

January 30, 2008

# OPEB Liabilities Pose Some Risk For State And Local Governments

**Primary Credit Analyst:**

Peter Block, Chicago (1) 312-233-7040; peter\_block@standardandpoors.com

**Secondary Credit Analysts:**

Robin Prunty, New York (1) 212-438-2081; robin\_prunty@standardandpoors.com

Marc Savaria, Boston (1) 617-530-8315; marc\_savaria@standardandpoors.com

## Table Of Contents

---

New Reporting Requirements Highlight Issue

OPEB Credit Analysis

# OPEB Liabilities Pose Some Risk For State And Local Governments

Standard & Poor's Ratings Services expects most state and local governments to eventually come up with workable strategies for other postemployment benefits (OPEB) without adversely affecting their credit quality. While near-term fiscal stress is unlikely, there could be some intermediate-term credit pressures — possibly as soon as three to five years -- as governments grapple with funding solutions amid rising health care costs. If unmitigated, OPEB costs -- which in some cases are projected to be several multiples larger than what governments currently pay to cover retirees -- are likely to strain some municipal budgets, potentially affecting other spending priorities and the magnitude of reserves.

With the deadline for compliance with the new Governmental Accounting Standards Board (GASB) requirement for OPEB looming, all state and many local governments are developing solutions to address the liability. In many instances, state legislative action has been taken and still may be required to provide local governments and school districts a range of options to manage their OPEB liabilities, including authorizing trust funds, reserves, and managing benefit levels.

OPEB liabilities are just one of many credit factors Standard & Poor's evaluates during the ratings process. We recognize that the overall effect of the liabilities will be felt over many years. How the OPEB liability is managed by issuers, along with a government's capacity to fund these obligations on an annual basis -- either on a pay-as-you-go or an accrual basis -- will be an important element of the credit review. The framework for evaluating the solution includes three broad areas: finances, management, and debt.

## New Reporting Requirements Highlight Issue

OPEB requirements are not new and have been a part of the cost structure of state and local governments -- as well as not-for-profit organizations -- for a long time. GASB Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions," established new accounting and reporting practices for OPEB liabilities for governmental entities. This standard affects all governmental entities, including state and local governments, school districts, transportation sector issuers (including transit agencies, airports, and toll roads), utilities, and housing agencies. GASB 45 is essentially a new way to account for, and report on, these accrued liabilities. It can also be viewed as a tool to better manage OPEBs in the long term. GASB 45 is being phased in over three years. Governments with annual revenues in excess of \$100 million must adopt the standard for fiscal years ending after Dec. 15, 2006.

Standard & Poor's recently reported on OPEB liabilities for state governments (see "U.S. States Are Quantifying OPEB Liabilities And Developing Funding Strategies As The GASB Deadline Nears," Nov. 12, 2007). Based on our research, of the 40 states that have reported to date, the scope and range of OPEB liabilities -- \$400 billion in total and counting -- underscore the enormous challenges that OPEB presents for governmental entities in the future. This is not simply because the absolute size of the liabilities is large, but ongoing costs to cover promised health care benefits are projected to be many multiples larger than what governments currently pay.

Not-for-profit entities, primarily health care and higher education, that follow accounting rules established by the

Financial Accounting Standards Board (FASB) have been reporting OPEB liabilities for many years under FASB's Statement of Financial Accounting Standard (SFAS) No. 106: "Employees' Accounting for Postretirement Benefits Other Than Pensions." On Sept. 29, 2006, FASB issued its new standard, SFAS No. 158: "Employers' Accounting for Defined-Benefit Pension and Other Postretirement Plans." SFAS 158 amends SFAS 106, requiring employers to recognize the overfunded or underfunded status of their defined-benefit OPEB plans as an asset or liability in their statement of financial position for fiscal years ending after June 15, 2007. Under prior accounting standards, the funded status of an employer's OPEB plans was not always recorded in the balance sheet.

FASB 158 has had some impact on balance sheets and income statements of many not-for-profit organizations, although to date, Standard & Poor's has not revised ratings solely because of unfunded liabilities. In many of these cases, the new rule caused a weakening of balance sheets following an increase in liabilities and a decrease in equity. Standard & Poor's will continue to monitor the impact of the new rule, especially the strategies used by these organizations to absorb the cost of OPEB.

## **OPEB Credit Analysis**

OPEB liabilities are just one of many credit factors Standard & Poor's evaluates during the ratings process. We recognize that OPEB liabilities are likely to be more volatile than pension liabilities over time. In addition to variation in actuarial methods and assumptions, OPEB liabilities factor in health care cost inflation assumptions, which have varied over time and continue to increase at double-digit rates. We have already seen wide ranges of liabilities for the same OPEB plan in subsequent actuarial valuations due to changes in assumptions. Nevertheless, once the final OPEB liabilities and the annual required contribution (ARC) are determined, it will be up to management and political leaders to decide how best to handle liabilities. Options include prefunding the liability and paying the ARC, continuing with pay as you go, or some combination thereof.

Failure to fund the ARC or at least establish a workable plan to do so in an identifiable time frame may indicate that the OPEB structure is unaffordable. If funding costs go largely unmitigated, OPEB has the potential to slowly crowd out other spending priorities, potentially leading to credit problems. In analyzing the impact of OPEB liabilities on a government's general credit, we focus on how OPEB affects management, finances, and debt.

### **Management**

Management should be able to clearly discuss the details of OPEB, consequences of restructuring benefits if possible, and demonstrate an understanding of the impacts of the results of GASB 45 actuarial valuations in terms of how conservative (or aggressive) the methods are and the assumptions used to determine the OPEB liabilities. If OPEB liabilities are material, Standard & Poor's is interested in the various alternatives that management is pursuing to soften the impact on the government's finances. Additionally, it should be clear where the OPEB problem ranks in relation to other planning and spending priorities. If, after the OPEB liability has been agreed upon, the ultimate solution to a government's OPEB liability is prefunding, additional challenges will arise, which must also be considered.

### **Finances**

As part of our financial review, we will analyze the effect of the OPEB liability, together with pension liabilities, on a government's income statement and balance sheet. Our analysis will be enhanced when trend information for OPEB becomes available.

From an income statement perspective, the annual and projected costs of addressing both pension and OPEB liabilities, along with annual debt service costs, will be analyzed as it relates to the size of the budget, the strength and diversity of the revenue base, and other spending priorities. This analysis is similar to the way in which we have traditionally analyzed the impact of unfunded pension liabilities. Specifically, we will measure the ARC and actual contribution rates, along with funding progress. As with pension funding, OPEB contribution rates can lag and be distorted by investment return assumptions, asset smoothing methodologies, and amortization periods for unfunded actuarial accrued liabilities. Nevertheless, contribution rates and funding ratios are useful for comparison across governmental entities because they shed light on the burden pension and OPEB liabilities and costs have on an issuer's budget and balance sheet. These metrics may be less significant for issuers who do not actually fund the cost of OPEB but instead allow retirees to participate in their plans by paying for themselves.

From a balance sheet perspective, we will focus on the impact of unfunded pension and OPEB liabilities on reserves, the ability to fund capital improvements, and retire debt obligations within a reasonable time frame.

### **Debt**

Pension and OPEB liabilities are debt-like in nature, although the annual costs to service the obligations differ. Debt costs are traditionally fixed and must be paid on time, whereas ARC payments for pension and OPEB can be deferred or only partially paid. Further, OPEB ARCs are subject to significant variation based on the actuarial methods and assumptions used to calculate the OPEB liability as well as the performance of any fund assets.

If pension obligation bonds or OPEB obligation bonds have been issued, we are concerned with the source of funding for these obligations and the additional fixed costs associated with this prefunding solution. (For further information about the risks and benefits of issuing bonds to prefund pension and OPEB liabilities, see "Time May Be Ripe For A POB Revival," dated Jan. 23, 2008, and "OPEB Obligation Bond Funding Strategies Offer Risks And Rewards," dated Nov. 19, 2007.)

### **Prefunding challenges**

While there is no requirement under GASB 45 to prefund benefits, significant attention is placed on future funding requirements due mainly to the rapidly escalating costs of health care and the implicit penalty of not prefunding liabilities. Under GASB 45, governments are permitted to use the typically higher discount rate (about 8%) of the OPEB trust fund assets, rather than the government's own rate of return (about 3%), for prefunding purposes. This serves to reduce the government's overall OPEB liability and future cost requirements.

If governments try to prefund OPEB liabilities through bonds and achieve funding ratios consistent with or exceeding pension plans, they will face several new challenges related to maintenance of adequate funding ratios. Indeed, the annual process of balancing affordable and predictable contribution rates for the government while maintaining adequate funding ratios for beneficiaries will likely become the government's priority in dealing with the OPEB issue, similar to the situation faced currently with pension plans.

As government investment strategies became more diversified (away from fixed-income) in the 1980s toward equity investments, pension funding ratios increased markedly in the latter part of the 1990s. However, as of the early part of this decade, investment returns fell precipitously, depressing pension funding ratios. It is almost inevitable that OPEB trust funds will face similar pressure over time. Therefore, if a government chooses to prefund OPEB liabilities, management must be cognizant of the pressure to achieve outsized investment returns to stabilize and reduce contribution rates. For these reasons, Standard & Poor's will also focus on the OPEB fund's structure,

governance, investment allocation, and return assumptions. This analysis is identical to the way in which we view a government's pension plan and its impact on a government's general credit.

Copyright © 2008, Standard & Poors, a division of The McGraw-Hill Companies, Inc. (S&P?). S&P and/or its third party licensors have exclusive proprietary rights in the data or information provided herein. This data/information may only be used internally for business purposes and shall not be used for any unlawful or unauthorized purposes. Dissemination, distribution or reproduction of this data/information in any form is strictly prohibited except with the prior written permission of S&P. Because of the possibility of human or mechanical error by S&P, its affiliates or its third party licensors, S&P, its affiliates and its third party licensors do not guarantee the accuracy, adequacy, completeness or availability of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. S&P GIVES NO EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates and its third party licensors be liable for any direct, indirect, special or consequential damages in connection with subscriber's or others' use of the data/information contained herein. Access to the data or information contained herein is subject to termination in the event any agreement with a third-party of information or software is terminated.

Analytic services provided by Standard & Poor's Ratings Services (Ratings Services) are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or third parties participating in marketing the securities. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact Client Services, 55 Water Street, New York, NY 10041; (1)212.438.9823 or by e-mail to: [research\\_request@standardandpoors.com](mailto:research_request@standardandpoors.com).