You Dropped a Bomb on Me, GASB

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Anything Remotely Related to Accounting

- Written research
  - The Magic of Pension Accounting, Part IV
  - Peeking Behind the Tax Curtain, FIN 48 Reveals Tax Risk
  - You Dropped A Bomb on Me, GASB, Uncovering $1.5 Trillion in Hidden OPEB Liabilities for State and Local Governments
  - Converts Under Fire Again, Last Time it Was Co-Co's, This Time It's Instrument C
  - Fair Value Option (FAS 159), Tossing Comparability Out the Window
  - Pension Protection Act, Pension Funding Rules, Basketballs, and Camel Hair, Too
  - Options Are Like Onions, They Have Layers
  - Bring it On, Off Balance Sheet Operating Leases
- Accounting consultant
- Customized product

Why Focus on GASB 45?

Makes OPEB a Hot Topic

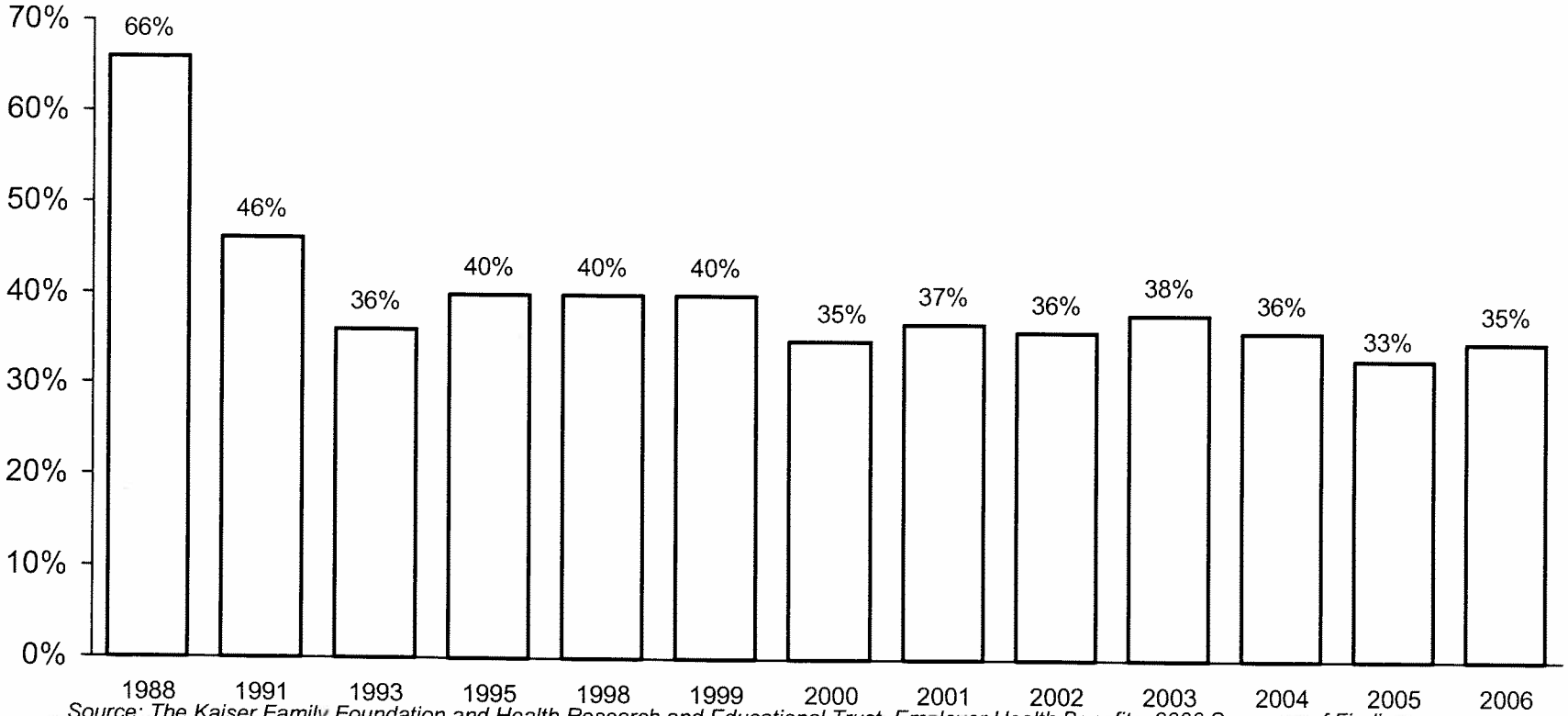
- **GASB No. 45, shines a spotlight on OPEB for state and local governments**
- **Change in accounting rules (FAS 158) brings OPEB funded status on balance sheet for Corporate America**
- **Battles between Corporate America and labor over retirement benefits**
- **Does Congress get involved?**
- **Medicare Part D 28% subsidy**
- **Ongoing cash burden**

What is OPEB?

- Other Post Employment Benefits
- All the retirement benefits other than the pension plan
  - **Retiree Healthcare,** Life Insurance, etc. etc.
- Generally not funded, pay-as-you-go

Fewer Employers Offer Retiree Healthcare Benefits

- Note drop in % of companies offering these plans between 1988 and 1993, around the time FAS 106 was being crafted and put into effect. Companies hit with sticker shock.
- However, 82% of state and local govt's with more than 200 workers still provide retiree healthcare (only 29% with less than 200 workers) and all but 3 states, Mississippi, Nebraska, and Wisconsin.



Source: The Kaiser Family Foundation and Health Research and Educational Trust, Employer Health Benefits, 2006 Summary of Findings.

Percentage of All Large Firms (200 or More Workers) Offering Retiree Health Benefits, 1988–2006

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GASB 45: A Summary

Moving from Cash (pay-as-you-go) to Accrual

Today

- Simple yet misleading
- Pay-as-you-go
- Expense today for benefits earned long ago
- Obligation and deferred compensation as benefits are earned not recognized not even disclosed
- Understates liabilities and expenses

GASB 45

- Measuring the OPEB liability for the first time – You manage what you measure
- Still does not fully capture underlying economics of OPEB plan (uses smoothed value of assets and expected return as discount rate)
- Recognize OPEB costs as incurred
- Annual required contribution (ARC) = Normal cost + Amortization of underfunding/overfunding
- New disclosures
- Going into effect soon

Who Has Exposure?

Our Methodology

- Step 1 – Get our hands on the CAFR
- Step 2 – Dig through the CAFR for any data on OPEB
- Step 3 – Search for other sources (actuarial studies, bond offering documents, census data, etc.)
- Found estimates of unfunded OPEB liabilities for 31 states
- For remaining states estimated OPEB underfunding by multiplying number of state employees by $100,000

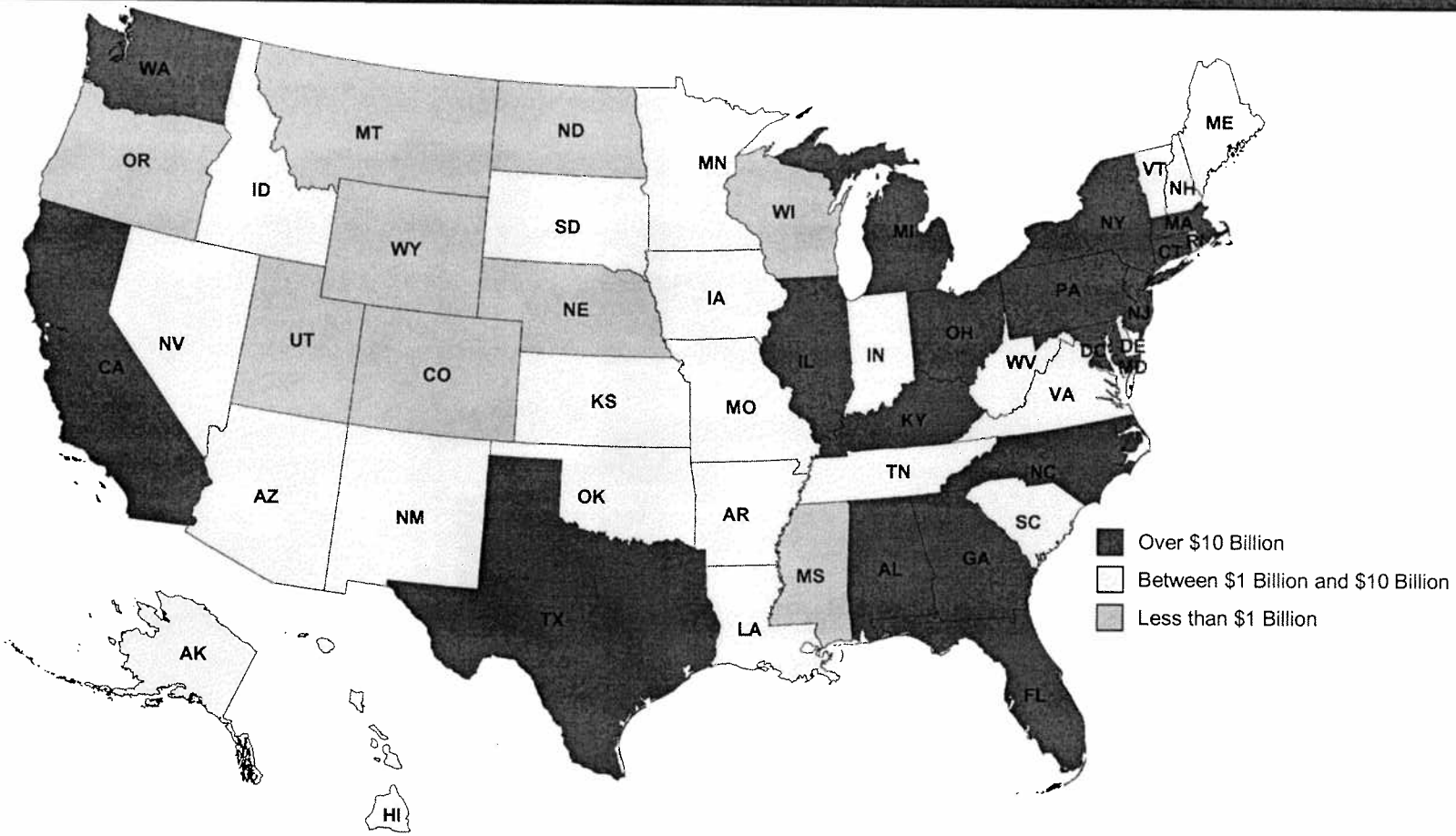
Warning: Our Estimates May be Way Off

- Each OPEB plan is unique (different benefits, levels of coverage)
- It's a starting point for gauging a state's exposure to OPEB

Estimated $1.5 Trillion in Hidden OPEB Liabilities for State & Local Governments

Exposure Varies Widely

Estimated $558 Billion in Unfunded OPEB Liabilities for the 50 States



OPEB Plans of S&P 500 Companies "Only" $292 Billion Underfunded 2006

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Largest Estimated OPEB Underfunding

If state provides range of underfunding, we used high end of range.

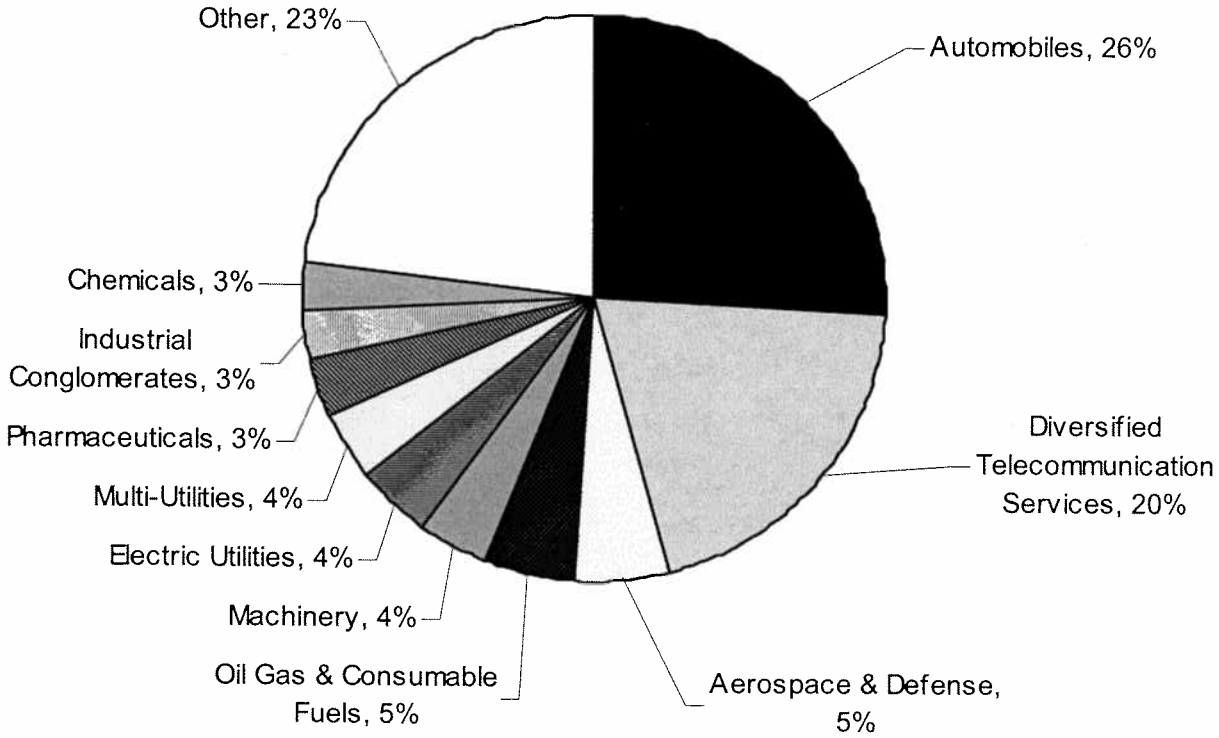
US$ in millions

State	Abbreviation	Estimated OPEB Underfunding
California	CA	$ 70,000
New Jersey	NJ	60,000
New York	NY	54,000
Texas	TX	26,817
North Carolina	NC	23,786
Maryland	MD	22,903
Michigan	MI	22,745
Connecticut	CT	21,100
Alabama	AL	20,000
Georgia	GA	20,000

No Surprise: Larger Populations Generally = Larger OPEB Liabilities

Breakout of OPEB Obligation by Industry Group

Aggregate 2006 OPEB Obligation for the S&P 500 = $385 Billion



Over 75% of Total Obligation Belongs to 10 Industry Groups

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Largest Estimated OPEB Underfunding per Capita

US$ in millions, except per capita amounts

State	Abbreviation	Estimated OPEB Underfunding	Population	OPEB Underfunding per Capita
Alaska	AK	$ 4,722	670,053	$ 7,047
New Jersey	NJ	60,000	8,724,560	6,877
Connecticut	CT	21,100	3,504,809	6,020
Hawaii	HI	5,654	1,285,498	4,398
Alabama	AL	20,000	4,599,030	4,349
West Virginia	WV	7,781	1,818,470	4,279
Maryland	MD	22,903	5,615,727	4,078
Delaware	DE	3,175	853,476	3,720
Maine	ME	4,756	1,321,574	3,599
Kentucky	KY	13,425	4,206,074	3,192

Median OPEB Underfunding of $1,581 per capita

OPEB Underfunding Could be Overstated

US$ in millions

Company	Ticker	OPEB Obligation 2002	Medicare $ Savings	Medicare % Savings[1]
General Motors Corp	GM	$ 57,229	$ 4,100	7%
Ford Motor Co	F	30,263	1,800	6%
SBC Communications Inc	SBC	24,564	1,629	7%
Verizon Communications	VZ	17,431	1,337	8%
Bellsouth Corp	BLS	7,387	1,100	15%
Lucent Technologies Inc	LU	9,845	600	6%
General Electric Co	GE	7,435	583	8%
Du Pont (E I) De Nemours	DD	5,280	526	10%
Delphi Corp	DPH	6,872	500	7%

[1] Medicare percentage savings is based on Medicare dollar savings as a percentage of 2002 OPEB obligation.
2002 OPEB Obligation is used for consistency, since some companies included the estimated Medicare Savings in their 2003 OPEB obligation, while others deferred recognition of the benefit.
Note: Obtained estimated Medicare savings from company 10-K filings.
Source: Company data, Credit Suisse estimates.

- Medicare Part D Subsidy – 28 cents (tax-free) on each dollar of prescription drug costs between $250 and $5,000 that it incurs per retiree per year
- Maryland, $22.9 billion OPEB underfunding, $2.5 billion savings Medicare Part D subsidy

GASB Does Not Allow Estimated Savings from Medicare Part D Subsidy to be Taken Into Account When Calculating OPEB Liability

Balance Sheets Not as Healthy as They Appear

OPEB Underfunding 34% of Total Assets for 50 States

US$ in millions

State	Abbreviation	*A* Estimated OPEB Underfunding	*B* Assets	*A/B* %
New Jersey	NJ	$ 60,000	$ 35,430	169%
Connecticut	CT	21,100	20,871	101%
Maine	ME	4,756	5,823	82%
Alabama	AL	20,000	25,896	77%
Michigan	MI	22,745	30,472	75%
Maryland	MD	22,903	35,580	64%
Georgia	GA	20,000	34,283	58%
Vermont	VT	1,419	2,447	58%
West Virginia	WV	7,781	13,590	57%
North Carolina	NC	23,786	46,101	52%
Kentucky	KY	13,425	26,771	50%

Most States No Assets Set Aside for OPEB – Only 13 Partially Prefund

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Balance Sheets Not as Healthy as They Appear

OPEB Underfunding > $483 Billion in Total Long-Term Debt for 50 States

US$ in millions

State	Abbreviation	*A* Estimated OPEB Underfunding	*B* Long Term Debt	*A/B* %
Alabama	AL	$ 20,000	$ 1,270	1,574%
Maine	ME	4,756	1,063	447%
Idaho	ID	2,314	564	410%
North Carolina	NC	23,786	6,519	365%
Michigan	MI	22,745	6,300	361%
Kentucky	KY	13,425	4,100	327%
Delaware	DE	3,175	1,027	309%
South Dakota	SD	1,320	427	309%
Vermont	VT	1,419	461	308%

OPEB Just Another Form of Financing, Borrowing from Employees

OPEB, Increasing Drain on State & Local Governments

Liabilities Exist Whether or Not States Had to Measure Them…

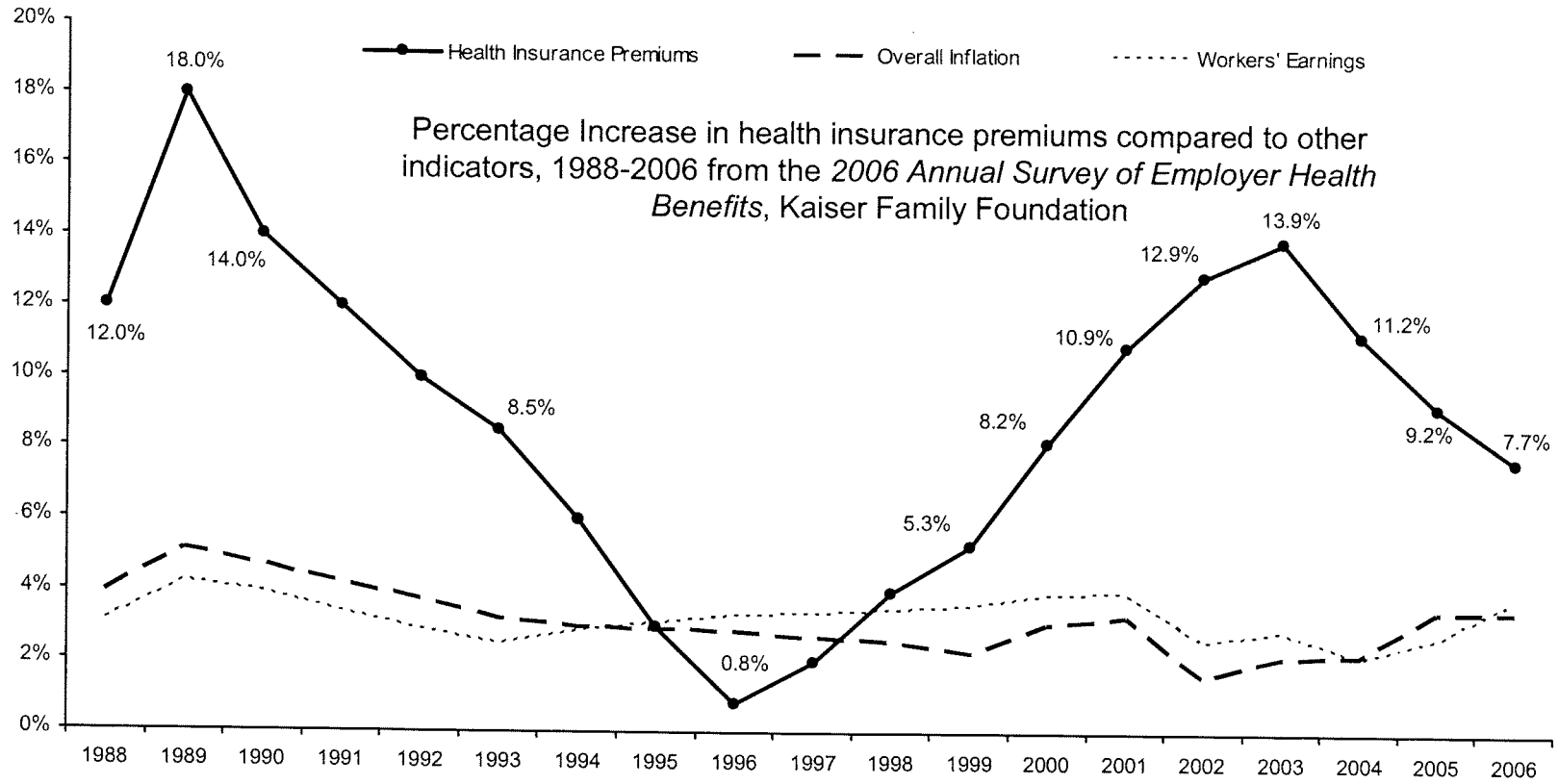
US$ in millions

		States					Cities		
		A	*B*	*A/B*			*C*	*D*	*C/D*
State	**Abbr.**	**OPEB Benefits Paid**	**Revenues**	**%**	**City**	**State**	**OPEB Benefits Paid**	**Revenues**	**%**
Alaska	AK	$ 295	$ 11,098	3%	Detroit	MI	$ 146	$ 2,440	6%
Hawaii	HI	178	7,096	3%	Baltimore	MD	121	2,217	5%
Michigan	MI	1,060	43,895	2%	New York City	NY	2,183	56,081	4%
New Jersey	NJ	964	49,371	2%	Milwaukee	WI	32	913	4%
Connecticut	CT	377	20,214	2%	Boston	MA	77	2,337	3%
North Carolina	NC	477	35,861	1%	San Antonio	TX	30	1,268	2%
Illinois	IL	623	50,002	1%	San Francisco	CA	115	5,909	2%
Alabama	AL	209	17,747	1%	San Jose	CA	29	1,520	2%
Kentucky	KY	213	18,684	1%	Fort Worth	TX	16	895	2%
West Virginia	WV	106	11,049	1%	Houston	TX	50	2,890	2%

…Eventually Catch Up Through Higher Benefit Payments

OPEB is an Economic Obligation

Problem: Health care inflation + Aging of the Workforce + Weak funding = Cash flow issue



Obligation May be Growing Faster Than Revenues

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Taking A Look at the ARC (Annual Required Contribution)

ARC as a % Of OPEB Underfunding 6.2% - 14%

US$ in millions

State	Abbreviation	A ARC	B Revenues	A/B %
New Jersey	NJ	$ 6,000	$ 49,371	12%
Alabama	AL	2,000	17,747	11%
Connecticut	CT	2,110	20,214	10%
Maryland	MD	2,202	26,001	8%
Hawaii	HI	565	7,096	8%
Kentucky	KY	1,342	18,684	7%
West Virginia	WV	765	11,049	7%
North Carolina	NC	2,390	35,861	7%
Delaware	DE	317	5,466	6%
Georgia	GA	2,000	36,044	6%
Maine	ME	356	6,481	5%
Michigan	MI	2,274	43,895	5%

Maybe OPEB Costs Are Higher Than They Initially Appear

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Changing Behavior

- Old rules made it very easy to promise OPEB
- GASB 45 rude awakening, big promises with no assets
- Only two simple options:
  1. **Shrink the obligation**
  2. **Set aside more assets**

GASB 45 does not create obligation, however, its spotlight could change behavior

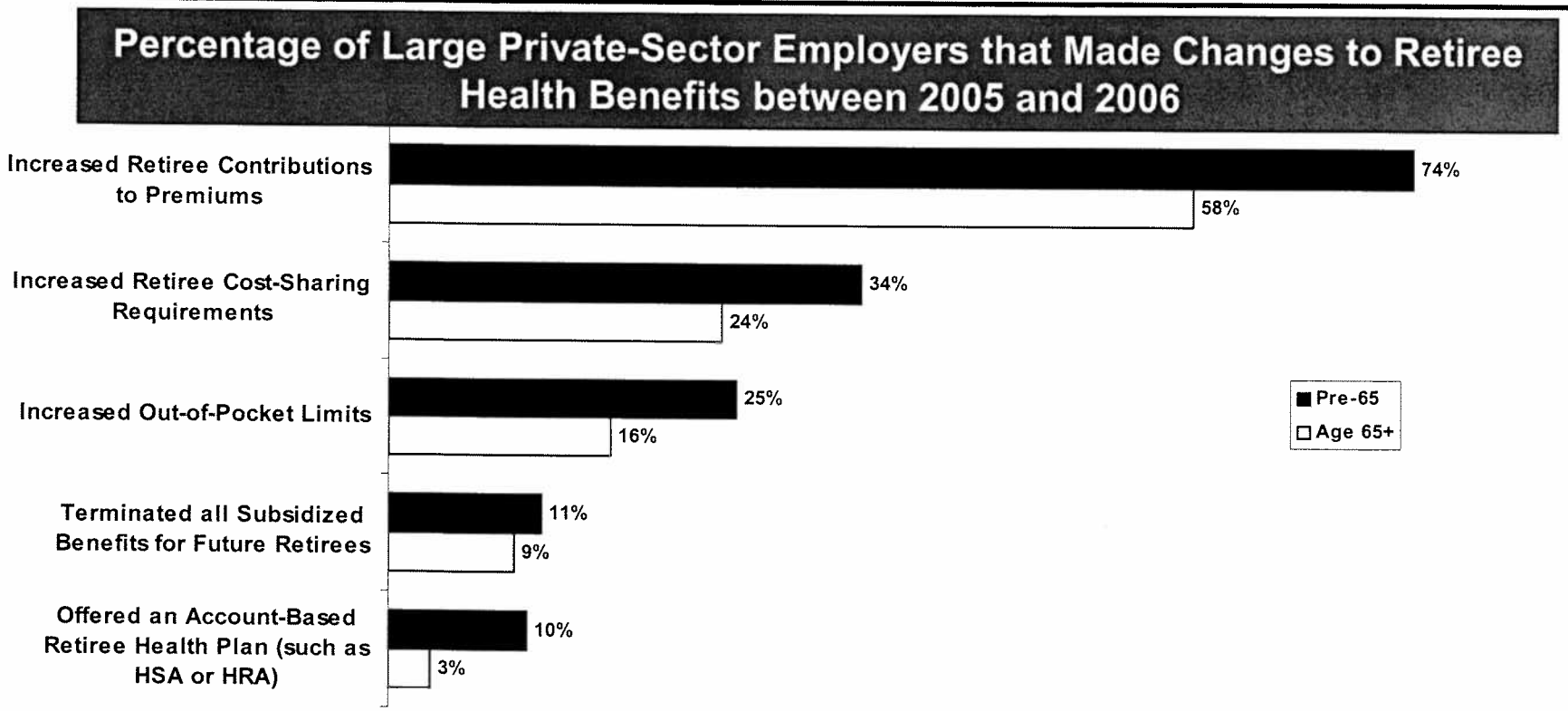
1. Passing the buck
2. Higher taxes / Cut other services
3. Major new investor
4. Increased borrowing
5. Selling assets

Passing the Buck

"Well, we used to give our employees the benefit of the doubt. But we're dropping that benefit, too."

Source: From The Wall Street Journal—Permission, Cartoon Features Syndicate

Making Changes



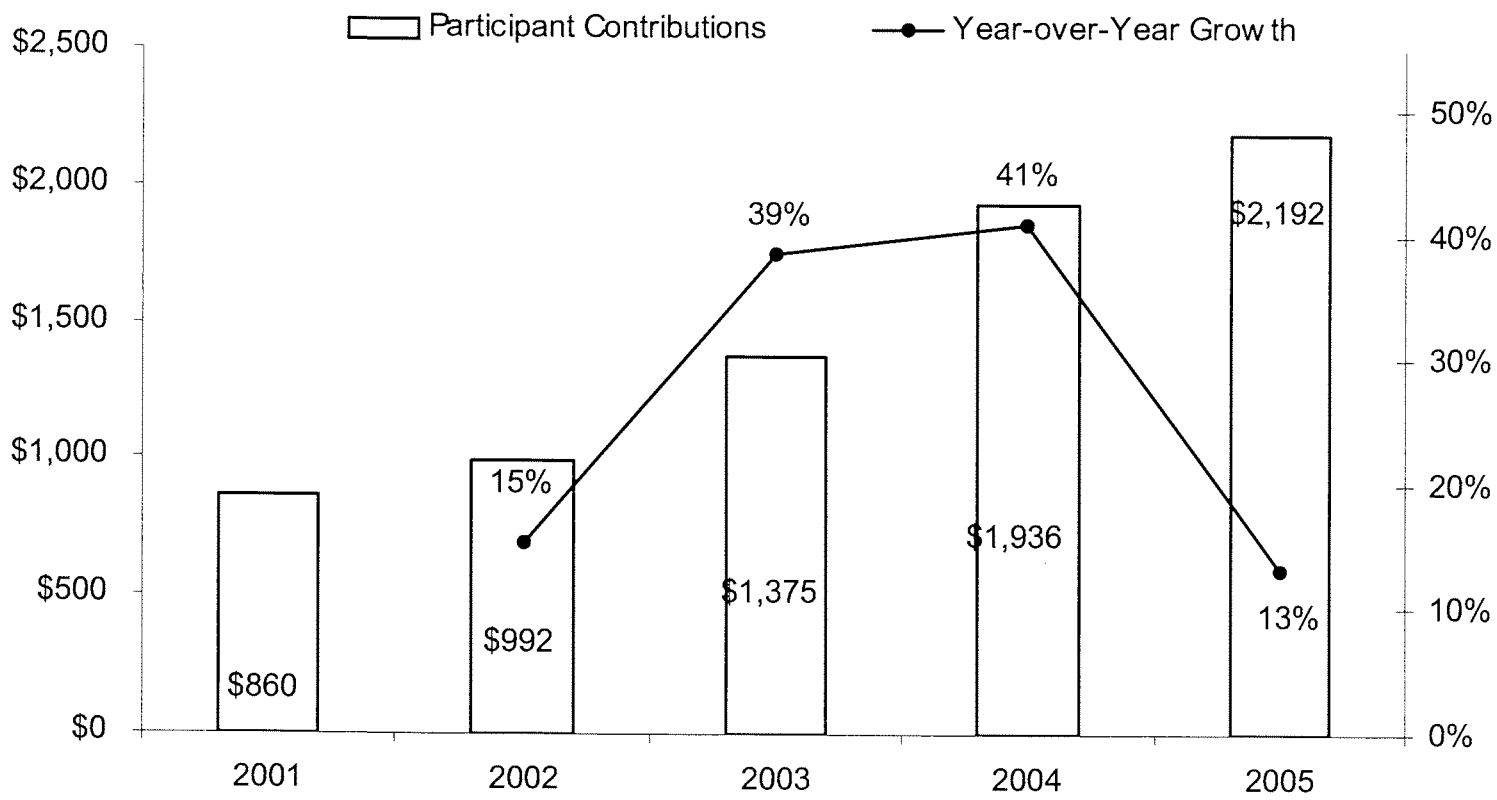
State & Local Government Examples

- Michigan higher copayments and deductibles
- Ohio limited eligibility to only long-tenured employees
- Alabama increased premiums for employees that smoke
- Anaheim (CA) defined contribution plan for new employees
- Utah, Orlando (FL), Pittsburgh (PA) closed plans to new employees

Increasing Participant Contributions

- 26% CAGR in participant contributions from 2001 to 2005

US$ in millions, unless otherwise stated



S&P 500 OPEB Participant Contributions, 2001 to 2005

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Higher Taxes

US$ in millions, except per capita amounts

State	Abbr.	Taxes	Population	Tax Burden Per Capita	Incremental Tax Burden from Prefunding OPEB per Capita	Estimated % Increase in per Capita Tax Burden
Alabama	AL	$ 7,018	4,599,030	$ 1,526	$ 389	26%
New Jersey	NJ	20,986	8,724,560	2,405	577	24%
West Virginia	WV	3,749	1,818,470	2,062	362	18%
Connecticut	CT	10,291	3,504,809	2,936	494	17%
Alaska	AK	1,343	670,053	2,005	323	16%
Maryland	MD	12,328	5,615,727	2,195	350	16%
Kentucky	KY	8,463	4,206,074	2,012	269	13%
Georgia	GA	14,571	9,363,941	1,556	195	13%
South Carolina	SC	6,804	4,321,249	1,574	187	12%
North Carolina	NC	16,836	8,856,505	1,901	216	11%
Maine	ME	2,870	1,321,574	2,172	233	11%
Hawaii	HI	3,849	1,285,498	2,994	302	10%

Taxpayers Get Stuck With the Bill For States Overpromising OPEB

Big Incentives to Prefund OPEB

Higher Discount Rate = Smaller OPEB Obligation

US$ in millions

		Low Estimate		High Estimate		Difference	
State	Abbr.	OPEB Underfunding	Discount Rate	OPEB Underfunding	Discount Rate	% Change in OPEB Underfunding	Discount Rate (bps)
Maine	ME	$ 3,234	7.50%	$ 4,756	4.50%	47%	300
Massachusetts	MA	7,562	8.25%	13,287	4.00%	76%	425
Nevada	NV	1,350	8.00%	2,640	3.50%	96%	450
New York	NY	27,000	8.00%	54,000	4.10%	100%	390
Vermont	VT	691	8.00%	1,419	3.75%	105%	425
West Virginia	WV	5,113	7.50%	7,781	4.50%	52%	300
Wyoming	WY	41	8.50%	72	4.00%	76%	450

- Rating agencies also prefer that state and local governments prefund OPEB

Long Duration Liability = High Sensitivity to Discount Rate

Major New Investor

Expect to See More Prefunding to the ARC Over Time

US$ in millions

State	Abbr.	OPEB Benefits Paid	Annual Required Contribution (ARC)	Potential Increase in OPEB Funding
California	CA	$ 993	$ 7,000	$ 6,007
New Jersey	NJ	964	6,000	5,036
New York	NY	858	5,400	4,542
Texas	TX	629	2,682	2,053
Maryland	MD	236	2,202	1,966
North Carolina	NC	477	2,390	1,913
Georgia	GA	174	2,000	1,826
Alabama	AL	209	2,000	1,791
Connecticut	CT	377	2,110	1,733
Michigan	MI	1,060	2,274	1,214

On the Other Hand, No Requirement, Budget Concerns, Flexibility

Increased Borrowing

Issue OPEB Bonds, Trading One Form of Debt for Another

Rating Agency	Commentary
Fitch	Fitch believes that OPEB funding bonds, if used moderately and in conjunction with a prudent approach to investing the proceeds and other plan assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices could expose the plan sponsor to market losses. Because a sponsor's unfunded OPEB liability will be factored into the rating, bond issuance would simply move the obligation from one part of the government-wide or full accrual-based fund statements, to another. However, Fitch notes that OPEB or pension funding bonds create a true debt, one which must be paid on time and in full, rather than a softer liability that can be deferred or rescheduled from time to time during periods of fiscal stress. Consequently, issuing bonds to fund an OPEB plan could have a significant effect on financial flexibility over time.
Moody's	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 its effect on the issuer's overall debt burden.
Standard & Poor's	These bonds are basically arbitrage funding, in that the proceeds are placed in a plan trust and invested in equities, bonds, and other instruments that are expected to return a higher rate of return than the interest cost of the bonds. The principal risk of this strategy is that investment returns may not meet expectations over the long term and the bond issue could have the effect of actually adding costs during period of weak investment returns instead of generating savings. The success of any pension obligation bond or OPEB obligation bond in the future will depend on conservative planning and fortuitous market timing.

Appears to be Riskless Strategy, Is Actually Risky Arbitrage

Selling Assets

- GASB 45 could be spark for sale/lease of assets, privatizing toll roads, lottery systems, etc.
- Two key questions:
  1. **How does state know it is getting a fair price for these hard-to-value illiquid assets?**
  2. **What would state do with proceeds?**

State / Local Governments Play the Role of Hedge Fund

- Sell hard assets to buy other assets (stocks, bonds, etc.)
- Residents hope governments have done their research and have good timing

Provides Supply of Long-Duration Assets

Promises, Promises

- GASB 45 highlights another large legacy obligation, where a promise made to U.S. workers is going to be hard to keep

"Over the long term, the nation's growing fiscal imbalance stems primarily from the aging of the population and rising healthcare costs . . . Continuing on this unsustainable path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our domestic tranquility and national security."

David Walker, Comptroller General of the United States

Disclosure

Disclosure Appendix

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