

KNN Schools Conference

Understanding Other Post Employment Benefits and GASB 45

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I. Introduction and Background

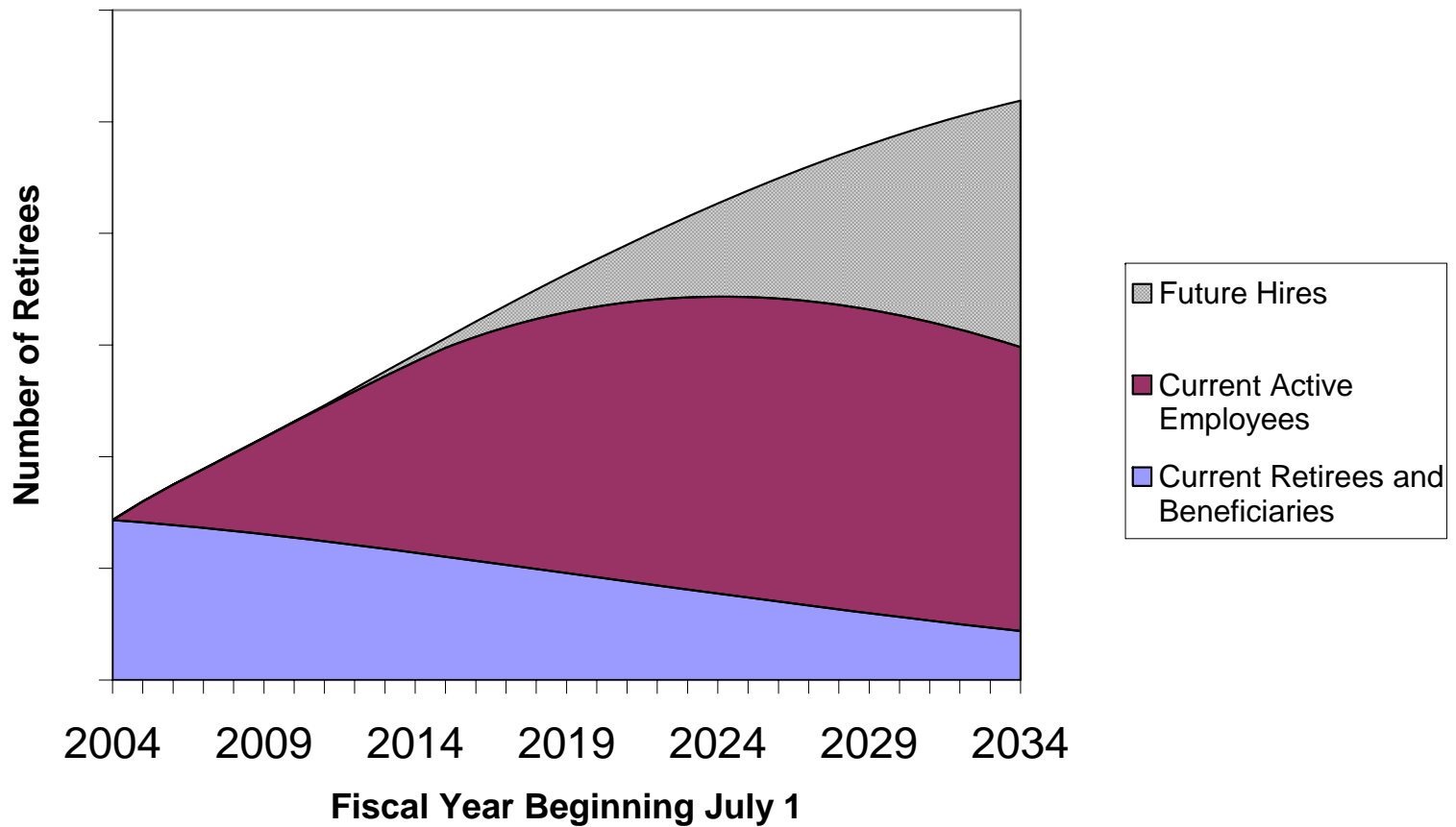


Other Post Employment Benefits (OPEBs)

- OPEBs are retirement benefits other than conventional pension benefits, including 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.
- This is unlike pension benefits which are calculated over an extended time or “working career of a member” and are typically pre-funded through contributions to a retirement system.

More People are Retiring

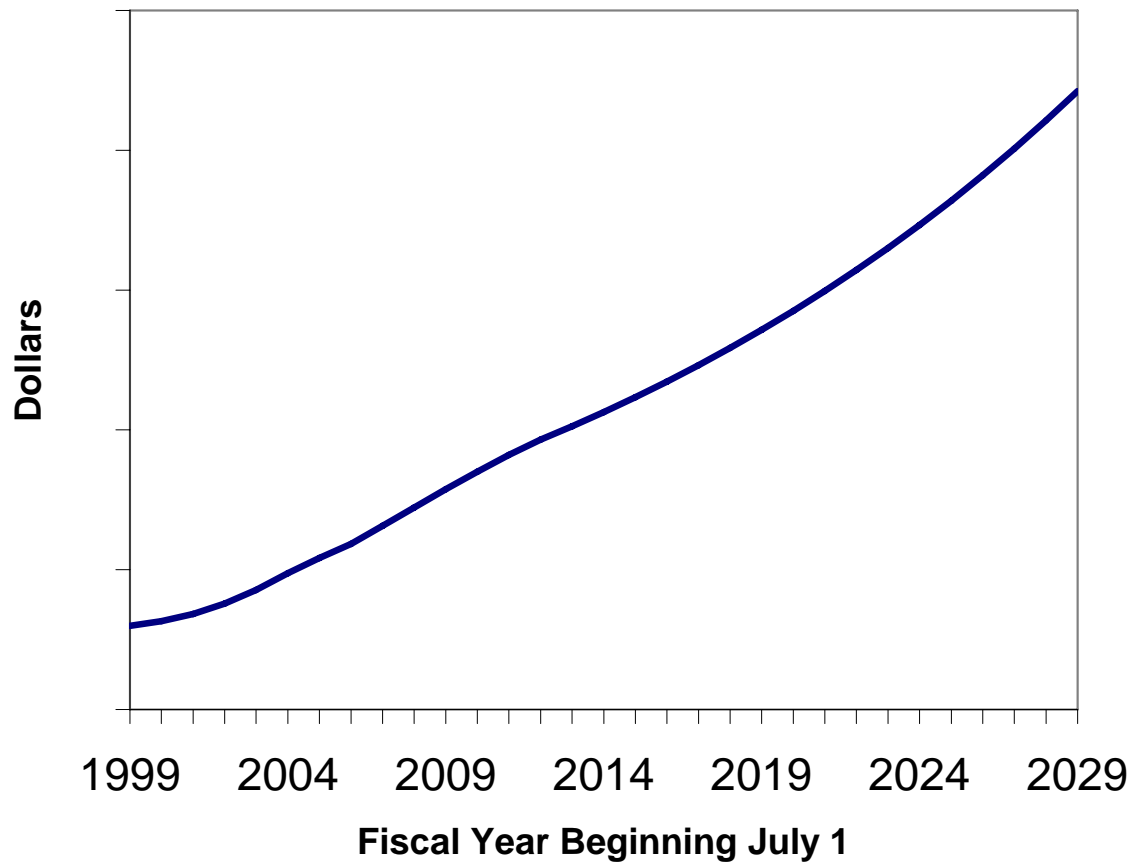
Projected Number of Retirees



Source: Ira Summer, Public Pension Professionals

Health Costs are Rising

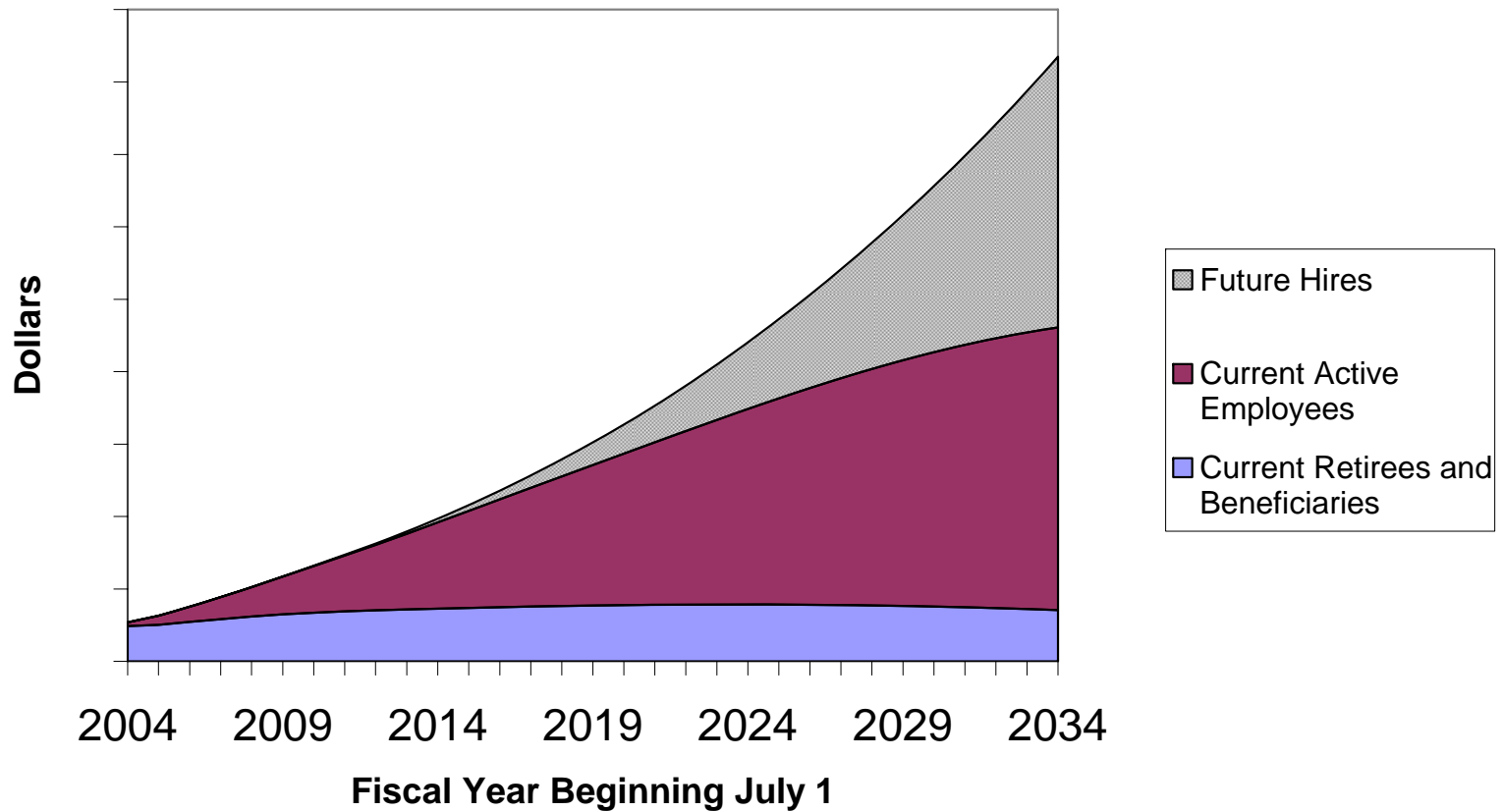
Projected Premiums



Source: Ira Summer, Public Pension Professionals

Total Payments Rising FAST

Projected Payments toward Retiree Health Premiums



Source: Ira Summer, Public Pension Professionals

II. GASB 45



OPEB Liabilities and GASB 45

Under GASB 45, municipalities will be required to account for the cost of their OPEB liabilities starting in FY2007.

- GASB 45 requires municipalities to quantify and disclose -- but not fund -- their OPEB liabilities
- Requires agencies to accrue the OPEB liabilities over working career of plan members rather than on a pay – go basis
- The GASB standard aims to recognize the true financial costs of benefits

Important Dates

- Although GASB 45 encourages earlier adoption, implementation is required by the following dates:

| Total Annual Revenues | Effective for Fiscal Year ending after: |
|-------------------------------|--|
| Over \$100 million | 12/15/2006 |
| \$10 million to \$100 million | 12/15/2007 |
| Under \$10 million | 12/15/2008 |

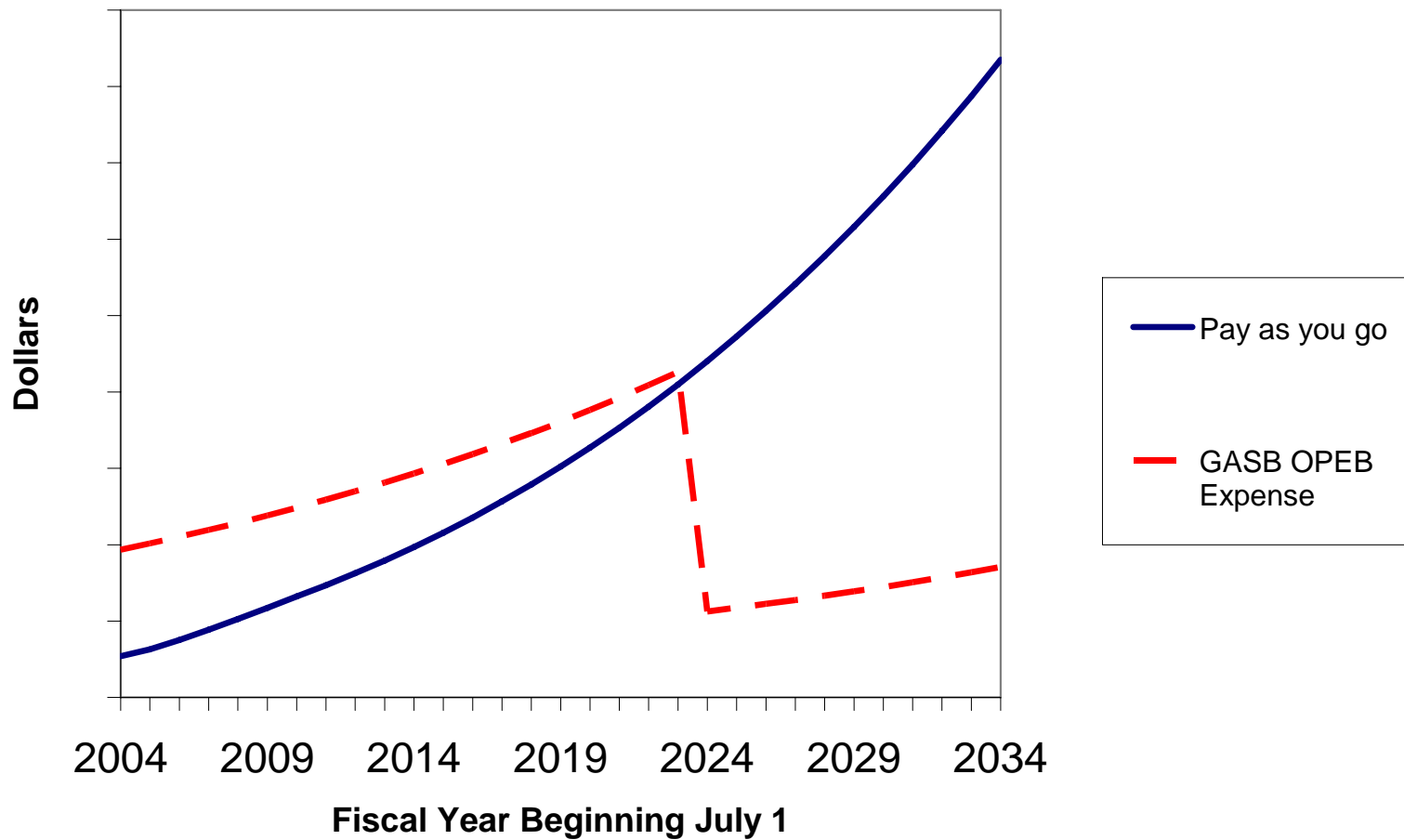
- Certified actuarial valuations are required:
 - Every two years if OPEB plan has over 200 members
 - Every three years if over 100 but less than 200 members
 - Alternative measurement method if under 100 participants

Actuarial Valuation

- Under GASB 45, based on an actuarial valuation, an annual required contribution (ARC) is determined for each municipality.
- The ARC is the sum of (a) the normal cost for the year (the PV of future benefits being earned by current employees) and (b) amortization of the unfunded accrued liability (benefits already earned by current and future employees but not yet provided for) using an amortization of not more than 30 years.
- If a municipality contributes less than the ARC, a net obligation will result, which is required to be reported as a liability on its financial statement.

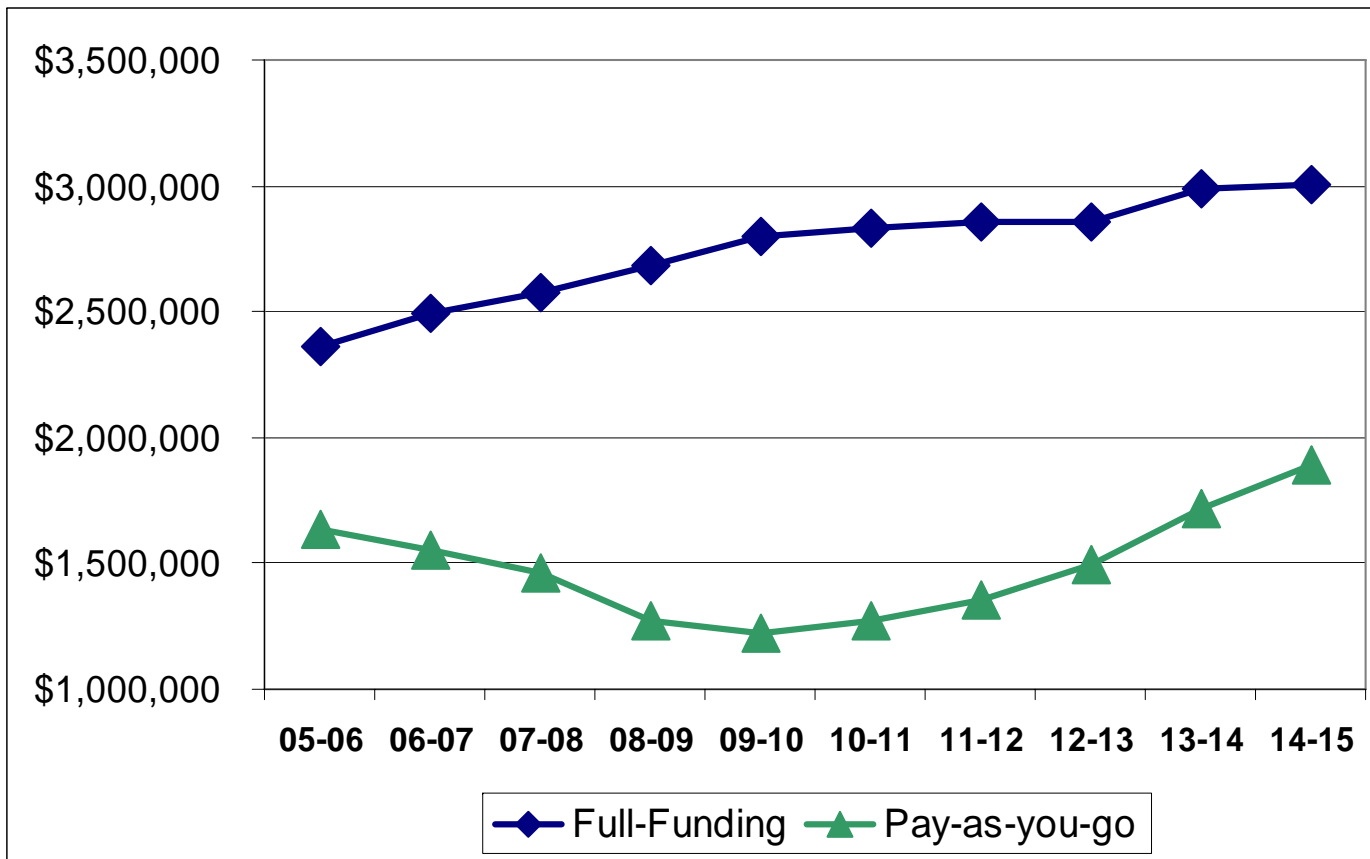
Significant Budgetary Consequences

Projected Payments toward Retiree Health Premiums



Source: Ira Summer, Public Pension Professionals

Sample School District Retiree Benefit Funding Model



III. Consequences of GASB 45 for Next Several Years



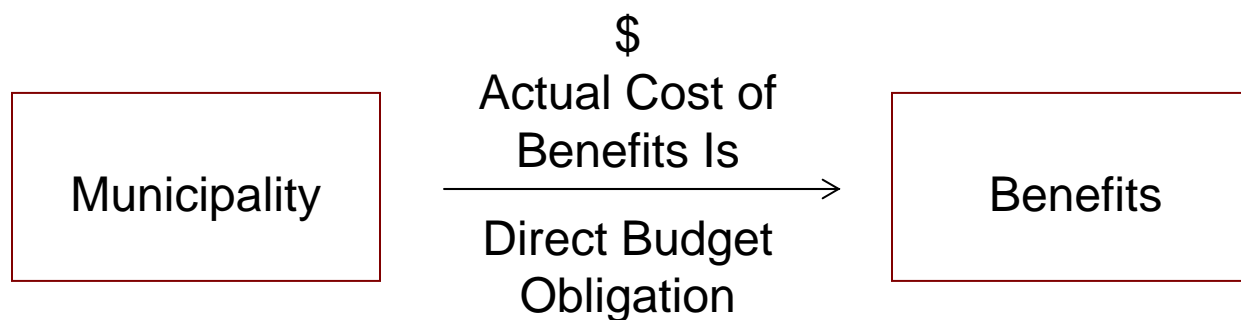
Consequences

1. Define your District's OPEB Plan
2. Obtain actuarial valuation of unfunded OPEB liability and related ARC
3. Work with accountants to determine appropriate accounting treatment
4. Disclose OPEB liabilities in connection with bond and TRAN offerings
5. Develop a funding strategy

Strategies to Fund OPEB

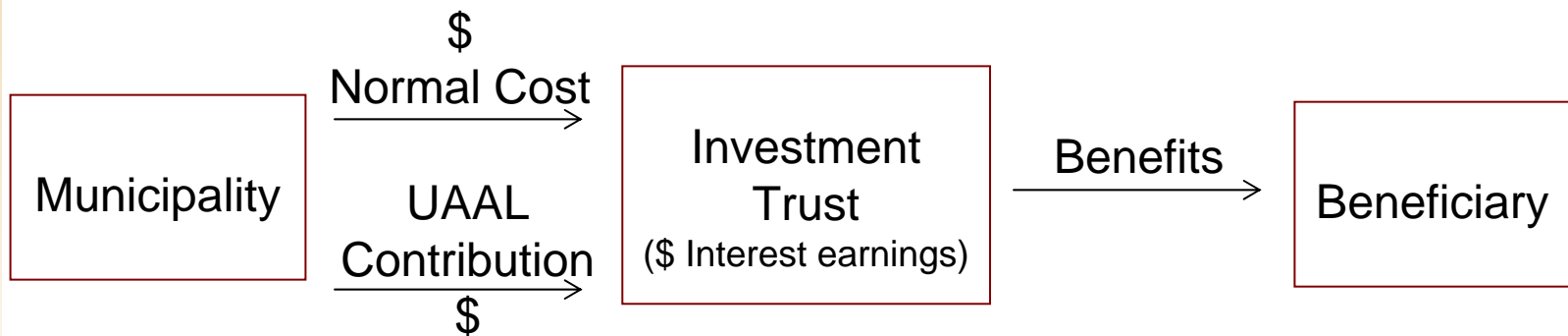
- Continue to pay–as–you go
- Set aside funds in a District-held special fund
- Create an irrevocable trust fund
- Use bonds to fund all or part of the OPEB liability
- Modify or renegotiate OPEB obligations

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 RequiredYet!

- 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 may include an investment return assumption
- However, Earnings assumption for pay-go funds is limited (i.e. 2-3 %) whereas earnings assumption for irrevocable trust funds may be closer to that used by pension funds (i.e. 7 – 8 %)

OPEB Bonds.... An Idea Whose Time Has Not Yet Come

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 agreement
- Opportunity to benefit from investment returns on more assets sooner

Disadvantages

- Converting what may be an “informal” obligation into bonded indebtedness
- Exposure to potential investment losses

Other Options for Reducing OPEB Liabilities

- Reduce programs/services to constituents to direct/pre-fund OPEB liabilities
- Increase employee/retiree contribution levels
- Reduce/eliminate vesting of OPEBs for new retirees (tiering)
- Eliminate non-vested OPEBs for existing retirees
- New “Retiree Medical Savings accounts” authorized by various federal legislature, which typically allows additional deferred compensation savings specifically for post-retirement health care costs; tax-free in, and in some cases tax-free out.

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
 - Creates 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