



ADVISORY

A GFOA *advisory* identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Need for Considerable Caution in Regard to OPEB Bonds (2007) (CORBA and DEBT)

Background. GASB Statement No. 45, *Accounting and Financial Reporting for Employers for Postemployment Benefits Other than Pensions*, requires public-sector employers to disclose in the notes to the financial statements the full amount of their unfunded actuarial accrued liability (UAAL) for other post-employment benefits earned by employees for services rendered to date.¹ In addition, employers who subsequently fail to fully fund their actuarially determined annual required contribution (ARC) each year will also be required to report the cumulative effect of underfunding the ARC as an accounting liability on the face of their financial statements. Nothing in GASB Statement No. 45 requires employers to advance fund their OPEB obligations. The decision to advance fund OPEB should reflect a given jurisdiction's careful analysis of its own unique financial situation.

In the wake of GASB Statement No. 45, some employers have contemplated the possibility of issuing debt to fund their UAAL for OPEB, as has sometimes been done in connection with pension obligations. In either case, the objective is to invest the proceeds in appropriate qualified investments at a return substantially higher than the interest cost of the debt. The Government Finance Officers Association (GFOA) has already adopted a recommended practice that addresses the issuance of debt in connection with pension obligations: *Evaluating the Use of Pension Obligation Bonds*.² While the underlying concept is the same, several crucial additional factors must also be considered for OPEB bonds:

- The unfunded actuarial accrued liability for OPEB is inherently and significantly more volatile than the actuarial liability for pension benefits for several important reasons. First, health-care costs and utilization are less predictable than life expectancy. Second, unlike pension benefits, in many jurisdictions health-care benefits are not guaranteed by state law and employers may choose to reduce, cap, or eliminate these benefits. Third, state or federal health-care initiatives might also significantly change the way health care benefits are provided in the future. Furthermore, it generally has been observed that healthcare cost trends are more volatile and difficult to project than inflation rates for pension costs because the former must take into account ongoing changes in medical technology and societal expectations.
- Some employers may elect to respond to the disclosures required by GASB Statement No. 45 by reducing benefits, capping employer contributions, or moving toward defined contribution arrangements, as

¹ This disclosure normally is not required of employers participating in defined contribution plans (disclosures for costsharing plans are normally provided in the plan report).

² Originally issued in 1997 and subsequently revised in 2005. Many of the risks identified for pension obligation bonds in this Recommended Practice also apply to OPEB bonds: (1) OPEB bonds possess an inherent degree of risk to the extent that their economic utility depends upon the reinvestment of the proceeds at a higher rate of earnings than the rate of interest being paid on the bonds. This problem is compounded by the fact that these bonds are taxable bonds bearing a higher interest rate; (2) As a result of debt ceilings set by policy or statute, OPEB bonds may create a loss of flexibility for state and local governments' by using up debt capacity that might be applied to other important projects and tying up revenue streams for an extended period of time; and (3) The influx of cash from a bond issuance will improve the benefit plan's funded ratio even though the jurisdiction has incurred debt and possibly create pressure on elected officials to provide additional benefits.

sometimes occurred following a similar change in private-sector accounting rules that took effect in the 1990s.

- The potential volatility in actuarial estimates described earlier could lead to over-funding. Such overfunding could raise potentially troublesome budgetary or policy issues.
- Rating agencies and similar authorities have yet to determine what constitutes a safe and reasonable funded ratio for OPEB.
- Most jurisdictions have yet to establish trust funds for OPEB that meet the criteria of GASB Statement No. 45. Likewise, state laws that currently may hinder the establishment and permissible investments of such trusts have yet to be addressed.
- Issuing OPEB bonds could require governments to prematurely create an irrevocable trust that might not be warranted.

It is essential that the foregoing factors be taken into account before any decision is made regarding the appropriateness of issuing OPEB bonds.

Recommendation. Despite the similarities between OPEB bonds and other types of debt as financial products, the analysis needed to determine their appropriateness is substantially different. Therefore, GFOA strongly recommends that jurisdictions contemplating the possibility of issuing OPEB bonds not only follow the guidelines already set forth in GFOA's recommended practice on pension obligation bonds, but also do all of the following:

- Allow sufficient time for a public-policy dialogue to occur between the governing body, employee groups, finance officials, and the public they serve regarding the appropriate funded ratio for OPEB. Failure to do so could produce "solutions" that ultimately fail to reflect the desires and considered judgment of constituents.
- Consider OPEB bonds only upon consultation and advice from a knowledgeable financial advisor who is not also serving, or planning to serve in the future, as an underwriter of the OPEB bonds. As part of their consideration, potential issuers should compare the results of any proposed OPEB bond issuance to both (1) advance funding on the basis of the ARC and (2) pay-as-you-go funding.
- Refrain from issuing OPEB bonds until all issues concerning the proper establishment of a qualified trust fund, investment procedures, and investment guidelines have been resolved.
- Consider, upon consultation with actuaries and other experts, limiting the planned funded ratio to an amount suggested by actuarial and other analysis.

In summary, GFOA urges governments to exercise considerable caution when contemplating the possibility of issuing OPEB bonds.

Approved by the GFOA's Executive Board on March 2, 2007.