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Public Employee Post-Employment Benefits Commission

Orange, CA-April 26, 2007

"Pension & Other Post-Employment Benefit Liabilities: A Bond Rating Perspective"

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Standard & Poor's

The McGraw·Hill Companies

A Bond Rating Perspective

- **Issue Credit Rating:…our *issue-specific* opinions of an obligor's creditworthiness with respect to a specific financial obligation, class of obligations, or financial program…for example:**

Issue	S&P Rating
State of California General Obligation Bonds	'A+'
Orange County PFA Lease Revenue Bonds	'A+'
Los Angeles USD GOs	'AA-'
San Francisco GOs	'AA'

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A Bond Rating Perspective-continued

- **S&P was founded in 1860**
- **Has provided bond rating information for about 80 years**
- **Ratings outstanding on thousands of municipal entities in the U.S.**
- **My remarks on government retiree benefits reflect a credit ratings perspective captured in the following expression:**

“Likelihood of repayment—capacity and willingness of the obligor to meet its financial commitment…”

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Postemployment Benefits Preview

- **Retiree Benefit Issues: What Are We Talking About?**
- **Global Impact of Retiree Benefits**
- **S&P Survey of State Pension Funding**
- **CA State Pension System Examples**
- **Developments in Other Postemployment Benefits (OPEB)-Retiree Healthcare**

Postemployment Benefits Preview-continued

- **Potential Strategies for Managing Retiree Benefits**
- **The Fiscal Effect of Retiree Benefit Pressures**
- **Credit Implications of Retiree Benefits**

Pension Liabilities

- **Traditional defined benefit plans**
- **Challenge: plummeting funding levels have led to rapidly increasing contribution rates**

OPEB Liabilities

- **GASB 45 is focusing attention on the full costs of funding these obligations**
- **Challenge: Manage this liability under the new rules**

Retirement Costs: A Global Issue

- Driven by demographics, mainly aging populations

- By 2050 the world's average age will be 38 years—more than 10 years higher than in 2005
- Fourteen countries (mostly in Europe) will have a median age of 50 or more
- Worldwide dependency ratio (% of population aged 60 or more) will surge to 45% by 2050, compared to 19% in 2005

Source: "Global Graying: Aging Societies and Sovereign Ratings," Moritz Kraemer, et al., S&P RatingsDirect, June 27, 2006

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Global Retirement Costs

"…countries will face very significant deterioration in public finances over the next half-century as a result of demographic change, unless countervailing fiscal adjustment is put in place or social security and other age related spending programs are reformed."

Age related spending (% of GDP)

	2005	2050
France	22.8	27.4
Germany	19.5	23.2
UK	14.7	18.8

Source: "Global Graying…", Kraemer

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National Retirement Costs

- **The United States would also see these costs increase:**

Age related spending (% of GDP)

	2005	2050
United States	**9.7**	**19.6**

Source: “Global Graying…”, Kraemer

S&P Survey of State Pension Funds

Key Findings:

- **State Pension Funded Ratios (Actuarial Value of Assets/Actuarial Accrued Liabilities) had fallen to a mean average of about 82% as of 2005**

- **This level compares to a mean of 100%+ in 2000**

Source: "Improved U.S. State Pension Funding Levels Could Be on the Horizon," Parry Young, et al, S&P RatingsDirect, February 27, 2007

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Funding levels were above average in 2005

System	Funded Ratio	Unfunded Actuarial Accrued Liability
CalPERS PERF	87.3%	$26,621,000,000
CalSTRS DB	85.7%	$20,311,000,000

New Developments in OPEB

The OPEB landscape is changing…driven by Governmental Accounting Standards Board (GASB) Statement No. 45 – Released June 2004:

"Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions"

OPEB ISSUES

- **What is OPEB?**
- **When will the new reporting be implemented?**
- **Why did GASB do this?**
- **How will reporting/funding be affected?**
- **Specific OPEB cases**

OPEB/GASB 45 - What?/When?

What?

- **Other Postemployment Benefits (OPEB) – largely healthcare related – part of an exchange of salaries and benefits (like pensions) for employee services rendered**

When?

- **GASB 45 will be implemented for phase 1 (large) governments for fiscal periods beginning after 12/15/06**

GASB 45 – Why?

GASB said that the current {OPEB} financial reporting generally fails to:

- **“Recognize the cost of benefits in periods when the related services are received by the employer**
- **Provide information about actuarial accrued liabilities for promised benefits associated with past services and… to what extent those benefits have been funded**
- **Provide information useful in assessing potential demands on the employer’s future cash flows”**

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OPEB Before GASB 45

- **Most employers account for OPEB on a PayGo basis**
- **The long-term liabilities associated with retiree healthcare had not been determined prior to GASB 45**
- **Projections of future OPEB costs were not known**

GASB 45: How will reporting be affected?

Major New Requirements of the Financial Statements for Employers—

- **Conduct actuarial valuation of retiree health care plan which would include actuarial accrued liabilities (and assets, if any)**
- **Determine Annual Required Contribution (ARC)--adjusted annual OPEB cost on an accrual basis**
- **Report the net OPEB obligation—the cumulative difference between the ARC and the employer's actual contribution**

Note: GASB does <u>not</u> require funding of OPEB—only the reporting and accounting of the obligations

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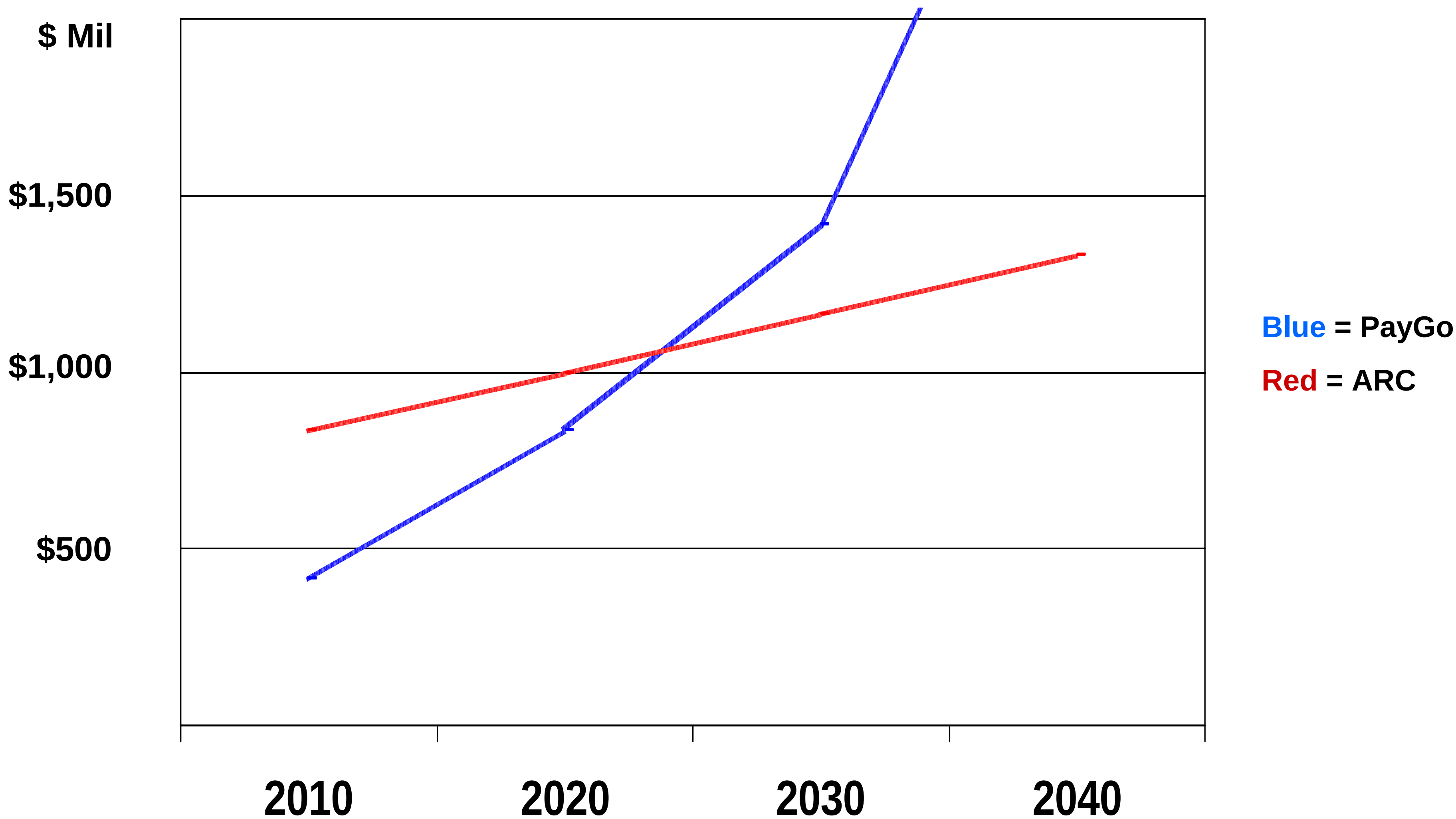
Hypothetical OPEB Comparison: PayGo vs. ARC Payments



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Selected CA OPEB Cases: Unfunded Liabilities

OPEB UAAL:

• California	$40-$70 billion
• Los Angeles	$816 million
• LA USD	$10 billion
• San Francisco	$3-$4.9 billion

Note: Figures may be estimates

Managing pension or retiree health benefits

If the benefit system is actuarially funded—one major objective would be to balance:

- **Assets and**
- **Liabilities**

Balance is not easy

Strategies to Enhance Pension or OPEB Assets

- **Increase employer contributions/increase (introduce?) employee contributions**

- **Alter asset allocation strategy to increase returns (of limited use with OPEB--when there are no assets to begin with)**

- **Issue Pension or OPEB Obligation Bonds to immediately increase assets & funded ratio**

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Strategies to Lower Pension or OPEB Liabilities

- **Reduce benefits, if legally and politically feasible**
- **Close plan to new members…create new plan (tier) with lesser benefits**
- **Cap total employer-provided benefit (pension & OPEB) payments**
- **Convert defined benefit plan into a defined contribution plan**

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DB vs. DC

Key Issues Resulting From Change of DB to DC:

- **Investment risk shifts from employer to employee**
- **Final benefit no longer fixed or predictable**

Private Sector Experience:

- **Since the enactment of ERISA in 1974, the trend of pensions in corporate America has been a pronounced shift from DB to DC**

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Fiscal Effect of Retiree Benefit Pressures

Pensions:

- **Annual contribution rates have increased dramatically during this decade, but now may begin to moderate if investment returns meet assumptions and liabilities are kept in check;**
- **If contribution rates remain high or increase, they will add fiscal stress.**

OPEB:

- **In many cases where a government has a significant OPEB liability, there will be OPEB cost pressures (medical inflation rates plus demographics);**
- **In cases where the increases are material, budgets may be strained.**

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Credit Implications of Pensions

- Pension liabilities have been incorporated into ratings for a long time and, excluding any unusual event in an individual system, we would expect any asset volatility to affect DB plans more-or-less uniformly (as in the 2001-2002 investment loss experience)

- Based on investment experience over the last several years, contribution rates could start to level off or decline over the medium term if funded ratios improve

- Should either poor investment returns or liability growth cause contribution rates to again increase rapidly, this development could become a rating factor for weaker credits

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Credit Implications of OPEB

- Unlike pension liabilities, the new OPEB reporting represents fresh, more specific information about an employer's total long-term liabilities

- We are seeing a wide range of OPEB exposure as the actuarial valuations become available…from little or no liability…to huge, unfunded liabilities, with large Annual Required Contributions relative to current PAYGO amounts

- We expect most employers will be able to continue to meet their ongoing OPEB cost requirements without an adverse effect on credit quality over the near term

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