

## OPEB Obligation Bond Funding Strategies Offer Risks And Rewards

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Identifying and quantifying other post employment benefits (OPEB) liabilities has been a laborious process for many government entities. Some are finding a potentially significant unfunded liability because most governments handled these costs on a pay-as-you-go (PAYGO) basis and assets were not set aside to fund future costs.

With the onset of GASB 43 and 45 (GASB 45 in fiscal 2008), public sector employers are required to account for OPEB expenses in a method similar to pension benefits. Under the new statement, OPEB liabilities and the corresponding annual required contributions (ARC) would be actuarially determined. We now have some clarity on the magnitude of state OPEB liabilities, which are sizable for many, (see "U.S. States Are Quantifying OPEB Liabilities And Developing Funding Strategies As The GASB Deadline Nears," on RatingsDirect, Nov. 12, 2007) and in some cases, exceed the level of their unfunded pension liabilities.

OPEB obligation bonds (OPEBOBs), a prefunding strategy, are one solution for funding a government's OPEB costs, although many governments are not yet considering this option until they are certain of their OPEB liability. OPEBOBs could be a viable option only if all risks are considered and actively managed. GASB does not require governments to fund their OPEB liabilities; however, GASB 45 allows governments that advance fund liabilities and establish qualified OPEB trusts to discount future benefit payments using a discount rate that reflects the earning assets in the trust fund. This dramatically lowers the government's OPEB liability.

However, as with all debt, there are risks to consider. For example, if the investment return on invested bond proceeds is less than the OPEBOB interest cost, the transaction becomes a drag on cash flow since an unfunded actuarial accrued liability (UAAL) could re-emerge. The government must also determine whether incurring a hard liability for OPEB liabilities makes sense given the vagaries of health care costs, other capital improvement priorities, and the

political climate. OPEBOBs can become a political issue if the OPEB is sold to the public as a complete solution to the government's OPEB problem.

### ***Health Care Costs: The Big Unknown***

The validity of a government's OPEB liability centers on numerous actuarial assumptions, but one assumption in particular, the health care cost inflator, is the big unknown factor because it could be key to a government's OPEB liability. Health care costs have long been a major cause for concern in all municipal budgets and are an important component in any issuer's OPEB liability. The sustained rates of health care cost increases, in many cases at double-digit levels, have resulted in OPEB costs accounting for an increasing share of governmental operating expenses. As the expected rates of cost increases are projected into the future, the associated liabilities grow even faster.

Since governments began establishing OPEB liabilities through actuarial methods several years ago, Standard & Poor's has seen wide variability of OPEB valuations. However, the long-term growth rate of health care costs appears to confound analysis, driving the OPEB liability significantly higher or lower. Actuaries typically assume that health care cost growth will average 10%-12% annually over the next 10 years, and 5% annual growth thereafter. Health care experts and casual observers continue to debate this growth assumption since costs have been increasing 10%-20% annually for the last decade.

In comparison to OPEB valuations, determining pension liabilities is much more precise (although still not exact) based on historic records of employment and salary changes, and demographic trends, among other variables. In addition, the fact that health care recipients are living longer complicates total liability certainty. This factor is particularly true for those entities with generous, lifetime health care benefit arrangements. Another complicating factor would be a national health insurance plan, which could change the entire equation for governments' OPEB liability, depending on the benefits provided.

### ***Possible Solutions***

Faced with addressing a large OPEB liability, many government entities are considering a number of options, including:

- Continue using a carefully managed and forecasted pay-as-you-go funding plan;
- Decreasing benefits;
- Closing the existing benefit level for new employees, creating a new tier with lower benefits (as has been done in some cases with pension benefits);
- Seeking to contain health care costs through adjustments to current plans;
- Instituting, or increasing, contributions from current members; and
- Advance funding of a trust fund using OPEBOBs.

Each option has its challenges. In reality, it may not be possible to change an existing plan's benefit structure due to legal or political considerations, among others. For this reason, like pension obligation bonds (POBs), OPEBOB may play a role in reducing OPEB liabilities because issuing could reduce or eliminate an employer's OPEB liability.

### ***OPEBOB Credit Benefits***

Advance funding OPEB by issuing OPEBOBs offers a vehicle for employers to build an asset base to offset the actuarial accrued liabilities and pay benefits as they come due in future years. Contributions to a funded OPEB plan over time should be more stable, if initially higher, than under a PAYGO arrangement because these outlays are directly (immediately) affected by the vagaries of health care costs. While advance-funding the OPEB would not rein in actual health care costs, the flows into the plan should be more predictable because actuarially funded benefit plans usually attempt to stabilize contribution rates. However, due to the dynamics of the health care industry, actuarially determined contribution rates for OPEB will probably be more susceptible to change than contribution rates for pension benefits.

Real assets growth through advance funding also will provide greater benefit security for employees/retirees, since funding by tangible investments can be measured and monitored. As the asset base builds and the funding ratio increases, a larger share of the revenues in the plan will come from investment income, while the corollary portion from contributions declines. This relationship is part of the design and was the experience in developing U.S. pension trust funds during the last century. Today, reasonably well funded defined benefit pension plans may receive up to 60% to 70% of total revenues from investment income.

Another advantage to employers from advance funding OPEB comes from the potential ability under GASB 45 to use a higher discount rate to value liabilities than under the PAYGO method. Using a higher discount rate would result in lower actuarial liability and expense calculations. For employers that are expected to contribute amounts equal to or greater than the ARC, a discount rate based on the long-term expected rate of return on the OPEB plan's assets would be used. Plan assets would most likely be invested in a portfolio of securities designed to generate a higher long-term rate of return, maybe 7% to 8%, similar to pension trust funds. Employers that have no plan assets would use a discount rate based on its own investments, which may return 1% to 3%. Employers with some plan assets that are expected to contribute less than the ARC would use a blended rate. Therefore, full, advance funding of OPEB through OPEBOBs would generate both real cost savings from investment earnings and more favorable liability calculations.

### ***OPEBOB Credit Risks***

Like POBs, OPEBOBs are typically secured by a traditional pledge: GO or appropriations. The issuer's principal risks for an OPEBOB are similar to POBs and fall into several categories:

- Arbitrage
- Leverage
- Market, and
- Political

OPEBOBs are essentially an arbitrage arrangement, the success of which depends on the premise that the OPEB trust fund assets (including OPEBOB proceeds) will earn on average more than the OPEBOBs' interest cost, and hopefully the assumed investment return rate (generally about 8%) or better each year for the life of the bonds. If the bonds are sold at an interest cost of 6%, for example, the spread could generate savings if the investment returns goals are met over the life of the bonds.

If the OPEB trust fund earns 8% or more on the bond proceeds, the issuer would pay lower OPEB-related costs (contributions plus OPEBOB interest) than without the OPEBOB. However, if the

investment return is less than the OPEBOB interest cost, the transaction becomes a drag on cash flow since an unfunded actuarial accrued liability (UAAL) could re-emerge. If returns are above 6% (as in the example above) but below 8%, the employer would have increasing contribution rate costs, but would have had them even without the OPEBOB.

While the 1990s produced some impressive investment returns, they can vary dramatically and may (or may not) average the investment return assumption or even the OPEBOB interest rate cost. For this reason, an OPEBOB's full effect can only be known at the bonds' final maturity. Since our experience with OPEBOBs is limited—only a handful has been issued to date—the POB market is instructive. Many POBs have appeared successful for several years, or even a decade, only to have investment gains eroded.

Conversely, after poor results in the early years, POBs achieve projected benefits in the final analysis. In any event, we do know that even if projections are met on average over the life of the OPEBOBs, there will be years of higher returns, and some that are lower (maybe significantly), than the 8% investment hurdle. We do not have to look back very far to see evidence of such swings: in fiscal 2001, the S&P 500 index of domestic equities fell 16%, in 2002, it fell another 19%, but in 2003, it fell only 1.6%. These market declines hurt issuers with POBs outstanding: most had to pay increased contribution rates to cover the new actuarial losses and they had the higher debt service costs due to issuing the POB.

Because OPEBOBs, like POBs generate very large infusions of cash into a trust fund compared with the more steady investment and reinvestment of interest, dividends, and contributions, the plan for investing OPEBOB proceeds must be considered. Should the monies be invested according to the existing asset allocation guidelines, or should OPEBOB proceeds have a different asset allocation strategy because of the nature of the liability? In fact, OPEBs are paid out differently than pension benefits, with the majority of cash flow needed in the period immediately after an employee's retirement and before Medicaid eligibility. However, most pension benefits are paid at a level rate throughout the retiree's remaining lifespan. Furthermore, the issuer needs to think through ongoing fund management and determine who would have fiduciary responsibility for managing the investments.

Adding too much leverage is another risk factor for OPEBOB issuers to consider. Borrowing for any purpose increases leverage, and incurring debt to pay unfunded liabilities is no different. While the issuer is substituting one type of long-term liability (OPEBOB) for another (OPEB UAAL), there is a difference. In most cases, bond debt service is a "hard" obligation compared with the "softer" contribution payments used to amortize the UAAL. Bond debt service must be paid in full and on time or the issue falls into default, with wide ramifications. Conversely, employers' contribution payments to a pension or OPEB trust may be temporarily deferred or reduced without serious negative consequences.

However, risks and opportunities are also associated with "softer" obligations. A soft obligation may be deferred during a temporary period of reduced liquidity resulting from a one-time unexpected expenditure or an unexpected dip in revenues. The obligation may be deferred until fiscal balance is restored to bring payment of the obligation back on schedule, resulting in no credit impact. Unfortunately, soft obligations may also be deferred for political expediency, creating significant credit issues if this deferral is practiced over successive periods. A hard obligation could lead to better long-term fiscal stability if political deferrals are a real risk. Regardless of the political climate, the size of the

OPEBOB relative to the issuer's total debt structure must be measured in terms of what level of debt service can be managed if actual future investment returns do not meet the original OPEBOB plan projections.

As we have seen with POBs, OPEBOBs can become a political issue if the OPEB is sold to the public as a complete solution to the government's OPEB problem. For example, if an OPEBOB is issued for the full UAAL, resulting in a 100% funded ratio, and subsequent higher-than-average returns push the ratio to 110% or 120%, political pressure could arise to distribute the so-called "excess" funding by increasing benefits or decreasing contributions, potentially incurring new liabilities. There is also the issue of irrevocability of assets in an OPEB trust that could prove nettlesome to undo. Under GASB 45, only irrevocable trusts qualify for favorable accounting treatment.

To the extent that an OPEB trust becomes overfunded, the government's ability to reclaim surplus assets may be impeded. Health care costs could also prove to be politically damaging to an OPEB funding strategy. As previously discussed, health care costs could rise or fall faster than expected causing the re-emergence of a significant UAAL or overfunding, creating political pressure to re-examine the funding strategy. Indeed, to the extent health care costs are lower or higher than expected, due either to inaccurate inflation rates, a national health care plan or otherwise, the government's liability can dramatically increase or decrease. This begs the question of whether to issue OPEBOBs to fund the full UAAL, or only a portion of it to avoid future political problems.

### ***Legal Authorization***

In most states, OPEB obligations are established through collective bargaining agreements between an employer and a union and are considered contractual obligations under the law. As such, there is a legal basis for delivering the promised benefits. The OPEBOBs issued to date were in California, Michigan, and Florida. These OPEBOBs were secured by GO or general fund pledges and the states granted OPEBOB issuers legal authority to issue the bonds. In California, the bonds went through further validation proceedings in the courts.

New state legislation and/or voter approval may be required to authorize bonds to pay OPEB liabilities. However, in other states where POBs issued as GO previously received voter approval, there is at least a precedent for the citizen assent of OPEB liability bond financing. Some employers could also have the option to use appropriation debt to fund OPEB obligations, or develop a new security for this purpose.

Once bonds are issued, employers must administer health benefits under a qualified legal framework approved by the IRS. Some issuers have established 501(c) and Voluntary Employee's Beneficiary Association (VEBA) trusts with a board comprising employees. Issuers could also establish a trust under the IRS Code Section 115, which functions like a pension trust fund and does not require a board. In addition, issuers with pension boards can establish a 401 (h) account, which is typically set up as an adjunct to an existing pension fund.

### ***The Rating Process***

Rating OPEBOBs parallels that of long-term debt with similar security and certain additional analytical factors pertinent to the OPEBOB and trust fund. Like POBs, the OPEBOBs issued to date have a GO or general fund pledge. In our specific analysis of OPEBOBs, we focus on the bonds' effect on the issuer's debt structure and the ability to meet obligations. The financial review includes the impact on

both the balance sheet and the operating statement or cash flows. The status of the issuer's OPEB trust fund on a pro forma basis is also part of the review as with any similar analysis. From the balance sheet perspective, we look at how the OPEBOB fits into the issuer's total capital improvement plan. We look at total debt with and without the OPEBOB so as not to penalize an issuer in comparison to another issuer that may have relatively low debt (and no OPEBOBs) but sizable unfunded liabilities. We also evaluate the leverage added by the OPEBOB:

- Does it markedly increase hard, fixed costs (bond debt service) in place of a softer, more discretionary obligation (health care and/or pension contributions), especially since most OPEBOBs will be taxable?
- If sub par investment returns put upward pressure on contribution rates, will they, coupled with the new higher debt service costs due to the OPEBOB, put the issuer's budget under greater strain?

The issuer must also be cognizant of the effect issuing an OPEBOB may have on statutory debt limits or whether the issuance impedes debt issuance for the capital improvement plan.

From a cash flow standpoint, we review projected debt service and contribution costs, with and without the POB, and the validity of the assumptions, including those for OPEBOB interest costs and trust fund investment returns to determine how these projections compare in total and annually.

The spread between interest costs and investment return generates the savings expected from the transaction:

- What is the magnitude of annual savings and total present value savings?
- Where (in what years) are the savings taken?
- Are the savings front-loaded in an attempt to mask budgetary stress?
- Will any front-loading lead to higher, unsustainable contribution rates in later years?
- Do the potential savings from the OPEBOB outweigh the risks involved?

The cash flow analysis is a critical component to understanding the full impact of the transaction. As part of the OPEBOB analysis, we also review the status of the trust fund, which receives the bond proceeds:

- What is the statutory relationship between the issuer/employer and fund?
- How have the laws and precedents for contributing affected funding progress, and how do they play into the OPEBOB strategy?
- What are the funding goals and how will the OPEBOB affect these objectives?

In addition, OPEBOBs often require documentation that is not usually requested for other types of ratings:

#### *Additional Rating Documentation For OPEBOBs*

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OPEBOB financing plan, including its effect on the overall capital improvement plan.

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Projections of UAAL contributions and debt service with and without the OPEBOB.

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The most recent actuarial valuation and any experience studies of the OPEB trust fund; and

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Asset allocation strategy and plan for overseeing and investing OPEBOB proceeds.

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