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Selling Bonds to Fund OPEB: A bad idea…

The Michigan Legislature has just passed a bill, No.1129, that allows municipalities to sell bonds to fund their post-employment benefit obligations. The idea is that in this low interest rate environment, municipalities can put aside enough to cover the future obligations for retiree healthcare and reduce the strain on municipal budgets. The law, which does not require voters to approve the issuance of these bonds, requires that prior to issuance the municipality makes available to the public a comprehensive financial plan that includes:

Sec. 518 (1) (b) Evidence that the issuance of the municipal security together with other funds lawfully available will be sufficient to eliminate the unfunded pension liability or the unfunded accrued health care liability.

For reasons we detail below, we believe it is not possible to provide adequate evidence that the health liability has been eliminated. This well intentioned law is of dubious value and presents a potential future disaster for the taxpayers of the State of Michigan. The underlying premise that selling enough bonds to cover the unfunded liability will solve the retiree healthcare problem is misguided at best. The Other Post Employment Benefit (OPEB) Liability number is based on numerous assumptions that are highly likely to turn out to be inaccurate over the future benefit period.

Big Assumption Number 1: Interest Rates

An underlying premise of prefunding the OPEB liability is that the municipality can capitalize on the spread between the investment rate of return assumptions and its funding cost. If a municipality puts funds into an OPEB trust they are allowed to assume a relatively high rate of return on assets which helps to bring the OPEB number down significantly. Because the municipality issues tax fee bonds with a low interest rate the municipality effectively arbitrages its funding rate and the rate of return assumption. However, this spread is likely to be a mirage. What has happened to pension fund assets over the last few years? The market collapse in 2008 had a devastating effect on the funds that were put aside. There can be no assurance that the funds generated by selling the bonds will drive returns greater than the cost of paying the interest on the bonds. The healthcare liability does not go away when bonds are sold, but if the fund

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loses money the municipality has to pay the health care cost and repay the bonds. This scenario is a potential disaster for taxpayers.

Big Assumption Number 2: Medical Cost Trends

The actuary who calculates the OPEB liability number needs to estimate how much the cost of providing health care in the future will rise or fall. To do this they typically start with a growth rate, say eight or nine percent, and then reduce it by 0.5% each year until it reaches a terminal growth rate of five percent some number of years later.

As a simplifying assumption for ease of calculation, this method seems reasonable on the surface. But what are municipalities actually paying for healthcare in the marketplace? What, if anything, are they doing to achieve this yearly reduction in the cost trend of providing retiree health care? Unless the municipality is taking specific actions to lower the cost trend, the OPEB number will be significantly underestimated. Furthermore, the actuarial analysis assumes that the OPEB costs are compounding annually at lower and lower rates which further underreports the number.

If the medical cost trend turns out to be higher than the trend assumed by the actuary, then the OPEB liability was understated when the bonds were sold. The municipality will not have sold enough bonds and the unfunded liability was not eliminated by selling the bonds.

This observation about the retiree healthcare cost trend brings to light a critical difference and greater risk in prefunding OPEB liabilities as compared to prefunding pension liabilities. When a municipality prefunds pension benefits they run the risk that the returns generated will not achieve a known (assumed) rate of return. But at least they can project what those benefits will cost and they can determine the rate of return needed to generate enough to cover the pension costs. The same is not true for the healthcare. The municipality has promised to provide healthcare in the future. Unlike pension benefits which are paid out in dollars, you cannot put aside health care today to provide healthcare in the future. The municipality is projecting the cost of providing a service in the future. There is a real risk that the service, healthcare, will cost more than the amount projected. So the municipality may not get enough of a return from the money put aside, and even if they get the required rate of return, the healthcare may

cost more in future than was projected. The risks are compounded. Again, in this instance the liability has not been eliminated as required by the law.

Who is going to benefit from this law?

Municipal bond underwriters will make out like bandits if the market takes off. Hopefully the taxpayers will realize that this short term tactic is not a solution to the problem.

As an additional note of caution, the government finance officers association (GFOA) has been on record for some time recommending caution with regard to this prefunding strategy:

http://www.gfoa.org/downloads/corbaopebbonds.pdf

Conclusion

We do not believe that is possible for any municipality to satisfy the requirement that it provide: “Evidence that the issuance of the municipal security together with other funds lawfully available will be sufficient to eliminate the unfunded pension liability or the unfunded accrued health care liability.” There are too many variables that can change the required funding level. Also, following this course of action will give a false sense of security that the problem has been solved.

In our opinion, the OPEB problem will not be solved with financial engineering. The underlying problem is the cost of providing the benefits. Unless municipalities are doing everything they can to reduce the cost of providing the promised benefits, they are doing their retirees and the taxpayers a disservice.

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