PERSPECTIVES

5 KEY CONSIDERATIONS FOR YOUR OPEB PLAN

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As many employers have fully funded and hedged their pension plans, some are beginning to turn their attention to other post-employment benefits (OPEB) liabilities as the next addressable source of balance sheet volatility.

OPEB liabilities are valued for financial reporting purposes similar to pension liabilities, i.e., projected future benefits are discounted at prevailing interest rates based on yields of high-quality corporate bonds to determine a present value. However, changes in assumptions used to estimate future benefits and differences between assumptions and actual experience may be more variable for OPEB plans, leading to additional actuarial noise.

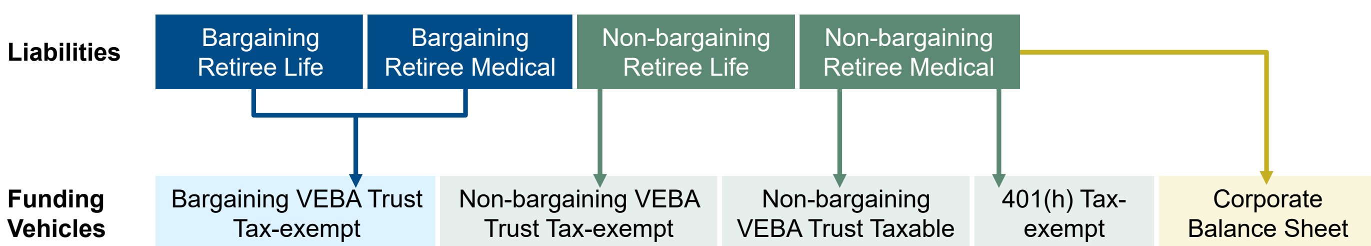
For example, future benefits for a traditional pension plan depend primarily on mortality and salary growth, both of which are relatively predictable. In contrast, future benefits for a retiree medical plan may depend on trends in healthcare costs, which are considerably less predictable. Therefore, depending on plan design, the minimum realized funded status volatility achievable for the OPEB plan may not be as low as that of the pension plan, but can be managed to limit the impact of interest rate risk following the same de-risking principles that apply to pension liabilities.

Additionally, certain asset allocation considerations apply to OPEBs that may not be relevant for pensions, primarily due to distinctions with regards to available funding vehicles and tax status.

1. Funding Options for OPEB Liabilities

Unlike pension liabilities, OPEB liabilities do not have funding requirements. However, many employers choose to prefund these benefits instead of pay-as-you-go funding because it provides tax savings, stabilized budgeting and assured asset availability to pay benefits. Figure 1 indicates available funding vehicles and their tax status for various OPEB liabilities. Because of their flexibility and tax-exempt status, both life and retiree medical benefits for bargaining employees and life benefits for non-bargaining employees are funded almost exclusively via Voluntary Employee Beneficiary Association (VEBA) trusts. However, employers have a choice to make regarding the funding vehicle to pay for non-bargaining retiree medical benefits.[1] This choice involves several tradeoffs.

Figure 1: Available Funding Vehicles for OPEB Liabilities[2]



2. Using a 401(h) Account to Reduce Taxes

Employers that sponsor both a defined benefit pension plan and a retiree medical plan can take advantage of a 401(h) account to reduce taxes.

Section 401(h) of the Internal Revenue Code allows a pension plan to establish an account for employee retiree medical benefits. Contributions to a 401(h) account within a pension trust receive the same tax advantages as contributions to pay pension benefits — tax-deductible contributions and tax-exempt earnings. However, aggregate 401(h) contributions are limited to 25% of aggregate contributions since the date of establishment of the 401(h) account. There are other limitations and considerations for funding a 401(h) account which are beyond the scope of this paper. Nevertheless, to allow flexibility for higher tax-advantaged contributions, most pension plans for employers that also provide retiree medical benefits should consider establishing a 401(h) account.

In some cases, the pension surplus can be tapped as a source of funding a 401(h). As we described in our 2023 post, [Funding Post-Retirement Benefits Made Easier Under SECURE 2.0](), pension plans that are above 110% funded may transfer a portion of excess pension assets to a 401(h) account to pay for OPEB benefits, subject to certain restrictions. As of February 2025, 31 of the top 100 corporate pension plans had a funded status above 110% based on NISA's Pension Surplus Risk Index (PSRX).[3]

3. Coordinating 401(h) and VEBA Funding for an OPEB Plan

Assets held in a 401(h) account can only be used to pay retiree medical benefits for employees who are participants in the pension plan.[4] This has implications for funding and paydown strategies, particularly for pension plans that have been frozen for a long time, such that a significant portion of the retiree medical liability may be owed to employees who are not in the pension plan. Employers need to be careful to avoid assets from becoming trapped in a 401(h) account. Surplus assets held in a 401(h) account can only be withdrawn with a hefty tax penalty — 70%+ due to excise taxes and income taxes. VEBA assets, on the other hand, are more flexible and can be used to pay for other employee benefits.

Using a 401(h) account in conjunction with a VEBA trust to fund non-bargaining retiree medical liabilities introduces considerations regarding which type of assets to hold in each trust. A common tax management strategy suggests that tax-efficient assets, such as indexed equities, are preferred in the VEBA, while tax inefficient assets, such as bonds, are preferred in the 401(h) account. However, this well understood shorthand oversimplifies asset location considerations for minimizing taxes. Several factors, including expected equity risk premium, level of interest rates, trust tax rate, capital gains tax rate and average equity holding period, influence the decision regarding asset location. For example, Figure 2 illustrates the equity risk premium at which the capital gains tax owed on a taxable equity investment equals the income tax owed on a taxable bond.

Figure 2: Tax Tradeoff Between Level of Rates and Equity Risk Premium

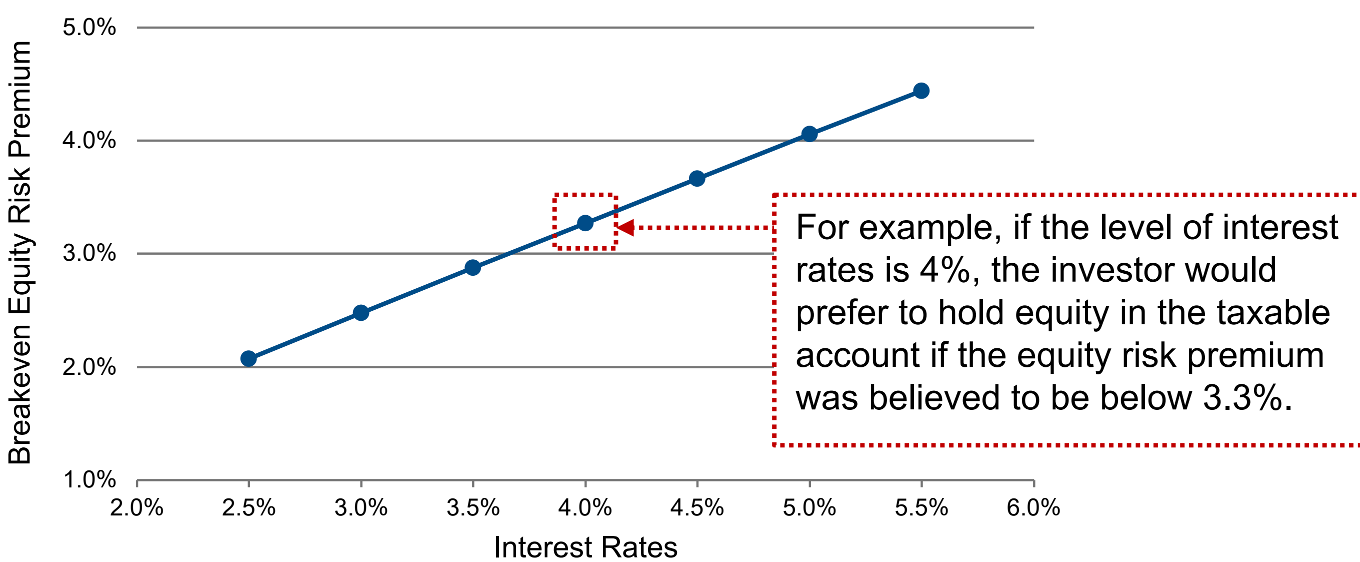


Chart assumptions: capital gains rate — 20%, income tax rate — 37%, average equity holding period — 5 years.
Sources: IRS, NISA calculations.

4. How 401(h) Accounts Impact OPEB Plan Glidepaths

The allocation of assets held in the VEBA must build around the 401(h) allocation such that the total assets supporting OPEB liability have the desired allocation and hedge percentage. This makes managing separate glidepaths for the pension and OPEB liabilities relatively inefficient. The example in Figure 3 illustrates how the VEBA allocation would need to be adjusted to maintain the desired allocation for OPEB assets if a change is made to the pension asset allocation. In this example, the pension trust fixed income allocation increases from 70% to 80% and the pension hedge percentage increases from 80% to 100% while the desired overall OPEB asset allocation is unchanged. In order to maintain the OPEB asset allocation, the VEBA trust allocation to fixed income must be reduced and the duration shortened. Completion portfolios are maintained in both the pension trust and VEBA trust to adjust the fixed income duration to achieve the desired hedge targets.

Figure 3: Derisking a Pension Trust that Includes a 401(h)

	Before Pension Derisking					After Pension Derisking				
	A	B	A+B	C	B+C	A	B	A+B	C	B+C
	Pension Assets	401(H)	Total Pension Trust	VEBA Trust	Total OPEB	Pension Assets	401(H)	Total Pension Trust	VEBA Trust	Total OPEB
Return-seeking Assets ($mm)	300	53	353	198	250	200	35	235	215	250
Percent of Assets	***30%***	***30%***	***30%***	*61%*	***50%***	***20%***	***20%***	***20%***	*66%*	***50%***
Fixed Income ($mm)	700	123	823	128	250	800	140	940	110	250
Percent of Assets	***70%***	***70%***	***70%***	*39%*	***50%***	***80%***	***80%***	***80%***	*34%*	***50%***
Duration	13.7	13.7	13.7	19.1	16.5	15.0	15.0	15.0	18.3	16.5
Total Assets	1,000	175	1,175	325	500	1,000	175	1,175	325	500
Liability Present Value	**1,000**				**588**	**1,000**				**588**
Liability Duration	12.0				10.0	12.0				10.0
Funded Status	**100%**				**85%**	**100%**				**85%**
Hedge Percentage	**80%**				**70%**	**100%**				**70%**

In order to maintain the total OPEB asset allocation and hedge percentage, the VEBA trust asset allocation and fixed income duration must be adjusted to offset changes to the 401(h) asset allocation associated with the pension derisking move.

5. Unitizing Pension Trusts to Separate OPEB Plan Allocation

When OPEB plans are linked to pension trusts via a 401(h) account, changes to one allocation often affect the other. Unitizing accounts within the pension trust offers a way to manage them independently. The example in Figure 4 is based on the same plans illustrated in Figure 3. However, in this example, accounting unitization is utilized within the pension trust. Specifically, the non-completion fixed income and equity accounts are grouped together and unitized at the asset class level. Separately, a completion portfolio is unitized within the pension trust and allocated only to the pension plan. By unitizing accounts within the pension trust in this manner, the asset allocation and duration of the pension plan assets can be managed independent of the 401(h) account, thereby breaking the linkage between the pension assets and OPEB assets.

Figure 4: VEBA Allocation Adjustment Scenario with Accounting Unitization Within the Pension Trust

Pension Trust Asset Allocation

	Pension Assets		401(h)		Total Pension Trust	
	MV ($mm)	Percent	MV ($mm)	Percent	MV ($mm)	Percent
Return-seeking Account (Unitized)	200	**20%**	0	0%	200	17%
Domestic Equity	*100*	*50%*			*100*	*50%*
International Equity	*60*	*30%*			*60*	*30%*
Alternatives	*40*	20%			*40*	*20%*
Fixed Income Account (Unitized)	600	**60%**	175	100%	775	66%
Long Credit	*300*	*50%*	*88*	*50%*	*388*	*50%*
Long Government Credit	*300*	*50%*	*88*	*50%*	*388*	*50%*
Pension Completion (Unitized)	200	**20%**	0	0%	200	17%
Total Assets	1,000	100%	175	100%	1,175	100%

Pension Liability Present Value	**1,000**
Funded Status	**100%**
Hedge Percentage	**100%**

VEBA Trust Asset Allocation / **Total OPEB**

	VEBA Trust Assets		401(h) + VEBA	
	MV ($mm)	Percent	MV ($mm)	Percent
Return-seeking	250	77%	250	**50%**
Fixed Income	0	0%	175	**35%**
OPEB Completion	75	23%	75	**15%**
Total Assets	325	100%	500	100%

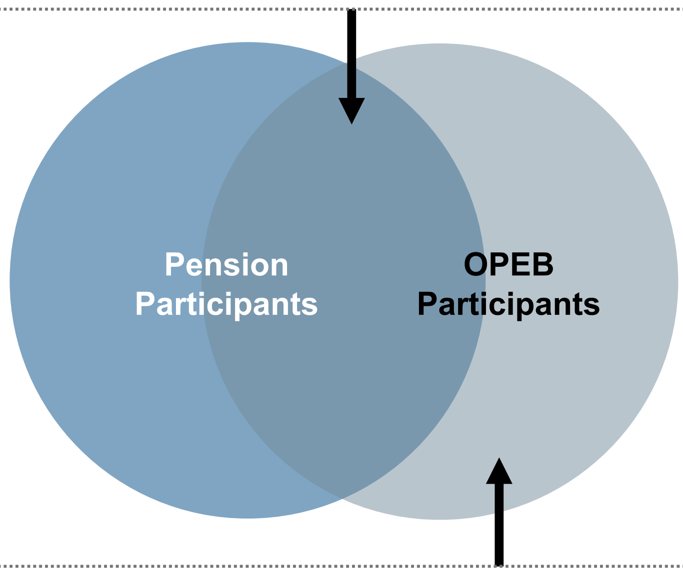
OPEB Liability Present Value	**588**
Funded Status	**85%**
Hedge Percentage	**70%**

By unitizing accounts within the pension trust, the pension plan asset allocation can be managed independent of the 401(h) account asset allocation, thereby breaking the linkage between the pension asset allocation and OPEB asset allocation.

In practice, while employers may tilt asset location preferences to mitigate taxes, a full bifurcation as shown is uncommon. Furthermore, if all OPEB participants are not also participants in the pension plan, the employer needs to ensure that various participant groups are treated equitably. There cannot be a significant difference in how assets supporting liabilities are invested for one group over another.

Figure 5: OPEB Asset Location

Asset available for OPEB benefits: 401(h) + VEBA
Asset allocation: 50% RSA/50% FI



Asset available for OPEB benefits: VEBA Only
Asset allocation: 73% RSA/27% FI

To the extent OPEB participants don't fully overlap with pension participants, special consideration must be given to asset location decisions.

Summary: Managing an OPEB Plan Effectively

While familiar pension liability hedging strategies and instruments used by many employers are equally effective for hedging OPEB liabilities, additional implementation decisions and tradeoffs apply. A well-designed OPEB asset allocation and liability hedging strategy needs to consider tax management, funding and paydown sources, potential linkage between pension and OPEB asset allocation, and equitable treatment of various participant groups. We believe that with careful planning and leverage of available tools, sponsors of OPEB plans can effectively manage costs and stabilize funded status, thereby improving the long-term sustainability of benefits for retirees and limiting the impact of these obligations on the sponsor's financial statements.

[1] Employers have options for funding benefits for bargaining employees as well, but due to their tax-exempt status, alternative funding vehicles, such as a 401(h) account, have limited use for these liabilities.

[2] This illustration somewhat oversimplifies choices of funding vehicles for various liability types. For example, technically, any OPEB liability could be funded on the corporate balance sheet, however, only non-bargaining retiree medical makes sense from a tax perspective.

[3] Data taken from NISA's PSRX data, which is based on the 100 largest pension plans, as determined by NISA based on publicly available information. For more information on PSRX, go to: https://www.nisa.com/psrx/.

[4] Importantly, individuals who have previously been participants in the pension plan but are no longer owed a pension benefit due to having received a lump sum payment or being subject to an insurance buyout, still qualify for retiree medical benefits paid from a 401(h) account.

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