


“OPEB and GASB 45: A Rating Perspective”

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OPEB and GASB 45: A Rating Perspective

Preview:

- What's the big deal about OPEB?
- Significance of GASB 45
- How GASB 45 can be used as a framework to manage OPEB liabilities
- Expectations of employers
- How OPEB/GASB 45 fits into the rating process
- Credit Implications of OPEB

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OPEB: It is a big deal for many state and local governments

OPEB Unfunded Actuarial Accrued Liabilities are huge, but...

- The underlying danger may really be escalating OPEB PayGo costs—forget about GASB 45 (for a moment)

Increasing OPEB costs are driven by

- high medical inflation rates
- upcoming baby boomer retirements; and
- people (retirees) living longer

OPEB annual payouts may be the fastest growing item in a government's budget


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OPEB: It is a big deal...continued

- The OPEB issue existed before the release of GASB 45...the full financial impact just hadn't been quantified
- The State & Local Government OPEB problem parallels the similar Federal juggernaut: projected Social Security, Medicaid, and Medicare costs
- For the US Government these costs are projected to take a larger and larger share of GDP
- OPEB also has the potential to gobble up State and Local Budgets over time


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Selected OPEB UAAL reporting, so far

- California
- Los Angeles Unified School District
- Massachusetts
- Maryland
- Michigan
- Wisconsin
- Nevada
- Utah


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Significance of GASB 45

- It focuses attention on an important national (and global) issue: funding retiree healthcare
- The reporting implementation schedule adds a needed sense of urgency to the issue...with the clock ticking
- It encourages government jurisdictions to do their OPEB homework
- The resulting actuarial valuations and new reporting will provide for greater transparency
- Disclosure will lead to an examination of the current viability and long-term deliverability of the current benefit levels

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Significance of GASB 45...continued

Let's step back and review why GASB issued this statement:

Current (OPEB) financial reporting generally fails to:


"Recognize the cost of benefits in periods when the related services are received by the employer

Provide information about actuarial accrued liabilities for promised benefits associated with past services and... to what extent those benefits have been funded

Provide information useful in assessing potential demands on the employer's future cash flows"

Source: GASB Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions

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GASB 45 as a tool to manage OPEB

New valuable information, includes:

- Actuarial valuation, including the complete picture of what your PayGo costs look like for the next X years
- Funding Progress: OK...the funded ratio (0%?) doesn't look too good right now but at least we know where we stand and what the objective is
- Annual Required Contribution: What is needed to fully fund the liability
- Net OPEB Obligation: The cumulative effect of funding or not

All this information provides a framework to better understand the components of these liabilities and manage them more effectively

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Potential management strategies


The employer may act to enhance assets or mitigate liabilities;

Assets:

Increase payments towards retiree healthcare

- Employee contributions may be initiated or increased
- Employer may pay ARC or a larger share of it

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If full ARC is made

- Employer takes advantage of a higher discount rate under GASB #45
- Receives the benefit of investment earnings from the trust
- Increases the benefit security to employees
- But, has to deal with a higher cost structure for benefits

Note: if partial funding is chosen...blended discount rate may be used

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OPEB obligation bonds may be used to boost assets

All or a part of the unfunded OPEB liability may be funded with the proceeds from the sale of OPEB obligation bonds:

- Similar in concept to Pension Obligation Bonds
- OPEBOBS may face greater legal hurdles...at least initially
- Have the effect of quickly injecting a large amount of assets into the OPEB trust
- Embody risks similar to those affecting POBS, including investment risk

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Managing OPEB: Options to Mitigate Liabilities

Options to reduce liabilities may include:

- Lower the level of retiree healthcare benefits granted outright
- Offer new employees (or new retirees) a reduced benefit level
- Place a cap on total (OPEB and pension) employer-provided benefits

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Managing OPEB: Options to Mitigate Liabilities...continued

Other options may include:

- Closing the current plan
- Changing from a Defined Benefit model to a Defined Contribution model


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Potential Challenges in Making Changes to Retiree Healthcare Benefits

- The legal framework for altering retiree healthcare benefits includes many uncertainties which vary from state to state
- While most states have legal protections (constitutional or statutory) for pension benefits, the legal status of OPEB is less clear
- Where does OPEB fit in from the standpoint of its inclusion in collective bargaining agreements?
- Even if OPEB can legally be changed...is it feasible politically?


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Expectations of employers

- If an employer knows or suspects it has a material OPEB liability, S&P would expect it to address the problem in a speedy and forthright manner
- Delaying or ignoring the issue is not a prudent strategy...it is not going away
- Hiding behind the GASB implementation schedule is also a poor excuse for adequate disclosure
- GASB encourages early implementation which also can give the employer a jump on resolving any problems

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Expectations of employers...continued

Advantages to early action:

- Problems like OPEB generally cannot be resolved quickly or easily
- They usually involve consensus building with various constituencies: i.e. taxpayers, collective bargaining units, etc.
- Time is needed for new or different professional services, including
 - Actuarial
 - Accounting
 - Legal
- Some of the solutions will involve legislative acts (for example establishment of GASB trusts, contribution rate changes) which can take years

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How OPEB/GASB 45 fits into the rating process

OPEB touches ratings in in three key areas:

- Management,
- Finances, and
- Debt


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OPEB Rating Factors: Management

- Are the consequences of OPEB obligations fully understood by management or will the results of a GASB 45 actuarial valuation come as big surprise?
- If liabilities are material, is management actively pursuing alternatives to soften the impact?
- Where does the OPEB problem rank in relation to other planning priorities?
- How conservative (or aggressive) are the methods and assumptions being used to determine OPEB liabilities and plan for the future?


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OPEB Rating Factors: Financial

- Can the budget afford the OPEB ARC (or even an escalating PayGo scenario)?
- Are there other areas in the budget to cut to make room for increasing OPEB costs?
- Will total carrying charges of bond debt service, pension contributions, plus OPEB contributions be sustainable given existing (or projected) resources?


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OPEB Rating Factors: Debt

- What is the legal obligation of the employer (how "debt-like") to meet retiree healthcare obligations: i.e. to make contributions.... to pay benefits?
- How does OPEB alter the total long-term liability landscape for the employer: bonded debt + pension liabilities + OPEB liabilities?
- Does OPEB put the employer at a comparative disadvantage in relation to its peers from the standpoint of total long-term liabilities


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Credit Implications of OPEB

- Unlike pension liabilities, the effects of which have been incorporated into S&P's ratings for decades, the new OPEB reporting represents new, more specific information about an employer's total long-term liabilities
- We are seeing a wide range of OPEB liability exposure as the actuarial valuations become available...from little or no liability...to huge, unfunded liabilities
- The key to preserving creditworthiness in the face of OPEB pressures will be how these liabilities are managed

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Credit Implications of OPEB...continued

- We would expect any employer that has an OPEB liability to act to quantify it through an actuarial valuation in an expeditious manner
- The next step is to determine if the current benefit structure is financially workable over the long-term and optimal within the total benefit scheme
- If PayGo OPEB costs or pre-funding amounts under GASB #45, if applicable, are projected to squeeze budgets...then the employer may have to change certain features to affect assets or liabilities in order to sustain the plan and continue other services
- To the extent that OPEB cost pressures act to weaken financial position or flexibility, credit quality may suffer

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