OPEBs & GASB
A Question and Answer Guide
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What are OPEBs?
OPEBs provided to retirees, spouses, and their dependents, generally include:
- Medical benefits
- Dental benefits
- Vision-care benefits
- Prescription medicine benefits
- Life insurance benefits
- Disability insurance benefits
- Group legal coverage benefits
- Long-term health care benefits
- Other health benefits

What is GASB 45?
GASB’s new standard requirements for OPEBs for GASB 45, applies to all public agencies (e.g., state governments, county and city governments, school districts) that follow generally accepted accounting principles (GAAP) in filing their annual financial statements and offer post-employment benefits other than pensions. Under GASB 45, public agencies must account for, and report, the annual required contribution (ARC) for OPEBs in the same way they report pension benefits. As a result, the annual OPEB expense is to be reported by most employers will need to be based on actuarially determined amounts rather than on the "pay-as-you-go" method. Governments must use actuarial evaluations to determine the final accounting and reporting amounts expected in the future. OPEB costs also must be reported over the working lifetime of employees and, the information provided in financial statements must include the funding, costs and provisions in an OPEB plan. While GASB 45 does not require that OPEB plans be funded, it requires disclosure of net OPEB obligations (NIO).

GASB 45 Implementation
Implementation of GASB 45 will be in three phases: public agencies with revenues of $100 million or more per year must comply with GASB 45 beginning the fiscal year after December 15, 2008; those with revenues of $10 million to $100 million must comply beginning the fiscal year after December 15, 2007, and those with revenues of less than $10 million must comply beginning the fiscal year after December 15, 2006. With theses dates approaching, CDIAC has compiled this Guide to address some basic questions regarding GASB 45 implementation. Because GASB 45 will require public agencies to disclose the NIO on their financial statements, public agencies need to address questions regarding the handling of any net OPEB obligations. This Guide compiles basic information on options for addressing OPEB liabilities. In addition, the Guide concludes with a list of sources used as the basis for much of the information found in this document.
What actuarial methods are available? GASB 45 permits a choice of six actuarial cost methods to determine the annual expense. According to GASB, demographics, the level and amount of benefit, the funding status of the plan generally influence the actuarial method chosen. The public agency’s actuary will review these factors and recommend the best method given the agency’s particular situation. In practice, many actuaries prefer to use the “unit credit” actuarial cost method, under which an employer is assumed to earn a unit benefit for each year employed, with all benefits assumed accrued upon retirement.

What options other than modifications to existing plans does a public agency have for funding OPEB liabilities? Continue “Pay-As-You-Go” Funding. While making annual payments towards annual OPEB costs is the simplest method in the short run, the “pay-as-you-go” method in the long run may result in annually increasing NOO for GASB 45 reporting purposes. This may occur because the investment return assumptions used in the OPEB calculation for the “pay-as-you-go” method likely will be based on the public agency’s general investment portfolio, which usually are based on a shorter investment horizon (and thereby, generally lower rates of return) than the investment horizon for certain trust funds (see below).

Pre-funding OPEB Liability. Pre-funding an account (e.g., making annual payments consistent with the ARC) can allow the public agency to allocate funds for the express purpose of funding future OPEB costs. The investment returns can be used to reduce the ARC and can result in lower long-term costs. Pre-funding amounts may be deposited in either:

1. Dedicated Fund. This is a separate fund set within the public agency’s accounting system. However, in order for funds to be counted towards the ARC for GASB 45 purposes, they must meet certain conditions (see answer to the question “What are the basic elements of a qualified pension plan?”). Therefore, revenues deposited in internal funds will still be treated as “pay-as-you-go” funding for GASB 45 accounting purposes.

2. Trust Fund. GASB 45 does not require liabilities to be funded through an inactive contribution; however, the rules applied under GASB 45 make the use of an irrevocable trust beneficial to the public agency (see below for more information on OPEB trusts). These trusts may be funded through various means (see below for examples of funding sources).

What are the basic features of an OPEB trust? In order for a trust to be properly structured to fund OPEBs for GASB 45 reporting purposes, it should have the following features:

1. Tax Exemptions. Investment trust assets must be held by a tax-exempt entity, protected from creditors, and limited to the funding of benefits to retirees, spouses, and their dependants as specified in the public agency’s OPEB plan.

2. Investment. A Wider Variety of Securities. Many public agencies are required to broadly define the California Constitution to a narrow range of low-risk, primarily short-term, fixed-income investments for their operating funds. OPEB trusts should be structured to allow in investment in long-term securities, such as equities, that match the long-term nature of the obligations and therefore may provide higher investment returns over the life of the trust.

What types of OPEB trusts are available? There are multiple categories of OPEB trusts:

1. A Section 401(h) account is a separate account established within a qualified pension plan dedicated to pay health benefits for retirees, spouses and their dependants. Contributions to the account may not exceed 25 percent of total pension contributions after the date on which the account is established. The Section 401(h) trust is a separate trust designed specifically to pay OPEB benefits.

2. A Section 115 trust is a separate account that may be established by a state or political subdivision for the purposes of funding OPEB liabilities. The Section 115 trust is exempt from federal income tax.

3. A Section 385(b) trust is a trust established for a charitable organization.

What is an OPEB bond? An OPEB bond is a debt security that is issued by a public agency to raise money to fund future OPEB costs. The OPEB bond is structured like pension obligation bonds. There are multiple categories of OPEB trusts:

1. General Fund and Reserve Funds. A public agency that is considering funding OPEB liabilities by issuing OPEB bonds should consider whether any of its UALs and ARC. The legal authority for OPEB bonds will vary from entity to entity within a state. For some public agencies, OPEB bonds may generally be structured like pension obligation bonds. That is, they may be issued, depending on the public agency, as a federally taxable bond to refund an existing obligation such as an OPEB unfunded liability. In such cases, the bonds would be issued with the expectation that the bond proceeds will be invested at a rate of return that exceeds the total cost of borrowing. The desired result is that the transaction reduces the public agency’s total OPEB costs, such that total debt service plus any remaining ARC is less than the total payments that would have existed if the bonds were not issued. By applying the higher interest rate assumption to the increased amount invested, a public agency may reduce the overall amount of its UALs and ARC.

What are the advantages/disadvantages to issuing an OPEB bond? Advantages of OPEB bonds may include:

1. Interest rate savings (bond interest costs may be less compared to the investment return assumption used in calculating the UAL and ARC).

2. Investment earnings (rate of return may exceed the yield on the bonds generating higher net income).

3. Possible bond relief as compared to “pay-as-you-go” funding (debt service can be tolled to meet budget targets).

4. Positive credit rating implications (because the OPEB liability is being addressed proactively).

5. Reduced UAL and ARC (achieved through higher investment return expectations).

OPEB Bonds. See details below.

Medicare Part D Subsidies. Qualifying em- ployers who continue to provide prescription drug coverage to Medicare beneficiar- ies receive a 28 percent federal govern- ment subsidy if their employer sponsored health care benefit plan provides cover- age equivalent to the benefits provided under Medicare. Employers may choose to dedicate subsidy proceeds to pay for broader retiree health care costs.

What are the potential funding sources for OPEB obligations? Categories of potential funding sources for OPEB obligations include, but are not limited to, the following:

1. General Fund and Reserve Funds. If a public agency decides to set aside revenues for OPEB funding, various existing revenue sources may be used to fund the costs.

This question addresses methods of measuring and disclosing OPEB liabilities as deter- mined by the public agency. It does not address whether legal obligations exist, nor does it address whether the actuarial methods used by the public agency are effective in measuring costs or projecting future costs. These remain divergent issues across the nature and extent of public agen- cies’ obligations to members. In addition, state laws vary in the extent to which a public agency, and such questions likely would require consultation with legal counsel and specific legal guidance and approval among representatives from all affected parties.

The UAAL will likely appear as a footnote to the financial statements.

What are the basic features of an OPEB trust?

In order for a trust to be properly structured to fund OPEBs for GASB 45 reporting purposes, it should have the following features:

- Tax Exemptions: Investment trust assets must be held by a tax-exempt entity. That contribution income is not considered as income to the employee or retiree under federal and state income tax laws. Also, income on investment of trust assets must be exempt from taxation.
- Meet the Requirements of GASB 45: Contributions must be irrevocable, protected from creditors, and limited to the funding of benefits to retirees, spouses, and their dependents as specified in the public agency’s OPEB plan.
- Investment in a Wider Variety of Securities: OPEBs should be structured according to GASB 45 to allow investments in securities that usually are based on a shorter investment horizon (and thereby, generally lower interest rates). If the investment return assumptions used in the OPEB calculation are based on the “pay-as-you-go” method, then contributions will be based on the actuarial value of the benefit obligations and will be recorded in current period earnings in the governmental fund.
- Consider whether investment in municipal bonds is appropriate. GASB 64 requires that the investment fund should be structured to meet GASB 45 reporting requirements. Therefore, revenues derived from investments in municipal bonds will be treated as “pay-as-you-go” funding for GASB 45 accounting purposes.
- Actuarial valuation generally will be needed every two or three years, depending on the nature and extent of public agency practices. There remain divergent views about the nature and extent of public agency actuarial obligations to maintain fund balances adequate for each public agency, and such questions still need to be answered.
- Consider whether investment in municipal bonds is appropriate. GASB 64 requires that the investment fund should be structured to meet GASB 45 reporting requirements. Therefore, revenues derived from investments in municipal bonds will be treated as “pay-as-you-go” funding for GASB 45 accounting purposes.

What can a public agency do if it has elected to “pay-as-you-go” funding?

A public agency that has elected to “pay-as-you-go” funding should be aware of the following:

- The use of a plan that is based on the difference between the actuarial value of the benefit obligations and the accumulated contributions to date may result in an accumulated UAAL greater than the accumulated ARC. If this is the case, the UAAL is considered to be an OPEB unfunded liability. In such cases, the UAAL unfunded liability. In such cases, the UAAL must be recorded in the statement of net position (as a liability) at the end of the period.

How might GASB 45 affect pension and OPEB plans?

GASB 45 will affect all public agencies that have pension and OPEB plans. The actuarial valuation generally will be needed every two or three years, depending on the nature and extent of public agency practices. There remain divergent views about the nature and extent of public agency actuarial obligations to maintain fund balances adequate for each public agency, and such questions still need to be answered.

What are the advantages or disadvantages to “pay-as-you-go” funding?

There are multiple categories of OPEB trusts:

- A Section 401(h) annuity is a separate account established within a qualified pension plan designed to pay health benefits for retirees, spouses, and their dependents. Contributions to the account may not exceed 25 percent of the current pension contributions on the date on which the account is established.
- A Section 115 trust is a trust created by a public agency or any other governmental unit, as specified in the public agency’s OPEB plan. Trust funds under GASB 45 must be irrevocable and not subject to creditors’ claims. The trust fund will be funded by the public agency and will be used to pay benefits to retirees, spouses, and their dependents as specified in the public agency’s OPEB plan. The trust fund will be used to finance the cost of the health benefit plan provided under Medicare. Employers may choose to designate trusteed proceeds to pay for greater retiree health care costs.

What are the potential funding sources for OPEB obligations?

- General Fund and Reserve Funds. If a public agency decides to set aside reserves for OPEB funding, various existing reserve sources may be used to fund the costs. These trusts must be funded through various means (see below for examples of funding sources).
- OPEB Bonds. See details below.
- Medicare Part D Subsidies. Qualifying em-
Lower long-term costs of OPEBs (while debt service funding may be higher than pay-as-you-go funding in the early years, debt service funding will be predictable, while required “pay-as-you-go” funding costs may rise unexpectedly in the future).

Disadvantages. Disadvantages to issuing an OPEB bond may include:

- Concentration of investment risk (may result due to lump sum contribution from bond proceeds as compared to spreading the investment risk (e.g., “dollar cost averaging”) by making ARC deposits over time).
- Potential negative arbitrage (could occur if unfavorable market conditions develop such that returns consistently fall below cost of funds).
- Replacement of a theoretically negotiable OPEB obligation with an absolute bond obligation.

Sources Used in this Guide:

Resources for Further Information:
Fitch Ratings. The Not So Golden Years (Credit Implications of GASB 45) (2005).

Acknowledgements:
CDIAC thanks Barbara Lloyd (Lehman Brothers), Jenna Magan (Orrick, Herrington & Sutcliffe LLP), Lee Squire (City of Brea) and Christine M. Vuletich (City of South Lake Tahoe) for their comments.