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# Reporting & Credit Implications of GASB 45 Statement on Other Postemployment Benefits

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The significance of other (nonpension) postemployment benefit (OPEB) obligations to state and local government credit analysis was again brought to the forefront with the release of GASB Statement 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions," in June.

Postemployment benefits were already a point of much interest in the credit ratings of these entities in terms of pension benefits, due in large part to the recent dramatic declines in funding ratios and concomitant increases in required contributions. Now, GASB 45 changes the way governments report for OPEB obligations. OPEB obligations, which are primarily centered on health care coverage, represent a significant expense for public sector employers. The current level of OPEB promises are primarily the result of employment contracts entered into by governmental entities. The funding of these obligations is of an increasing credit concern, exacerbated by the rapid cost acceleration in many health-related areas. Government jurisdictions have a wide range of OPEB liabilities in terms of absolute size and relationship to budget resources, depending on how generous they have been in awarding benefits. The disparities between employers will now be made more apparent under the new GASB 45 reporting. In some instances, the new reporting may reveal cases in which the actuarial funding of OPEB obligations would seriously strain operations, or, further, may uncover conditions under which employers are unable or unwilling to fulfill these obligations. In such cases, OPEB liabilities may adversely affect the employers' creditworthiness, in that overall liabilities, including debt-like obligations such as OPEB, would be increased and future expenditure flexibility reduced.

Currently, OPEB expenses are included in governmental entities' general fund expenditures and broken out in an audit note, as the cost is expensed in the current year (pay-as-you-go). GASB 45 requires employers to account for OPEB expenses in the same manner as pension benefits are currently handled. Under the new statement, the liabilities attributable to OPEB, and corresponding annual required employer contributions, would be actuarially determined. It is believed that the unfunded actuarial liability related to OPEB, when calculated, will be sizable, and, in many cases, greater than the current unfunded liability for pension benefits, reaching billions of dollars for larger state plans. Initial feedback indicates that, in some cases, the unfunded OPEB liability could total roughly 50% of an employer's corresponding total pension liability.

## Reporting Changes in GASB 45

In contrast with the current practice of reporting the cost of retiree health care benefits on a pay-as-you-go basis, GASB believes that there may be a vast difference between this approach and accounting for the cost to the employer of OPEB earned by employees that year. While these benefits are paid out after retirement, GASB has taken the position that OPEB, like pension benefits, are a portion of the compensation currently earned by government employees, and therefore should be part of the current cost of providing public services.

The GASB 45 changes, in part, require determining the full cost of OPEB using actuarial methods and assumptions in much the same way that pension benefits are measured. This approach would require the employer to measure and disclose an amount for annual OPEB cost that is equal to the employer's annual required contribution, which would finance these benefits after the employees retired, amortizing the liability. Factors in this calculation would

include average length of employment, salary increase expectations, demographic trends, projected health care cost growth rates, and investment return assumptions. The normal cost for benefits to be earned in the future, and the portion of the unfunded accrued liability to be amortized that year (for OPEB already earned but not provided for) would, when combined, make up the employer's annual required contribution. On an ongoing basis, the cumulative difference between the annual required contribution and employer's actual contributions would result in the net OPEB obligation, which is to be displayed as a liability (or asset) in governmentwide financial statements.

Actuarial valuations would be required for OPEB every two years for plans with 200 or more members, and every three years for smaller plans. Currently, with pay-as-you-go funding practices, the total future liability is unquantified, and thus, there is no way to determine a fully funded system. GASB 45 sizes the liability, and sets the amortization period for the unfunded OPEB liability so as not to exceed 30 years. These standards are to be implemented on a schedule similar to the recently completed GASB 34 conversion schedule, starting with periods beginning after Dec. 15, 2006 (for "Phase 1" employers with annual revenues of \$100 million or more), and over the next two years for smaller jurisdictions.

## Credit Implications

The GASB 45 statement for reporting on OPEB will make more transparent the full liabilities and costs of this current compensation to be received in future years by government employees. In addition, it will provide insight into the potential effect on future benefit agreements before, rather than after, they are entered into. While these benefits, in many cases, represent significant long-term liabilities, it is highly likely that the total costs will not be fully understood. The continued absence of the actuarial funding of OPEB may have given rise to intergenerational inequities in funding benefits. The absence of the nature of the true future costs could have led to reductions in promised benefits, or an additional burden shifted to retirees if, in the future, the employer finds itself unable to deliver the benefits promised. Granted, the vagaries of the components of health care costs make projections very difficult, but the new statement is, at a minimum, an attempt to quantify the issue and plan for its fulfillment on the basis of a tested methodology and, at best, another significant step toward more complete disclosure.

It is expected that mature governmental entities with large percentages of unionized employees, such as states in the Northeast and Midwest, will have considerable obligations identified under this statement. All Standard & Poor's Ratings Services-rated employers will be monitored closely in terms of their reporting under GASB 45. Additionally, the states in which governmental employees do not pay into Social Security will experience a greater effect from these new changes than those states that receive a reduction in costs attributable to retirees receiving the offsetting federal benefits.

Standard & Poor's will analyze any OPEB obligations in the same way it currently evaluates pension obligations. As unfunded actuarial assumed liabilities of public pension funds are considered in the rating process as tantamount to bonded debt of the fund's sponsors, the unfunded OPEB liabilities will be viewed in a similar way. Poorly funded pension plans, historically, have acted to constrain the credit quality of their sponsors. As part of the overall OPEB analysis, Standard & Poor's will include the implications of not only the total unfunded liability, but also how the annual required contribution is managed. For example, an increasing net OPEB obligation would be a negative rating factor, just as an increasing net pension obligation would be.

While health care benefits may be marginally easier to change (reduce) than pension benefits, they are both difficult to alter, and Standard & Poor's believes that each are commitments made by employers to employees as part of their

total compensation, and that they will be honored. We will weigh the effect these obligations have on an employer's ability and willingness to pay debt service on its bonds. While the payments of pension and other postemployment benefits are just two of large number of factors that go into a complete rating analysis, cases may arise in which OPEB obligations, due to their relative magnitude, adversely affect creditworthiness. Upon implementation of these new standards, Standard & Poor's will include the new information as part of its ongoing analytical surveillance of ratings. Close attention will be paid to the newly quantified OPEB unfunded liabilities, given their expected magnitude, and to employers' strategies for managing them.

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