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## OPEB Bonds: A Cautionary Tale for Counties

*By Rebecca Otto, State Auditor*

The 2008 Legislature authorized the creation of both revocable and irrevocable trusts to pay Other Post Employment Benefits (OPEB). This new legislation also permits public employers to issue bonds to pay their OPEB actuarial liability. The option of using debt to get OPEB actuarial liability under control can be a powerful tool for any local government, but it can also be a rollercoaster to disaster, as a few unfortunate school districts in Wisconsin are learning.

**The Appeal**

Over the past two years a number of public entities in Minnesota have been approached by brokers, who make attractive presentations encouraging the entities to get involved in arbitrage plans involving the issuance of OPEB bonds. The plans entail the public entity issuing OPEB bonds, then investing the proceeds in an investment security paying a higher interest rate than the OPEB bonds.

It's an appealing scenario: the difference between the two interest rates would produce income that the public entity can then use to pay its OPEB liability. Instead of just saving funds to pay their OPEB liability, the prospective investors are told that they will actually be generating funds to pay this liability. Since OPEB bonds are taxable, this form of arbitrage is not a problem with the Internal Revenue Service. Until the 2008 legislative session, the possibility of getting involved in these types of arbitrage deals did not exist for Minnesota public entities.

**Where the risk is**

Borrowing money to make investments is rarely a good idea. Placing millions of borrowed public dollars at risk in investment schemes is never a good idea. These OPEB arbitrage schemes place government entities at risk to bond holders, regardless of the rate of return or value of the investments made with the bond proceeds. Some school districts have learned this the hard way.

Five school districts in Wisconsin are seeing the expensive downside of OPEB borrowing to invest. Back in 2006, the school districts of Kenosha, Kimberly Area, Waukesha, West Allis-West Milwaukee and White Fish Bay all got involved in an OPEB arbitrage proposal.

They issued bonds and invested the proceeds in Certified Debt Obligations (CDOs). These CDOs had been presented to the districts as "safe investments". The CDOs were placed in a trust for the bondholders and the districts promised in the bond covenants to maintain the value of the securities in that trust at 101% of the value of the outstanding bonds.

In 2007 the collapse of the subprime market caused the CDOs to lose value. With the loss in value of the securities in this trust, the districts must now find $53 million to fulfill their covenants and make bond holders secure. If the districts do not purchase $53 million in securities and place them into the trust for the bond holders, they will be in default of the bonds they have issued.

These districts thought that by participating in this investment scheme, they could finance part of their OPEB liability without raising property taxes. Now they have to raise property taxes to transfer $53 million in securities to provide bond investors with security while their own OPEB liability remains large. For example, the Kenosha School District, according to its published school board minutes in May of 2007, had a projected OPEB actuarial liability of $126 million. According to a Milwaukee Journal Sentinel article from April 5, 2008, the Kenosha school district must now pay $8 million in additional collateral or it will be in default on $28.7 million it issued in OPEB bonds. The amounts to make OPEB bondholders secure are funds diverted from students.

**Use Caution**

Counties in Minnesota can avoid these unfortunate situations that have befallen these Wisconsin school districts by being extremely cautious with any proposal that involves the issuance of OPEB debt to produce investment returns. One characteristic of these schemes is that bond proceeds are not placed in an OPEB trust, but instead are placed in a trust for the bondholders. The bond proceeds themselves are never intended to be used to pay OPEB benefits in these situations. It is only the profit they generate that is to be used for OPEB. By making sure that bond proceeds are placed in an OPEB trust, counties can avoid some of the arbitrage schemes.

Another step counties can take is to have an independent financial advisor review any proposed issuance of OPEB bonds. This financial advisor should not be involved in the issuance of the bonds. This precaution is recommended by the GFOA in their memo entitled *Need for Considerable Caution in Regards to OPEB Bonds* (2007) at:
http://www.gfoa.org/downloads/corbaopebbonds.pdf

The investment marketplace can be very complicated. Caution and additional professional advice are prudent courses of action for those issuing public debt and investing public funds.

Additional information on the Wisconsin school district story is available online from the Milwaukee Journal Sentinel. See April 5, 2008, *Schools In Risky Business* at:
http://www.jsonline.com/story/index.aspx?id=735976.

There is also an article entitled *Wisconsin Schools Flunk Investments 101* by Girard Miller, author of GFOA book "Public Investing," at:
http://www.governing.com/articles/0804gmillerc.htm