
Central Valley County CAO's OPEB Workshop

Managing Other Post Employment Benefits and GASB 45

The logo for Kelling, Northcross & Nobriga (KNN) features the letters 'KNN' in a bold, teal, serif font.

Kelling, Northcross & Nobriga
Financial Advisors to Public Agencies

David Leifer, Vice President
(510) 208-8264
dleifer@knninc.com



"WELL, WE USED TO GIVE OUR EMPLOYEES THE BENEFIT OF THE DOUBT... BUT WE'RE DROPPING THAT BENEFIT, TOO."

Approach to GASB 45 and OPEB Liability

- Form a team: CAO, accounting, HR, legal, investment
- Retain actuary and calculate liability
- Action
 - Evaluate benefits and ways to reduce liabilities
 - Pre-fund or Pay-Go
 - If pre-funding, establish trust
 - Consider bonds as a tool for funding strategy
- Continuous education with elected officials



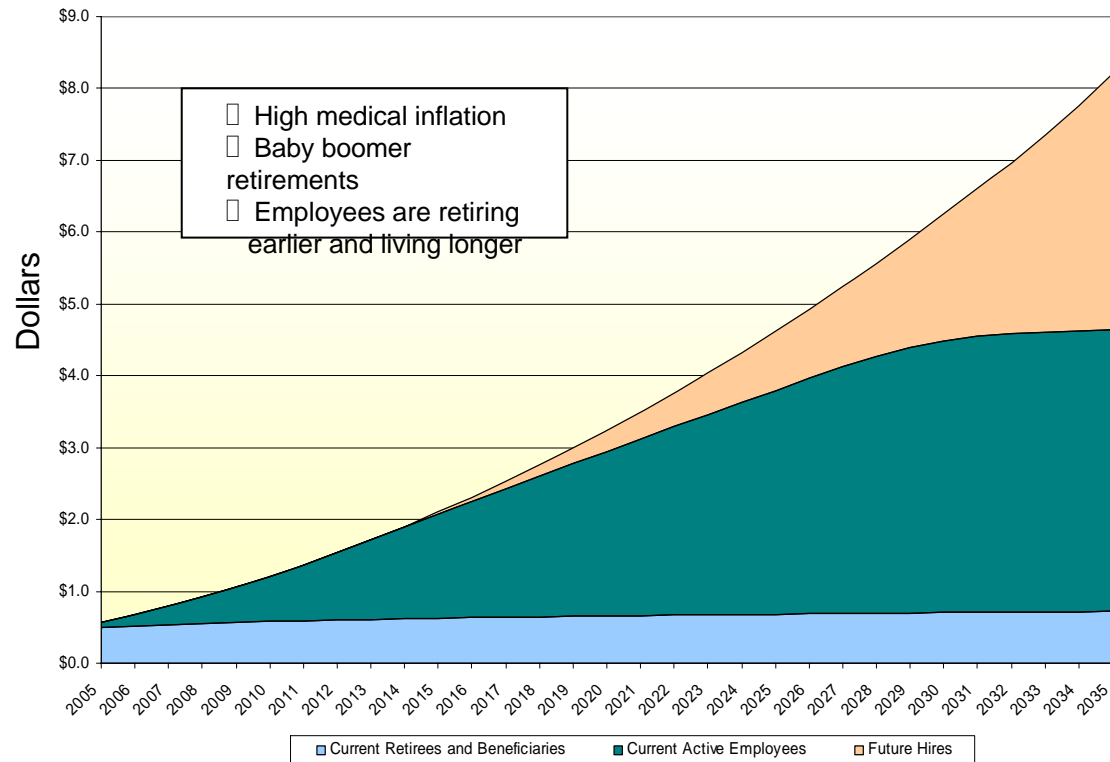
I. Introduction and Background

Other Post Employment Benefits (OPEBs)

- OPEBs are retirement benefits other than conventional pension benefits, including retiree medical, dental, life insurance and long term care benefits.
- Until now, OPEBs have generally been paid on a pay-as-you go basis and not reported as a liability on municipal financial statements.
- Most state and local governments have not set aside assets to meet OPEB liabilities

Magnitude of the Problem

- Annual OPEB payments are rising quickly



- Aggregate OPEB UAAL of US state and local governments estimated at \$700 billion - - \$292 billion for S&P 500 companies

GASB 45 – Core Objectives

- Improve financial accounting and reporting
 - Recognize true financial costs of benefits when the related services are received by the employer
 - Provide information about accrued liabilities for promised benefits associated with past services
 - Provide information useful in assessing demands on the employer's future cash flows
- GASB 45 does not require funding

Benefits of GASB 45

For municipalities: Better decision making

For market: True accounting and disclosure of long term costs and liabilities

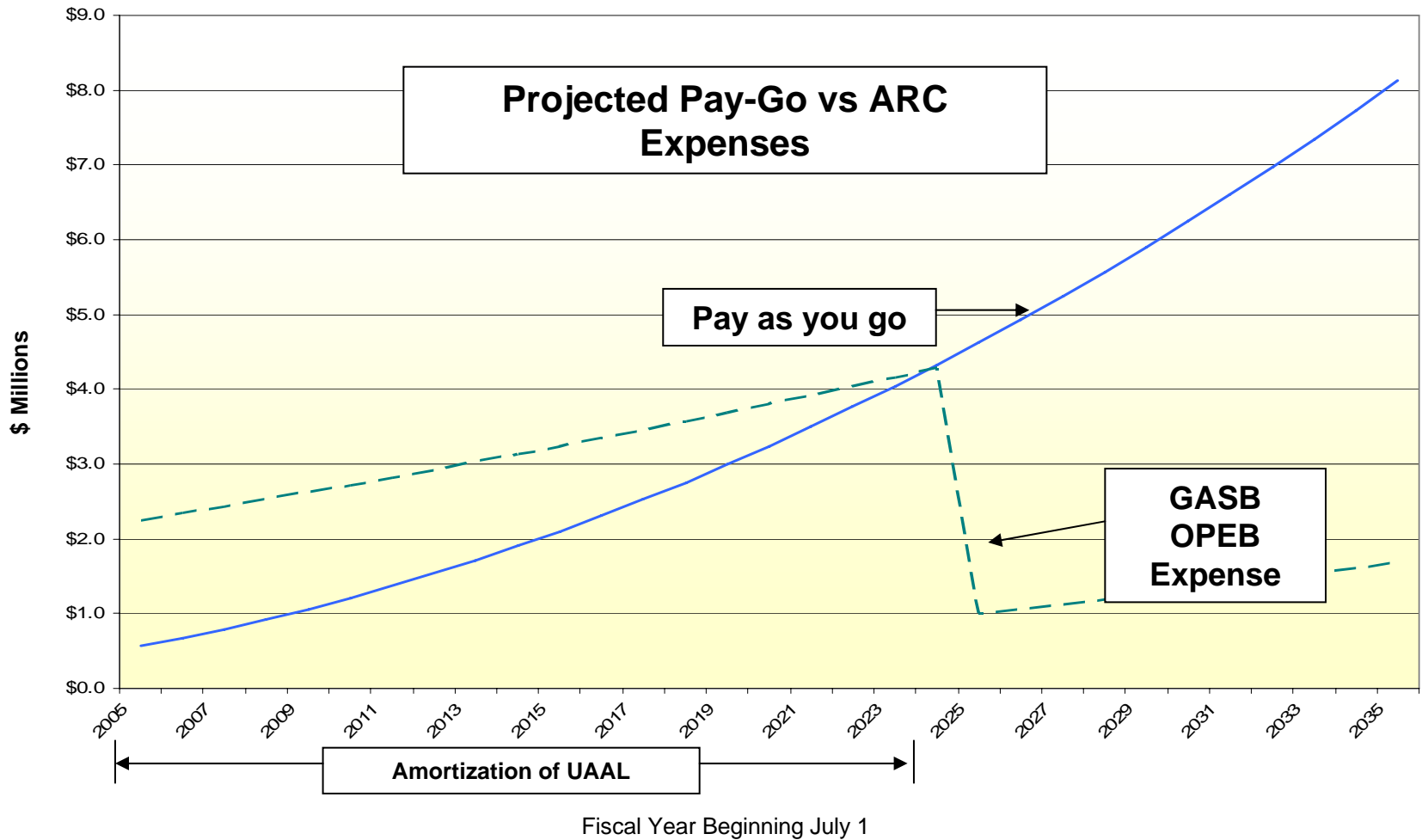
GASB 45: Impact on Financial Statement

- Annual Required Contribution (ARC) – Income Statement
 - Adjusted annual OPEB cost on accrual basis
- Net OPEB Obligation - balance sheet
 - Cumulative difference between the ARC and the employer's actual cash contribution
 - At inception, most employers will report Net OPEB Obligation of zero
- Apply to OPEB the pension note disclosure requirements
 - Actuarial liability, funding status, plan provisions, etc.

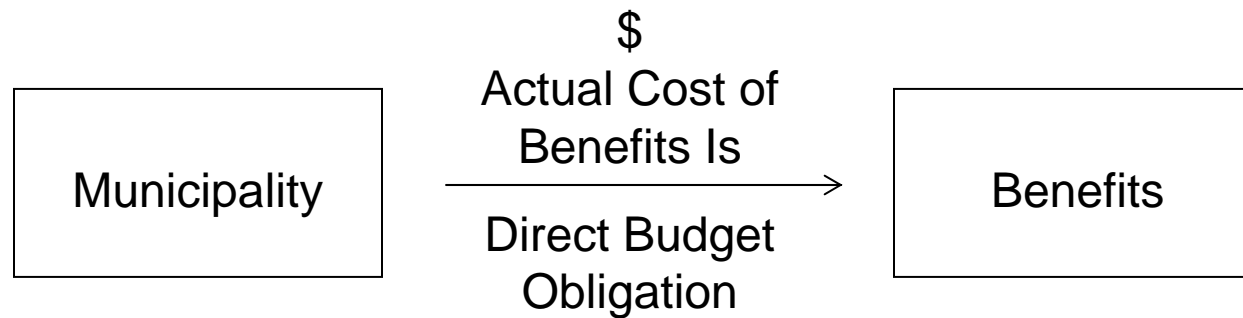
Actuarial Valuation

- $ARC = \text{Normal cost} + \text{amortization of unfunded actuarial accrued liability (UAAL)}$
 - Normal Cost funds the PV of future benefits earned by current employees
 - UAAL amortization funds benefits already earned by current and former employees but not yet provided for
- If a municipality contributes less than the ARC, a Net OPEB Obligation will result, which is required to be reported as a liability on its financial statement.

Funding ARC May Be 2 to 5 Times Higher than Current Pay-As-You-Go Expenses

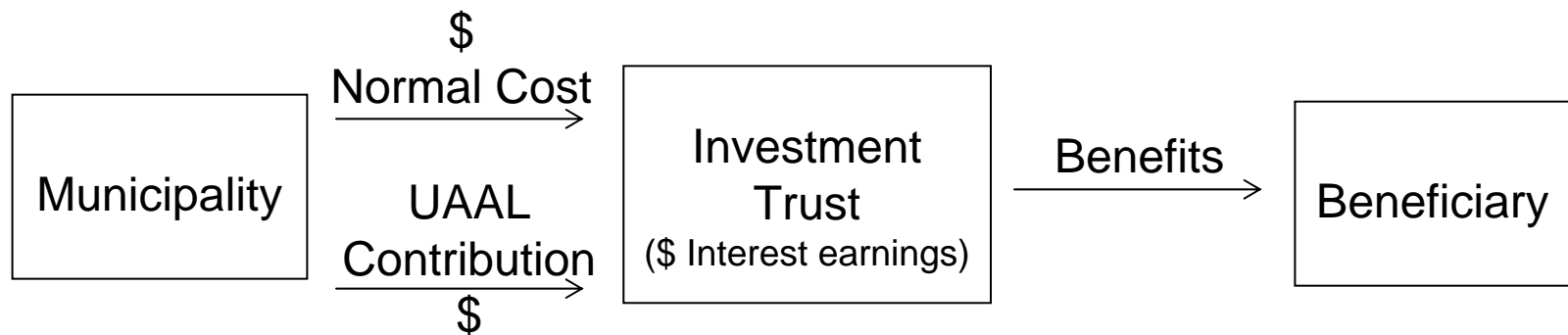


Current OPEB Funding Method Pay-As-You Go



- No trust fund or investment vehicle
- No earnings off-set future obligations

Funded Plan Approach Similar to Pension Funding



- Trust uses combination of employer and employee contributions and investment earnings to pay benefits

GASB 45 Encourages Establishing a Trust though Funding is Not Required

- GASB 45 only recognizes an employer contribution if it is irrevocably transferred to a qualifying trust in which assets are dedicated to providing benefits pursuant to the Plan and are legally protected from creditors
- Calculation of unfunded OPEB liability uses discount rate reflecting investment return assumption
- However, earnings assumption for pay-go funds is limited (i.e. 3 - 4 %) whereas earnings assumption for irrevocable trust funds may be closer to that used by pension funds (i.e. 7 – 8 %) depending on investment strategy
- A higher discount rate = lower UAAL



II. Disclosure and Credit/Rating Implications



Disclosure Obligations Before First Financial Reports due under GASB 45

- Anti-fraud securities law provisions prohibit making “any untrue statement of material fact or to omit to state a material fact...”
- SEC staff: “Issuers should include material information about OPEB in disclosure documents ... even if final numbers are not yet available.”

Martha Haines, Chief of SEC Office of Municipal Securities,
The Bond Buyer, March 2, 2006

Credit Implications of New OPEB Accounting

- Improved Disclosure is Good for Credit Quality
 - Clearer measurement of an existing liability
 - Improved timeframe for addressing potential difficulties
 - Created useful pressure to reduce future liabilities now
- No “immediate rating adjustments on a broad scale”
(Moody’s Special comment, July 2005)
 - OPEB liabilities expected to vary widely
 - Funding pressures/stress will vary widely
 - Still early in the discovery phase
- An absence of action taken to fund OPEB liability or otherwise manage them could adversely affect credit ratings
(Fitch Ratings, “The Not So Good Golden Years Credit Implications of GASB 45”, June 22, 2005)

Probable Key Rating Factors

- Absolute size of unfunded liability and size relative to key financial measures such as payroll, budget, and tax base
- Plan for UAAL amortization as well as ongoing funding of new OPEB costs-the impact of full funding on a issuer's financial flexibility and strength
- Actuarial assumptions used to determine values of liability and pledged assets, particularly discount and medical cost inflation rates
- Nature of the retirement benefits promised to current workers and retirees and the ability to modify benefit offerings

III. Strategies to Manage OPEB

- Pre-Fund or Pay-Go
 - Reduce the ARC
 - OPEB Bonds
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What Can Local Governments Do?

- Do nothing: Continue pay-as you-go but face higher annual costs in the future
- Fund all or a portion of ARC
 - Recognize and budget for true costs of benefits
 - Eliminate or reduce net OPEB obligation on balance sheet
 - Increase security of benefit
 - Take advantage of higher investment earnings and higher discount rate, reducing GASB liability
 - But . . . ARC may not be affordable!
- Manage Liabilities: Re-examine benefits and implement strategies to reduce ARC

Alternative OPEB Funding Strategies

Pay-as-You-Go	Governmental/ Proprietary Fund	Irrevocable Trust
<ul style="list-style-type: none"> • Lowest cost in short term. • OPEB costs likely to exceed pay-go outlays and will rise as liability grows • No reduction in UAAL; likely to result in rising net OPEB liability • May be a rating negative over long-term 	<ul style="list-style-type: none"> • Under GASB 45, governmental fund balances are not recognized in calculating UAAL • Assets not restricted • UAAL discount rates reflect general governmental investment portfolio (i.e. 3-4% today) • Lower discount rate= higher UAAL 	<ul style="list-style-type: none"> • Trust assets explicitly recognized by GASB 45 in calculating UAAL • Assets must be dedicated to funding OPEB liability and legally protected from creditors • UAAL discount rate reflects a large, longer term, diversified investment portfolio (i.e. 7-8%) as in most pension plans • Higher discount rate = lower UAAL

Types of Trust Funds

- Key characteristics
 - Earnings protected from unrelated business income tax (UBIT)
 - Contributions not taxable to employees and benefit payments from trust not taxable to retirees
 - Funds protected from creditors
- Alternative trust structures that meet criteria
 - 501(c)(9) voluntary employees' beneficiary association ("VEBA") trusts (HB 1608)
 - 401(h) accounts
 - Section 115 essential governmental function trusts
- Consider political, labor and legal implications of forming an OPEB trust fund

Reducing the ARC: Managing OPEB Liabilities

- Terminate existing Plan
- Reduce, rollback or cap retiree healthcare benefits
- Offer new employees reduced benefits (tiering)
- Plan Design Alternatives
 - Reduce pre-65 benefits
 - Vary benefits by length of service or age
 - Cap employer provided benefits or contribution or remove future medical inflation
 - Convert from defined benefit to defined contribution plan
 - Change cost sharing between employer and employee
- Utilize more effective delivery systems – i.e., Medicare HMO's, coalition purchasing

Can OPEB Benefits Be Reduced?

- Generally, OPEBs don't have same legal protections as pension benefits
- At best, there is controversy regarding legal basis for reducing benefits
- Inquiry is fact specific
 - How and where is OPEB Plan defined?
- Expect a court battle in any event
- Ultimately, is it politically feasible?

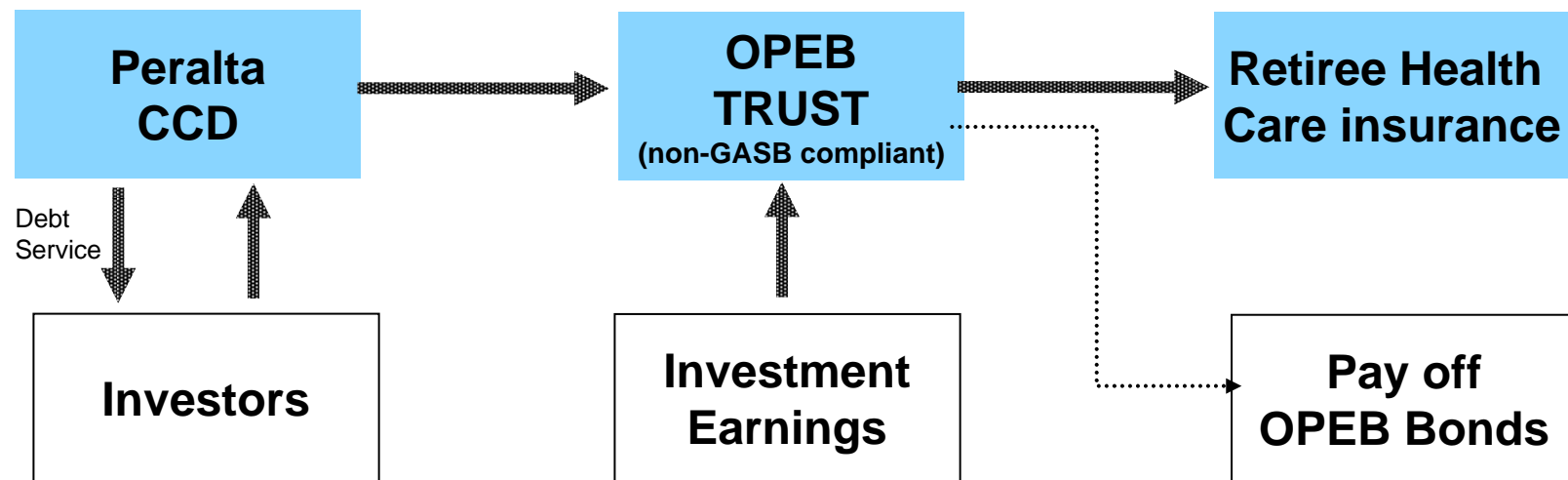
IV. OPEB Bonds . . .
One Element of an
Overall OPEB Funding Strategy

What is an OPEB Bond?

- Issue taxable bonds for all or a portion of the “UAAL”
- Deposit bonds proceeds in a GASB compliant or other trust fund and invest funds
- Trust makes payments to retiree health benefit plan
- UAAL is now AAL – “funded”, not “unfunded”
- County makes annual debt service payments, instead of annual payments toward the UAAL
- Repayment structure not tied to 30 year actuarial assumption and does not have to be level

Peralta Community College District OPEB Bond Structure

Par: \$153 million
Date: December, 2005
Rating: AAA/A+ Underlying (S&P)
DS Structure: Constant % of est. GF Revenues (7%)



OPEB Bond Considerations

Advantages

- Reduce unfunded OPEB liability due to combination of “low cost” funding and investment earnings
- Lower long-term cost of OPEB if earnings exceed debt cost
- Demonstrate pro-active financial management, a credit positive
- Opportunity to benefit from investment returns on more assets sooner

Disadvantages (similar to Pension Obligation Bonds)

- Converting what may be an “informal” obligation into bonded indebtedness
- Exposure to potential investment losses
- Impact on overall debt load

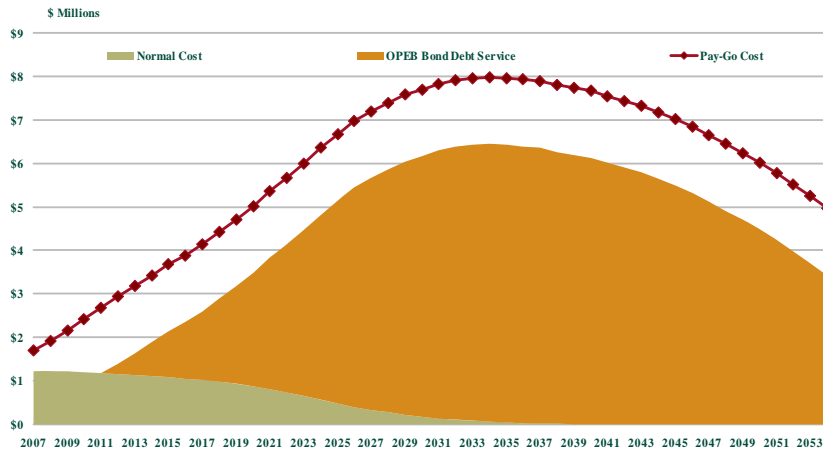
OPEB Bond Considerations (cont'd)

- Funding 100 % of UAAL is not recommended due to volatility of actuarial assumptions (i.e., health care inflation, investment returns, etc.) or potential changes to benefits
- Flexibility to pay bonds early might be important
- Reinvestment Program is Crucial
 - Wait for statutory authority for CalPERs or 1937 Retirement Act systems to manage OPEB assets
 - Contract with investment managers per special investment policy or asset allocation
 - Self-directed for government held funds

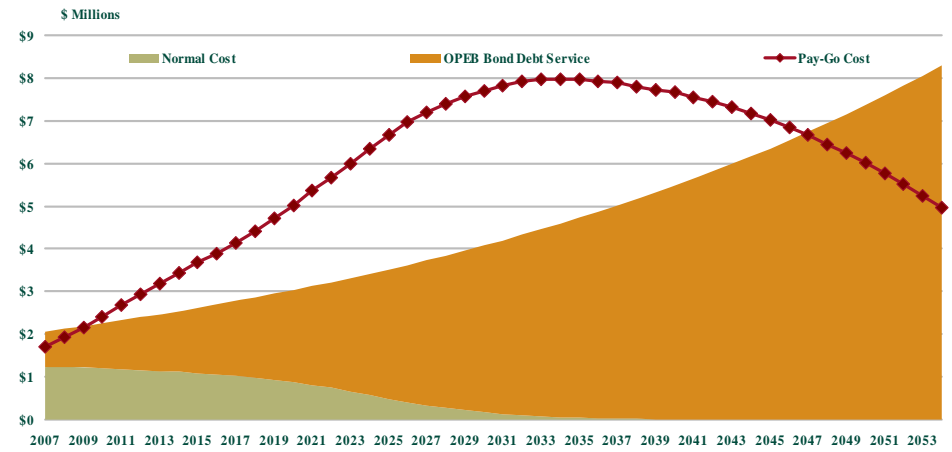
There are Many Options for Structuring “Savings”

- Structure vs. Pay-Go cash flow - - more affordable on budgetary basis

Level Savings



Level % of GF Expenditures



* Source: Lehman Brothers presentation to County Auditor-Controllers, April 2006

- Against the ARC?
 - Least affordable on budgetary basis
 - Possible conjunction with strategies to reduce ARC.

Legal Analysis

- Is this debt? And if so, how can a local agency issue without voter approval?
 - Obligation Imposed by Law exception to Constitutional Debt Limit
 - Peralta CCD OPEB bond issue: Govt. Code 53570 & 53584 provide legal authority to “refund/refinance” existing contractual obligations to provide retiree health benefits
 - Other
- Requires careful legal review of contracts and OPEB commitments
- Court validation process likely