



Michael J. Havey, Bureau Chief
Division of Accounting and Reporting
California State Controller's Office
P. O. Box 942850
Sacramento, CA 94250

FEB 13 2003

Dear Mr. Havey:

Following is a discussion and policy interpretation relative to refinancing (including refunding or restructuring) of pension obligation bonds (POBs) under the January 31, 1994, OMB policy statement. You may distribute this to the counties for their use.

Issue

Under what condition is the refinancing of pension obligation bonds (POBs) an allowable cost?

Background

OMB Circular A-87 provides that interest on borrowed capital, however represented, is unallowable except when associated with building acquisition or construction.

Governmental entities have argued that the issuance of POBs at a lower interest rate to replace the unfunded accrued actuarial liability (UAAL or UAL) which were being amortized at higher interest rates would be less costly. As a result, OMB has allowed an alternative method of financing the UAL through the issuance of POBs to accomplish the same purpose at a lower cost.

OMB Policy Letter

On January 31, 1994, OMB issued a policy statement stating that interest on POBs issued to finance the UAL is a surrogate for the actuarially determined interest on the pension liability and, therefore, is allowable under A-87 provided that (condition 1 of 3):

"Debt financing of the unfunded actuarial liability (UAL) is not more costly to the Federal Government than regular pension financing over the remaining unamortized life of the UAL, considering bond principal, interest, issuance costs, and any other relevant factors, as determined at the time of the financing."

This policy was narrowly constructed for the specific purpose as indicated above and further illustration of its restricted purpose is indicated in the closing paragraph of the 1994 policy which states:

"This interpretation only addresses the criteria that should be met for an entity to recover interest on bonds issued to fund unfunded pension liability"

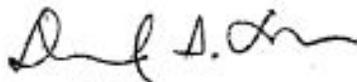
POBs

In the climate of lower interest rates, a number of governmental entities issued POBs beginning in the mid 1990s. Interest rates have continued to come down to levels not seen in over forty years. Some entities have refinanced or are considering to refinance those original POBs to obtain savings on yet lower interest rates. Questions have been asked if this is permissible under the 1994 policy statement.

Policy Interpretation

While the 1994 policy statement did not discuss refinancing of the POBs, it is our opinion that if the aggregate cost of the refinanced POBs is less costly than the POBs that it replaces, the refinanced POBs would be acceptable under the 1994 policy statement. Conversely, if the aggregate cost of refinancing the POBs is more costly than the POBs that it replaces, the excess cost would not be allowable. This interpretation is consistent with the 1994 policy that made the original POB allowable if it accomplishes the same purpose at a lower cost.

Sincerely,



David S. Low
Director



FEB - 3 1994

TO: Directors, Divisions of Cost Allocation

FROM: Gary M. Talesnik *Gary Talesnik*
Director, Office of Grants Management

SUBJECT: Interpretation of OMB Circular A-87 -- Interest Related to Funding of Pension Plans

Attached is a letter I recently received from OMB concerning an interpretation of the pension provision of Circular A-87. The specific issue addressed by the interpretation involves the allowability of interest on bonds issued to fund an unfunded pension liability under paragraph B.13.b. of the Circular. The letter concludes that these costs are allowable as a surrogate for interest on the unfunded pension liability included in the annual actuarially-determined pension contribution if certain criteria are met.

This issue has been raised by several counties in California and may come up in other parts of the country. The criteria described in the OMB letter should be used where these situations come to the attention of DCAs.

We worked closely with OMB and the DCA office in San Francisco in developing the interpretation and believe it is sound and equitable. I would like to express my appreciation to Dave Low and his staff, especially Todd Stevenot and Jean Chui, for their excellent work on this complex issue. Todd is highly knowledgeable in this area and can provide technical assistance to other DCA offices on the application of the interpretation to specific cases should the need arise.

Attachment



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D. C. 20503

OFFICE OF FEDERAL
FINANCIAL MANAGEMENT

January 31, 1994

Mr. Gary M. Talesnik, Director
Office of Grants Management
Department of Health and Human Services
200 Independence Avenue, SW
Room 517-D, HHH Building
Washington, DC 20201

Dear Mr. Talesnik:

This is in response to your request for an interpretation of the provisions of OMB Circular A-87 pertaining to the allowability of pension costs. You indicate that your office has received several inquiries about whether interest on bonded debt issued to fund an unfunded pension liability is an allowable cost under paragraph B.13.b. of OMB Circular A-87.

Recently, during this period of lower interest rates, State and local governments have sought to reduce the interest costs on unfunded pension liabilities by selling bonds that bear interest at a rate lower than the expected rate of return on pension plan assets. The expected rate of return on pension plan assets is the interest rate used by actuaries in calculating a government's annual pension contribution requirement. This contribution requirement includes, among other things, an amount to fund a portion of the unfunded liability as well as interest on the unfunded liability.

State and local governments argue that, since interest on unfunded liabilities has been allowed by Federal agencies under the foregoing provisions of Circular A-87, interest on debt issued to fund the unfunded liability should be allowable if this financing mechanism reduces costs to the Federal Government. You indicate that the Department of Health and Human Services and other Federal agencies interpret Circular A-87 to allow interest on unfunded pension liabilities and that State and local governments are being reimbursed for the Federal Government's share of these costs under various grant programs.

In consideration of the foregoing, I believe interest on bonds issued to finance an unfunded pension liability is a surrogate for interest on the unfunded pension liability included in the annual actuarially-determined pension contribution and, therefore, is allowable under paragraph B.13.b. of Circular A-87, if the following criteria are met:

1. Debt financing of the unfunded actuarial liability (UAL) is not more costly to the Federal Government than regular pension financing over the remaining unamortized life of the UAL, considering bond principal, interest, issuance costs, and any other relevant factors, as determined at the time of financing. If this criterion is not met, interest on debt issued to finance the UAL will be allowed only to the extent of the regular pension financing.
2. All net bond proceeds are made part of pension fund assets.
3. The funding for bond principal and interest is (a) included in each period's pension requirement (e.g., annual, biennial, or other), (b) computed in the same manner as the actuary's amortization of the UAL at the time of the conversion to debt financing, and (c) calculated using the weighted average interest rate on the bonds for the period in place of the actuarially-assumed interest rate. The period's pension requirement consists of funding for bond principal and interest applicable to the period and the pension contribution requirement computed by the actuary for normal costs and any UAL not funded by the bonds. Alternatives to (b) and (c) may be used if they do not result in substantially different pension charges.

This interpretation only addresses the criteria that should be met for an entity to recover interest on bonds issued to fund unfunded pension liabilities. It does not address when an entity must fund normal costs for such costs to be allowable. OMB currently is revising Circular A-87 to clarify the criteria for the allowability of normal costs.

I hope this satisfactorily answers your inquiry and should you have any further questions, please do not hesitate to call me.

Very truly yours,



Norwood J. Jackson, Jr.
Chief, Financial Standards and
Reporting Branch