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FCMAT News Alert — Other Post-Employment Benefits

OPEB Bonds — Are they the solution for LEAs?

In what may be one of the most intractable and unparalleled fiscal challenges for local educational agencies (LEAs) in recent years, the funding of Other Post Employment Benefits (OPEB) is now front and center for the State of California and many school boards. According to Credit Suisse Bank and the CATO Institute, the national liability for OPEB under the Governmental Accounting Standards Board Statement No. 45 (GASB 45) is estimated to be between $1.4-$1.5 trillion. Another report released in December 2007 by The Pew Charitable Trusts' Center on the States and titled, *Promises with a Price,* finds that states have saved enough to cover about 85 percent of their long-term pension costs, but only 3 percent of the funds needed for promised retiree health care and other non-pension benefits. The report, which is the first 50-state analysis of its kind, goes on to state that none of the five largest states—California, Texas, New York, Florida and Illinois—had put aside money for non-pension benefits as of fiscal year 2006.

- The State of California estimated $48 billion
- The State of Nevada: $4.0 billion
- The State of New York: $50.0 billion
- New York City: $4+ billion

This topic has become a very public conversation and concern as the current value of promises made in years past to provide retiree benefits must now be calculated and recognized as a financial obligation on a LEA's financial statements. Because this has not been a requirement in the past, the total amount of the liability has not been a recognized concern in the past.

LEAs will face difficult choices about the employee benefit programs they can afford in the future and how to manage the cost of programs to which they have committed.

GASB Standards for OPEB

In 2004, GASB issued two statements related to OPEB: GASB 43 and 45. Issued in April 2004, GASB 43, Financial Reporting for Post-Employment Benefit Plans Other Than Pension Plans, related to OPEB Plans. The most common framework for this statement is the establishment of a qualifying irrevocable trust administered as an OPEB Plan. A LEA using a trust or LEA fund to administer financing and payment of benefits would apply GASB 43 requirements for the OPEB Plan. If GASB 43 applies, it must be implemented one year prior to GASB 45 (see table below).

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In June 2004, GASB issued GASB Statement No. 45, Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions, which establishes new accounting standards for state and local governments for reporting non-pension costs. These costs include retiree medical care, prescription drugs, life and dental insurance. These costs are primarily related to health care provided to employees who have retired.

This statement deals exclusively with issues of disclosure and financial reporting and does **not** require that the liability be pre-funded. LEAs may continue funding OPEB on a pay-as-you-go basis. However, according to published reports from Fitch and Standard & Poor's credit rating agencies, reporting a substantial unfunded liability on the LEA's financial statements **may** have a negative effect on future credit and bond ratings.

To comply with GASB, a LEA will recognize on its governmentwide financial statements not only the payment of current year expenses (pay-as-you-go) in the funds, but also the future liability over a maximum period not to exceed 30 years. Even if the OPEB is not fully funded by the LEA, the liability must be recognized in the annual audited financial statements.

The annual OPEB cost consists of the annual required contribution (ARC) and is broken down into the following categories:

Normal Cost: The present value of future benefits being earned by current employees

Past Service Cost: The amortization of the unfunded actuarial accrued liability (UAAL) or benefits already earned by current and former LEA employees

If the LEA contributes an amount less than the ARC, the net result is an increase in the OPEB obligation recorded in the LEA's financial statement. The UAAL will normally appear in a related footnote.

Understanding the Facts

1.) GASB Statement No. 45 does not require LEAs to change how they fund other post-employment benefits; a decision to continue using a pay-as-you-go strategy will not prevent the LEA from receiving an unqualified opinion from its independent auditor.

2.) A LEA can continue to recognize expenditures for OPEB as funding occurs; this accounting treatment will not create an immediate deficit in the general fund balance.

3.) GASB No. 45 will not cause a liability to be reported in the LEA's financial statements for benefits previously earned or past service cost. The LEA's financial statements will not report a liability for the OPEB as long as the LEA fully funds the actuarially determined ARC.

GASB Implementation Timeline

The new accounting standards are being phased in over several years, based on the amount of revenue collected by each LEA in its governmental and enterprise funds as of June 30, 1999.

All LEA Governmental and Enterprise Funds	GASB 43 Implementation Date	GASB 45 Implementation Dates
Revenues over $100 million	2006-07	2007-08
Revenues between $10 million and $100 million	2007-08	2008-09
Revenues under $10 million	2008-09	2009-10

Every two or three years, depending on the number of members in the plan, employers will have to complete an actuarial valuation of their OPEB plans to determine the LEA's liabilities.

OPEB Bonds

In response to GASB Statement No. 45, many LEAs are considering issuing debt to fund their unfunded actuarial accrued liability (UAAL) for other post employment benefits (OPEB). The objective is to invest proceeds in appropriate qualified investments at a substantially higher return than the combined cost of interest and issuance of the debt. Because OPEB bonds are not tax-exempt, the cost of issuance may cause LEAs to seek investments that will generate a higher targeted yield.

A LEA's actuarial data will initially estimate an expected rate of return on LEA assets to drive the calculation to offset the unfunded liability. LEAs will need to develop investment portfolios that generate long term rates of return that match the unfunded long term exposure. This type of investment strategy may have inherent risk. Government Code Section 56320 reads:

> Notwithstanding Section 53601 or 53635, the governing body of a local agency may invest funds designated for the payment of employee retiree benefits in any form or type of investment deemed prudent by the governing body pursuant to GC 53622.

This section concludes by stating that the governing board should diversify investment of the funds to minimize the risk of loss and maximize the rate of return, unless under the circumstances it is clearly not prudent to do so. No further limitations are imposed on the LEA by these code sections. Previously, Government Code Section 53646 required LEAs to report the status of their investments quarterly. However the code section was amended and is no longer mandatory; thus the investment reporting requirement is left to the discretion of the LEA.

AB 1200 Oversight

Under current law only school districts and county offices of education with qualified and negative certifications are obligated to disclose non voter-approved debt to the county office of education or the California Department of Education prior to issuance. In these cases, the district or county office is prohibited from issuing debt unless their oversight agency determines that repayment is probable.

If the bond issuance is structured as non voter-approved debt and the school district or county office has a positive certification, there is no AB 1200 fiscal oversight of that transaction under current law. In this

circumstance, it is possible for a LEA to obligate its general fund for 30 years or more without disclosure or review by its oversight agency.

Some LEAs' legal interpretation with regard to issuing bonds for OPEB related to GASB 45 has led to a speculative conclusion that the LEA has already incurred this obligation. In essence, the issuing of bonds is simply considered a refinancing of the LEA's existing debt. Regardless of the circumstances or legal interpretations, fiscal oversight and review of any transaction related to OPEB Bonds or other long term debt financing mechanisms are recommended and considered fiscally prudent.

Questions the LEA should answer about OPEB

For LEAs that are evaluating the option of OPEB bonds, there are no quick or simple solutions, but there are fiscally responsible steps all LEAs should evaluate regarding this issue. The items listed below will require time, attention and, above all, political will to make the proper decision:

- What are the LEA's legal obligations with regard to benefits offered under the current plan? Has the LEA reduced or capped employer contributions for benefits? Has the LEA developed hybrid pension plans that combine elements of both defined benefit and defined contribution plans?
- Do the actuarial assumptions properly track and include the benefits being provided under existing plans? Are future plan adjustments included?
- Can the LEA identify risks or changes in the actuarial valuations? What assumptions and cost methods were used?
- Has the LEA engaged representatives from the respective labor groups to discuss various financing and cost management strategies related to OPEB? What can the LEA do to negotiate the outcome?
- Are pooled or joint arrangements for funding or cost management strategies available to achieve greater economies of scale?
- If it is decided that pre-financing of OPEB obligations is the answer, what legal and financial infrastructure is needed to make it work? Have multiple investment strategies been reviewed?
- Can bond issuers address the legal and regulatory risks affecting the feasibility of bond financing?
- Has the LEA considered the creation of an OPEB irrevocable trust fund that meets GASB 45 requirements? Does the LEA understand the options under an irrevocable segregated trust fund only for OPEB?

In summary, each LEA has its own unique set of circumstances, and LEAs should develop their own plan and mitigation strategies. The Government Finance Officers Association (GFOA) has already adopted a cautious approach with recommendations that address the issuance of debt in connection with pension obligations. The following are recommendations from GFOA:

> Despite the similarities between OPEB bonds and other types of debt as financial products, the analysis needed to determine their appropriateness is substantially different. Therefore, GFOA strongly recommends that jurisdictions contemplating the possibility of issuing

OPEB bonds not only follow the guidelines already set forth in GFOA's recommended practice on pension obligation bonds, but also do all of the following:

- Allow sufficient time for a public-policy dialogue to occur between the governing body, employee groups, finance officials, and the public they serve regarding the appropriate funded ratio for OPEB. Failure to do so could produce "solutions" that ultimately fail to reflect the desires and considered judgment of constituents.

- Consider OPEB bonds only upon consultation and advice from a knowledgeable financial advisor who is not also serving, or planning to serve in the future, as an underwriter of the OPEB bonds. As part of their consideration, potential issuers should compare the results of any proposed OPEB bond issuance to both (1) advance funding on the basis of the ARC and (2) pay-as-you-go funding.

- Refrain from issuing OPEB bonds until all issues concerning the proper establishment of a qualified trust fund, investment procedures, and investment guidelines have been resolved.

- Consider, upon consultation with actuaries and other experts, limiting the planned funded ratio to an amount suggested by actuarial and other analysis.

This is an area of fiscal responsibility that is uncharted and evolving. More than 100 LEAs in the state began implementation in the 2007-08 fiscal year. FCMAT recommends that the information in this FCMAT Alert be reviewed and discussed internally within your organization and externally with the respective oversight agencies prior to making any final decisions regarding the issuance of OPEB bonds.