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FINANCE COMMITTEE

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2013 Actuarial Valuation of Staff-related Liabilities

Addendum 1

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EXECUTIVE SUMMARY

- **Addendum I** provides further information on options to address the funding gap of the ASMC Liability.
- At its 151st session in November 2013, the Finance Committee reviewed document 151/5 which put forward broad-based options to address the funding gap of the ASMC accrued liabilities based on the 2012 Actuarial Valuation of Staff Related Liabilities report.
- As requested by the Committee, this document sets out the Secretariat's findings on the key options relating to the funding of the ASMC liabilities, relating to capital funding and insurance.

GUIDANCE SOUGHT FROM THE FINANCE COMMITTEE

- The committee is invited to note the further information presented by the Secretariat on options to reduce FAO's unfunded ASMC liabilities in the context of the considerations of this matter by the United Nations System and to provide any views or guidance.

Draft Advice

The Committee:

- **noted the options submitted by the Secretariat to fund the ASMC liability gap**
- **encouraged the Secretariat to evaluate in greater detail the option of additional funding of ASMC liabilities, while also seeking to determine the feasibility and cost effectiveness of a fully-insured option**
- **emphasized the importance of continuing to work with others within the UN System to seek a common approach to this matter , including a common protocol for establishing assumptions such as discount rates, to be used for computing ASMC liabilities**
- **urged the Secretariat to use its best efforts to maximize cost savings under the medical insurance plan**

Introduction

1. This document is presented as a follow-up to document FC 151/5 *Funding of After Service Medical Cover (ASMC) Liabilities*, for which the Committee requested detailed information on the proposed options to reduce the unfunded ASMC liabilities. The options are reviewed in terms of how they will satisfy stakeholders, the external auditor, be cost efficient and make a credible case to be supported financially.
2. The actuaries have issued their latest report updating the ASMC liability position to 31st December 2013 and this valuation forms the basis for the figures presented in this document. The total ASMC Defined Benefit Obligation (DBO) liability on a funding basis is now shown as USD869 million, which is the accrued liability based on service rendered to 31st December, 2013. This figure reflects an assumed 64.5% cost share by FAO¹. This amount increases each year as the cost of additional benefits are recognized for active staff who are not yet eligible to retire and decreases by, claims and related amounts paid out for retired staff. The liability will also change as actuarial assumptions, such as the discount rate, change over time.
3. The actuaries report that the actual claims paid under ASMC were USD27 million in 2011; USD28 million in 2012; and USD35 million in 2013, an increase of 12.5% in two years. This amount is expected to increase in the near future due to medical inflation, with more new retirements than deaths expected over that time frame. It should be further noted that the liability will also change when actual plan experience is different than expected, which is likely to occur given the uncertainty and volatility in retiree medical claims experience.
4. The IPSAS25 accounting standard does not require a plan sponsor to fund these benefits but only to recognize these liabilities in the organization's financial statements as they accumulate during the current staff's working career (the liability is fully recognized at/during retirement). In addition, the DBO liabilities determined under this standard may not be appropriate for the long-term funding of these liabilities given that the discount rates used do not anticipate the expected return on plan assets. However, the introduction of this standard has brought to light the underfunded nature of these benefits resulting in organizations, such as in FAO, and focussed the discussion on options to reduce the unfunded liabilities.
5. The actuaries suggest that 25 years is a reasonable period to fully fund the current DBO liability when measured on the current accounting basis. The actual amount of time required to achieve full funding will depend on the level of contributions made, investment earnings on the assets, changes in assumptions (e.g., discount rate), and amounts of medical payments and demographic experience in the future.
6. As presented in table 5 of FC 154/3, as at 31 December 2013, the Organization had USD343.7 million of earmarked long-term investments available to fund ASMC liabilities. Assessments on Member Nations towards funding of the past service ASMC liability for the biennium 2014-15 currently amount to USD 7.05 million per year (USD 14.1 million per biennium) as approved by Conference in June 2013. Additional contributions would be required in order to eliminate unfunded liabilities under all of the options presented.
7. There are two main options for funding these liabilities, which could be combined: (a) financing them directly via investment (for example, assets invested in a mix of bonds and equities), through additional Member Nation contributions, or by a charge on staff/retiree costs; and/or (b) insuring the liabilities. These are addressed in the paragraphs below.
8. The ultimate funding approach will need to consider not only current accrued liabilities (as at 31st December, 2013) for ASMC, but also the expected future increase in liabilities as benefits are

¹ For IPSAS accounting purposes, the FAO assumed cost share is 77%, which produces an accounting liability of USD1,037 million as of 31st December 2013 as reported in FC 151/4 para 3. Further information on the reason for differences between the valuation on an "accounting" and "funding" basis were presented in FC 132/3, paras 18-19.

recognized on account of additional years of service by active staff not yet eligible to retire, and which will include future staff hired by FAO.

9. At present, the DBO liability would not be fully funded because the liabilities either on an IPSAS 25 or a funding basis exceed the current assets. A plan is considered fully funded if (1) the fund is at least equal to the appropriate liability; (2) the fund is dedicated solely to meeting the liability and is ring fenced (i.e., the fund cannot be accessed or controlled by the organisation once it is established); and (3) the fund must be in existence for as long as the liability exists. While it is not necessary to achieve full funding over the short-term, FAO would need to establish a systematic funding approach in order to reach full funding (if that is an agreed FAO goal). It is important to note that even after such full funding is reached, it will be necessary to continue to contribute to the fund in order to retain this funding level. FAO is also continuing to investigate whether the risk associated with a portion of the future benefits can be transferred to an insurance company (further details on this option are provided below).

10. Document FC151/5 also introduced the possibility of adjusting the current medical plan during 2014 to ensure optimal pricing. This is work in progress, the results of which are not expected to be known until mid-2014. It is believed however that any changes made will probably have little impact on resolving the ASMC liability issue and this option will be considered in the next report on this matter to be presented to the Autumn 2014 Session of the Finance Committee.

Proposed Options to Address the Funding Gap

(a) Provide additional funding towards the liabilities

11. Document 151/5 noted that the total ASMC liability could be funded in a progressive manner by increasing the annual medical expenses assessment on Member States and/or by making a separate charge on staff/retiree costs. Assuming that the relevant funding is available, this section further illustrates the feasibility of the options. The actual funding options will be presented for discussion to the Autumn 2014 Session of the Finance Committee.

12. The measurement of DBO liabilities using the AA bond discount rate required by the IPSAS 25 accounting standard, means that future returns on plan assets are recognized implicitly only to the level of AA bond yields. In practice the return achieved by FAO's diversified investment portfolio has historically exceeded the discount rate. The reported return over the last 20 years was 7.78% (please refer to document FC 154/4, *Report on Investments 2013* for further details) although it is noted that investment returns for the years ahead are expected to decline.

13. In order to demonstrate the impact of the rate of return on funding requirements by way of example, if liabilities are discounted at 6.0% (funding basis) rather than 4.3% (accounting basis) it is estimated that the amount of assets required for full funding would be about USD630 million, rather than the USD869 million disclosed in the actuaries' report. Assuming that the USD344.5 million of assets as of 31st December 2013 is used to offset this liability, the additional funds required as of the measurement date would be about USD284.5 million on a funding basis compared with USD 524.5 million when using the 4.3% discount rate.

14. In terms of funding via investment, since the performance of capital markets is inherently uncertain, one cannot predict precisely the amount of assets or contributions required to bring about full funding within a specified period of time. However, the annual actuarial valuations could be enhanced to disclose the position of the assets and liabilities, and whether the current schedule of contributions is expected to result in full funding within the desired time frame.

15. Direct funding (i.e., additional Member Nation contributions) could be made to supplement the current earmarked long-term investments available to fund ASMC liabilities of USD344.5 million. As described in paragraph 13, it is estimated (pending more detailed analysis) that future contributions with a present value of USD284.5 million would be adequate to fund benefits accrued to date. These contributions (required to fund past service costs) would have to be in addition to annual contributions sufficient to fund the benefits accruing in that year for current staff not yet eligible to retire (referred to as the Service Cost). It should be noted that the Service Cost is not the same as annual pay-as-you-go

claims payments made on behalf of current retirees and their dependents (which could be higher or lower).

16. The amount of time required to fund the USD284.5 million deficit would depend on the contribution schedule chosen. It is important to keep in mind that if these annual “past service contributions” are greater than the interest on the unfunded liability (in the first year, USD284.5 million times 6%, or approximately USD17.1 million), then the unfunded past service liability will decrease. If, conversely, the past service contribution is less than USD17.1 million, then the past service liability will increase.

(b) Insure the liabilities

17. The purpose of entering into an insurance contract would be to transfer the liabilities for the ASMC benefits to a third party. If the contract effectively eliminates FAO from all further legal or constructive obligation for all of the benefit payments for the group of retirees covered by the contract, the associated ASMC liabilities could be removed from the balance sheet for the purposes of financial statement presentation. This would be a “settlement” under IPSAS 25. Assets/cash would, of course, have to be transferred to the insurer in consideration for their guaranteeing all benefit payments associated with those liabilities. Such a settlement would result in additional accounting charges under IPSAS 25.

18. It is critical to note that the ASMC payments and related liabilities are variable in nature. In contrast to a pension plan like the UNJSPF, where there is a defined benefit formula, the ASMC payments are more variable given that ultimate costs will depend on the cost, intensity and utilization of medical benefits in retirement as well as changes in the macroeconomic healthcare marketplace, such as the introduction of new technologies and prescription drugs or the impact of future diseases. This is certainly true for current retirees and their beneficiaries, but could be even more volatile and uncertain for future retirees and their beneficiaries. These factors, as well as the uncertain timing of their retirement and the cap on retiree premiums, which is tied to pension size, make the liabilities inherently unclear and unpredictable. Any insurer entering into an arrangement where 100% of obligations are transferred to the insurer would demand a significant risk premium for the uncertainty of these future payments. Furthermore, it should be noted that in the event an insurance contract is secured at this time, the cost quoted by an insurance company would be based on the current actual effective cost share for FAO. Therefore, this option may not be cost effective.

19. As an alternative to an insurance contract which leaves FAO with no potential for residual obligation, another approach would be for FAO to enter into an insurance contract in which the insurer administers payment of claims and assumes a limited amount of short-term risk. Since premiums would change in future years based on actual experience and claims paid, the risk and obligation to make good on the ASMC promises will not have transferred to the insurer, but would remain with FAO. Based on the IPSAS 25 standard, since a settlement has not taken place, the DBO liability could not be removed from FAO’s books for the purposes of financial statement presentation. However, the value of the claims that would be paid to participants by the insurer may be ring-fenced, counted as an asset, and thus offset the liability.

20. Clearly any decision to enter into an insurance arrangement will require further discussion with Legal and other units as to whether such arrangement(s) would achieve the desired goals.

21. Additional considerations with respect to any potential insurance contract would include that due diligence is required in selecting any insurer, to minimize to the greatest extent possible that an insurer would become insolvent and the ASMC liabilities would revert to FAO.

22. The possibility of using a combination of both financing and insurance was also investigated. Under such a combined arrangement, insurance could be purchased to cover the liabilities of current retirees. Liabilities for claims during retirement for current active staff would be retained by FAO, at least for now. This combined approach would eliminate the complexities of trying to settle liabilities associated with current active staff who are still accruing benefits. This approach assumes that an insurance arrangement covering current retirees can be secured that is affordable relative to the true

expected cost of the covered claims, and effective in terms of settling the portion of the liability being insured.

23. Since FAO would retain the ASMC liabilities associated with current active staff, the strategy discussed above for providing additional funding could be applied towards those liabilities.

24. Depending on the availability and price of the insurance arrangement under discussion, such a combination could achieve an efficient use of both insurance and capital.

Potential New Accrued Liabilities and other Cost Savings Measures

25. The foregoing sections dealt with the liabilities as at 31st December 2013. As described in paragraph 8, as additional benefits are earned on account of post-2013 service rendered by current staff, the value of those benefits increases the ASMC liabilities. The liabilities will also increase as new staff are hired. Unless the circumstances that gave rise to the ongoing increase in benefits are changed, the liabilities will continue to grow.

26. The FAO liability could also be reduced by adjusting the 50%-50% premium payments cost sharing balance. At present, because of ceilings on maximum amounts payable as a percentage of income, retirees pay on average 23% of the cost of their ASMC, serving staff are estimated to pay a further 12.5% of this cost through a cross-subsidy from their own medical insurance payments, and the Organization meets the balance of 64.5%. The same issue applies to current staff, where the 5% ceiling leads to the Organization subsidizing even in cases of higher grade professionals.

27. ASMC could also be provided on a defined-contribution basis. On this basis, funds paid in by the Organization and the staff Member during service would be set aside and be made available on retirement to facilitate the purchase of health insurance. It may be possible to apply a vesting schedule so that funds attributable to the Organization's contributions are paid only to staff who remain employed until they are eligible for ASMC benefits. No liability arises in respect of defined contribution schemes. If the retiree uses the proceeds of the defined contribution scheme to purchase health insurance, all of the risk associated with longevity, medical inflation and utilization of medical benefits would be transferred to the retiree. It must be noted that no other UN agencies are providing ASMC via a defined contribution arrangement and FAO would need to consider whether providing ASMC coverage on this basis will impact its ability to attract highly qualified talent.

28. Savings may also be achieved by re-designing the plan and re-enforcing the following provisions which would bring down the cost of the plan:

- agreements with service providers (fixed tariffs and discount rates for services);
- case management includes activities (such as: monitoring the length of stay; proposing alternative places of treatment or home care; negotiating additional discounts);
- change of the travel provisions;
- reasonable and customary charges;
- third-party administrators in some locations (such as USA, UAE);
- fraud detection activities, etc.

29. In addition, the current medical insurance contracts expire in December 2014 and the Secretariat is currently involved in the process for concluding a new contract. It is hoped this will result in improved terms for the period of 1st January 2015 onwards.