only recently and may not see effects of the change for another 25 or more years. About 41 percent of the jurisdictions capped or otherwise limited the employer's share of retiree health care premiums.

With nearly any change, however, jurisdictions face limitations. In a recent court case, judges ruled that a public employer could not unilaterally reduce the "aggregate value" of health benefits in its collective bargaining agreement without first negotiating the change with the employees' representatives. Another ruling stated that a public employer's duty to pay promised health benefits for retirees did not expire when the collective bargaining agreement expired.

Minnesota's local jurisdictions lack clear authority to establish irrevocable trusts for funding other postemployment benefits.

Accounting standards will require public employers to report and account for other postemployment benefits in the same period that employees earn the benefits. They do not, however, require funding the liabilities in that same period.

Some jurisdictions, realizing that they face large future liabilities for the benefits, have begun reserving money to pay for them. Amounts set aside to date are small relative to liabilities.

Governments that opt to fund their liabilities in advance are required by accounting standards to reserve money in irrevocable trusts. In Minnesota, however, authority to set up such trusts is unclear. The Legislature should allow local governments to establish irrevocable trusts for this purpose and prescribe fiduciary standards for the trust funds.

Minnesota's statewide public pension plans are not as fully funded as reported funding ratios make them appear.

Minnesota has basic statewide pension funds—for the Public Employees Retirement Association (PERA), the Teachers Retirement Association (TRA), and the Minnesota State Retirement System (MSRS)—into which most state and local employees and their employers make contributions throughout employees' careers. Upon retirement, assets to cover retirees'

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The Legislature should develop a plan to fully fund the Postretirement Fund and change the benefit formula to help avoid future deficits.

benefits are transferred to the Postretirement Investment Fund, which is used to pay pension annuities for the duration of retirement.

One way to measure the financial health of a pension plan is to examine the ratio of its assets to its liabilities. As of July 1, 2006, the "funding ratios" ranged from a low of 75 percent for PERA's Public Employee Retirement Plan to a high of 96 percent for the MSRS General Plan. The total unfunded liability (deficit) for the statewide plans was $6.7 billion. However, the funding ratios for the plans appear better than they really are because they do not reflect the Postretirement Fund's deficit of $4 billion.

Recent changes in state law will increase pension plan contributions by most employees and employers in amounts sufficient to nearly achieve full funding by target dates ranging from 2020 to 2037. There is no mechanism, however, to ensure that the Postretirement Fund will achieve or maintain full funding.

The Legislature should require that funding ratios for the statewide plans reflect the Postretirement Fund's deficit, as accounting standards require.

Benefit increases in the recent past contributed to a significant deficit in the state's Postretirement Fund.

By giving large, permanent benefit increases when the stock market temporarily did very well, the benefit formula for the Postretirement Fund placed the fund at risk for deficits. Benefits increased when investment earnings were high, but they did not decrease when earnings were negative. The deficit risk existed because the fund did not retain sufficient earnings during good years to offset bad years.

In addition, the fund's benefit increases were not aligned with inflation. During 1997 to 2001, benefit increases consistently exceeded inflation by 3 to 9 percentage points. But for the last three years, benefit increases lagged behind inflation. This, combined with a requirement that the fund may not award investment-based increases when it has a deficit, created inequities between cohorts of employees.

The 2006 Legislature capped the amount of future benefit increases at 5 percent starting in 2010. The cap reduces, but does not eliminate, risks of future deficits from investment-based benefit increases, and it does not resolve today's deficit.

The Legislature should develop a plan to eventually achieve full funding of the Postretirement Fund. This could include increased contributions from employers or employees, additional state appropriations, or reductions in the size of retirees' benefit increases, all of which pose tradeoffs. Concurrently, the Legislature should change the formula to increase benefits by eliminating the investment-based component and enhancing the inflation component.

The St. Paul Teachers' Retirement Fund is at risk of serious future funding problems.

Seven local pension funds have funding ratios below 93 percent as of the last fiscal year. The St. Paul Teachers' Retirement Fund had the lowest funding ratio (69.1 percent) and the largest deficit ($420 million). Its formula for increasing benefits and insufficient contributions from employees and employers each led to the deficit. The Duluth Teachers' Retirement Fund has a deficit but is in better shape than St. Paul's fund. The Legislature should change the benefit formula to disallow certain benefit increases when large deficits exist in the local teacher pension plans. It should consider basing the postretirement benefit formulas on inflation. Further, it should consider increasing contributions to improve the financial health of St. Paul's fund.