



Winter 2006 Visit our Website at www.gfoact.org Volume 13, Issue 2

President's Message

By Bob Curry

Our first quarterly meeting of the 2005/2006 year was held on November 16th at the Aqua Turf in Southington. I thank First Vice President/Program Chair Jeff Jylka for putting together an informative program with diverse and important topics. I would also to thank our speakers for donating their time and efforts. The winter meeting will be held on February 2nd at the Rocky Hill Marriott, the spring meeting will be held on April 6th Waters Edge in Westbrook, and the annual meeting/election of 2006/2007 officers will be held on June 1st at Tunxis Plantation in Farmington. All of these dates as well as those for the New England States GFOA and other organizations with municipal finance interests have been posted to our web site - www.gfoact.org . In addition, the national GFOA conference will be held from May 6th through 10th, Montreal, Canada. Event Chair Tom Hamilton has been quite busy working out the details for "Connecticut Night", which will be held May 8th in Montreal. The New England States GFOA is sponsoring a training session in Marlborough, MA on March 30th & 31st. Also note that Connecticut is the host state for their Fall conference at Foxwoods from September 17th-20th (Sun - Wed) and we need volunteers to help out.

Mark your calendars for all these events and best of luck to everyone during the current budget season!

Secretary's Report

By Chris Hutton

Minutes of GFOA Executive Board Meeting

November 16, 2005

Aqua Turf, Southington, CT

- Meeting called to order at 9:05 a.m. **Board members present:** Robert Curry, Jeff Jylkka, Christine Hutton, Sal Pandolfo, Diana Doyle, Mike Walsh, Lisa Hancock (late), Jim Finch, Alan Desmarais, Jim Jaskot, Kate Clarke Buch, Barbara Bertrand, Jeff Smith (late), Richard Darling, Don Miklus (late), and Tom Hamilton, Board **members absent:** Jan Godley, Dena Diorio, Greg Simmons, Jim Bowes and Bill Hogan. **Others present:** Linda Savitsky, and Jessica Sanchez.

- **Minutes of September 1, 2005 Meeting** – Robert Curry moved and Richard Darling seconded approval of minutes as amended to reflect \$5,000 increase for

2

web site budget; monies to be appropriated from Fund Balance. Motion passes unanimously by all board members present and able to vote.

- **Treasurer's Report** – A copy was distributed to each board member. The report was reviewed and accepted by board members. Motion to approve the report was made by Kate Clarke Buch, seconded by Mike Walsh. The report reflects change made to the web site budget at the September 1, 2005 meeting.

- **Financial Status** – There was a discussion about leaving the dues at \$30 for future years, and increasing the meeting fees. A sub committee of Alan Desmarais, Sal Pandolfo, Kate Clarke Buch, Barbara Bertrand, and Tom Hamilton was formed. The committee requested a total number of meeting

attendees at past meetings from Linda Savitsky. The committee will have a partial report for the board with their projections on December 8, 2005. The full report should be ready at the following meeting.

- **Accounting Standards** – Jim Jaskot encouraged the board to attend the OPEB class on Tuesday, November 29, 2005. He suggested that each board member have someone from their organization attend the workshop. Jim Jaskot will report back to the board with upcoming topics. He also informed the board about the GASB Exposure Draft, Sales and Pledges of Receivables and Future Revenues
Comment Deadline: December 30, 2005.

- **Auditing** – Nothing to report. Greg Simmons not present.

- **Education** – The education committee (Linda Savitsky, Chris Hutton, Ann Harter and Diane Doyle) gave their report. They informed us that there is a workshop set up for Tuesday, November 29, 2005. The presenters have a meeting scheduled for November 17, 2005. Registration is at 75 as of November 16, 2005. Robert Curry will make an announcement on this upcoming workshop at the November 16, 2005 meeting. National GFOA is sponsoring a Satellite Downlink Teleconference on January 25, 2006. The topic will be Budgeting for Outcomes. Linda has a meeting room on hold at Rensselaer. Sal Pandolfo made a motion to support this event. Kate Clarke Buch seconded the motion. Motion was approved unanimously.

- **Historian's Report** – Nothing to report. Jan Godley not present.

- **Legislative** – Mike Walsh and Alan Desmarais gave an update on the OPEB work group.

- **Membership** – Applications have been sent out. Linda has taken over this

responsibility. Sal reported that as of the day of the meeting, there were 449 paid members

- **National Event** – The letters to help sponsor the National event have been mailed out. Tom will look into cutting the cost down on this event by scaling down on the food. All board members liked the idea of going to the museum in Montreal as part of the entertainment at this event.

- **Newsletter** – Dena Diorio was not present to give her report. Prior to the meeting Dena gave her verbal report to Robert Curry. The newsletter will be published on January 27, 2006. The deadline for submissions to Dena will be January 13, 2006.

3

- **Program** – Jeff Jylkka gave his report. The next meeting is scheduled for February 2 at the Rocky Hill Marriott.

- **National GFOA Representative** – Nothing to report.

- **2006 New England Conference** – Jeff Smith handed out a proposed schedule for the Connecticut Conference Committee. This Conference is scheduled for Sunday, September 10, 2006 – Wednesday, September 13, 2006. The next meeting to discuss this event is scheduled for December 8, 2005. Jeff Smith requested \$5,000 from the board to open a separate account for this Conference.

Lisa Hancock moved the motion, and Don Miklus seconded. Sal Pandolfo made an amendment to the motion to increase the GFOA Budget. The motion as amended was approved.

- **New Business :**

- National GFOA Scholarship Applications – copies of the applications

were going to be put out at November 16, 2005 meeting.

- o New England meeting dates need to be scheduled.

- **Next Board Meeting** – Scheduled for Thursday, December 8, 2005 at Tomasso's

in Rocky Hill near the Marriott at 11:30 a.m.

- Meeting adjourned at 11:10 a.m.

Minutes of GFOA Executive Board Meeting

Thursday, December 8, 2005

Tommaso's Restaurant

Rocky Hill, CT

- Meeting called to order at 11:45 a.m. **Board members present:** Robert Curry, Jeff

Jylkka, Christine Hutton, Sal Pandolfo, , Mike Walsh, Lisa Hancock, Jim Finch,

Alan Desmarais, Jim Jaskot, Kate Clarke Buch, Barbara Bertrand, Jeff Smith,

Richard Darling, Tom Hamilton, Jan Godley, Dena Diorio, Don Miklus and Bill

Hogan **Board members absent::** Diana Doyle and Greg Simmons **Others**

present: Linda Savitsky, and Jessica Sanchez.

- **Minutes of November 16, 2005 Meeting** – Sal Pandolfo moved and Barbara

Bertrand seconded approval of minutes. Motion passed unanimously by all board

members present and able to vote.

- **Reinstatement** – In accordance with the by-laws, the board had to vote to reinstate

member, Dena Diorio who missed two or more meetings. All board members

present and able to vote voted unanimously to reinstate Dena..

- **Treasurer's Report** – A copy was distributed to each board member. The report

was reviewed and accepted by board members.

- **Accounting Standards** – Nothing to report.

- **Auditing** – Nothing to report.
- **Education** – The education committee (Linda Savitsky, Chris Hutton, Ann Harter and Diana Doyle) gave their report. They informed us that the training session held on Tuesday, November 29, 2005 was successful. Linda received phone calls
4
with positive feedback. They had 130 registrants, 15 no shows, and 5 walk-ins. The Evaluations need to be compiled. Linda will have a financial report with all the expenses for the OPEB training session at the next meeting. National GFOA is sponsoring a Satellite Downlink Teleconference on January 25, 2006. The topic will be Budgeting for Outcomes. Linda has a meeting room on hold at Rensselaer. The Board agreed that GFOACT should sponsor this event. Linda will forward all the information on this meeting to Robert Curry.
- **Historian's Report** – Nothing new has been added to the report.
- **John Walsh Scholarship** –Bill Hogan reported that the GFOA Advanced Govt. Institute would be held at the University of Wisconsin, August 13-18. The Application forms for the scholarship will be mailed out in January. There are enough monies available in the Walsh Scholarship Fund to support 2 scholarships each valued at 1,800 a person. The winners will have to pay for their own airfare.
- **Legislative** –Mike Walsh did not have anything to report.
- **Website** – The website contract needs to be signed with Web Solutions. Alan Desmarais, Robert Curry, and Linda Savitsky will be working together on this topic.
- **Membership** – Linda reported that there are 467 paid members. Follow ups need to be mailed out.

- **National Event** – Tom Hamilton is working with the caterer's, and he has made contact with a second caterer. Tom is still trying to meet the budget. Sponsorship is up to \$5,400.
- **Newsletter** – Dena Diorio reported that the newsletter will be published on January 27, 2006. The deadline for submissions to Dena will be January 13, 2006.
- **Program** – Jeff Jylkka gave his report. The program for the next quarterly meeting scheduled for February 2 at the Rocky Hill Marriott is in process.
- **National GFOA Representative** – Jeff Smith reported that he went to Milford and presented a certificate of achievement for Excellence in Financial Reporting. This was the first time the city had been given the award.
- **2006 New England Conference** – Jeff Smith reported that the preliminary information on this conference will be distributed at the next meeting.
- **Dues** -This will be discussed at the February meeting.
- **OPEB Task Force** – Alan Desmarais reported that POB discussions have been finalized, and that they have two more meetings scheduled.
- **New Business** :
Possible By law review- The by laws will not be reviewed right now.
Discussion regarding possible legislation, increasing the term of Education Financing to 30 years Frank D'Ercole advised GFOA that he plans to submit legislation to allow this change. The board chose to take no action at this time.
- **Next Board Meeting** – Scheduled for, Thursday, February 2, 2006

- Meeting adjourned at 12:05 p.m., Robert Curry made the motion to adjourn. Lisa

Hancock moved the motion. Richard Darling seconded the motion.

Education Committee

By Linda Savitsky

The Education Committee had a busy quarter. They helped facilitate a session cosponsored by CT GFOA at the CCM Convention Session on Performance Measures. It was moderated by Bob Curry. Don Shaw from Hartford and Lyle Wray, ED of the Capital Region Council of Governments (CRCOG) were the GFOA speakers. The session was well received and well attended.

The Committee held a Training Session on OPEB Implementation on November 29, 2005 at the Rocky Hill Marriott. The session speakers were: Vanessa Rossitto of Blum, Shapiro, Becky Sielman and Steve May of Milliman, Doug Gillette of Day, Berry and Howard and Mike Goss of UBS. Over 130 people pre-registered; app. 110 attended. The feedback was excellent. Geoff Buswick from S&P brought copies of articles that S&P has written about this topic. Copies of the articles and speaker's presentations are available by contacting Linda Savitsky at lr_savitsky@snet.net

CT hosted the GFOA GAAP Update on November 10, 2005. App.22 people attended the session. CT also hosted a site for the National GFOA January 25, 2006 Satellite Downlink Teleconference about Budgeting for Outcomes.

The committee is exploring the possibility of developing a set of courses of varying levels that would be available to members on a regular schedule. More information will be available in the next edition of the newsletter.

Accounting Standards Committee

By James Jaskot

The GASB has issued the following document since the Fall 2005 Newsletter:

Guide to Implementation of GASB Statement 44 on the Statistical Section

The GASB issued an Implementation Guide in December 2005 to assist in preparing the updated and expanded statistical section in accordance with Statement 44, *Economic Condition Reporting: The Statistical Section*. The guide provides the answers to over 120 questions on important aspects of Statement 44, including presenting newly required information, identifying a government's most significant own-source revenue and its overlapping governments, calculating total direct rates, debt ratios, overlapping debt, and debt limit information, obtaining and reporting demographic and economic information, and selecting appropriate trend information about government employees, operating indicators, and capital assets. In addition, there are more than 160 illustrations, including complete sample statistical sections. Statement 44 encompasses the new information resulting from GASB Statement 34 among other developments over the last two decades. Governments that prepare a Comprehensive Annual Financial Report (CAFR) are required to implement Statement 44 for fiscal years beginning after June 15, 2005. The

6

Implementation Guide (Product Code GQA44) can be ordered by telephoning the GASB Order Department at 1-800-748-0659, or via the GASB website, www.gasb.org.

There is also a Preliminary Views (PV) document and an Exposure Draft (ED) currently outstanding. Details on these documents can be found in the previous newsletter, or GASB website. An overview is provided below:

GASB PV document, *Accounting and Financial Reporting for Pollution Remediation Obligations*

The GASB issued a PV document, *Accounting and Financial Reporting for Pollution Remediation Obligations* in March 2005. The comment period on the PV concluded on

June 24, 2005. Issuance of an ED is tentatively scheduled for January 2006.

GASB ED, Sales and Pledges of Receivables and Future Revenues

An ED on *Sales and Pledges of Receivables and Future Revenues* was issued in

September 2005. The comment period on the ED concluded on December 30, 2005.

Issuance of the resulting Statement is tentatively scheduled for the third quarter of 2006.

The GASB has issued various pronouncements since the last update appearing in the

Winter Newsletter early this year. A brief description of each is provided below:

John T. Walsh Scholarship Committee

By Bill Hogan

The JOHN T. WALSH Scholarship is now in its 10th year and has awarded

approximately \$30,000 in awards. This year the committee intends to once again fund

up to two annual scholarships to the GFOA's Advanced Government Finance Institute

held each year at the University of Wisconsin. It is awarded to a senior level municipal

finance officer who has demonstrated leadership and active participation in the GFOACT.

Our past winners included Ann Harter-Newington, Alan Desmarais- Manchester,

Bob Curry-Meriden and Glen Kloocko-Bristol.

The Institute is a five-day intensive program that provides senior level finance

professionals the opportunity to analyze long-term finance issues in an academic

environment. This year's seminar will be held August 13-18th. The Walsh Scholarship

will pay for the \$1,850 Institute fee, which includes tuition, housing, meals, books and

sponsored activities. Transportation and other costs will not be covered.

For more information on the *Advanced Government Finance Institute* go to

<http://www.gfoa.org>

Walsh Scholarship information and the application will be distributed to CT- GFOA via

e-mail to members in early 2006.

The John T. Walsh Scholarship Committee is comprised of William J. Hogan, Director of Finance with the Town of Newington, Catherine S. Boone, Deputy State Treasurer and William J. Cochran, former Director of Finance with the City of Hartford. All are former employees of Mr. Walsh.

7

Other Post Employment Benefits

By Dena Diorio

At the Education Committee's session on Other Post Employment Benefits, Geoffrey Buswick from Standard & Poors gave a brief overview on how S&P is looking at OPEB as it relates to municipalities credit ratings. Mr. Buswick provided some articles for distribution to GFOA Members through the newsletter. I was also able to obtain articles from Moody's & Fitch that should provide a comprehensive view on how the rating agencies are looking at this new requirement. We were given permission from all three rating agencies to reprint this material. I hope you find it useful.

Public Finance

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www.fitchratings.com

Special Report

Reversal of Fortune: The Rising

Cost of Public Sector Pensions and

Other Post-Employment Benefits

Analyst

Joseph D. Mason

1 703 245-3068

joseph.mason@fitchratings.com

This report was prepared with the research

assistance of Sahil Khera.

This report examines the potential credit

impact of increasing defined-benefit pension

funding requirements on governmental plan

sponsors in the U.S. Included also is a

discussion of the historical, legal, and

accounting contexts for public sector

pensions. Other post-employment benefit

liabilities are getting attention in light of

evolving accounting standards and this topic

will also be addressed.

•• Outlook

Public sector sponsors of defined-benefit pension plans have reason to be concerned. The worst three years of domestic equity market performance since World War II have cut deeply into plan funding ratios, in many cases leading to substantial increases to contributions at a time when budgets are already stretched thin. The actuarial practice of smoothing gains and losses on invested assets, usually over a five-year period, takes some of the sting out of the recent market slide because actuaries are still factoring in the great returns earned prior to 2000. However, unless the equity markets quickly revert to late 1990s form, pension expense for state and local governments can be expected

to rise sharply over the next several years. Defined-benefit pension plans are estimated to cover 90% of state and local government employees.

Pension funding is an important element of credit analysis because pension expense has a direct effect on current budgets and a long-term impact on overall financial flexibility. Contractually obligated pension expenditures, along with debt service commitments, are amongst a governmental entity's fixed-cost burden, pulling resources from other essential programs. Significant increases in pension expense will further challenge governments already reeling from weak revenue growth and rising costs in areas such as employee health care and social services programs. As economic conditions improve and revenue growth returns, pension costs will compete with other governmental priorities, like restoring programs that were eliminated to save money or rebuilding reserves. Fitch Ratings expects few, if any, downgrades to occur solely as a result of rising pension costs.

However, increasing pension expenses can contribute to or exacerbate declines in liquidity and financial flexibility that may lead to downgrades in the absence of corrective action.

Pension funding issues received less attention during the latter half of the 1990s as a buoyant stock market boosted pension plan returns and restored the average funding ratio to 104% in 2000 from 81% in 1990 according to a study by the Public Pension Coordinating Council.

From its June 1, 1996 price of 6,677, the Wilshire 5000 Total Market Index, widely considered the broadest measure of U.S. equity

performance, rose 121% to 14,752 on March 24, 2000, a period of less than four years. These tremendous gains allowed many governments to take “funding holidays” — dramatically reducing or, in some cases, even eliminating annual pension payments. Also during this period, the widening spread between municipal bond yields and achieved rates of plan returns enticed many governments to issue pension obligation bonds (POBs). As the selloff in equities has demonstrated, reaching

Public Finance

Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits

2

fully funded status through sale of a POB does not guaranty that a plan will stay fully funded. Some governments may now have to pay both the pension bond debt service and new unfunded liabilities.

Beyond market volatility, several other factors are affecting the fiscal health of pension plans and their sponsors. First, is the fact that many governments were tempted by the strong plan valuations of the late 1990s to enhance member benefits. Many of those overfunded plans are now underfunded, even before the costs of the enhanced benefits are considered.

Second, budget shortfalls have led many governments to defer pension contributions or reduce payrolls by offering early retirement incentives, rationalizing that the pension systems are healthy

enough in the short-term to meet these obligations.

Lastly, accounting and actuarial standards require pension plans to assume rates of return having some relationship to actual investment return experience based on given asset allocations. It now appears likely that some plans may have to reduce their investment return assumptions, which would further increase annual pension expense.

A related issue lurking in the wings is an exposure draft by the Governmental Accounting Standards Board (GASB) that calls for other post-employment benefits (OPEB), consisting principally of retiree health care, to be treated similarly to pensions from an accounting standpoint. Most OPEB benefits are paid from current budgetary resources, but the accounting change could cause annual contributions to explode since new, presumably unfunded liabilities would have to be amortized.

Despite the likelihood of increasing pension costs for plan sponsors, the plans themselves are, on the whole, in good condition at the present time. A recent survey of state and teachers retirement systems showed that these plans averaged a 92.9% funding ratio on an actuarial basis. It should be noted that the average incorporates a wide variance among plans,

with many overfunded and some less than 50%

funded. The average funding ratio decline from

2001–2002 was a relatively modest 4.2%. However,

as the poor investment returns of 2000–2002 work

their way into subsequent plan valuations, the

average funding ratio may decline more rapidly;

some experts predict the average will fall below 80%.

•• Credit Considerations

Fitch analyzes pension liabilities in conjunction with

the analysis of an issuer's debt profile and future

borrowing plans. Pension liabilities are similar to

bonded debt in that both are considered long-term

liabilities on the balance sheet. However, unlike fixed

debt costs, pension liabilities can be altered through

changes to plan assumptions or to valuation methods,

making direct comparisons difficult. For this reason,

pension liabilities are not included in the long-term

debt ratios. Moreover, unlike bonded debt, which

must be repaid on time and in full, pension payments

can be reduced or deferred.

Fitch analysts begin to evaluate pension plan status

by reviewing the overall funded ratio, the size of the

annually required contribution (ARC) relative to the

sponsor's overall budget, and the sponsor's net

pension obligation (NPO). Generally, a current

funding ratio of 70%–80% or better is considered by Fitch to be adequately funded from a credit perspective. However, in cases where actuarial assumptions are clearly aggressive and outside current norms, this range may be insufficient.

Conversely, a lower funding ratio may be acceptable if actuarial assumptions are notably conservative.

Below this 70%–80% threshold, the pension plan could be considered to have a potentially significant impact on the sponsor's budget and additional analysis is warranted. This is particularly true in cases where the ARC is a significant and growing part of the sponsor's budget. Similarly, a rising NPO usually reflects a deferral of required pension payments, and the reasons for such a deferral will be explored. *(See later sections for a discussion of key accounting and actuarial concepts related to pension plans.)*

Generally, pension funding status affects rating outcomes at the margins, or only in the more severe cases of underfunding. For example, during the assignment of an initial rating, a low funding ratio and the presence of a large NPO can have a negative impact on the rating outcome, keeping a rating below where other factors might suggest it should be. On

the other hand, a fully funded pension plan would not typically result in a higher rating assignment or a rating upgrade since it simply represents the fulfillment of a contractual obligation.

Deferrals of minimum required pension payments can, in some cases, affect a plan sponsor's credit rating over time, depending on the current and

Public Finance

Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits

3

historical funding level of the plan, the reason for the deferrals, and the overall credit profile of the plan sponsor. At a minimum, Fitch considers the deferral of pension expense as a significant indicator of fiscal stress and one that merits closer scrutiny. In some states, annual pension expense payment amounts and deferral rules are governed by constitutional or statutory considerations, which must be factored into the analysis.

The current weakness of the equities markets is causing many pension plan funding ratios to decline, although these market-related swings are normal and are to be expected over the long-run time horizon associated with pension funding. After all, plans that appeared poorly funded in the early 1990s benefited

greatly from the strong equities market in the latter half of the decade; a decline from those levels is to be expected. Fitch analysts will work with plan sponsors to gain a complete understanding of the impact on operating budgets of increasing ARCs. Plan sponsors that exhibit a steady history of meeting their pension commitments should not experience rating pressure due to market-driven declines in funding ratios unless it becomes clear that pension expense will have to be significantly deferred.

Economic and demographic assumptions are also reviewed given their direct impact on the aforementioned benchmarks. Aggressive investment return or salary assumptions could inflate a plan's funding ratio. Changes to the benefit structure since the last plan valuation, such as an ad hoc cost of living adjustment for retirees, can also affect plan liabilities. Fitch analysts will work with plan sponsors to gain an understanding of how such assumptions and benefit changes will affect the direction of plan funding ratios and ARCs. If significant unfunded liabilities are present or anticipated, the government's plans for addressing the liability will be reviewed. The current or potential magnitude of pension expenses on the sponsor's cash

flow will be factored into the rating analysis.

The analysis will differ somewhat for governments that do not sponsor a pension plan but rather participate in a cost-sharing multiple employer plan.

In such cases, information about the cost-sharing pension plan is often not readily obtainable from a participant's financial reports. In these cases, Fitch analysts will look to see that the issuer has been paying 100% of the amount billed by the cost-sharing retirement system. As circumstances warrant, additional information about the cost-sharing plan may be requested to determine the likely future direction of bills sent to participants.

•• History of Public Sector Pensions

Public sector pensions originated as disability benefits granted to soldiers as an incentive to join armies. Such benefits have been used throughout recorded history and were first granted in the U.S. by the Plymouth Colony in 1636.

Pensions for public sector civilian employees did not appear until the 1850s and were largely confined to big cities. Plans were first offered only to public safety personnel as additional compensation for hazardous duty. Some cities extended benefits to teachers; other municipal workers were generally not

covered. Benefits typically consisted of a disability payment only, with some plans offering a survivor benefit. Retirement benefits were rarely offered except for “forced savings” plans, which invested the employees’ own contributions for future payout.

Widespread coverage of all classes of public sector employees did not begin until the early 20th century, with many workers not receiving coverage until after World War I. The first state retirement system was created by the Commonwealth of Massachusetts in 1911. Still, public sector workers were far more likely to receive some retirement benefit than their private sector counterparts, who did not significantly expand coverage until after World War II.

Even the earliest of public sector plans typically required some contribution from the employee, a practice that continues today. By contrast, most private sector defined-benefit plans are entirely employer funded, probably due to favorable tax treatment afforded employer contributions.

The historical information in the above section was derived from a book entitled “A History of Public Sector Pensions in the United States,” by R. Clark, L. Craig, and J. Wilson.

•• Modern Public Sector Pensions

Public pensions developed unevenly over a long period of time without any significant regulatory oversight. As a result, the modern public pension system is a patchwork of plan types that entails different benefits, different valuation and funding methods, and varying intergovernmental relationships between the states and their subunits. This diversity complicates comparative analysis and heightens the

Public Finance

Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits

4

need for analysts and municipal bond investors to focus on the unique facts of each pension plan and plan sponsor.

The lack of centralized oversight of public pensions reflects both the remoteness of governmental bankruptcy and the unique taxing power of public entities. Governments generally do not go out of business, and their power to tax citizens historically provided, at least in theory, an almost limitless source of revenue to meet pension obligations. However, over the past 25 years, tax limitation measures and anti-tax sentiment have become widespread, dramatically altering the latter point.

In contrast, private sector pensions are highly

regulated by the federal government under the Employee Retirement Income Security Act of 1974 (ERISA). Moreover, corporate pension plans are guaranteed by the Pension Benefit Guaranty Corporation, a government enterprise created by ERISA and funded by premiums from covered companies. No such guaranty exists for public sector pension plans.

The vast majority of modern day public sector pension plans are defined benefit plans. A defined benefit plan is one that pays a specific amount to retirees, usually based on a formula that considers length of service and average wages during the final years of employment. Another type of plan that is growing in use is the defined contribution plan.

Defined contribution plans invest employee and, in some cases, employer contributions in individual accounts for the benefit of the employee. The chief difference between defined benefit and defined contribution plans is that in the former, the plan sponsor/employer assumes the investment risk, whereas with defined contribution plans, the employee is at risk for investment returns.

•• Accounting for Public Pensions

Public sector pension accounting and financial

reporting are dictated by Statements 25 and 27 of the GASB. Statement 25 governs financial reporting standards for plan sponsors, including required supplemental information. Statement 27 establishes rules for valuing pension assets and liabilities and determining annual contributions.

There are three types of plans covered by GASB accounting standards. Single-employer plans are administered directly by state and local governments for their own employees. Agent multiple-employer plans aggregate single-employer plans and pool investment and administration functions. Actuarial valuations are done for each plan and funds are segregated. Cost-sharing multiple-employer plans aggregate the contributions of all participating employers and bill those jurisdictions for pension contributions based on the overall performance of the plan. Most state retirement systems include at least one cost-sharing multiple-employer plan.

Local government financial statements may include data or references to all three plan types. A local unit may have its own plan for certain of its employees, typically public safety personnel, while general employees and teachers may participate in agent or cost-sharing multiple-employer plans. Plan

organization varies around the U.S. with the differences primarily reflecting either legislative initiative or collective bargaining between employee unions and plan sponsors.

Analysts and investors should note a key distinction made by the GASB between the accounting treatment of pensions and the actuarial valuation of pensions.

GASB 25 sets forth financial reporting requirements for retirement systems and pension trust funds of individual plan sponsors that call for the valuation of assets at fair market value and the reporting of current liabilities. The difference, known as net assets held in trust for pension benefits, is not a true reflection of the actuarial funding status of the plan.

The actuarial funding status information, along with the sponsor's required contributions and the compliance with the contribution requirements, is contained in the supplemental reporting information of the financial statement.

•• Measurement of Defined-Benefit

Pension Costs

Pension accounting includes both a short- and a longterm focus, but in either case is heavily reliant on actuarial assumptions. Over the short term, the focus is on determining annual pension expense and the

extent to which the government is meeting its minimal funding requirements. The longer term view seeks to establish the overall funding status of a pension plan — will actuarially valued assets be sufficient to pay for actuarially accrued liabilities?

As mentioned, actuarial assumptions play a critical role in determining a plan's funding status. The purpose of using actuarial funding methods is to

Public Finance

Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits

5

promote the consistent accumulation of assets over time while limiting year-to-year volatility in contribution levels. However, actual plan experience as it relates to actuarial assumptions, including investment return, the level of contributions by the plan sponsor, and employment and wage trends, affect plan performance over time and assumptions must be periodically adjusted.

GASB pronouncements require that all actuarial assumptions used in plan valuation and the related determination of funding requirements be chosen in accordance with the Actuarial Standard of Practice (ASOP) No. 4, Measuring Pension Obligations as promulgated by the Actuarial Standards Board (ASB)

in 1990. Subsequent to the adoption of GASB Statements 25 and 27 in 1994, the ASB promulgated ASOPs 27 and 35 to provide additional guidance to actuaries in selecting appropriate economic and demographic assumptions, respectively.

Three key metrics may be considered benchmarks of public pension plan analysis: the funded ratio, the ARC, and the NPO.

Funded Ratio: The funded ratio is the actuarial value of assets (AVA), expressed as a percentage of the actuarially accrued liabilities. GASB requires the asset valuation method to be market related, not necessarily equivalent to market value. Asset valuations are typically smoothed over a period of five years to reduce short-term volatility related to investment returns. GASB requires the calculation of actuarial costs (liabilities) to be made with one of six methods, each of which yields somewhat different results. The actuarial cost method must be consistent with the method used to value assets.

ARC: The ARC is the actuarially determined amount a government must contribute to its pension plan each year. The ARC consists of two components, the normal cost — that portion of future benefits allocated to the current year — and an amount

sufficient to amortize any actuarially accrued liability. The ARC will move inversely with respect to the funding ratio. A decline in the funding ratio, by definition, means that either the normal cost has increased due to benefit enhancements or a change in assumptions, or there is a larger amount of unfunded liability to amortize due to reduced asset values, or both.

NPO: The NPO is the sum of the any shortfall in pension contributions existing on the effective date of GASB 27 and any cumulative differences between actual sponsor contributions and the ARCs since the effective date of GASB 27. Any shortfalls in contributions are added to the NPO, along with interest accrued at the discount rate. The NPO attempts to measure how reliably a plan sponsor has kept up with its pension payment obligations.

Because most defined-benefit plans use an asset smoothing methodology, actuarial valuations of plan assets tend to lag market valuations. When the market value of assets (MVA) grows due to strong investment returns, the AVA increases at a slower pace because the market returns are gradually phased into the valuation. Accordingly, annual pension costs do not fall in direct correspondence to the rise in

asset values due to the smoothing practice.

Conversely, in a down market such as the current environment, the AVA will tend to exceed the MVA because investment losses are phased-in over time. In this environment, pension expenses will rise more slowly than if they were correlated directly with market losses; although they will rise as the losses are realized (*see chart, page 6*).

- Actuarial Assumptions

Economic Assumptions: The two primary economic assumptions are the investment return/discount rate and the salary scale.

By far the more important assumption is the investment return/discount rate. This rate is used to discount the aggregate value of all future plan benefit payments to present value. Actuarial standards of practice require a number of factors to be considered in selecting the appropriate rate, including the existing allocation of plan assets between equities and fixed-income securities, actual plan return experience, and likely future returns.

The selection of a discount rate that is on the high end of the range that would be considered reasonable could substantially reduce the present value of future liabilities. Obviously, this would reduce the amount

of assets needed to meet those future liabilities and the ARC would be lower. While most plans assume discount rates that may be deemed moderate or conservative (the average is about 8%), there are clearly some retirement systems that may have to reduce their discount rates, opening up additional liabilities.

Public Finance

Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits

6

The salary scale assumption attempts to incorporate future wage increases granted to plan beneficiaries.

Implicit in the overall assumption is a component related to cost of living (inflation) and one related to bargained step increases or expected merit pay increases.

Demographic Assumptions: Major non-economic assumptions in plan valuations include those regarding the pace of retirements from active service, life expectancy, separation rates, disability, and administrative expenses. Life expectancy is emerging as a key assumption due to advances in medical science that allow people to live longer.

Implementation of new mortality tables reflecting longer life expectancy will increase future liabilities.

The assumption regarding the rate of retirement can also have a short-term impact on some plans as discussed below.

- External Factors

Once a defined benefit plan's assumptions are established, the plan should be largely self regulating given sponsor compliance in meeting its annual cost.

The ARC will adjust based on investment performance, and the amortization of unfunded liability will, over time, allow the plan to reach full funding. However, assumptions are never completely accurate and plan sponsors frequently take actions that must be incorporated in the valuation.

Pension Deferral: Governments may reduce or defer entirely their ARC for a given year, usually for budget relief. While such actions do provide shortterm budget savings, the unpaid ARC is added to the NPO and must be made up at some point in the future.

Benefit Changes: Benefits may be adjusted as part of the collective bargaining process or to achieve some budgetary goal of the sponsor. Extra retirement benefits are sometimes granted to employees when plans appear well funded, or if resource limitations preclude larger wage increases. During times of fiscal

stress, governments often establish early retirement programs to reduce payrolls; these programs usually entail some extra retirement benefit. Also, cost of living adjustments are periodically granted to retirees, some of which may not have been part of the original plan valuation.

Assumption Changes: Actuaries are required to apply a reasonableness test to all of their assumptions, which should generally have some basis in market performance or actual experience. Plan sponsors occasionally run experience studies to test the accuracy of assumptions. These studies can result in changes to assumptions that can dramatically alter a plan's funded ratio, to the good or bad. For example, the inflation rate has remained at or below 3% for an extended period, a level below most plans' assumption. Among other possible effects, a reduction in the inflation rate could mean that cost of living adjustments for active and retired beneficiaries will be less, thereby reducing future liabilities.

Market Value

of Assets

Actuarial Value

of Assets

Deferred Gains

Available to Offset

Investment

Losses

Investment Losses

Not Yet Reflected in

Actuarial Valuation

Impact of Asset Valuation Changes Assuming Smoothing Methodology

Public Finance

Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits

7

•• Pension Obligation Bonds

The current low interest rate environment is attractive

to pension plan sponsors who may be considering an

issuance of POBs. POBs are typically secured by the

issuer's general obligation pledge — debt service on

POBs is not an obligation of the pension plan

receiving the bond proceeds. POBs are an arbitrage

play that attempts to take advantage of the interest

rate differential between taxable municipal bonds and

the assumed investment return on plan assets. Bonds

are issued to fund all, or a portion of, a sponsor's

unfunded pension liability, with the hope that the

debt service on the bonds will be less than what the

sponsor would otherwise have to pay in annual

pension costs over the long term.

If the invested proceeds of the POBs do not realize a rate of return in excess of the cost of capital, new unfunded liabilities could arise. Similarly, if a plan is brought to full funding status by virtue of a POB issuance, there may be a temptation on the part of elected officials to sweeten pension benefits (increase liabilities), particularly in areas where there is significant labor pressure.

Fitch believes that POBs, if used moderately and in conjunction with a prudent approach to investing the proceeds and other pension assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices with respect to POB proceeds could expose the sponsor to market losses.

Because a sponsor's unfunded pension liability is already factored into the rating, the issuance of POBs simply moves the obligation from one part of the balance sheet to another. However, Fitch notes that POBs create a true debt, one which must be paid on time and in full, rather than a softer pension liability that can be deferred or rescheduled from time to time during periods of fiscal stress. Consequently, POBs can have a significant effect on financial flexibility over time.

The use of POBs to provide near term budget relief can, as one factor considered in the total rating analysis, have a negative impact on credit. Using POB proceeds to pay current and subsequent year pension contributions is considered by Fitch to be a type of deficit financing — the use of borrowing funds to pay for an annually recurring expense.

•• Other Post-Employment Benefits

In February 2003, the GASB issued an exposure draft of a new accounting standard that would require governments to account for those post-employment benefits granted to retirees that go beyond simple retirement benefits as if they were pensions. In GASB's view, the accounting change is needed because present accounting rules do not capture the cost of benefits earned by current employees. Rather, employers are only required to book cash outlays actually paid in a given year for OPEB on behalf of existing retirees.

OPEB consists primarily of health care benefits such as hospitalization, prescription drugs, and dental and vision benefits, but can also include such benefits as life insurance or estate planning services. In most instances, the government granting OPEB pays for them on a pay-as-you-go basis, either on a direct

billing basis or through payment of insurance

premiums. Cost sharing of health care premiums with

retirees is considered an implicit rate subsidy and an

OPEB expense. If retirees pay 100% of the premium,

there is no OPEB expense to the government.

GASB's exposure draft presumes that many

governments either already have or will establish

defined-benefit plans for OPEB. These plans would

be required to determine actuarial assets and

liabilities for OPEB every two years, the same

timetable as pension benefits. The actuarial standards

applied to pension plan valuations would also be

applied to OPEB. Fitch anticipates that the new

accounting standard will generate a number of new

(10)

(5)

0

5

10

15

20

1993 1994 1995 1996 1997 1998 1999 2000 2001 2002

Median Investment Return Resulting Actuarial Return

Median Public Fund Returns and Resulting

Actuarial Valuations Based on Five-Year

Asset Smoothing

(%)

Source: Public Fund Survey, August 2003.

Public Finance

Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits

8

methods for funding OPEB, including defined-benefit plans, but also new defined-contribution or other arrangements. The magnitude of the cost associated with funding a defined-benefit OPEB plan may force government employers to look at funding arrangements that significantly increase employee contributions.

When the GASB adopts new standards, it typically provides guidance regarding transition from an old accounting practice to the new rules. In the transition to the new OPEB standard, it is expected that governments with defined-benefit plans will have to account for some prior service credit for OPEB benefits already earned by current employees. This will contribute to an unfunded liability at transition for many governments, which they must begin amortizing. However, unlike the GASB 27 pension rules, employers will not be required to “look back” to determine if they have a net OPEB obligation at the time they transition to the new OPEB standard.

At transition, the net OPEB obligation will be zero and will change over time as governments either meet or fail to meet their annually required OPEB costs.

This new accounting standard can be expected to apply significant budgetary pressure in coming years for a number of reasons. First, the requirement to begin amortizing unfunded OPEB liabilities will likely boost OPEB expenses above current pay-asyou-go expenses. Second, the governmental workforce is dominated by the baby boom generation, meaning it will start consuming benefits over the medium term. Since most defined-benefit OPEB plans are unfunded, this will result in higher cash outlays for benefits. As a result, plan sponsors will have to keep a disproportionately large amount of plan assets in shorter term, more liquid assets to meet current benefits, thereby lowering the assumed rate of investment return on assets. Third, the cost of health care continues to rise above the level of general inflation. Fitch expects annually required contributions to OPEB will be significantly pressured by health care cost inflation.

If adopted, GASB would have the standard implemented by governments with revenues of \$100

million or more beginning with the fiscal year starting after June 15, 2006. Governments with revenues between \$10 million–\$100 million would implement one year later, and those with less than \$10 million in revenue would implement for the fiscal year beginning after June 15, 2008.

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Special Comment

Other Post-Employment Benefits (OPEB)

New Accounting Requirements to Shed Light on Cost of State and Local

Retiree Health Benefits; Funding Pressures Expected to Vary Widely

Summary

Just as U.S. local and state governments are emerging from one of the most difficult fiscal periods in recent memory, they face a new hurdle in the form of accrued retiree health-care liabilities. The costs associated with retiree health benefits, though they have been magnified by growth in healthcare spending, are not a new phenomenon. Governments in coming years will have to improve their measurement and disclosure of OPEB costs and liabilities under statements 43 and 45 of the Government Accounting Standards Board (GASB). For many state and local governments rated by Moody's, the rules will apply to fiscal years starting after Dec.15, 2006. A wide range of previously unmeasured liabilities will be reported as a consequence, and the expected drive to address these liabilities will add to the fiscal pressures governments already face from programs such as public education, Medicaid, and employee pension funding.

Moody's does not anticipate that the liability disclosures will cause immediate rating adjustments on a broad scale.

In fact, certain positive long-term effects seem likely to stem from the new requirements. This special comment describes the GASB statements and how they may affect the state and local government credit rating process. For municipal issuers, the credit impact of the new statements probably will depend on the following factors:

- The absolute size of unfunded actuarial accrued liability (UAAL) and UAAL size relative to key financial measures such as size of payroll, budget and tax base
- The plan for UAAL amortization as well as ongoing funding of new OPEB costs as incurred, on an accrual basis
- Actuarial assumptions, including discount and medical cost inflation rates, used to determine values of liability and pledged assets
- Retirement benefits promised to current workers and retirees as well as the ability (under contract or statute) to modify benefit offerings
- The impact of full funding on the issuer's financial flexibility and strength, based on measures such as debt or

reserve levels

- The current credit assessment of the issuer and other factors affecting financial flexibility

New York

Ted Hampton 1.212.553.2741

Robert Kurtter 1.212.553.4453

Dallas

Douglas Benton, CPA 1.214.220.4381

Contact Phone

July 2005

2 Moody's Special Comment

NEW RULES ARE INTENDED TO IMPROVE DISCLOSURE OF PUBLIC PAYROLL COSTS

Statements 43 and 45 will improve disclosure of costs that, along with salaries, pension benefits and pre-retirement health insurance, make up government employees' total compensation package. Like pensions, OPEB are a form of deferred pay, part of an exchange of salaries and benefits for employees' service. Their costs to employers accrue over the period of employment, even though the benefits are not provided until later. GASB's new standards require governments to measure and report OPEB costs as they are incurred, during the employment period. This mandate will force significant changes in government practice. Most governments, by measuring as expense only the outlays associated with current retirees' OPEB, have failed to capture the accrued cost and liabilities of promising retirement benefits to active workers. The actuarial methods used to estimate the cost of OPEB will be similar to those already applied to pensions. Biennial actuarial valuations of OPEB assets and liabilities will be required under the new accounting rules for state and local governments with 200 or more benefit plan participants; smaller plans will have to conduct valuations every three years and in some cases may be able to use an alternative method not requiring use of an actuary.

OBLIGATIONS COVERED BY THE STANDARDS CONSIST PRIMARILY OF HEALTH INSURANCE

OPEB refers to retirement benefits besides pensions and early-retirement incentive (or termination) payments. These include various health-related benefits, as well as disability, life and long-term care insurance provided outside of

defined-benefit pension plans. The largest component will be health insurance for which the employer pays some or all of retirees' premiums. The magnitude of this obligation will reflect the increases in prescription drug and other medical costs that have accounted for much of the recent growth in Medicaid, the joint state-federal health program for the poor.

GASB's new standards also require the inclusion in OPEB liability calculations of any implicit rate subsidy provided to retirees whose coverage is derived from a pool serving current employees (*see box*). It is because of this subsidy that even those state and local governments that do not explicitly pay part of their retirees' premium costs will likely have OPEB liabilities.

The rules apply to state and local governments and to government-sponsored enterprises, as well as government-owned hospitals, universities, and utilities. Non-profit organizations are covered by standards issued by GASB's sister organization for the private sector, the Financial Accounting Standards Board (FASB). Statement 43 applies to financial reports prepared by health insurance or other OPEB plans, and 45 applies to the governments themselves.

STANDARDS ARE PART OF BROADER EFFORT TO IMPROVE ACCOUNTING FOR PENSIONS AND RELATED

COSTS

The new accounting standards are part of a long-running effort in which GASB and FASB have mandated more disclosure of pension and other retirement benefit costs. FASB's Statement No. 81, issued in 1984, outlined disclosure practices for post-retirement health care and life-insurance benefits; Statement No. 87, in 1985, did the same for pension costs. Further clarification of OPEB cost reporting procedure followed when FASB issued Statement No. 106, in 1990. The same year, GASB published Statement No. 12, providing for disclosure of OPEB-related data in notes to governments' financial statements. These disclosures generally were to include the covered year's OPEB expense; the groups receiving (and the eligibility requirements for) the benefits; the respective contribution requirements for beneficiaries and employers; the statutory, contractual or other basis for the benefits, and a description of funding policy (either pay-as-you-go or paying in advance of future costs). Statement No. 12, which was intended as an interim measure, did not require the calculation of an actuarial accrued liability (AAL) or the recognition of current employees' accrued benefits. GASB in 1994 issued Statement No. 25 and Statement No. 27 to clarify how governments should

report pension costs. Also at that time, it released Statement No. 26, providing interim guidance on financial reporting practices for post-employment healthcare plans administered by defined-benefit pension plans.

IMPLICIT RATE SUBSIDIES

A government's retirees in many cases are able to purchase health insurance at the same premium rate as current employees,

based on the blending of premium rates that would apply to the two groups independently. The cost per participant of covering

both groups together is higher than current-employee coverage would be on its own, and not as high as the cost per participant

in a group consisting solely of retirees. Because of this arrangement, retirees with blended-rate health benefits are said to receive implicit rate subsidies. The new standards require measurement and reporting of the rate subsidy of retirees, even in

situations where the retirees are required to pay 100% of their stated premiums.

Moody's Special Comment 3

INCREASED BENEFIT PRE-FUNDING, OPEB-BOND ISSUANCE AMONG LIKELY GOVERNMENT RESPONSES

Under the new rules, a government will determine the annual required contribution (ARC) needed to amortize its actuarial liability (in no more than 30 years) and to cover the "normal cost" associated with services rendered by employees during the current year. The UAAL will appear in the notes to financial statements and in a required multiyear schedule of funding progress. But to the extent that a government in a given year fails to make the full ARC, that year's funding deficit will create (or add to) a liability called the net OPEB obligation, which will appear in the statement of net assets. The rules require calculation of an annual OPEB cost that differs from the ARC once this net obligation is recorded. This cost, which must be recognized as an expense in accrual-basis financial statements, will be derived from the ARC plus interest on the net OPEB obligation.

Because failure to pre-fund benefits will result in new balance-sheet liabilities, governments may begin to set aside assets for future OPEB obligations to an increasing extent. Moreover, the rules allow a higher assumed discount rate (and hence a lower present-value actuarial liability) for plans with assets set aside in a trust for OPEB obligations than for those with no (or insufficient) assets set aside. Governments may seek to address large, unfunded liabilities for

retiree healthcare through the issuance of taxable bonds similar to pension-obligation bonds. An early example of this practice is the city of Gainesville, Florida, which has issued bonds to address a \$30.6 million liability in its self-insured Retiree Health Care Plan. The credit impact of borrowing to address a retiree health plan funding deficit will depend, as it does with pension-obligation bonds, on the extent to which the debt is part of a realistic plan to address these liabilities, and on its effect on the issuer's overall debt burden.

GOVERNMENTS HAVE BEGUN TO ADDRESS OPEB COST GROWTH

Some state governments, partly in response to the new standards, have already taken steps to reduce growth rates of their OPEB costs. Moody's expects this trend will continue, in part because improved OPEB information will encourage restraint in legislative debates and contract talks where benefits are determined. Alabama (rated Aa3 on watch for a possible upgrade) has enacted legislation increasing the premium payment obligation for various types of employees, including smokers and those who retire after a relatively short period of service. Ohio (Aa1) has modified its retiree health plan so that full coverage is available only to the employees with at least 30 years of service (*see box*).

Utah (Aaa) passed legislation this session to change its practice of providing retirees a month of health insurance for every day of unused sick leave. This policy, which was initiated when health insurance costs were substantially lower, will be modified so that the wages for each day of unused sick leave are placed in retiree health savings accounts, which retirees will then be able to use to purchase their own health coverage. The state still will have to address the liability accumulated through its existing policy, which remains in effect through the end of calendar year 2005. Other states that have taken steps to prepare for compliance with the new OPEB accounting rules include Delaware (rated Aaa), which in May of this year formed a committee to oversee an actuarial assessment of retiree health liabilities. In 2003, Delaware performed an actuarial analysis of its retiree health benefits using a preliminary version of the GASB standard. Georgia (rated Aaa), also in May, enacted a law creating the Georgia Retiree Health Benefit Fund to receive annual contributions based on the state's ARC.

Local governments also have begun to scale back retirement health-benefit offerings for new employees. After performing actuarial assessments of liabilities, Orlando, Florida (Aa2), and Arlington, Texas (Aa2), modified the percentages of employees' healthcare premiums that are covered, as well as length-of-service requirements for eligibility.

OHIO'S APPROACH TO POST-EMPLOYMENT BENEFITS

Ohio is one of the few states that already have accumulated assets pledged to retiree health obligations. The Ohio Public Employees Retirement System (OPERS) oversees an \$11 billion healthcare fund. Even so, because of rapid growth in both medical costs and the number of covered retirees, the OPERS trustees determined in 2003 that the health benefits fund would be used up in less than a dozen years. In September 2004, the trustees acted to restrain the fund's cost growth. They cut the portion of insurance premium coverage available to retirees with only 10 years of service to 50% for workers hired in 2002 or earlier, and to 25% for those hired later. For workers who retire with 30 years of service, however, 100% coverage was retained.

The overhaul also reduced retiree spouse coverage and mandated increased contributions from active workers and employers.

These actions are expected to extend the solvency of the health benefits fund to 18 years. Annual benefits and program adjustments will be reviewed periodically to maintain a balance between responsibilities of the system and its members.

4 *Moody's Special Comment*

RETIREMENT HEALTH BENEFITS VARY WIDELY AMONG STATES AND LOCAL GOVERNMENTS

Retiree health benefits offered to public employees vary dramatically among state and local jurisdictions. States such as Iowa (Aa1) and Mississippi (Aa3) offer little or no health-care coverage to retired workers. Some, such as Wisconsin (Aa3) and Montana (Aa3), offer post-employment health insurance but require retirees to pay most of the cost. Still other states, such as California (A3), fully cover many retirees' health-insurance premiums as well as the majority of the premium costs for retirees' dependents. New Jersey covers retiree health insurance costs of local school teachers and college and university professors in addition to those of its regular employees. As a result, its OPEB expenditures for existing retirees already account for more than 3% of its general fund budget. A Kaiser Family Foundation survey of state governments found that in 2002, monthly premiums ranged from as little as \$105 per month for the Indiana (Aa1) Medicare complement plan to as much as \$668 per month in an indemnity-style plan provided by Alaska (Aa2).¹ State and local governments are further distinguished by benefit eligibility requirements, the legal measures that provide for the benefits, and the demographic characteristics of covered employee and retiree groups. As a result, there

is likely to be great variation in the relative sizes of OPEB liabilities reported.

OPEB FUNDING STATUS WILL BECOME A MORE VISIBLE FACTOR IN CREDIT RATING PROCESS, SIMILAR

TO PENSION OBLIGATIONS

As governments and their retirement benefit plans begin issuing financial reports in compliance with the new rules, OPEB funding status will become more visible among the many attributes Moody's assesses in the municipal credit rating process. While it will most closely resemble pension funding status, there are differences between the two types of obligations. OPEB obligations reflect medical cost trends, while those for pensions are based on salaries, over which a government's management has more control. On the other hand, retiree health benefits may be somewhat easier to modify than pensions, which may have stronger legal or contractual protection. Moody's views both OPEB and pension obligations as less binding than bonded debt, because they tend to allow some flexibility to alter the terms of the benefits (such as eligibility requirements), the assumptions used to derive the actuarial values of plan assets and liabilities, the liability amortization schedule, or other variables.

Moody's therefore will exclude OPEB liabilities from calculations of state or local debt burdens, but include them as a factor in the overall credit assessment of an issuer. This practice is consistent with Moody's approach to municipal pension liabilities. Some governments provide post-retirement health benefits through pooled programs known as cost-sharing, multiple-employer plans. For these governments, the new standards will require reporting of OPEB payments in relation to the amount contractually mandated by their cost-sharing plans. Moody's may have to rely in these cases on the financial reports of the plans, rather than of the governments participating in them, for actuarial information on OPEB funding.

IMPORTANCE OF OPEB TO RATING PROCESS WILL DEPEND ON ISSUER'S OVERALL CREDIT STANDING

The extent to which OPEB funded status becomes an influential or decisive credit factor will depend on an issuer's current rating and how consistent its other attributes are with that rating. State and local governments' liabilities may be large in many cases, given the lack of prefunding in the past. For some issuers, it is possible that efforts to satisfy OPEB funding requirements will exacerbate fiscal pressure. Even so, Moody's does not anticipate that the disclosures

required by the new rules will cause immediate and widespread rating adjustments. It is more likely that rating levels will be affected by observations of changes in OPEB funding measurements over time. Statistics such as the UAAL-to-covered payroll will be made available under the new rules, and Moody's expects to use these in the rating process.

Plans for UAAL amortization, amortization periods, use of debt, and differences between actual and required contributions will also figure into the analysis, along with actuarial assumptions about medical costs and other variables key to estimating OPEB liabilities. Issuers' flexibility under relevant statutes or contracts to modify their post-employment health benefit offerings will likely be another focal point. Moody's also will monitor financial reserve, liquidity and debt levels that will be affected as issuers begin to set aside funds for OPEB. In general, a state or local government's effectiveness and initiative in OPEB liability management probably will influence our overall assessment of the government's management strength.

1. Hoadley, Jack: "How States are Responding to the Challenge of Financing Health Care for Retirees"; The Henry J. Kaiser Family Foundation, September 2003.

Moody's Special Comment 5

LONGER-TERM IMPACT OF REPORTING REQUIREMENTS WILL BE LARGELY POSITIVE

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. As previously mentioned, the rules will require governments to disclose and record the full current cost of benefits provided to employees. Governments will have a strong incentive, though not an obligation, to set aside funds for benefit obligations as they are incurred, which is in keeping not only with accounting principles but also with prudent financial management. 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.

Until the release of audited reports subject to the standards, the lack of actuarially derived OPEB liability information limits Moody's ability to make a more detailed assessment of how these future costs will affect state and local government credit. Expenditures on current retirees' healthcare costs are already incorporated in the rating process.

GASB's schedule for compliance with the new OPEB reporting rules is staggered, with smaller-revenue governments afforded additional time (*see Appendix I*). For states, the first financial reporting periods subject to Statement No. 45

will be those ending during calendar year 2008. A comprehensive overview of states' OPEB funding status is therefore not likely until early 2009, when published comprehensive annual financial reports covering fiscal 2008 become available. At that time, Moody's will focus on the OPEB factors listed earlier, including the UAAL size relative to key financial indicators and the plan for UAAL amortization. Before compliant financial statements become available, Moody's may request information from issuers on various aspects of health plans and other retiree benefits that factor into OPEB liabilities (*see Appendix II*).

6 Moody's Special Comment

Appendix I

Appendix II

Related Research

Special Comments:

[GASB 34: What Does It Mean for the Rating Process?](#), December 2002 (#76862)

[Moody's Perspective On Increased Pension Costs For California Local Governments](#), June 2003 (#78417)

Rating Methodology:

[Moody's State Rating Methodology](#), November 2004 (#89335)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Effective Dates

GASB 45

Government Description Effective Date

Tier 1 (annual revenues > \$100 mln*) Yrs Starting After 12/15/2006

Tier 2 (annual revenues > \$10 mln) Yrs Starting After 12/15/2007

Tier 3 (annual revenues < \$10 mln) Yrs Starting After 12/15/2008

GASB 43

Plan Description Effective Date

Tier 1 (annual revenues > \$100 mln) Yrs Starting After 12/15/2005

Tier 2 (annual revenues > \$10 mln) Yrs Starting After 12/15/2006

Tier 3 (annual revenues < \$10 mln) Yrs Starting After 12/15/2007

** Tiers are based on first fiscal year ending after June 15, 1999, the same basis as applied to Statement No. 34.*

Following are examples of questions Moody's will pose pending disclosure under the new rules:

1) Has an actuarial assessment of OPEB liabilities been performed? If so, what were the accrued actuarial liability, actuarial value of plan assets, and funded ratio?

2) What health-care and other post-employment benefits subject to the standards are provided? What are the benefits' eligibility requirements?

3) Describe the mechanisms (e.g., single-employer or agent multiple-employer defined- benefit plans) through which benefits are provided.

4) What legislative or other actions would be required to reduce the benefits' cost?

5) What is the total cost of retiree health and related benefits in the budget? How much has this sum changed in recent years, and what has accounted for that?

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Authors Sr. Production Associate

Ted Hampton Arminé Jeamgocian

Douglas Benton

Publication date: 01-Dec-2004 Primary Credit Analyst(s): Parry Young, New York (1) 212-438-2120; parry_young@standardandpoors.com

Secondary Credit Analyst(s): Geoffrey Buswick, Boston (1) 617-530-8311; geoffrey_buswick@standardandpoors.com John Kenward,

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

Reporting Changes in GASB

45

Credit Implications

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.

Media Contact(s): Christopher Mortell, New York (1) 212-438-2756;

christopher_mortell@standardandpoors.com

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