

REPORT TO THE
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**A Review
of
Higher Education's
Post-Retirement Benefits**

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Digest of A Review of Higher Education's Post-Retirement Benefits

Chapter I: Introduction

Utah higher education's post-retirement salary stipends and health insurance benefits, offered in addition to employee pensions, have not yet been fully acknowledged. Just as with the state's post-retirement benefits, higher education has probably amassed a large, unfunded liability that should be addressed to prevent future educational funding problems. This audit addresses a legislative request for an estimate of both accrued and future liabilities for higher education and, if needed, recommendations for an appropriate course of action to resolve concerns with higher education's benefit liabilities.

Chapter II: Higher Education's Post-Retirement Benefits May Need Modification

Higher Education Post-Retirement Benefit Programs Have a Potential Liability of \$979 Million. About \$633 million of this liability is committed to current employees with prior years of service and is, for the most part, unfunded. An unfunded liability increases the risk of an inability to pay future benefit obligations. The remaining \$346 million represents the additional costs that will result if the programs are allowed to continue unchecked.

Higher education may need to modify or eliminate offered benefits and then develop a plan to fund the remaining liability without compromising educational services or requiring additional taxpayer assistance. The 2005 Legislature's passage of House Bill 213 established a clear policy position to modify the cost of post-retirement benefits and improve the fiscal integrity and soundness of its benefits package. It is important that higher education do likewise.

Chapter III: Legislature Can Play Vital Role

Although Large Potential Liabilities Exist, These Costs Can Be Reduced and Better Managed. Primary control of higher education's post-retirement benefits rests within each institution. However, there may be a tendency to address short-term funding needs rather than these post-retirement potential liabilities that could be years or decades away. The Legislature can play a vital role helping institutions to promptly address the growing liability problem created by these benefits.

Chapter III: Recommendations

Again, it is critical that each institution evaluate if they should reduce their liability by modifying or eliminating these benefits. Once modified, each institution must develop a viable funding plan for its remaining liability. Modification or elimination of these costly post-retirement benefits is a challenge, but can be done. The Legislature can also assist institutions by requiring actuarial studies and specifying reporting requirements for institution cost control and funding plans.

1. We recommend the Legislature require colleges, universities and applied technology centers to assess their full liability by having actuarial studies completed by the 2007 General Session on all post-retirement benefits including stipends, insurance to age 65 and insurance after age 65.
2. We recommend the Legislature require colleges, universities, and applied technology centers to standardize key actuarial assumptions such as the medical inflation rate and the discount rate and report these assumptions during the 2006 Interim.
3. We recommend the Legislature require the Board of Regents to provide for the compilation and reporting of all actuarial study results to the Legislature during the 2007 General Session.
4. We recommend the Legislature require colleges, universities, and applied technology centers to evaluate their post-retirement liabilities and, if necessary, modify or eliminate post-retirement benefits to a level that is affordable, sustainable, and more comparable with the state's costs.
5. We recommend the Legislature require colleges, universities, and applied technology centers to develop plans to fund post-retirement obligations by modifying or eliminating benefits instead of requesting additional funding from the taxpayers or students and without negatively impacting educational services. These plans should be reported to the Legislature during the 2007 General Session.
6. We recommend that the Legislature consider fiscal sanctions or other appropriate measures if the progress reported by higher education during the 2007 General Session is not satisfactory.

Chapter I

Introduction

Utah higher education's post-retirement benefits, offered in addition to employee pensions, have not yet been fully acknowledged. As a result, we estimate Utah universities, colleges, and applied technology centers have a potential benefit liability of approximately \$979 million. About \$633 million of this \$979 liability is committed to current employees with prior years of service and is, for the most part, unfunded. The remainder represents the additional costs that will result if the programs are allowed to continue unchecked.

These mounting post-retirement costs, however, can be minimized. Addressing the spiraling cost of health insurance benefits, the 2005 Legislature's passage of House Bill 213, as prompted by Government Accounting Standards Board (GASB) Reporting Standard 45, established a clear policy position to modify the cost of post-retirement benefits. It is important that those within higher education consider modifying or eliminating their benefits to ensure their liabilities can be met without compromising educational services or placing an unreasonable burden upon taxpayers to fund the obligation.

Our estimates show that higher education's liability appears greater than the state's, in part, because it offers post-retirement salary stipends not available for state employees. The total estimated cost of higher education's benefits are shown in Figure 1.

Higher education institutions may need to eliminate or change some benefits to avoid compromising educational services in the future.

Figure 1. Present Value of Estimated Post-Retirement Liabilities. Unless current benefits are changed, higher education institutions will pay \$979 million (expressed in today’s dollars) for insurance and stipends over the next 35 years for current employees alone. As institutions grow, new employees will accrue additional liability.

	Institutions	State of Utah
Health Insurance	\$578,721,000	\$875,153,000
Stipends/Termination Payments	400,227,000	No Benefit
Future Benefit Costs	\$978,948,000	\$875,153,000

Note : Not included in this figure is an estimated liability for the University of Utah between \$75 and \$150 million resulting from its 35-percent subsidy of the Medicare supplemental insurance program offered to its retirees.

If steps are not taken to modify and fund higher education’s liability, the problem will continue to grow disproportionately and the cost may exceed the institution’s ability to pay for these benefits. The Legislature can play a vital role by ensuring higher education promptly addresses post-retirement benefit programs by requiring the following:

- Institutions consider modifying or eliminating their benefits to a level that is affordable with costs more comparable to the state’s.
- Institutions must assess their full liability for all post-retirement benefits using the methodology described in GASB 45 and then fund all these benefits in such a way as to ensure their future sustainability.

The State Reduced Future Post-Retirement Benefits

The state has taken steps to control its post-retirement benefit costs. The Utah Legislature’s passage of House Bill 213 in the 2005 General Session reduced future benefits for current state employees while honoring those benefits already earned by them. By our estimate, this legislative action allowed the State to avoid about \$374 million in future benefit costs.

Prompt action should be taken to modify and fund higher education’s liabilities.

We estimate the passage of House Bill 213 allowed the state to avoid about \$374 million in future benefit costs.

The State of Utah started an early retirement incentive program in 1983. The program offered for those retiring before age 65 up to five years of health insurance. If employees retired before they qualified for Medicare (i.e., prior to age 65), this insurance benefit was seen as a bridge to Medicare coverage. The incentive program was later modified to allow employee sick hours remaining after an optional 25-percent cash-out and the deduction of 480 hours to be used to purchase either additional insurance to age 65 or insurance supplemental to Medicare after age 65. Specifically, eight sick-leave hours purchased one month of health insurance.

However, with the rising costs of health premiums, this benefit became more and more costly. As a result, during the 2005 General Session, the Legislature made the decision that this benefit was too costly for the state to continue, and it was reduced for current state employees. While this benefit was reduced for the future, the current obligation that employees have earned was honored.

Institutions Have Not Modified Benefits

Essentially, higher education is facing what the state faced when the Legislature passed House Bill 213. As of yet, institutions have not modified their benefit plans. Currently, colleges, universities, and technology centers offer three types of post-retirement benefits: stipend payments to age 65, including stipend payments for phased retirement; health insurance premium payments to age 65; and health insurance premium payments after age 65. While the qualification requirements vary among institutions, some general requirements apply:

- An employee must have reached a minimum age (from 55 to 60) and whose age combined with years of service total at least 75.
- An employee must also meet specific employment and age requirements (e.g., University of Utah requires employment for 15 years with 5 years in succession just prior to retirement and a minimum age of 60; Weber State University requires 15 years of service and the employee must be within 10 years of full retirement age).

Institutions offer retirement benefits beyond the typical state retirement package.

Institutions Offer Stipend Benefits

Higher education institutions offer stipend payments to employees who meet specific employment and age requirements. Stipends are generally described as retirement incentives that are paid as a bridge to full social security. These payments are in addition to any retirement pension being received and, in most cases, will continue even if the retiree becomes re-employed. Stipend payments are paid for a set number of years (most often for five or six years) or until the retiree reaches age 65.

Institutions also offer stipends as incentives for phased retirement. In this case, stipends are paid to compensate for the reduced work and for the reduced retirement contributions that result from reduced hours. For Weber State University retirees, each year of phased retirement exhausts a year of eligibility for early retirement incentives. Our estimates do not include phased retirement.

Health Insurance Paid by Most Institutions

Institutions offer health insurance to age 65 and one institution pays a portion of supplemental health insurance premiums after age 65 if an employee chooses to purchase this insurance.

Health Insurance Payments to Age 65. Like stipends, health insurance premiums are paid for a set number of years or until the retiree reaches age 65. Weber State University is unique because a retiree can receive insurance coverage for as many as seven years, depending upon the age at retirement. However, Weber pays all or a portion of the premium depending on the years of service and number of years over which it is paid. These health insurance payments are conceived as a financial support that bridges the gap from retirement until the employee qualifies for Medicare.

Health Insurance after Age 65. The University of Utah pays 35 percent of supplemental health insurance premiums if a retiree chooses to purchase this insurance. The University will pay its portion of the premium as long as the employee chooses to maintain the coverage. Thus, the University's plan is different from those plans offered within public education. In some local school districts, employees were guaranteed supplemental medical insurance coverage after age 65 for life and the participating districts paid 100 percent of the premium.

Liability Assessment for Post-Retirement Benefits Needed

Higher education institutions need to assess and recognize their post-retirement liabilities. The General Accounting Standards Board (GASB) has provided, through GASB 45, a standard to which we believe most post-retirement benefit commitments should be applied. The philosophy behind GASB 45 is to make those who commit to future benefits aware of the cost and need for funding such commitments. Employers (both in private industry and in government) generally have not calculated the future expense of today's commitments. If employers are unable to meet these unfunded commitments, employees can be left without a benefit they relied upon. In addition, the obligation may jeopardize educational programs by drawing funds away.

An actuarial study can help institutions understand and manage their post-retirement liabilities.

To insure that employers understand their liabilities, GASB 45 requires an actuarial study with periodic actuarial reassessments in years that follow. An actuarial study performed to comply with GASB 45 identifies the following:

- **The actuarial accrued liability (AAL)** - This is the organization's theoretical liability committed to employees because of prior years of service. The AAL can be thought of as the amount that should be funded as of the actuarial valuation date.
- **The unfunded actuarial accrued liability (UAAL)** - This is the portion of the AAL that is not funded. It is the UAAL that carries with it the risk of failure if future funds are limited.
- **The portion of the UAAL that must be paid annually** - GASB 45 allows the UAAL to be amortized over 30 years. In other words, an organization is allowed 30 years to eliminate the existing UAAL.
- **The normal cost, or current year benefits costs** - If not fully funded, then it adds to the UAAL. Modifying or terminating future benefits can reduce the normal cost considerably.
- **The projected future liability for current employees** - This projection assumes benefits will remain unchanged. If the AAL and the projected future liability are added together, the result is the present value of total projected benefits. The present value of total

Regardless of GASB requirements, we believe higher education's post-retirement benefits are real liabilities and a solution is necessary.

projected benefits is the single sum necessary to fully fund all anticipated future benefits for all members, active and retired.

The former GASB chairman believes GASB 45 is lenient with employers because it allows 30 years to accrue the actuarial liability. GASB has also developed a policy entitled *Accounting for Termination Benefits* (GASB 47) that the former chairman believes is tougher on employers than GASB 45. Under this policy, when the benefit is granted, the employer must calculate the total cost of the benefits and recognize that full amount as an income statement expense each year. Because of how the expense is recognized, actuarial studies are not required and liabilities are not accrued.

Some Board of Regents' staff believe that the post-retirement benefits offered in higher education are termination benefits and, therefore, the application of the GASB 45 methodology may be inappropriate. We disagree, the GASB 45 methodology provides a reasonable estimate of the total cost of higher education's benefit policies regardless of how the cost is classified.

Regent staff also point to institutional non-entitlement policies that restrict participation in post-retirement programs. Restrictive policies imply that early retirement benefits are granted selectively on a case-by-case basis. Based on this, retiree benefit participation rates (i.e., retirees receiving benefits compared to the current active population that may eventually receive the benefit) for institutions having restrictive policies should be much lower than those institutions that do not. This is not the case.

Retiree benefit participation rates among higher education institutions ranged from a low of one percent to a high of eight percent. Public education's school districts, with few exceptions, do not have policies that restrict receipt of early retirement benefits. Yet, 80 percent of public education's districts have retiree benefit participation rates between one and eight percent, and the district used as the basis of our estimations has a retiree benefit participation rate of six percent.

We believe that higher education's post-retirement programs, and termination benefits represent an on-going liability and that a sustainable solution is necessary. If steps are not taken to begin funding these liabilities, then the problem of unfunded liabilities and the associated risk

of being unable to pay future benefits will simply be pushed to future administrators. The Legislature provided a difficult but logical solution by modifying state employees' benefits.

Audit Scope and Objectives

Legislative awareness of unfunded post-retirement benefit liabilities was significantly heightened by House Bill 213. Through this process, concern for the state's exposure to liabilities was extended to higher education where it was known that post-retirement benefits included stipends and insurance. The Legislature requested an estimate of both accrued and future liabilities for the state's colleges, universities, and applied technology centers. This report contains:

- An estimation of actuarial accrued liabilities for higher education
- An estimation of future liability for higher education
- Information on the need for legislative involvement in modifying higher education's post-retirement benefits

To accomplish these objectives, we made liability estimations for each institution. For a detailed description of our methodology, see Appendix A. Our analysis is not an actuarial study, nor is it a substitute for one. Instead, these are estimates of what an actuarial study might identify.

**This audit analysis
is not intended to be
a substitute for
institutions'
actuarial studies.**

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Chapter II

Higher Education's Post-Retirement Benefits May Need Modification

Higher education post-retirement benefit programs have a potential liability of \$979 million. Much of this liability is from post-retirement health insurance. In addition, colleges and universities offer additional benefits beyond those offered by the state. Specifically, in addition to health insurance, most institutions offer cash stipends. Because of the expense, we believe higher education should follow the state's lead and consider modifying or eliminating these programs. It is important that institutions ensure liabilities can be met without compromising education services or placing an unreasonable burden upon taxpayers to fund the obligation.

To reduce this \$979 million potential liability, higher education should follow the state's lead and consider modifying or eliminating benefits.

Most post-retirement benefit liability is likely unfunded and, thus, institutions have an increased risk of inability to pay benefit obligations. Consequently, it is critical that institutions evaluate their unfunded liability, and, if appropriate, eliminate or modify their benefits. Each institution must develop a viable funding plan for its remaining liability. Modification or elimination of these costly post-retirement benefits is a challenge but can be done. The state, which offered post-retirement insurance as most institutions do, took action in 2005 to improve the fiscal integrity and soundness of its benefits package. Higher education may need to do likewise.

The liability discussed in this chapter is from an institutional perspective not just a state funding perspective. For example, the University of Utah's administration reported that less than half of their staff are paid with state dollars; the remainder are paid with private or federal dollars. This chapter reports total institutional liability regardless of the funding source.

Higher Education Should Address Existing Liability

Our estimate indicates that higher education's current accrued liability is about \$633 million. This amount represents the cost, to date, of accumulated benefits. Most of this liability is likely unfunded, since

Unfunded liability is not fiscally sound.

institutions generally use a pay-as-you-go methodology. These costs need to be modified and funded or eliminated altogether to follow sound fiscal principles. An unfunded liability is not fiscally sound and should be modified or eliminated to fit the funding ability of the organization.

This \$633 million liability is comprised of estimates for two benefits offered within higher education. Those two benefits and their contributions to the overall estimate are:

- Stipend payments—\$282 million
- Insurance premium payments up to age 65—\$351 million

Most higher education institutions offer both stipend payments and insurance premium payments up to age 65. The University of Utah also offers to pay a portion of retirees' Medicare supplemental insurance premiums after age 65. We could only estimate a range of costs for the supplemental insurance and could not estimate the liability for the phased retirement programs since the actuarial study used to make our higher education estimates did not address these retirement programs. Regardless, higher education needs to follow the state's lead in modifying its benefits to improve the fiscal integrity and soundness of its benefit packages.

The estimated accrued liability for each institution is shown in Figure 2. Again, none of the higher education institutions have completed an actuarial study, and so estimates were made using an existing actuarial study as a foundation. See Appendix A for the details of the estimation methodology.

Figure 2. Post-Retirement Accrued Liability. Higher education’s estimated accrued liability for stipends and insurance is \$633 million. These estimates exclude phased retirement stipends and insurance after age 65.

Institution*	Cost of Stipends	Cost of Insurance	Total
University of Utah	\$111,239,000	\$138,095,000	\$249,333,000**
Utah State University	68,485,000	83,089,000	151,574,000
Weber State University	25,703,000	31,618,000	57,321,000
Southern Utah University	15,833,000	23,149,000	38,982,000
Snow College	5,827,000	7,571,000	13,397,000
Dixie State College	6,260,000	7,776,000	14,035,000
College of Eastern Utah	3,918,000	4,576,000	8,493,000
Utah Valley State College	22,713,000	27,314,000	50,027,000
Salt Lake Community College	19,950,000	25,165,000	45,115,000
Bridgerland ATC	436,000	0	436,000
Davis ATC	799,000	1,640,000	2,439,000
Mountainland ATC	831,000	1,477,000	2,307,000
Ogden-Weber ATC	597,000	1,478,000	2,076,000
Rounded Total	\$282,592,000	\$350,848,000	\$633,440,000

* Some ATCs are excluded: Dixie ATC benefits are included with Dixie State College, Southeast ATC benefits are included with College of Eastern Utah. No benefits are offered to employees at Salt Lake, Southwest, and Uintah Basin ATCs.

** The University of Utah’s retiree participation rate for the early retirement program is unusually low relative to other institutions in both higher and public education. To try and prevent a large over-estimate, the numbers reported above are based on half of the University of Utah’s census numbers. If the University of Utah’s participation rate were more like those within the other institutions, our accrued liability estimate for stipends and insurance would be \$218 million and \$269 million, respectively.

Higher education should develop a plan to fund the estimated \$633 million liability without compromising educational services or requiring additional taxpayer assistance. While these estimates are the liabilities for past years’ service, additional liability will continue to be incurred if higher education allows benefit plans to remain unchanged.

Without Benefit Changes Higher Education's Liabilities Will Increase

An additional \$346 million liability increase is likely for current employees if benefits are not modified.

Modification or elimination of these benefits for future employees is necessary but does not fully address the growing liability. Higher education should also address the future post-retirement benefits of current employees, or an additional \$346 million liability increase is likely. This potential liability is just for current employees and is stated in present value terms. This \$346 million of future liability for current employees is comprised of estimates for the two benefits offered by higher education. Those two benefits and their contributions to the overall estimate are:

- Stipend payments—\$118 million
- Insurance premium payments up to age 65—\$228 million

An additional liability exists for Medicare supplemental insurance for retirees over age 65 from the University of Utah. This estimated liability is discussed later in this chapter. No potential future liability was identified for stipends for phased retirement programs. Figure 3 shows the potential additional liability estimated for each institution.

Figure 3. Additional Future Liability if Benefits Are Unchanged.
Higher education will incur at least \$346 million more liability if benefits are unchanged.

Institution*	Cost of Stipends	Cost of Insurance	Total
University of Utah	\$49,509,000	\$92,438,000	\$141,946,000**
Utah State University	26,734,000	51,575,000	78,309,000
Weber State University	10,272,000	20,358,000	30,631,000
Southern Utah University	6,342,000	13,655,000	19,997,000
Snow College	2,270,000	4,863,000	7,134,000
Dixie State College	2,540,000	5,081,000	7,621,000
College of Eastern Utah	1,387,000	2,699,000	4,087,000
Utah Valley State College	9,319,000	17,692,000	27,011,000
Salt Lake Community College	8,081,000	16,469,000	24,549,000
Bridgerland ATC	231,000	0	231,000
Davis ATC	361,000	1,164,000	1,525,000
Mountainland ATC	351,000	968,000	1,320,000
Ogden-Weber ATC	237,000	911,000	1,148,000
Rounded Total	\$117,635,000	\$227,874,000	\$345,508,000

* Some ATCs are excluded: Dixie ATC benefits are included with Dixie State College, Southeast ATC benefits are included with College of Eastern Utah. And, no benefits are offered to employees at Salt Lake, Southwest, and Uintah Basin ATCs.

** The University of Utah's retiree participation rate for the early retirement program is unusually low relative to other institutions in both higher and public education. To try and prevent a large over-estimate, the numbers reported above are based on half of the University of Utah's census numbers. If the University of Utah's usage were more like those within the other institutions, our future liability estimate for stipends and insurance would be \$99 million and \$185 million, respectively.

As shown in Figure 3, insurance to age 65 contributes the majority of the potential liability. Insurance liability levels are high because, for the last decade, medical premium inflation rates have escalated, and the actuarial study upon which our estimate is based assumed medical inflation rates would continue to rise. It was these increasing medical insurance rates that motivated the Legislature to cut costs

Not included with the estimates in Figure 3 is the University of Utah's liability for health insurance after age 65. The University pays 35 percent of the Medicare supplemental insurance for its retirees who choose to

purchase insurance through them. Our actuarial consultant estimated the liability for this insurance will probably range between \$75 and \$150 million. An actuarial study will better assess the University of Utah's liability.

Higher Education Must Evaluate If Benefits Should Be Eliminated

Addressing higher education's post-retirement liability is challenging. Institutions must first determine what benefits they can afford within their existing budgets. Most likely, the benefit level identified in this report cannot be met without compromising current and future educational services and/or without increasing taxes and tuition. The Legislature demonstrated fiscal responsibility to the taxpayer by substantially modifying the state's benefit program. Higher education may also need to modify and eliminate programs. Second, not all of the liability can be eliminated, so institutions must develop plans to fund the remaining liability.

Funding Benefits Will Be a Challenge Without Benefit Modification

To illustrate the funding challenges facing higher education institutions, Figure 4 shows the actuarially determined funding necessary for four public education school districts. Public education actuarial studies are being used because, to date, no actuarial study has been completed within higher education. It should be noted that only Jordan's actuarial analysis considers both stipends and insurance benefits—thus, only Jordan captures its full liability. The other three studies considered insurance benefits only.

The Legislature demonstrated fiscal responsibility to the taxpayer by substantially modifying the state's benefit program.

Figure 4. Actuarial Annual Costs of Four School Districts. The annual contributions necessary to fund benefits are as low as \$2.1 million and as high as \$17.8 million for these districts.

District	Normal Cost	Amortization of UAAL	Annual Required Contribution
Alpine*	\$ 8,789,824	\$ 9,005,412	\$ 17,795,236
Jordan**	9,169,363	7,480,162	16,649,525
Provo***	1,602,238	2,876,281	4,478,519
Tooele****	604,984	1,515,729	2,120,713

* Alpine's study was performed in October 2003 using a 4% interest rate. Analysis did not include stipend payments.
 ** Jordan's study was performed in September 2004 using a 3% interest rate. Analysis includes stipend payments.
 *** Provo's study was performed in March 2005 using a 3% interest rate. Analysis did not include stipend payments.
 **** Tooele's study was performed in September 2003 using a 4% interest rate. Analysis did not include stipend payments.

The payment represents the district's total UAAL amortized over 30 years. Under GASB 45, since this payment is funding the actuary's estimate of what has accumulated for current employees because of past years' service, this amount must either be placed in a trust fund or reported as a liability. Although potentially difficult, it is possible to reduce the actuarial UAAL estimate by modifying the benefit plan to reduce actual costs. Modifying the benefit plan can change the actuarial assumptions used to estimate the UAAL.

The normal cost, shown in Figure 4, identifies the benefit costs accrued for the current year that, if not paid in full, will increase the UAAL. While the amortization payment of the UAAL will continue for no more than 30 years, the normal cost will continue as long as benefits are offered. However, the normal cost can be reduced or eliminated if future benefit policies are changed for current employees.

Modification Options Are Available

Post-retirement benefits can be modified for the future and/or for the past. The former affects the potential accrued liability and was the approach used by the state. The latter approach affects the actuarial accrued liability and was the approach successfully implemented within one public education school district. Depending on an institution's

Annual contributions necessary to fund post-retirement benefit programs can be high.

Several modification options exist for institutions to consider regarding their benefit packages.

funding situation and legal obligations, several options can be considered when examining ways to terminate or modify benefits either in the past or for the future. Some possible options are:

- Change the benefit plan structure (e.g., change from a defined benefit to a defined contribution plan).
- Reduce or eliminate specific benefits levels (e.g., offer single or couple coverage only as a post-retirement benefit. Eliminate family coverage).
- Maintain current benefits but require employees to either pay a larger share of the benefit or take a salary cut to fund the benefits.
- Terminate the post-retirement benefits altogether and provide something else of value (e.g., payments into employees' 401K accounts).

The State Has Modified Its Future Benefits. The Legislature, during the 2005 General Session, took action and modified future benefits for state employees. The state modified these benefits because their continuation was fiscally irresponsible. It should be noted, however, that while future benefits were modified, accrued benefits (those benefits already earned by employees) were honored.

We estimated that the state's accrued liability for these post-retirement benefits is around \$521 million. Further, we estimated the total cost of the benefits for current employees (before modification by House Bill 213) was around \$895 million. We believe that, because the Legislature took action and modified the benefit as of January 2006, the state avoided future benefits costs of around \$374 million. The institutions should assess if this type of benefit modification would reduce some of their potential liability.

Modification of Past Benefits Is Possible. For example, one public education school district successfully reduced its Medicare supplemental actuarial accrued liabilities from approximately \$26 million to \$6 million. A representative committee was formed to study the issue and make a recommendation to the negotiating teams because the Medicare supplemental insurance benefit affected administrators, teachers, and classified employees. The committee determined that to fund the liability,

One public education district demonstrated how accrued liability can be reduced if it is too expensive to fund.

a salary cut of approximately 12 to 15 percent was necessary. This solution was considered unacceptable by the committee.

Instead, the recommended solution was to terminate the benefit and provide something else of value. The district accomplished this by requiring that current employees who had been offered Medicare supplemental insurance upon retirement make one of two choices prior to the benefit termination date:

- Retire by benefit termination date and receive the benefit under the old plan. To take this option, an employee had to meet the age requirements present under the old program.
- If retirement by the benefit termination date was not possible or desired, then employees could receive a one-time payment to their 401Ks for future retirement use in exchange for releasing the district from its supplemental insurance benefit obligation.

This type of benefit modification may not work for all colleges and universities. However, it provides an example of how the actuarial accrued liability can be reduced if it cannot be funded by the institution. Ultimately, however, each of the institutions must determine how its accrued and future benefit liabilities are going to be controlled and funded.

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Chapter III Legislature Can Play Vital Role

Primary control of higher education's post-retirement benefits rests within each institution. If, however, institutions cannot adequately address their post-retirement cost problems, the state does have an interest, and the Legislature can intervene. We believe the Legislature can play a vital role with legislation that requires colleges and universities to promptly address the growing liability problem. The institutions may not have strong incentives to identify and fund their post-retirement liabilities. Consequently, the Legislature can move the institutions forward by specifying an accounting methodology and reporting requirement for cost control and funding plans.

Funding Incentives Are Weak

From an institution's perspective, the effort necessary to identify and fund post-retirement liabilities is substantial for an outcome that is not on the near horizon. Most likely, institutions see other short-term funding needs as more deserving of action today. In fact, this particular issue was recently outlined in a 2005-06 Education Analysis conducted by the California Legislative Analyst's Office. This analysis provides two reasons why institutions might not want to identify and fund their liabilities:

- Setting aside funds on an annual basis to meet future obligations will complicate budgeting since it will reduce funds available for other priorities.
- Any financial crisis that would result from these liabilities may be years or decades away.

Given these reasons, it is not hard to understand why some administrators might not want to have an actuarial study done. Thus, the Legislature might need to require action.

Institutions probably see other immediate funding needs as more deserving of action today.

Legislature Can Help Move Institutions Forward

The Legislature should require institutions to identify their liabilities and develop plans to meet these obligations over time.

Legislative action supporting colleges and universities in their need to address post-retirement benefit liabilities may be a desirable option. Toward this end, we believe the Legislature should require institutions to take action in identifying liabilities and developing funding plans. Specifically, the Legislature should require higher education to:

- actuarially assess its full liability for all post-retirement benefits including stipends, stipends for phased retirement programs, and insurance for all current employees and retirees,
- modify or eliminate benefits, if necessary, so that they are affordable and costs are comparable to the state's, and
- fund all remaining benefits in such a way as to ensure that the benefits can be sustained into the future.

The Legislature should keep in mind that, as actuarial studies are performed, higher education may have an incentive to understate these liabilities. One way this understatement might occur is through the assumptions made in each institution's actuarial analysis. GASB 45 allows organizations to make a number of underlying assumptions—for example, the interest rate and the medical inflation rate used—and these assumptions can affect the actuarial results. Consequently, higher education's assumptions should be focused on insuring a reasonable estimate and adequate funding of obligations. In our opinion, higher education should standardize some of the actuarial assumptions that are used among institutions (i.e., medical inflation rate, general inflation rate) to increase the comparability among institution actuarial studies. Also, the Legislature may want to review the assumptions at some point in the future to make sure the assumptions are reasonable.

In summary, the post-retirement benefits offered by higher education should be brought under control. Our estimate of the total post-retirement liability for higher education is approximately \$979 million. However, this estimate excludes supplemental insurance benefits offered to retirees over age 65 and phased retirement stipends. Because the post-retirement stipends and health insurance benefits offered are so costly, colleges and universities should modify their benefits, if necessary, so they

are affordable and their costs are more comparable with the state's. In addition, since much of this liability is unfunded, it is important that each institution develop a funding plan to insure its obligation will be met.

Recommendations

1. We recommend the Legislature require colleges, universities and applied technology centers to assess their full liability by having actuarial studies completed by the 2007 General Session on all post-retirement benefits including stipends, insurance to age 65 and insurance after age 65.
2. We recommend the Legislature require colleges, universities, and applied technology centers to standardize key actuarial assumptions such as the medical inflation rate and the discount rate and report these assumptions during the 2006 Interim.
3. We recommend the Legislature require the Board of Regents to provide for the compilation and reporting of all actuarial study results to the Legislature during the 2007 General Session.
4. We recommend the Legislature require colleges, universities, and applied technology centers to evaluate their post-retirement liabilities and, if necessary, modify or eliminate post-retirement benefits to a level that is affordable, sustainable, and more comparable with the state's costs.
5. We recommend the Legislature require colleges, universities, and applied technology centers to develop plans to fund post-retirement obligations by modifying or eliminating benefits instead of requesting additional funding from the taxpayers or students and without negatively impacting educational services. These plans should be reported to the Legislature during the 2007 General Session.
6. We recommend that the Legislature consider fiscal sanctions or other appropriate measures if the progress reported by higher education during the 2007 General Session is not satisfactory.

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Appendices

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Appendix A

Liability Estimation Methodology

In order to develop an overall estimate of higher education's post-retirement liability, it was necessary to make estimations because no higher education institution has completed an actuarial study. To accomplish this estimate, we used an existing actuarial analysis, completed in September 2004, as the foundation from which all estimations were made. This analysis was used because it was recent and also included estimates of the liability associated with stipend payments.

One change was made to the actuarial study used. While the original study used a three-percent interest rate, the study was re-analyzed, at our request, using a four-percent interest rate. This re-analysis was done to maintain reporting consistency among other actuarial studies that we reviewed. Of course, this higher interest rate reduces the reported estimated liability amounts from what would have been reported using a three-percent interest rate.

Our estimates focused only on stipends and insurance to age 65. In making estimates for institutions, we made the following assumptions:

- A large factor that should influence an institution's actuarial estimates relative to that of the study would be its relative size. So, we made adjustments to the actuarial estimates based on the comparative institution's relative size.
- Another factor that should influence an institution's actuarial estimate would be the relative richness or leanness of the benefits offered to those in the study. In other words, under the same conditions, would the comparative institution pay more or less in benefits? As with size, we made adjustments to the actuarial estimates based on comparative benefit richness.

To enable adjustments based on relative size, each institution provided a valuation census. This census was comprised of the number of active employees—segregated into administrative, classified, and certified categories—who could potentially receive a benefit, as well as the number of retirees currently receiving an early retirement benefit.

Based on relative size, adjustments were made to the actuarial study. For example, Utah State University has 5.3 times more administrative employees than the institution in the actuarial analysis. So, we estimated that costs for their administrative employees are five times greater. Snow College has only one-third as many administrators, so we estimated their costs at only 34 percent of those in the actuarial analysis. Administrators, as they are used in this

methodology, can include a wide variety of professional staff not just those formally designated as administrators.

To enable adjustments based on relative benefit richness, each institution responded to five scenarios (two administrative, one certified, and one classified) for which salaries, insurance premiums, inflation rates, etc. were all standardized. By doing this standardization, we obtained a reasonable measure of actual differences in the benefit plans. Higher Education developed this methodology in 2004 for benefit comparison among higher education's institutions. Each institution's stipend and insurance benefit payout—calculated separately for administrative, classified, and certified employees—was expressed relative to the institution in the actuarial analysis.

Based on relative richness or leanness of benefits, adjustments were made to the estimates in the actuarial analysis. For example, Utah State University's stipend benefit for administrative employees is 1.43 percent richer than that of the analysis. Consequently, 1.43 times the actuarial estimate (after the relative size adjustment is made) would become our estimate for Utah State University's administrative stipend liability.

Provided in Appendix B is an example of how our estimates were made. Utah State University is used for this example, and all institution estimates were made using this methodology.

Our methodology and calculations for higher education were reviewed by an actuary specializing in post-retirement benefits. We contracted with Gabriel, Roeder, Smith, and Company to review our methodology and comment on its ability to provide a reasonable estimate of actuarial liabilities. Our consultant concluded that while there are limitations to our methodology “. . . , we believe the analysis is sound, [and] . . . will produce a ‘ballpark’ estimate of the true liabilities calculated under GASB 45 and GASB 27.” For our consultant's complete response, see Appendix C.

Appendix B Calculation of Utah State University's Stipend Accrued Liability

	4 Percent Discount Rate Used			Utah State University's Estimated Stipend (Rounded)
	Actuarial Estimate	Utah State University's Relative Size	Utah State University's Relative Benefits	
Administrative	\$ 5,379,643	5.3052	1.4288	\$ 40,778,000
Classified *		.7677	.4741	12,225,000
Certified	33,591,187	.2589	.8804	7,657,000
Retirees **	7,116,921	.4418	2.4889	7,826,000
Stipend Estimate				\$ 68,485,000

* Classified stipends were estimated using the certified actuarial estimate.
 ** Retirees' relative benefit is a weighted average of administrative and certified relative benefits.

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Appendix C
Gabriel, Roeder, Smith & Company



GABRIEL, ROEDER, SMITH & COMPANY

Consultants & Actuaries

4600 South Ulster Street • Suite 700 • Denver, Colorado 80237-2603 • 303-846-3031 • fax 303-740-6789

October 27, 2005

Mr. John M. Schaff, CIA
Auditor General
Office of the Legislative Auditor General
W315 Utah State Capitol Complex
PO Box 145315
Salt Lake City, UT 84114-5315

Dear Mr. Schaff:

As requested, we have reviewed your calculations of retiree liabilities of the Utah higher education departments relating to health care benefits and stipends. I have performed a cursory review and it looks to be accurate and consistent with the prior worksheet completed for the school districts.

Limitations of Process

We wish to reiterate that this process is not an actuarial valuation as required under Governmental Accounting Standards No. 27 and 45. It is merely an attempt to adjust another actuarial valuation of one school district to another educational employer. To the extent the Jordan School District is not identical to the various institutions of higher education, the liabilities will be different. Key characteristics which may vary among districts include:

- Pay levels
- Breakdown of retirees between classified, certified, and administrative, which differ from active employees
- Ages
- Male/Female ratios
- Utilization of health care
- Retirement patterns

Despite these limitations, we believe the approach chosen is reasonable and will produce a “ballpark” estimate of the true liabilities calculated under GASB 45 and GASB 27.

Some of these assumptions will result in numbers which are different from these estimated. In particular, if an institution’s pay is higher or lower than Jordan’s, then the liability related to the stipend will be higher or lower than these estimated.

Another difference is that the University of Utah figures have been reduced by half because they indicated that only about half of the members are approved for the benefits. Clearly this is only an approximation and the true value will be different than half.

Other Issues

Additional Measurement Difficulties for Medicare Supplement Benefits

The University of Utah's Medicare Supplement benefit would also result in a liability under GASB 45. Unfortunately, we know of no other Utah entity which has completed an actuarial valuation of comparable Medicare Supplement benefits. This is in contrast to the pre-Medicare health plan and the stipends which other entities, particularly Jordan, do provide.

You found two school districts which did provide post-65 health care: Tooele and Alpine. We understand that the University of Utah provides post-65 coverage to retirees who elect coverage and who have 5 years of service at retirement. The supplement covers 35% of the cost for the retiree and family for life.

Tooele also pays lifetime benefits, but requires 15 years of Tooele service and 25 years of service in education as of June 30, 2000, and retirement with 30 years of service. Alpine pays lifetime benefits, requires 10 years of service at retirement, but only covers those hired before August, 1995. Consequently a much higher proportion of University of Utah retirees will have coverage than will Tooele or Alpine retirees, particularly in the future, when the 1995 and 2000 dates are more significant.

Because of the substantial differences in benefit provisions, it is much less accurate to extrapolate one plans liabilities onto another plan here than it is for the stipend benefits and pre-Medicare health benefits.

Your estimates developed active liabilities based on Alpine and Tooele of \$129 million and \$103 million, respectively. I believe because of the uncertainties discussed above, that the active liabilities could be more in the wide range of \$75 million to \$150 million.

Applicable Accounting Standard

As we mentioned in our previous analysis, the Jordan actuarial report presented the actuarial liabilities for both the stipend and the health care benefits in total as a liability to be reported under GASB 45. We believe that the stipend is not subject to GASB 45, but should either be reported under GASB 27, or as a special termination benefit under less conservative accounting rules. We have broken out our liabilities between the two benefit types. We believe that the "Stipends" column is applicable under GASB 27, while the "Health" column is applicable under GASB 45.

Investment Return Rate

Statement No. 45 indicates that liabilities should be discounted based on the expected return of assets used to fund the liabilities. Because the plan is currently not pre-funded, this suggests that the rate of return on short term investments is appropriate. Both 3% and 4% discount rates were used in the Jordan reports, while a 4% rate is being used in the Office of the Legislative Auditor General's office. We believe that 4% is a reasonable rate to be used for this purpose. Although 4% is somewhat higher than current yields on short term bonds, it is reasonable to assume that bond rates will increase to be at the 4% level in the not too distant future. We have heard informal information from GASB that rates in the 6% to 7% range are not reasonable. They have not commented on lower rates.

Comparison with Actuarial Valuations

We wish to reiterate that our analysis was not an actuarial valuation as required under GASB Statements 27 and 45. It was a confirmation of your approximation attempt to map one actuarial valuation done on one district onto all districts. Subject to these limitations, we believe the analysis is sound.

Actuarial Definitions

This letter refers to the "actuarial accrued liability" and "present value of total projected benefits". The present value of projected benefits is the single sum necessary to fully fund all anticipated future benefits for all members, active and retired. The "actuarial accrued liability" is an allocation of the present value to years in the past. It can be thought of as the amount that should be funded as of the actuarial valuation date.

Conclusions

The following table presents the total present value of projected benefits and the actuarial accrued liabilities for the education departments' stipend and health programs that we have reviewed. This table excludes the Medicare supplement for employees of the University of Utah.

	Actuarial Accrued Liability	Present Value of Total Projected Benefits
Stipends (GASB 27)	\$282 million	\$400 million
Health (GASB 45)	\$351 million	\$579 million
Total	\$633 million	\$979 million

John M. Schaff
October 27, 2005
Page 4

Please do not hesitate to contact us if you would like to discuss these matters further.

Sincerely,

Gabriel, Roeder, Smith & Company

A handwritten signature in black ink, appearing to read "WB Fornia". The signature is written in a cursive, slightly slanted style.

William B. Fornia, F.S.A., E.A., M.A.A.A.
Senior Consultant

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Agency Response



UTAH SYSTEM OF HIGHER EDUCATION
STATE BOARD OF REGENTS

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RICHARD E. KENDELL
Commissioner and
Chief Executive Officer

December 7, 2005

Mr. John Schaff
Legislative Auditor General
W315 State Capitol Complex
Salt Lake City, UT 84114

Dear Mr. Schaff:

Thank you for allowing me to respond to your report titled "A Review of Higher Education's Post-Retirement Benefits." The report makes six recommendations, summarized on page 21. To the extent that you recommend conducting and reporting an actuarial study with standardized assumptions (recommendations one, two and three), we are happy to provide this information to you and the Legislature at the times specified. We are also committed to maintaining a benefit policy that is appropriate for higher education employees and affordable for the taxpayers of Utah and the students who pay tuition (recommendations four, five and six).

I understand that your report was designed to be an estimate of a potential need and is not in any way an actuarial study. With that understanding, I would like to offer several concerns regarding the study.

1. The report begins with the comment that "post-retirement benefits, in addition to employee pensions, have not yet been fully acknowledged" (page 1). The Utah System of Higher Education does not offer post-retirement benefits as defined in the study. The limited number of employees who are on state retirement are fully funded through the Utah Retirement System but were never eligible for the state's "sick leave exchange program."
2. The report repeatedly states that USHE's retirement benefits are richer than the state's, but no data is provided to confirm this statement. The USHE primarily offers a defined contribution plan – employee retirement is paid to a third party administrator and directed by the employee. With the exception of one benefit at the University of Utah, the institutions have no obligation to former employees. The University of Utah offers to cover 35% of the cost of Medicare supplemental insurance for certain former employees. This benefit expires at the end of this calendar year.
3. The report is based on the assumption that behaviors and policies regarding post-retirement benefits in a public school district provide a reasonable basis for estimating early-retirement benefits in the USHE. This assumption may or may not be supported by an actual investigation of higher education's benefit plan.

UNIVERSITY OF UTAH
Salt Lake City
1850

WEBER STATE UNIVERSITY
Ogden
1889

SNOW COLLEGE
Ephraim
1888

COLLEGE OF EASTERN UTAH
Price
1937

SALT LAKE COMMUNITY COLLEGE
Salt Lake City
1947

UTAH STATE UNIVERSITY
Logan
1888

SOUTHERN UTAH UNIVERSITY
Cedar City
1897

DIXIE STATE COLLEGE
St. George
1911

UTAH VALLEY STATE COLLEGE
Orem
1941

UTAH COLLEGE OF APPLIED TECHNOLOGY
Statewide
2001

4. The report states that it should not be treated as a substitute for an actuarial study but it makes recommendations and conclusions regarding how benefits must be addressed. We believe that such recommendations and conclusions may be premature and that all assertions should be supported by appropriate examples and comparative data. We cannot know in advance of the actuarial study whether or not benefits need to be modified.
5. We do not agree that the USHE "is facing what the state faced when the legislature passed House Bill 213" (page 3). First, the USHE's early-retirement program is an important management tool that is fully funded on each campus. Eight institutions fund this on a case-by-case basis, generally by reducing budgets in existing funded positions. One institution funds it with a surcharge on payroll funded by each department and spread across funding sources. Second, this benefit is a termination benefit, not a post-retirement benefit.
6. The report infers that in a single year a \$979 million charge is dangling over the USHE. The \$979 million calculation, even if it were accurate, is the total cost of benefits spread over 35 years. It is highly unlikely that such a liability would come due in the lump sum as implied. Moreover, the calculation does not take into account that less than half of the funds would come from state appropriated sources (including tuition). To put the number in context – even when the figure is calculated on employees paid through all funds, it represents less than five percent of the annual appropriated compensation budget.

I appreciate the chance to respond to this audit. We believe we can fully comply with the recommendations as they are consistent with our current practice. USHE institutions have been preparing for months to conduct an actuarial study to comply with GASB 45. In light of the legislative interest in that issue, we will accelerate our timetable to complete this work.

If you have any questions, please feel free to contact me.

Sincerely,



Richard E. Kendell
Commissioner of Higher Education

REK/KW/jc



Office of the Vice President
for Administrative Services

December 7, 2005

Mr. John M. Schaff, CIA
Auditor General
Office of the Legislative Auditor General
W315 Utah State Capitol Complex
PO Box 145315
Salt Lake City Utah 84114-5315

Re: Response to Legislative Auditors "Exposure Draft" report, **A Review of Higher Education's Post-Retirement Benefits**

Dear Mr. Schaff:

Thank you for the opportunity to share our concerns about the draft audit report as it related to the University of Utah. Our concerns and comments are:

- Effective January 1, 2006, the University will no longer pay 35% of the cost of Medicare supplemental insurance. From that time on, the University's contribution for health insurance for retirees who are Medicare eligible will be zero. Therefore, we believe that our post-retirement liability will likewise be zero. The new rates, effective January 1, 2006, have been communicated to the retirees.
- The report assumes that behaviors and policies in a public school district provide a reasonable basis for estimating the liability associated with early retirement benefits at the University. This is not a valid assumption. Perhaps the most obvious difference is that early retirement is not an entitlement at the University. The University is not obligated to grant any request for early retirement. A University employee may request early retirement, but that request can, and sometimes is, denied. The cost of an early retirement, both the stipend and the health insurance assistance, is borne by the operating unit, not the central administration. If the unit head is unwilling or unable to pay for the cost of the early retirement, the retirement is denied. Senior level administrators can also deny the request for budgetary or other reasons. To

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Salt Lake City, Utah 84112-9012
Office Phone (801) 581-6494
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characterize, as the report does, that early retirement is an unfunded liability at the University is misleading at best.

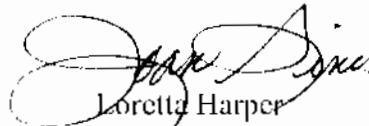
- The University is currently negotiating with an outside party to undertake an actuarial study to determine our full liability for early and phased retirement. As indicated above, we do not expect to have any liability for the post retirement years. We would be willing to coordinate the actuarial studies for any or all of the other USHE institutions. We believe that the University's portion of the study can be completed within the next few months.

We believe it is important that an accurate potential liability be determined. The assumptions used in the current report are not reflective of the actual nature and usage of our early retirement program and, therefore, do create some concern. We look forward to working with you to further refine this report.

Sincerely,



Arnold B. Combe
Vice President
Administrative Services

 FOR LORETTA HARPER

Loretta Harper
Vice President
Human Resources