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State of Michigan

House Committee on Retiree Health Care Reforms

August 2007

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SECTION 1

OPEB Overview

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OPEB Overview

- GASB 45 requires Michigan and its larger local governments to report the costs and liabilities of employee post-retirement health benefits (OPEB) on an actuarial basis beginning with FY2008
  - GASB 45 prescribes a set of accounting rules – it does not mandate funding
  - GASB's new rule has drawn attention to the substantial and rising costs of post-employment benefits
  - The State's funding policy will shape its financial reports and future budget requirements; over the longer term, funding strategy may affect credit ratings
- Michigan provides OPEB through its pension systems – the Judicial (JRS), State Police (SPRS) and State Employee (SERS) Retirement Systems
  - As part of their past actuarial valuations, the retirement systems have prepared estimates of their OPEB liabilities. (These estimates are not prepared under the guidelines prescribed by GASB 43/45.) The most recently disclosed estimates show a total liability of $7.3 billion for state employees covered by these three systems:

System	UAAL ($ millions)	As of
JRS	3.277	9/30/05
SPRS	499.587	9/30/04
SERS	6,830.238	9/30/04

- A GASB 45 actuarial study is in preparation
  - GASB 43 requires the State's retirement system financial statements to comply with the standards for the fiscal year ending 9/30/07
- Michigan faces a series of decisions on its post-employment benefit plans, funding strategy, and financing mechanism

Key Steps in Addressing OPEB and GASB 45

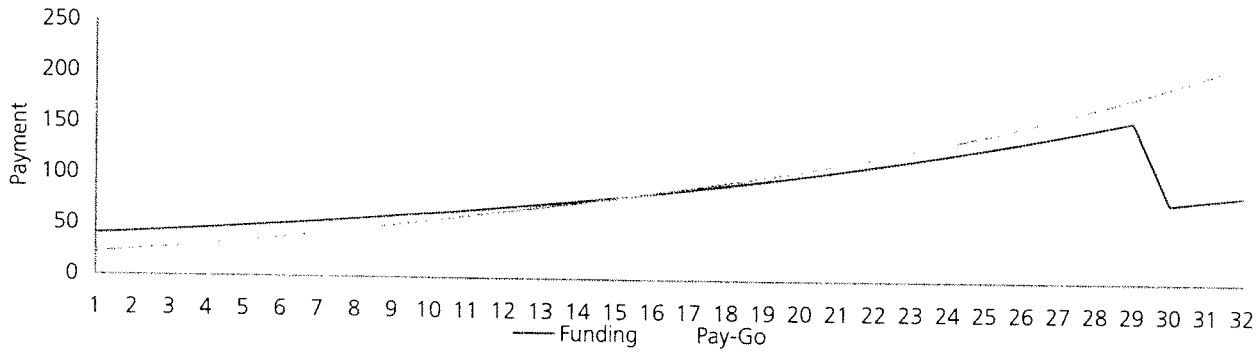
Plan Design and Review	◆ Actuarial cost estimates are based on the "substantive plan" — vested or not ◆ May have legal power to alter benefits by statute ◆ Ability to reduce OPEB costs through contract negotiations?
Measurement of Liability, ARC and Benefit Payments	◆ Subject to changes in plan design, if any ◆ Highly sensitive to key assumptions — medical cost inflation, discount rate ◆ Funding policy drives discount rate ◆ Comparison between costs of pay-go and various funding options ◆ Ongoing accounting impact will shape financial statements
Funding Policy and Strategy	◆ Pay-go or advance funding ◆ Qualified trust or reserve fund ◆ Contribution level and source ◆ Targeted funding level
Finance Plan	◆ Ad hoc or regular contributions ◆ OPEB bonds

OPEB Credit Rating Considerations

Credit Analysis Will Focus on Costs of Future Benefits

- An aging workforce and rapidly rising medical costs is likely to cause OPEB to claim a growing share of state and local budgets
  - Rating agencies are concerned with future fiscal constraints arising from OPEB liabilities
  - Each issuer faces distinct circumstances — there is no single, optimal strategy
- Initially, credit assessment is likely to center on a state's analysis of the issue — cost estimates, policy options, and decision-making process
- UBS does not expect OPEB disclosures to cause near-term rating changes
- Failure to provide analysis and disclosure of OPEB costs and liabilities may have adverse rating impact

Funding vs. Pay-Go Outlays



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SECTION 2

Managing and Measuring the Liability

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Managing the Liability

State May Have the Ability to Reduce Liabilities

- How much latitude does the State have in modifying employee health care benefits?
  - Legal status of benefits — implications of *Studier* case
  - Contractual and political issues
  - Can State differentiate among new hires vs. active employees vs. retirees
- The impact of liability reduction strategies will vary by employee group

EMPLOYEE GROUP:	**New Hires**	**Active Employees**	**Retirees**
IMPACT on UAAL:	**Modest**	**Significant**	**Most Significant**

1. **Reduce or Cap Benefits** – Offer less costly plan, limit employer benefit payments

2. **Increase Employee Costs** – Increase employee contribution levels, potentially with a new program tier for new or existing employees

3. **Convert System to Defined Contribution** – Convert the health care benefit to a defined contribution, providing funds for retirees to purchase healthcare insurance at market rates

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Funding Options

To Fund or Not to Fund...And at What Level?

- Segregating funds for future benefit payments can create investment income and permit the use of a higher discount rate to measure liabilities
- A key issue is the tradeoff between current and future OPEB outlays

Pay-as-You- Go

- Larger and growing unfunded liability (UAAL)
- Growing balance sheet liability (NOO)
- Higher future costs, total costs
- Avoid commitment to maintain specific benefit level
- Potentially a credit negative

Reserve Funds/Non-Qualified Trust

- Contributions and balances in trusts or reserves are not recognized as offset to ARC or liability
- Investment earnings mitigate future costs
- Control over funds – recapture if benefits change
- Limits on permitted investments?

Fund With Trust

- Policy goal may be full or partial funding
- Most favorable accounting treatment
- Signals commitment to maintain benefit level
- Higher near-term outlays
- High funding levels may lead to increases in benefits

- Partial funding is an option — establish qualified trust with funding target of less than 100 percent
  - May use a blended discount rate that is higher than the pay-go rate, resulting in a smaller liability
  - Can make regular contributions covering all or part of the ARC or deposit funds as available — operating surplus, proceeds of asset sales, or bond proceeds

Accounting for OPEB: Financial Statement Impacts

Funding Strategy Will Shape Financial Reports

- Actuary will estimate future benefits based on the "substantive plan" – vesting does not matter
- Actuary calculates Annual Required Contribution (ARC) consisting of:
  - Normal Costs, the Value of future benefits "earned" in the year
  - Payment to amortize the UAAL over 30 years or less
- Financial statements will disclose unfunded actuarial accrued liability (UAAL) for OPEB, the actuarial value of assets held in a "qualified trust" for benefit payments, the funding ratio, and key assumptions
  - Size of UAAL will hinge directly on the interest rate used to discount liabilities
  - Only assets held in a qualified trust are netted against the liabilities

	Statement of Income or Activities	Balance Sheet
Government-Wide (Accrual-basis)	♦ OPEB cost is the ARC. For unfunded plans, the ARC and UAAL are based on a lower discount rate and will therefore be greater than for funded plans	♦ Net OPEB Obligation — liability for cumulative difference between actuarial Annual Required Contribution (ARC) and actual payments
Governmental Funds (Modified Accrual basis)	♦ OPEB cost includes only the amounts paid for benefits and/or deposited into a qualified trust	♦ No Net OPEB Obligation is recorded ♦ Fund balances will reflect reserves for OPEB, if any

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SECTION 3

Funding and Financing Strategies

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Using Bonds to Fund OPEB

OPEB Bonds Can Serve Two Basic Objectives

① Generate investment earnings to offset costs

② Allow sponsor to reshape OPEB cash flows

- Unlike most debt issued for capital projects, pension or OPEB bonds must be issued on a taxable basis
- May deposit proceeds in a qualified trust or reserve fund

Issue bonds and deposit proceeds in a qualified trust

- Assets are irrevocably set aside for payment of OPEB
- Several types of trust vehicle are available
- Expected savings arise from difference between bond yield and actuarial discount rate; actual savings realized from spread between bond yield and asset earnings
- May be partially funded
- May need explicit authority to issue bonds to fund UAAL

Issue bonds and deposit proceeds in a reserve fund or non-qualified trust

- Bonds can be used to fund trusts that are dedicated to OPEB but not "qualified" by GASB Standards
- May offer greater latitude than reserve funds in permitted investments; higher investment yield can justify higher, blended discount rate that reduces liability
- May need explicit authority to bond for deposit to a non-qualified trust fund

- Two financing examples illustrate some possibilities

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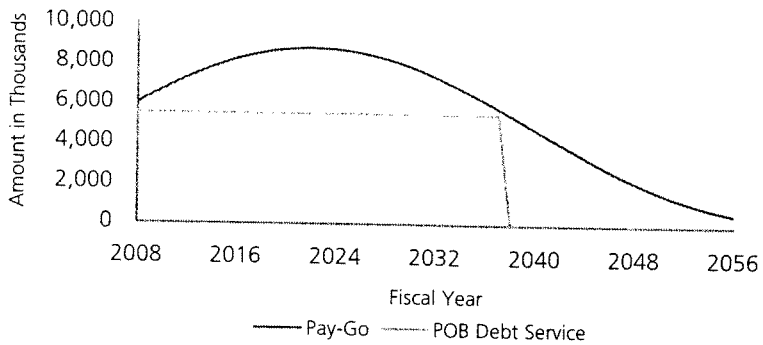
Hypothetical OPEB Bond Transaction

Example 1 – Pay-go versus OPEB Obligation Bond

- Illustration could represent either:
  - A mature, closed plan with majority of members retired or nearing retirement, or
  - A snapshot of future pay-go needs for current covered employees
- Benefit costs increase as retiree population peaks, then decline
- Closing plan reduces total liability, causes long-term decline in covered payroll — level debt service moderates near term payment (as opposed to level percentage of pay roll)
  - Level debt service structure of bonds matches level dollar funding of liability, but at a lower cost
- Create trust to fund prior service and future normal cost (if any) for remaining active members
- Infusion of bond proceeds into trust reduces unfunded actuarial accrued liability
- Expected returns on trust fund assets exceed debt service, creating potential savings through risk arbitrage

OPEB Bond in Closed System for $100 MM Liability



Bond Statistics ($ Millions)

Total PV % Savings (%)	35.7
Total PV Savings	35.7
All-in TIC (%)	5.882
Deposit to Fund	100.0

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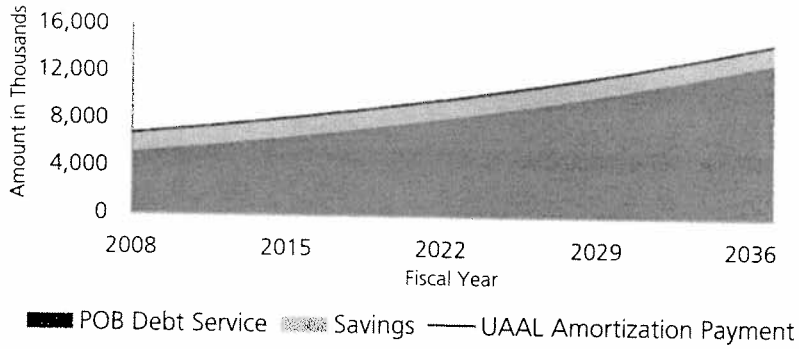
Example 2 – Amortize UAAL Over Time versus OPEB Obligation Bond

- Illustration represents open system with long-term growth in covered payroll
- Without the bond issue UAAL would be amortized over 30 years at a 7.5% interest rate
- Infusion of bond proceeds into qualified trust reduces unfunded liability
- Savings in annual contributions achieved through arbitrage of OPEB Bond proceeds: 5.927% TIC versus 7.5% UAAL discount rate
- Debt service is structured to track level percentage of payroll over the 30 year amortization period

OPEB Bond Transaction for $100 MM Liability in Open System



Bond Statistics ($ Millions)

Total PV % Savings (%)	22.3
Total PV Savings	22.3
All-in TIC (%)	5.927
Deposit to Fund	100.0

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Hypothetical Transaction Summary

Benefits and Considerations of OPEB Bonds

Benefits

- **Lower net payments** – Cashflow savings reduce expected employer contributions
- **Present value savings** – Savings can range between 15% and 30% of the total OPEB liability
- **Financial flexibility** – Ability to structure debt payments in early years to allow time to budget for increased costs

Considerations

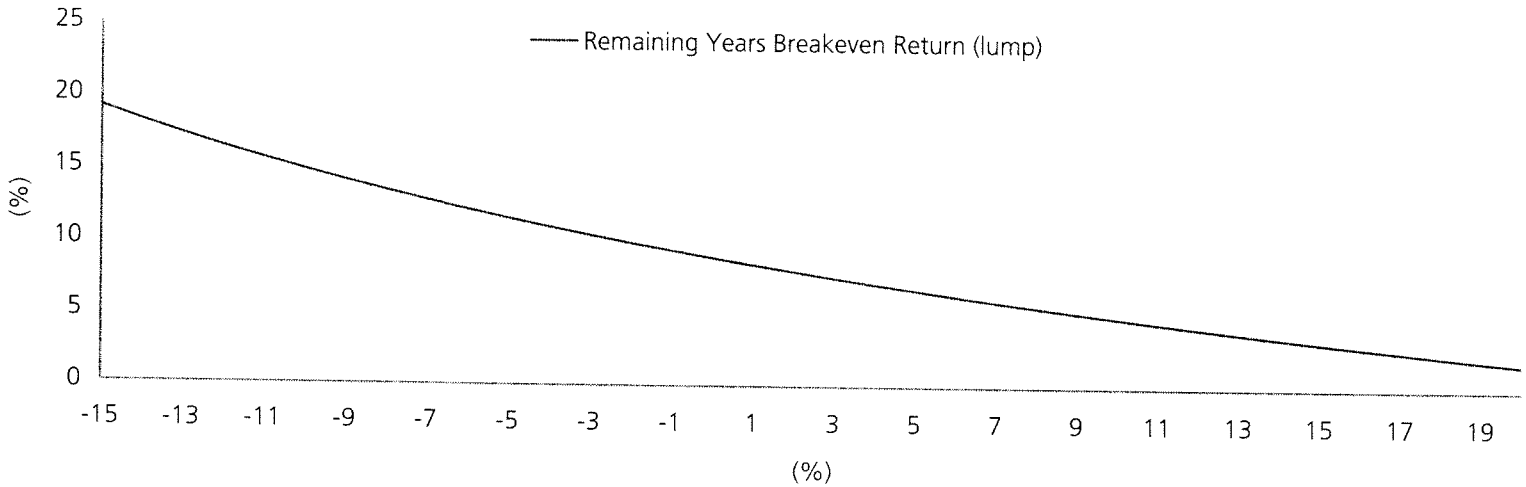
- **Loss of financial flexibility** – Replaces pension contributions with debt service, which cannot be reduced or deferred
- **Market Timing Issues** – If long-term investment return is less than bond yield, transaction will produce losses; if investment yield is less than the actuarial discount rate but greater than the bond yield, may realize actuarial losses
- **Risk of Benefit Increases** – Improved funding status may stimulate requests for increased benefits
- **Impact on debt capacity** – Dependent on applicable debt limitations and possible rating constraints

Investment Considerations

Savings from Bond Financing Hinge on Performance of Invested Assets

- Goal: returns on invested bond proceeds exceed cost of borrowing
- Risk: investment returns over the life of the bonds fall below cost of borrowing
- Returns in the early years have a disproportionate impact on the ultimate success of this strategy
  - Strategies to reduce investment volatility in the first few years may limit risk

Pension System Investment Return – Breakeven Analysis



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APPENDIX A

Case Studies

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Case Studies

(OPEB)

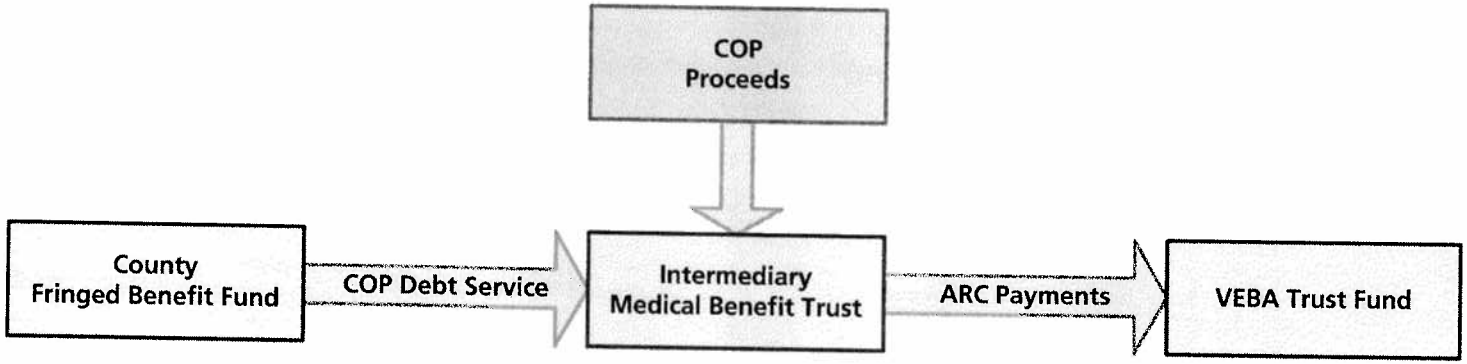
Gainesville, FL

- City of Gainesville fully funded its OPEB UAAL with the $35,210,000 Series 2005 Benefit Obligation Bonds. The financing allowed the City to obtain $5.5 million or roughly 15.8% in present value savings
- Gainesville closed its defined benefit OPEB plan and used the bond proceeds to fund the UAAL, shifting new and many current employees into a defined contribution plan
- Florida statues require municipalities seeking to self-insure their retiree medical plans to demonstrate to the State Office of Insurance Regulation the actuarial soundness of the plan. In seeking approval of its plan, a local government must show a plan to amortize any unfunded liabilities and a description of actions taken to reduce unfunded liabilities (Section 112.08(2)(b), Florida Statutes)
- Before gaining the right to finance OPEB UAAL, issuers must show the State that they have a comprehensive plan of finance that includes
  - Adequate contributions to meet the level of benefits provided
  - Description of all actuarial assumptions
  - A schedule for the amortization of any unfunded liabilities
  - A comparative review illustrating the level of funds available to the plan from rates, investment income, and other sources realized over the period covered by the report with the assumptions used
  - A statement by the actuary that the report is complete and accurate

(OPEB)

Oakland, Michigan

- Oakland established a trust and began actuarial funding of OPEB in 1987
  - As of 2006, plan was 36% funded with $526.6 million UAAL
  - Closed defined benefit plan to new employees
- In June 2007, issued $557mm taxable COPs based a estimated FY 2008 UAAL of $552.5 million
- Structure allows County to pay off bonds early if policy changes and OPEB becomes over-funded



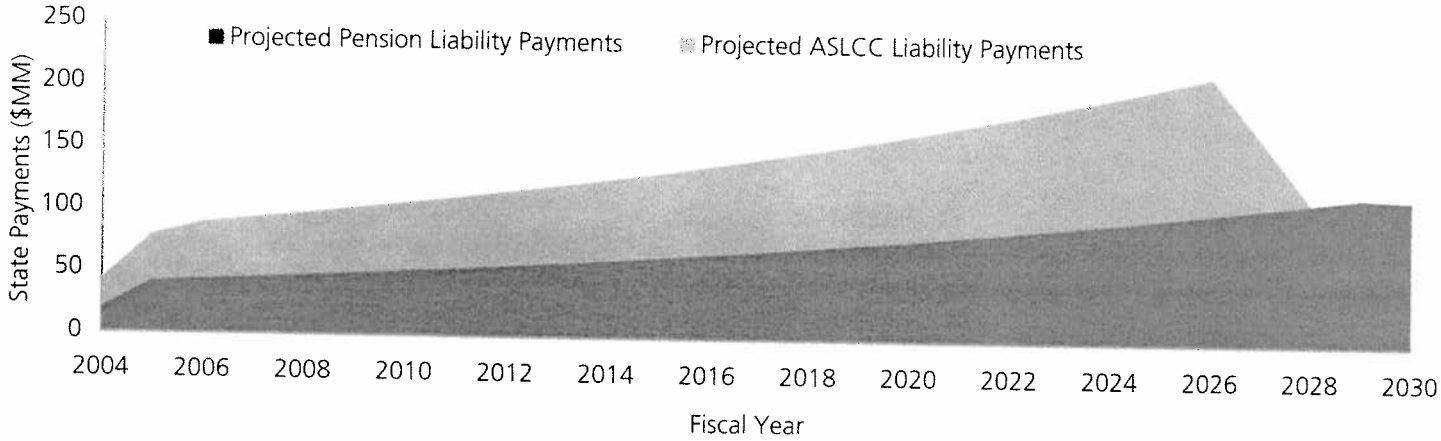
- Investments in Intermediary Trust allow County to realize savings – debt service is lower than ARC payment

(Pension and OPEB)

State of Wisconsin

Background

- The State of Wisconsin sold $1,794,850,000 General Fund Annual Appropriation Bonds of 2003 to retire the Unfunded Pension and ASLCC Liabilities owed to the Wisconsin Retirement System ("WRS") and lower its financing cost from 8% to the bond rate.
- Bonds were structured against the combination of the State's projected pension liability and ASLCC liability payments shown below as the, "red line"

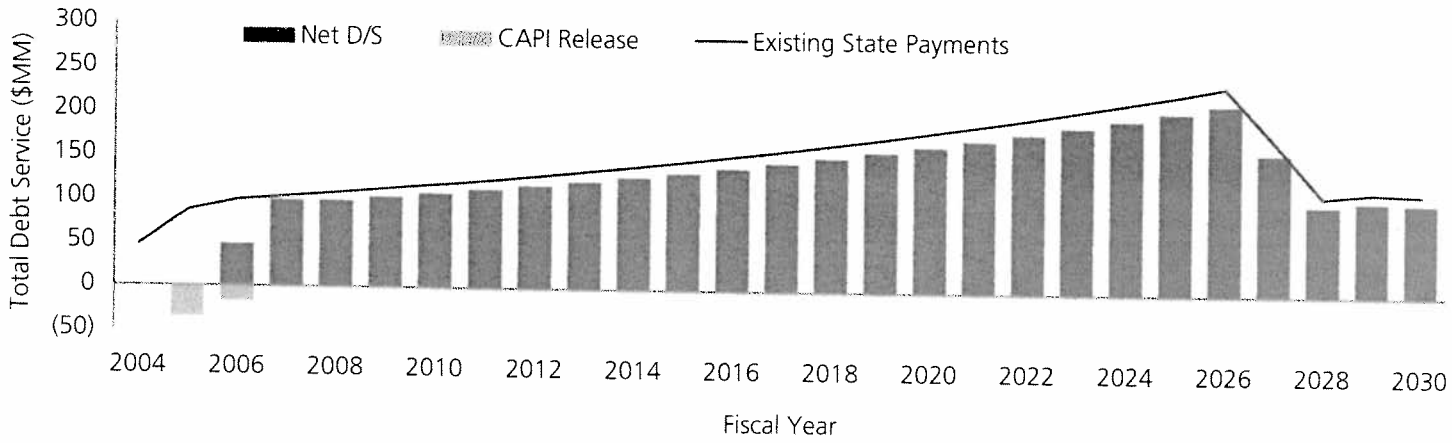


(Pension and OPEB)

State of Wisconsin

Benefits

- The State was able to fully fund its accrued pension and sick leave liabilities
- The transaction generated substantial expected PV savings of over $323 million or 22%
- The State realized immediate cash flow savings and significant budgetary relief
- An all-in true interest cost of 5.804% for the entire transaction (assumes unhedged ARCs at 5.59%)
- The State reduced its overall financing costs by executed its first synthetic fixed rate swap of $595 million with an all-in swap rate of 5.47% (average life 25.24 years)
- First issuance of ARCs issued at an initial rate of 1.20% offer future financial flexibility

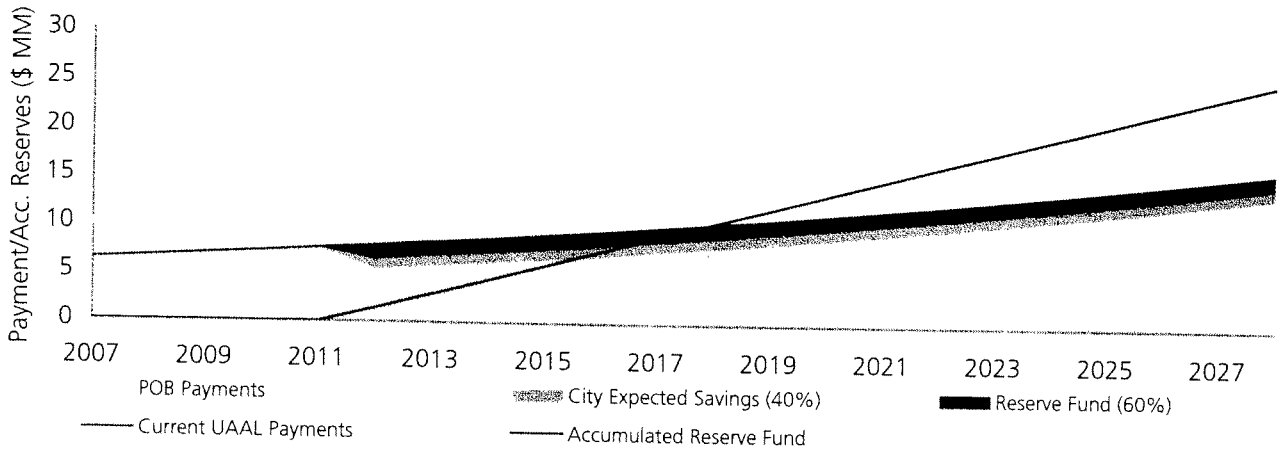


(Pension)

City of Brockton, Massachusetts

- UBS served as the senior book running manager the City of Brockton, Massachusetts' $100 million POB which will increase the system's funded ratio from 62% to 90%
- Brockton's POB is the first locally authorized transaction under by the Commonwealth of Massachusetts template legislation (Sec. 4 of Chap. 483 of the Acts of 2004)
- The transaction is notable in that no expected budgetary relief is realized in the first 5 years and a portion of the expected savings is scheduled to be accumulated in a reserve fund to offset "off-years" and to be used to pay off any remaining UAAL in 2028 or any new OPEB liability
- Brockton's POB priced on November 16th, 2005 with an all-in TIC of 5.51% (avg. life = 16.1 years) and expected present value savings of 24%
- Over 24% of orders came from international accounts

POB Structure with Accumulated Reserve Fund Balances



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APPENDIX B

Potential Trust Vehicles

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Potential Trust Vehicles

401(h) Account

- Sub-account within a pension fund
- May only cover retiree health benefits
- Assets may not be used for pensions or any other purpose until OPEB liabilities are met
- OPEB contributions limited to 1/3 of pension contributions
- May not be available to participants in multi-employer plans

501(c)(9) (VEBA)

- Separate trust designated solely for OPEB benefits
- Trustees appointed by employer and employees
- UBIT avoided if the trust is maintained pursuant to collective bargaining agreement OR if contributions are made by tax-exempt employer
- Allows funding of total OPEB liability, but maybe not expected health care cost increases

115 Trust

- Governmental-sponsored trust
- Assets must be held for a governmental purpose and funded by a tax-exempt entity
- Unlike VEBA and 401(h) accounts, contributions are not limited
- Usage is not restricted
- Offers flexibility, but may not be recognized as "qualifying trust" by GASB; IRS Private Letter Ruling advisable

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