GASB 45 Conference: *The Next Great Financial Challenge*

June 29, 2006

<u>WHAT IS GASB 45?</u>

Tom Green, Managing Director - Citigroup

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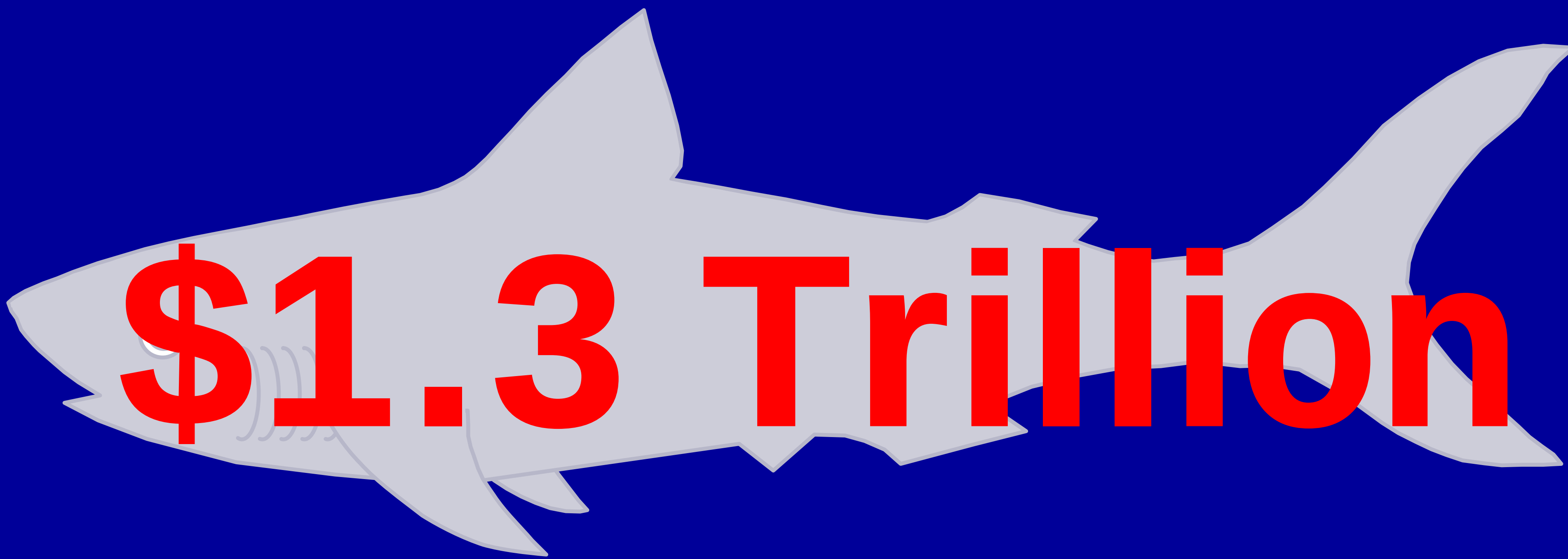
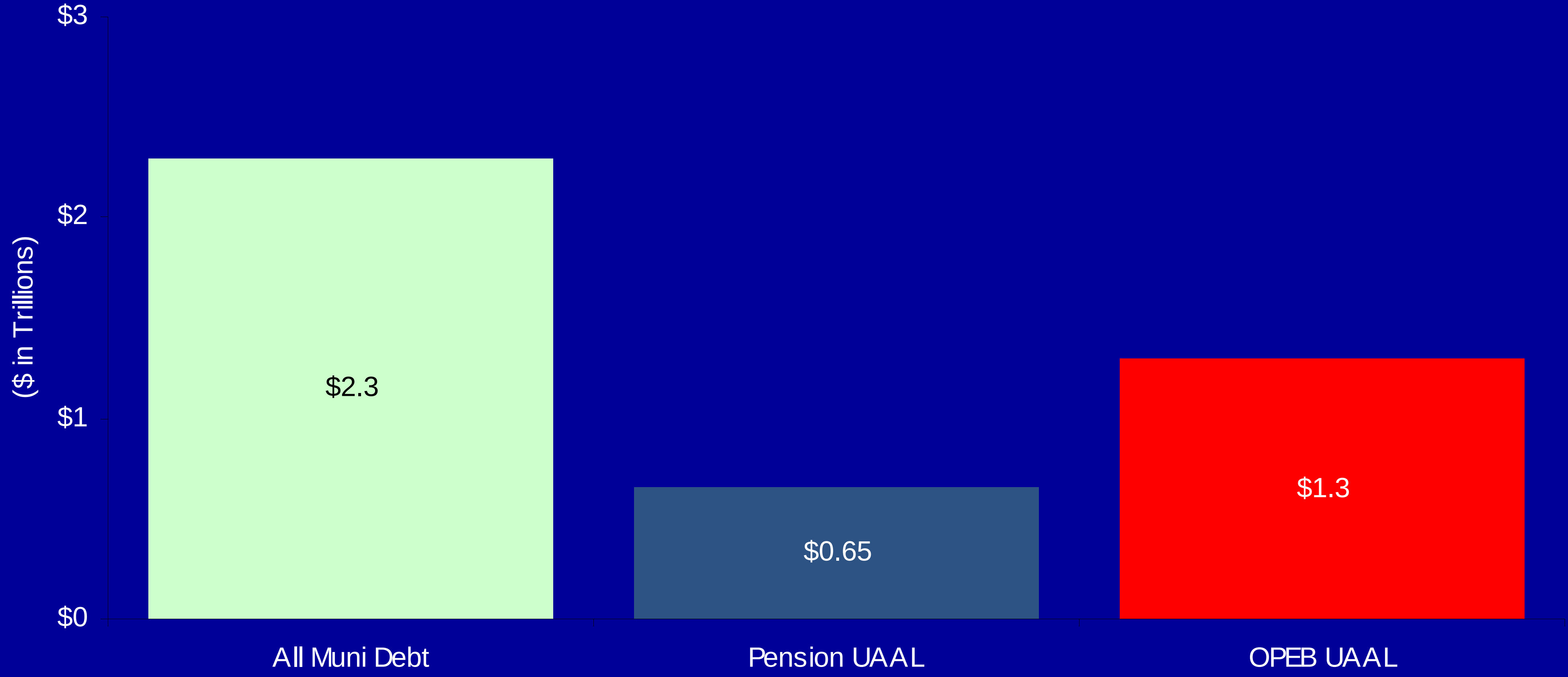
Other Post Employment Benefits (“OPEBs”)

Total OPEB Liability



$1.3 Trillion

How Big is $1.3 Trillion?



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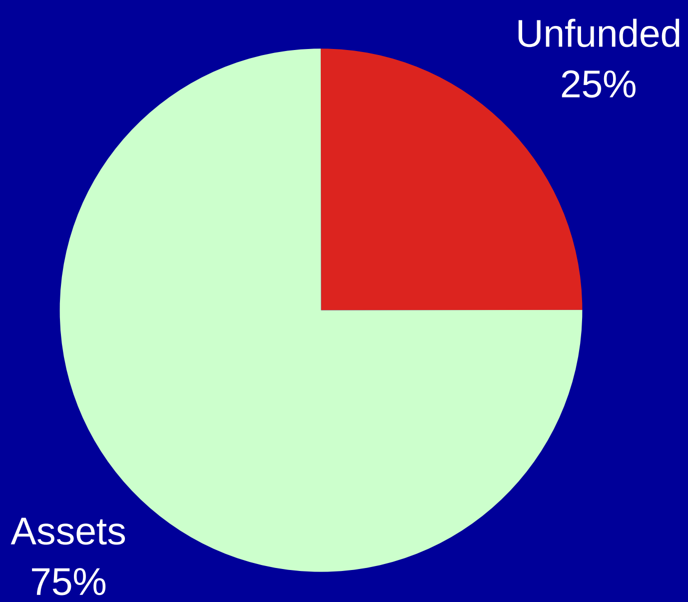
Pension Funding vs. OPEB Funding

Public Pension Funding

Assets and Liabilities

$3.2 Trillion



OPEB Funding

Assets and Liabilities

$1.3 Trillion

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Sizing-up the OPEB Problem

- $700 Billion[1] - $1.3 trillion: estimated public sector OPEB liability
- $336 Billion: unfunded OPEB Liability for S&P 500[2]
- $165 Billion: unfunded pension liability for S&P 500[2]
- $50 Billion: The City of New York estimated unfunded OPEB Liability[3]
- $?? Billion: State of New York unfunded OPEB Liability[4]
- Individual OPEB liabilities for NY Counties will vary widely
- $1.1 Trillion: US Federal Government unfunded OPEB liability[5]

[1]Federal Reserve Board of Chicago, February 2006.
[2]Credit Suisse, February 2006.
[3]The City of New York January 2006 Financial Plan.
[4]Actuarial study underway.
[5]S&P Report entitled "America's Other Looming Bill, Unfunded Government Pensions" dated May 30, 2006.

Financial Reporting of OPEBs – GASB 45

- Many state and local governmental employers provide Other Post Employment Benefits or OPEBs as part of an overall compensation package offered to qualified employees
- GASB 45 requires governmental employers to disclose accrued OPEB liability (funded and unfunded) and progress towards funding (in same manner as pension liabilities):
  - Requiring systematic, accrual-basis measurement and recognition of OPEB cost/expense over a period that approximates the employees' years of service.
  - Providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan.
- GASB 45 requires reporting estimates of the full OPEB liability based on promises or agreements in place.
- GASB 45 imposes no "new" benefit costs to the employer.
- Managing the OPEB UAAL will create significant budgetary pressures for many public entities

Healthcare Benefits:	Other Benefits:
• Medical	• Life Insurance
• Dental	• Disability
• Prescription Drugs	• Long-Term Care
• Vision	• Group Legal

Financial Reporting of OPEBs – GASB 45

- GASB Statement No. 45 becomes effective for reporting periods that begin after:

December 15, 2006	December 15, 2007	December 15, 2008
• Phase I Governments • Annual Revenues of $100 million or more	• Phase 2 Governments • Annual Revenues of $10 million or more but less than $100 million	• Phase 3 Governments • Annual Revenues of less than $10 million

- However, GASB does encourage earlier implementation.
- The SEC and the rating agencies also have called for early calculation and disclosure
- Actuarial valuation must be completed every 2 years for entities with more than 200 employees.
  - Annual cost can be based on a valuation date of up to 2 years prior to the beginning of the fiscal year.
- **Calculation of OPEB liabilities is more difficult than pension fund liabilities - less predictable, higher cost volatility and inflation, greater variation among employers**

The New OPEB Vocabulary

- AOC = Annual OPEB Cost
- ARC = Annual Required Contribution
- Contributions Made = Annual Actual Contribution
- NOO = Net OPEB Obligation
- If Contributions Made < ARC = NOO
- AAL = Actuarial Accrued Liability
- UAAL= Unfunded Actuarial Accrued Liability
- 115, VEBA, 401h Trust
- Funded, Non-funded, Blended Rate
- OPEB Bonds

Annual Required Contribution (ARC)

- GASB 45 requires the calculation of the Annual Required Contribution (ARC)

ARC Contains 2 Components	
Amortization of Past Liability	**Normal Cost**
• An amount needed to amortize the past liability over time at the discount rate (30 year maximum time frame) • Calculated as "level" or as "percentage of payroll"	• Actuarially determined amount to capture the total cost of benefits earned in the current year

- If a public entity always contributes the ARC beginning on the transition date, no Net OPEB Obligation (NOO) will be disclosed on the balance sheet

Measurement of OPEB Liability

- OPEB liability can be divided into 3 parts
  - Liability earned in the past - Current year's liability - Future liability
- Sample Illustration:
  - Jamie has 20 years of service and will have 30 years at retirement. Assume Jamie's total liability is $30,000 or a PV of $1000 per year

Liability "Earned" in the Past	Liability "Earned" this Year	Liability "Earned" in the Future
$20,000	$1000	$9,000

This liability will be disclosed in the CAFR footnotes as an "Actuarial Accrued Liability"

- The sum of all past earned liabilities will be the employee's total OPEB liability

Information derived from Milliman Inc. (October 5, 2005 presentation at BMA Conference).

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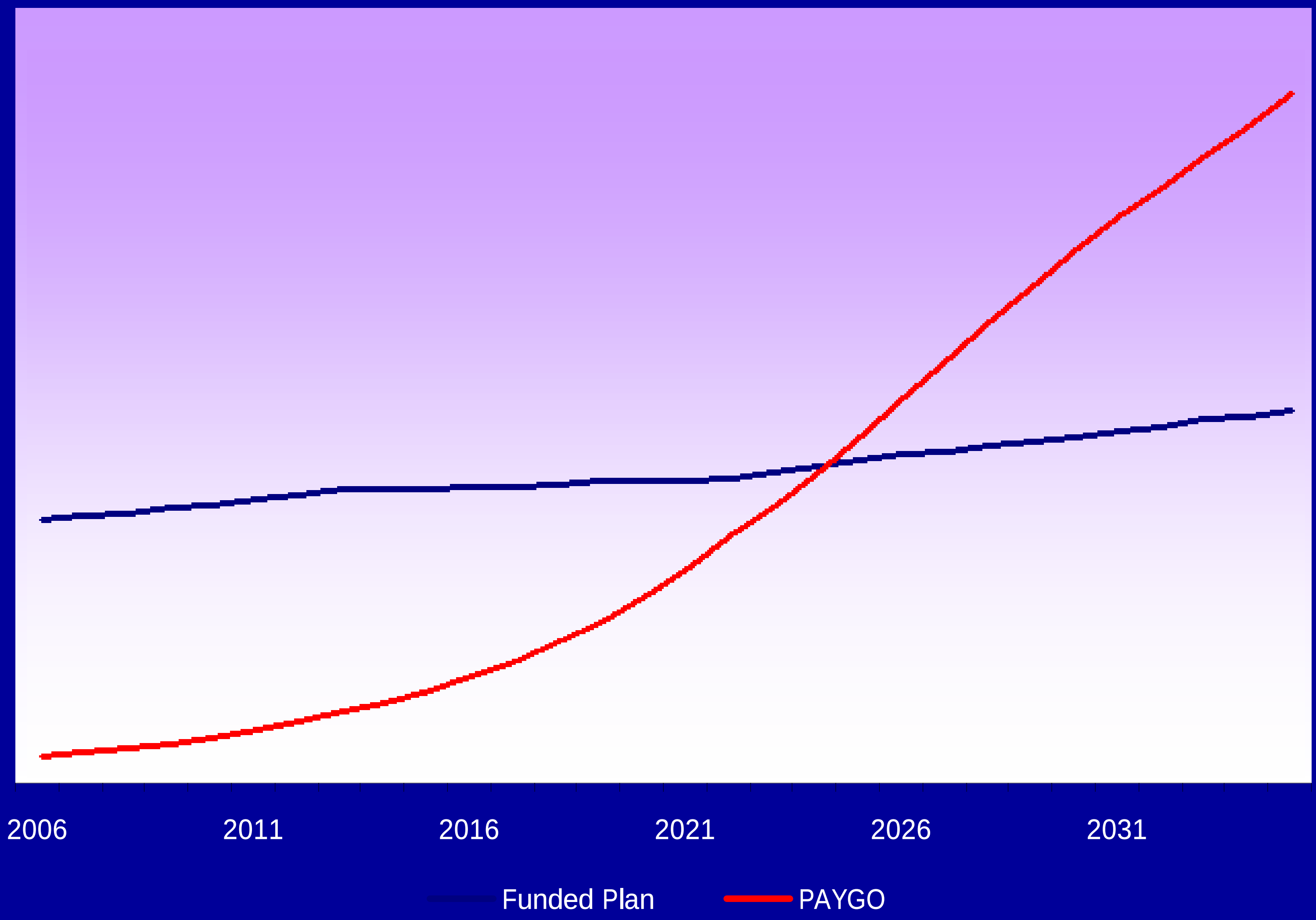
Why is GASB 45 & OPEB an issue?



Source: GFOA Annual Conference, July 2005

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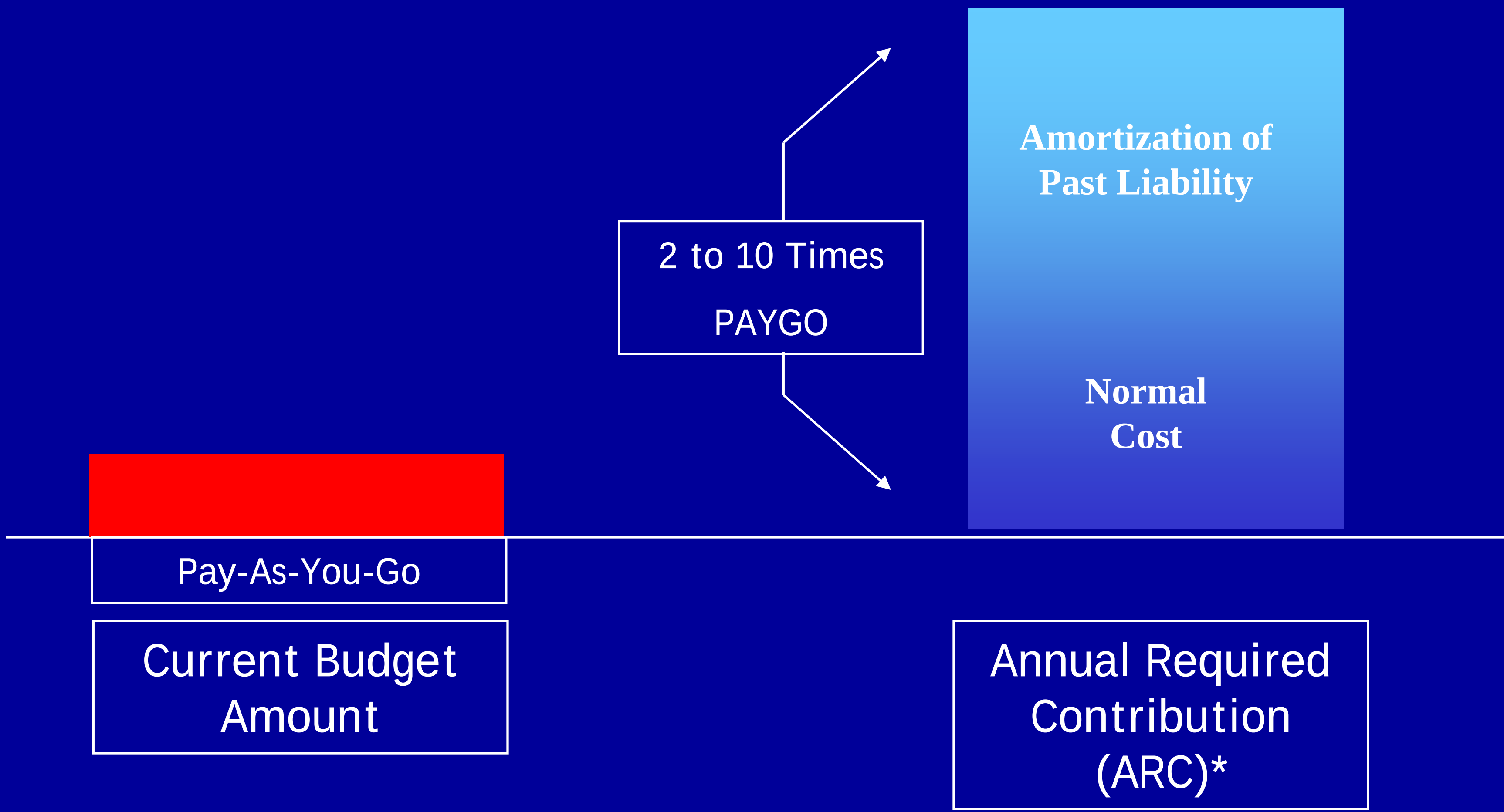
Relative Scale of OPEB Components



*Note that there's no requirement to actually pay this amount, just a requirement to calculate and disclose it.

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Selected OPEB Information for Counties in New York

EXAMPLES OF 5 LARGER COUNTIES

County	PAYGO
Erie	$12,071,497
Monroe	13,800,000
Nassau	90,000,000
Suffolk	60,938,724
Westchester	32,974,830

EXAMPLES OF 5 SMALLER COUNTIES

County	PAYGO
Allegany	$55,902
Delaware	21,700
Herkimer	566,684
Ontario	8,857
Steuben	207,199

Source: County annual reports for 2003 or 2004.

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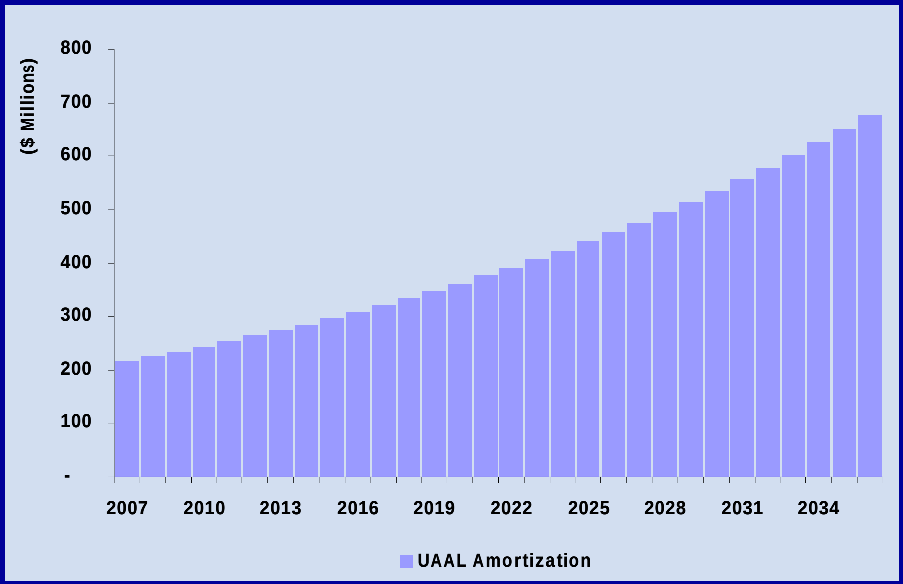
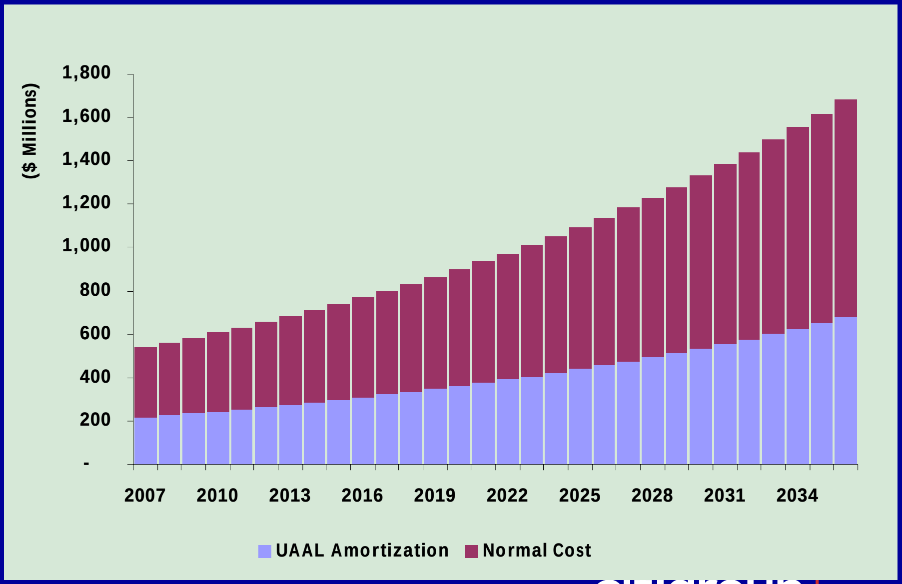
Example: "Larger County" OPEB Illustration

- While an actuarial valuation is necessary to accurately quantify the OPEB UAAL and ARC, estimates can be calculated using standard industry multiples
  - Hypothetical OPEB Pay-As-You-Go cost of $90 million
  - Hypothetical total members of 20,000+ (active and retired)
- Citigroup estimates that Larger County could have an unfunded OPEB liability in the range of $1.35 billion to $ 6.75 billion (assumes a high discount rate)
  - For illustrative purposes, our analysis assumes $3.6 billion
  - If an amortization schedule similar to that assumed for the pension system is applied to the OPEB UAAL, the following payment requirements would result:

UAAL Amortization



Annual Required Contribution



Note: Amortization schedule assumes level percent of payroll, 4% inflation rate and 8% investment rate of return

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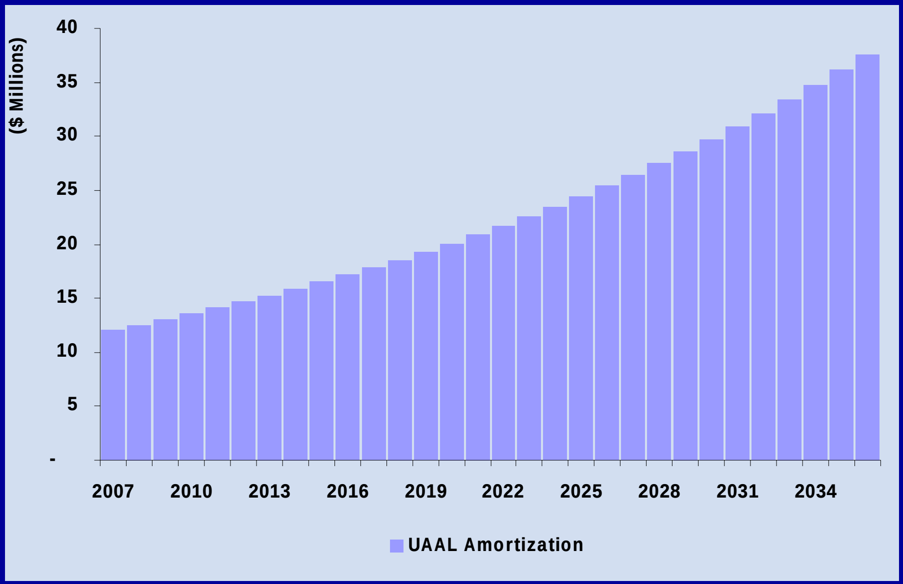
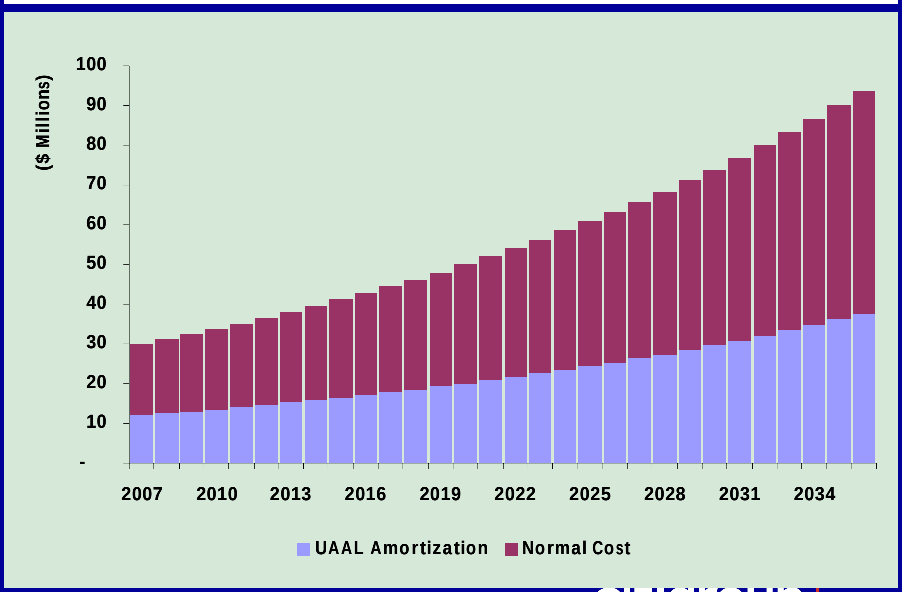
Example: "Smaller County" OPEB Illustration

- While an actuarial valuation is necessary to accurately quantify the OPEB UAAL and ARC, estimates can be calculated using standard industry multiples
  - Hypothetical OPEB Pay-As-You-Go cost of $5 million
  - Hypothetical total members of 2,000+ (active and retired)
- Citigroup estimates that Smaller County could have an unfunded OPEB liability in the range of $75 million to $375 million (assumes a high discount rate)
  - For illustrative purposes, our analysis assumes $200 million
  - If an amortization schedule similar to that assumed for the pension system is applied to the OPEB UAAL, the following payment requirements would result:

UAAL Amortization



Annual Required Contribution



Note: Amortization schedule assumes level percent of payroll, 4% inflation rate and 8% investment rate of return

GASB Irrevocable Trust

- The existence of an OPEB Trust with broad investment powers, in conjunction with a long-term plan for funding the remaining OPEB liabilities, would be the basis for the actuary to use a long-term investment rate of return, in the range of 7-9% used by many pension systems, as the discount rate used in determining the size of any remaining unfunded liability
- GASB 45 requires an OPEB Trust to have the following protections:
  - A legally separate entity ("Trust") under the control of a trustee or board of trustees
  - Employer no longer has ownership or control of the assets; the Trust is irrevocable
  - OPEB Trust moneys are dedicated to OPEB liabilities and may not be diverted by employer to other purposes
  - Legally protected from the employer's and administrator's creditors

Discount Rate and Relationship on Annual Payments

- Assuming OPEB assets are placed in an irrevocable trust with broad investment powers and employers contribute the ARC, GASB 45 allows use of estimated long-term investment yield, considering nature & mix of plan investments, to determine annual payments
  - If irrevocable trust with broad investment powers is not established, the discount rate is limited to a rate of return consistent with the limited investments local governments in New York can use
- Actuarial Discount Rate has a significant impact on the size of the UAAL and Normal Cost
  - Discount Rate should be representative of actual investment returns achievable
  - For PAYGO plans, typically reflects General Fund returns of 3-5%
  - Funded plans investing in equity and bonds can achieve returns of 7-9%
    - GASB 45 allows an irrevocable trust with broad investment powers to use a higher discount rate
- The use of a higher discount rate will translate into lower annual ARC payments since the Present Value of the future liability will be lower

What the Rating Agencies Are Saying

STANDARD & POOR'S

"From a rating standpoint, OPEB obligations, like other cost pressures that lack offsetting resources, affect not only debt and management factors, but also financial. If any changes resulting from OPEB have the effect of adversely affecting an employer's financial position or flexibility, then credit quality may suffer. 'The key to preserving credit quality will be in how OPEB liabilities are managed.'"

- June 15, 2006

"The difference between financing these benefits under the old pay-as-you-go (PAYGO) method and the new advance funding method will be significant. As OPEB obligations take on greater urgency, management must respond with thoughtful, long-term solutions."

-December 14, 2005

Moody's Investors Service
Global Credit Research

"Even though compliance with the This finding underscores the funding pressure that compliance with the new accounting rules may entail for many states, given their generous retiree health benefits and past lack of pre-funding. Many states are expected to set up and fund trusts to hold retiree health benefit assets, in order to avoid incurring balance-sheet liabilities and to take advantage of the higher assumed interest rate allowed under the standard for plans in which benefits are paid using assets held in trust.."

- January 2006

"Even though compliance with the new accounting rules is expected to exert financial stress and to bring to light previously unknown liabilities, Moody's expects the disclosure effects will be largely positive over the long term. Any resulting fiscal strain is likely to be more than offset in most cases by the positive implications of management practice improvements under the accounting rules ."

- July 2005

FitchRatings

"Failure to make actuarially determined OPEB plan contributions will most like result in rising net OPEB obligations, which like rising net pension obligations are a deferral of financial responsibility. Therefore, over time, a lack of substantive progress in funding and managing OPEB liabilities or a failure to develop a realistic plan to meet annual OPEB contributions could adversely affect an issuer's credit rating."

- June 22, 2005

Conclusion

- Massive OPEB liability by any measure
- GASB deadlines are imminent
- While accountants will not require action, rating agencies and creditors will
- NYSAC is here to help

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