



It's Time Addressing OPEB Liabilities

The implementation of GASB 45 and the reporting of Other Postemployment Benefits (OPEB) liabilities is becoming a reality this year for midsize public sector employers, such as states, municipalities and utilities.

This current phase of the implementation—which applies the new requirements to “phase 2” government employers, those with annual revenues of \$10 million to \$100 million—extends through the 2008 tax year.

These employers must begin reporting the actuarially determined liability for OPEB benefits for employees, and the assets, if any, that are available to offset that liability. They must also report a portion of the liability as an annual accounting expense on financial statements, as well as a cumulative accounting of the contributions the employer makes to offset this annual expense.

Even though these changes apply to the current tax year, it seems many public entities still haven't made any decisions about funding their OPEB liabilities. And, whereas the funding ratio for public sector pension plans tends to be between 70% and 90%,

the typical public sector OPEB funding ratio is zero. This is despite the fact that most public entities will have a larger OPEB funding shortfall than pension funding shortfall.

Assessing the Size of the Problem

Some employers may not be taking action because, in many cases, they don't really know what their OPEB liabilities are. Liabilities can vary dramatically from organization to organization, from those that have no commitment beyond the current budget year to those having to cover the full cost unless the law on their charter is changed. Procedures can even differ between adjacent school districts or cities, so it is difficult for different public entities to compare notes.

For employers, this complexity raises a number of challenging questions: What do I do? What actuarial assessments should I put in place? If I reserve money against these liabilities, does it meet the requirements of the accounting standards? What exemptions are available to protect myself against liabilities? What is my liability? Should I fund it? Should I fund part of it or all of it? How do I finance it, and where do I raise money from? J.P. Morgan is working on various fronts, from financing to trust and asset servicing, to answer these questions for clients and help solve their problems.

To Fund or Not to Fund?

There is no requirement to fund the Annual Required Contribution under GASB 45, but there are a number of reasons why that could make sense.

Not prefunding any of the liability can be more expensive in the long run. According to 2006 city, county, state and school/special district data compiled by J.P. Morgan, the average pay-as-you-go OPEB cost per retiree is \$4,709 per year. These costs might be lower in the short term, but with longevity becoming an issue and the cost of health care rising, meeting liabilities through the traditional pay-as-you-go method is going to become more expensive each year.

Furthermore, the financial viability of a pay-as-you-go approach over the next 20 to 30 years might be unclear. Long-term costs and accruals could rise sharply over time, which could affect credit ratings and the health of the balance sheet. Many governments are also likely to be concerned about raising taxes to cover these rising costs, so reserving money now and building assets to address these liabilities makes sense.

GASB 45 also has an accounting incentive to fund the full Annual Required Contribution for OPEB. However, 100% funding of the liability can also be problematic. There are potential problems in 100% funding of OPEB trusts—namely, overfunding. As with pensions in the late 1990s, short-term overfunding can lead to long-term benefit increases, or a greater likelihood of payment holidays, which can cause budget stresses.

Determining which funding ratio works best—from pay-as-you-go (0%) to overfunding (e.g., 110%)—will vary from employer to employer. For example, it might not make sense for some employers to fund a high portion of their current liabilities if that

liability may drop considerably in future years. On the other hand, for those that will have ongoing commitments, some funding will reduce long-term funding costs and signal balance sheet strength.

Once an employer has decided on a funding ratio, how should funding be approached? Certainly, funding OPEB liabilities may follow a similar method to funding pension liabilities. Copying the pension fund's policies is simple and easy to understand. It might also allow some economies related to investment management.

However, as OPEB assets increase, different OPEB investments may be appropriate. This is where OPEB liabilities and pension liabilities differ. Since expected long-term medical inflation is much higher than CPI or average wage increase trends, OPEB liabilities are likely to be much more volatile, have a longer average duration and can mount much faster than pension obligations. As people live longer, treatment becomes more expensive and new drugs and procedures become available. OPEB liabilities are also not always vested, so it is possible that they can be changed substantially, though doing so could cause a political stir. Aside from that, very low funding ratios typically mean the need for more liquid investments in an OPEB trust.

Choosing the Appropriate Vehicle

There are other factors that employers need to consider if they are going to set up an OPEB trust, such as who is going to manage it and which vehicle they should use. For the most favorable GASB 45 accounting treatment, OPEB assets should be held by a separate legal entity—one that is bankruptcy-remote from the employer and inaccessible to the employer's creditors. Contributions should also be irrevocable.

However, many employers don't have an appropriate place to store OPEB funds. The pros and cons of the different funding vehicles should be considered, such as a Voluntary Employee Benefits Association (VEBA), a 401(h) account for medical benefits under a tax-qualified pension or annuity plan or a Section 115 trust.

The Next Phase

Now that larger and midsize organizations have been given an opportunity to address these issues, smaller employers, with annual revenues under \$10 million, will be the focus of the next phase of GASB 45 implementation for the fiscal year beginning December 2008.

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