

OPTIS

OPEB Pension Trust Insurance Solution

Appendix



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(OPEB Pension Trust Insurance Solution)

The Challenge: Funding OPEB and Pension Promises

Most Political Sub-Divisions (PSD's) have been making retirement promises to their employees for years. Typically, generous pensions are offered in order to attract and retain valuable workers. In many cases, all or part of the retiree health insurance premiums are included in the workers' incentive packages. While some PSDs have either overfunded or fully funded plans others have seen their funded ratios fall below 80%. The objective for all PSDs going forward is to adequately fund these plans while mitigating the risks to plan assets that have existed over the last 10 years. **Simply stated, the challenge is to fund these commitments at the lowest cost and risk to all interested parties: the government, employees and taxpayers.**

The Funding Dilemma

PSD's are faced with four major challenges in the funding of their defined benefit and or OPEB plans.

- First, many have seen the benefits paid by these plans increase significantly over the last 15 years. This has been due in part to additional benefits being added to most plans.
- Secondly, in many parts of the country we have seen an increase in longevity which has caused plans to pay out more in benefits than had been actuarially assumed.
- Third, many governments have failed to fund plans at their Actuarially Required Contribution (ARC) rate. In the case of OPEB plans very few governments have any formal funding strategy other than pay as you go.
- Fourth, the actuarially assumed investment returns have failed to meet the actual investment results of most plans. This has been magnified by the significant investment losses that many plans have seen over the course of the last 18 months.

PSD's find themselves faced with the perfect storm, reduced revenues, increasing contributions and reduced funding levels of their Pension and OPEB plans.

OPTIS

OPTIS (OPEB Pension Trust Insurance Solution) uses a proven methodology for helping to address the challenges facing PSDs. OPTIS provides the following benefits:

1. Introduces an investment asset that reduces the risk of capital loss to Pension and OPEB plans.
2. Hedges a plan against longevity risk.
3. Reduces plan asset management fees
4. Allows for a contribution strategy that is fairly predictable and can assist in alleviating some of the volatile investment swings that have occurred over the last 10 years.
5. Provides for cost recovery to the PSD of some plan contributions
6. Assists in helping plans that are frozen or overfunded in continuing to meet their financial objectives.

OPTIS is part of a plan that can help PSDs fund their Pension and OPEB plans at the lowest cost and risk to all interested parties: the government, employees and taxpayers.

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Patent Pending OPTIS Core 5-15-2011

The Core Components

Trust and Split Dollar Life Insurance

The Process

- The comprehensive actuarial study, conforming to GASB 45(OPEB) or GASB 27 (Pension), PSD objectives and other data are reviewed by HRSolve.
- Based on plan needs and the actuarial projections, HRSolve prepares a customized proposal outlining design and strategy alternatives using life insurance as an asset class.
- PSD and interested parties are brought together to choose optimal design.
- An appropriate special purpose entity (SPE) is set up, i.e. an Irrevocable OPEB Trust, etc. if not already in place.
- A portion of the (SPE) assets is used to purchase life insurance on the PSD's employees.
- Program is monitored on an ongoing basis.

The Advantages

- Government pension or OPEB trust remains viable.
- Government and taxpayers recover a portion of the costs of their contributions into the plans.
- Government enhances its operating budget while improving the predictability of future contributions.
- Government potentially enhances or protects its credit rating, reducing all future borrowing costs.
- Employees' benefit promises are secured, enhancing recruitment and retention efforts by the government.
- Protects from negative market conditions on downside, but also protects on the upside

Pension & OPEB Shortfall Funding Using OPTIS *OPEB Pension Trust Insurance Solution*

Goal: Fund Pension or Retiree Healthcare liability shortfalls at the lowest *cost and risk* to the government/employer/taxpayer.

Solution:

- Pension or OPEB Trust purchases life insurance policies on active employees.
- Employees provide consent to be insured.
- Policies are owned by benefits trust.
- Death benefits can be retained by benefits trust or “split” between the Government and trust.
- Can be used in combination with bonding of unfunded liability.

Benefits: *Seven Reasons Why Life Insurance Makes Sense*

1. Life insurance creates a hedge against longevity risk inherent in a pension or OPEB plan.
2. Death benefits provide a guarantee component not otherwise available from other financial investments.
3. Life insurance is transparent and easy to understand.
4. Life insurance internal rates of return are competitive, and provide bond-like returns with reduced risk.
5. Life insurance as an asset class has zero correlation to other sectors of the investment marketplace.
6. Cost recovery of benefits provided can be achieved through the death benefits’ predictable revenue stream.
7. When life insurance is used in combination with a properly constructed bonding strategy, government and taxpayers can save significant sums over time, and employee promises can be secured.

Legacy Promises and OPTIS *OPEB Pension Trust Insurance Solution*

Risks and Rewards

The ability of government employers to honor the legacy promises they have made to their employees is an issue of great national concern. Throughout their working lives, our administrators, teachers, firefighters, police and other government employees have given their dedicated efforts in return for the promise that certain pension and OPEB benefits will be paid during their “golden years” of retirement. Many of these promises have been underfunded, and some have not been funded at all. Even before the current economic downturn, fulfillment of the promises to our loyal public servants was precarious. Now, with daily reports of market losses and financial uncertainty, it is clear that the ability to pay many of these promises is in grave jeopardy.

The issues are multifaceted. A long term solution will require the support of the three major constituencies; **government employees, taxpayers, and the government** itself. Each has its own agenda and unique perspective regarding retirement benefits. OPTIS addresses each of these agendas in a unique manner:

- 1) Employees** trust that the government will keep the promises that have been made to current and future retirees. They expect reasonable compensation for their efforts, and post-retirement benefits are an integral part of their compensation package. OPTIS immediately provides for a future stream of cash flows, inside a “lockbox” structure. Employees will know that their employer has committed to providing for their future retiree benefits.
- 2) Taxpayers** are concerned with maintaining a “tax friendly” business environment, while still receiving the necessary services provided by a strong, productive and efficient public sector. They understand the need to pay for government services, but they are reluctant to pay more for them than they believe those services are worth. OPTIS provides for funding pension and retiree healthcare liabilities at the lowest cost and risk to the government, and thereby to its taxpayers.
- 3) The government** has the responsibility of juggling the dual roles of being a servant to the taxpayers and being a responsible employer. Its elected officials and appointed managers are usually government employees themselves. They must be good stewards of public funds, and bargain for optimal pricing as they hire and contract for the performance of necessary public functions. OPTIS utilizes life insurance in a manner similar to that which the private sector has used for many years. Corporate employers have frequently used the technique to fund the competitive benefit packages necessary to attract and retain the best employees.

Engagement Structure

The HRSolve engagement process progresses through six basic stages:

- HRSolve is requested to provide expertise and services relating to the various retiree issues important to the client
- A preliminary engagement agreement is executed outlining the services to be provided by HRSolve and associated fee structure.
- An initial analysis is provided to the client. To provide the analysis HRSolve, Inc. typically requires the following information:
 - Copy of current pension and or OPEB actuarial report
 - Access to actuarial data supporting the Actuarial Report
 - Copy of most recent Annual Report for pension plan and OPEB plan
 - Description of and Summary Plan Description for benefit plans provided to retirees.
 - Review of the major issues, concerns and objectives of the plan and the employer.
 - A complete employee census (examples are provided).
- After HRSolve reviews the client information, a written summary of findings and an analysis of options available to the client will be provided.
- The plan and employer form a team to work with HRSolve. Review and implementation of strategies begins.
- Once strategies have been implemented, HRSolve remains active in the ongoing administration of the solutions chosen.

Frequently Asked Questions

Question: What are the precedents for using life insurance?

Answer: The use of OPTIS (OPEB Pension Trust Insurance Solution) is a mitigation strategy that can help to honor the promises made to employees while satisfying the needs of both employers and taxpayers. These strategies have been used effectively in the corporate and banking worlds (COLI – Corporate Owned Life Insurance & BOLI - Bank Owned Life Insurance) for over 50 years to provide funding for the promises made to employees. Their use in the public arena, while new, has the ability to help solve a problem that is becoming more complex everyday.

Question: What are the benefits of using life insurance?

Answer: The use of life insurance can assist pension and OPEB trusts in dealing with the risk exposure they face from increased longevity of their participants. The cash values in life insurance provide a competitive rate of return (similar to that of a corporate bond). The life insurance death benefits possess unique attributes as non-correlating trust assets. With these two components, the OPTIS design assists a governmental entity in creating future income streams to help honor the promises made to current and future retirees.

Additionally, life insurance has been used throughout the decades to help individuals and employers meet the needs of their families and workforces. It was designed to provide protection to loved ones and valuable employees. In much the same way, OPTIS is designed to provide protection to employees and their loved ones. These families' financial security is tied to the honoring of the promises made by the governmental employer. Without a means to fund current and future liabilities, many governments will be forced to cut or eliminate jobs and the benefits that go with them. Private corporations have been facing this ultimatum over the last 20 years. Those companies who have not dealt with the problem proactively are in dire straits today.

Question: How does OPTIS work?

Answer: The idea is as simple as this: a fireman, policeman, teacher or administrator agrees to have life insurance issued on his or her life. The death benefit from that life insurance is payable to the employee's pension trust or employer. The death proceeds can then be used to improve funding levels in the OPEB or pension trust. The result: the benefits of the employee and the financial independence of his or her family are secured.

OPTIS's use of life insurance provides an opportunity to help governments continue to honor the promises made to employees and gives employees the peace of mind that they and their families can count on those promises being honored. In a political environment like the current one, in which everyone will be called upon to contribute in multiple ways to the solution, the consent for insuring of a beneficiary's life should be an easy thing for him or her to give.

Question: What are the underlying risks of OPTIS?

Answer: Every investment and financing strategy carries with it inherent risks that must be evaluated and managed. OPTIS is not unique in that regard.

“Headline risk” is occasionally a matter of concern when using life insurance in an institutional setting. Individuals who are not familiar with the merits of the tool may focus on a perception that the owner of the insurance might be attempting to profit from the death of an employee. This misconception can easily be exploited by the media. Managing that risk involves a robust communication and education policy regarding the nature and objectives of the plan. That education includes creating awareness around the program's strict adherence to the “COLI Best Practices” adopted by the U.S. Congress to address those very concerns. Education is provided to the potentially insured employees (they will be required to give written consent to their involvement) and can be provided to taxpayers via distribution of a customized Media Fact Sheet.

Actuarial risk, the notion that deaths may not occur within the anticipated timeframe, is managed through extensive actuarial review. Typically the assumptions used are those already in place from the government pension or OPEB trust's actuaries. The larger the number of lives being insured, the higher the degree of certainty that can be predicted around the timing of death benefit revenue streams.

The **investment risk** that exists within the cash values of the life insurance policies requires the same kind of analysis and management involved in any portfolio. Decisions must be made regarding asset allocation and diversification, investment managers and the like. Credit risk, interest rate risk, market risk, liquidity risk, etc. must all be evaluated in this context.

In fact, the OPTIS strategy is itself a risk mitigation technique. Very few pension investment managers have tools to effectively deal with their biggest concern: that their beneficiaries will outlive the pension plans' ability to pay them. This is called “longevity risk”. By providing an immediate recovery of a retiree's pension or OPEB payments through death benefits upon his or her death, longevity risk can be mitigated.

Question: Why would an employee consent to being insured?

Answer: Virtually all employees should be concerned about the security of their retirement promises. Pension and OPEB benefits are under attack in all sectors, including the public one. The recent drops in stock market values, “pension envy” from private sector employees, and the resistance to further taxation of the electorate are just a few of the pressures coming to bear on public pensions. OPTIS gives the employee an opportunity to play a role in establishing the security of his or her future, and by participating the employee helps ensure payment of these future benefits.

Question: Is there political risk involved?

Answer: Elected officials and government administrators occasionally express concerns about potential political risk when adopting a financial plan that incorporates the use of life insurance. These individuals are typically interested in acting in the very best interest of their constituents, and in communicating to the electorate that they are working effectively on the problems that face the community. Their reelection and job security depend on it. The OPTIS strategy provides a reasonable approach to a vexing set of problems. In the current political climate it may be, in fact, more risky to avoid the problem than to propose a unique solution. In addition, the due diligence process that surrounds this financing strategy is no different than the due diligence process that is followed for any other investment or financing product; proper review and analysis should demonstrate the merits of the program.

Finally, regarding the use of life insurance for cost recovery: upon the passing of an individual leaving behind financial obligations, one of the first questions that come to mind for most people is – did they have life insurance? The question can apply here as well, and the answer should be “yes”.

Institutional Profiles:

HRSolve, Inc.

HRSolve, Inc. is a for profit organization based in Denver, Colorado. Its principals bring 50+ years of experience from the employee benefits, public accounting, investment banking and non-profit consulting industries. The firm's suite of offerings is designed to help governments and corporations deal with retiree pension and healthcare obligations.

Corporate Principal Biography:

Michael C. Gerali

Mike, a Colorado native, is a partner with HRSolve, Inc.

He has been active in the employee benefits and human resources consulting arena since 1989 and served as President of HR Source prior to his founding of HRSolve, Inc.

Mike has spoken at numerous conferences on the topics of OPEB and Retiree Obligations.

Mike's career has been dedicated to helping governments and corporations create long-term solutions to address their employee benefit problems and liabilities.

He is a graduate of the University of Colorado at Boulder with a Bachelor of Science degree in Finance. He lives in Denver with his Fiancé' and two daughters.

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