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OPEB Liability – Does it Matter?

There is a lot of discussion about OPEB liability and how municipalities can control it. OPEB (Other Post-Employment Benefits) refers to a municipality's financial obligation to provide retiree healthcare. Most municipalities fund the cost of healthcare benefits for current retirees from the current operating budget. However, many municipalities fail to set aside funds to pay for the benefits promised retirees in the past or future obligations for healthcare benefits promised to current employees when they retire. As a result, unfunded OPEB liabilities grow over time. That funding shortfall is estimated to be in the trillions of dollars when aggregated over the entire country.

GASB 45, the standard issued by the Government Accounting Standards Board on financial reporting of OPEB liability by employers, has done a service to taxpayers by bringing this discussion to the forefront and forcing municipalities to put a number on their balance sheets for this long-term obligation. However, like many well intentioned efforts, this has had some negative, unintended consequences.

Given the focus on unfunded OPEB liabilities from taxpayer groups, the media, rating agencies, and, to a lesser extent, the public, it is not surprising that municipal managers worry about this problem. Unfortunately, because of how the dollar value of a municipality's liability is typically calculated, focusing only on bringing down OPEB by manipulating accounting assumptions will have no meaningful impact on the underlying cost of retiree healthcare benefits.

To reverse this trend, it is essential to understand how an OPEB valuation is calculated, its shortcomings, and why focusing on the assumptions that drive the magnitude of OPEB liability and not the underlying costs is misguided.

What are the assumptions that generate the OPEB liability and how can they be manipulated?

The OPEB liability on a municipal balance sheet is an attempt by the accounting/actuarial profession to turn the continuing liability for retiree healthcare into a reliable present value. While there clearly is a liability for future healthcare costs, the amount calculated by the actuarial analysis appears divorced from reality in many ways. That is not to say that the number is not valuable. However, if municipal officials don't understand how the value of the

OPEB liability is generated and what its limitations are, the number can be misleading and misused.

In calculating the OPEB liability, an actuary looks at how many people work for the municipality, how many have retired and the benefits promised. Other critical inputs include the age of workers, when they are likely to retire, and how long benefits will continue after retirement.

Lastly, the actuary reviews the various health plans that the municipality offers retirees, the costs of those plans, and the retiree cost share. At this point, the actuary must make some big assumptions in order to calculate the present value of the OPEB liability.

Big Assumption Number 1: Medical Cost Trends

The actuary needs to estimate how much the cost of retiree healthcare coverage will rise or fall in the future. To do so they typically start with a growth rate, say eight or nine percent, and then reduce it by 0.5 percent each year until it reaches a final 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 (i.e., growth rate) of providing retiree health benefits? Unless the municipality is taking specific actions to lower the cost trend, the amount of the OPEB obligation will be significantly underestimated. Furthermore, the actuarial analysis assumes that OPEB costs are compounding annually at lower and lower rates, which, unless mirroring real cost trends, further understates the actual size of the liability.

What does an actuary do when they return two years later to do the bi-annual OPEB valuation and the municipality has not seen the rate of growth drop by one percent? More often than not, the actuary just resets the schedule at eight to nine percent and pushes back the terminal date.

Big Assumption Number 2: Cash Flow Valuations

The calculation of current cost, cost trends, the number of people receiving benefits and the timing of those benefits is designed to generate a set of future cash flows required to pay for retiree health benefits.

The next set of assumptions is used to turn those cash flows into a present dollar value, i.e. the OPEB liability. The unfunded OPEB obligation can be thought of as similar to a homeowner's mortgage. The amount of an existing mortgage is analogous to the level of unfunded benefits promised to retirees in past years. Like a mortgage, payments to an

unfunded OPEB liability consist of both principal and interest. The interest rate is equal to the assumed inflation rate for the cost of retiree health benefits in the future. Similar to a mortgage, an OPEB liability can be amortized over a number of years – typically 30 years, the maximum allowed by GASB – to make funding the liability more affordable for the municipality. But when a municipality continues to provide retiree health benefits but does not fund them, it is effectively increasing the outstanding balance on a mortgage.

If a municipality does not fully fund benefits earned by retirees in the past, currently, and in the future, the liability will continue to rise. Moreover, even if the municipality does fund the past, present, and future obligations to retirees, but health care costs outstrip the actuary's estimates or the fund's investment returns are below projections, the unfunded liability will only continue growing.

Big Assumption Number 3: Interest Rates

Another critical element is the interest rate assumptions made by the actuary.

The corollary to a mortgage payment in the OPEB world is the ARC or Annual Required Contribution. This is the amount calculated by the actuary to fully fund the OPEB liability. If the municipality were making the full ARC payment, it would generate a sizeable fund to pay for retiree healthcare costs in later years. The rate of return on funds set aside determines the size of the ARC. The greater return you get on the money you put aside, the less you actually have to save. However, the higher *assumed* rate of return leaves you to mistakenly believe that you need to set aside less money, and also, the lower the present value of the OPEB liability because the cash flows are discounted at the same rate as the return on assets.

OK, that may be a bit hard to follow but it is very important to understand some of the potential manipulation of OPEB liability. There are two interest rates that the actuary can choose from in order to calculate its present value, the funded rate and the non-funded rate. The funded rate is the interest a municipality earns from

the value of its retiree benefits fund assets (e.g., cash, stocks, bonds, etc.) if it has put aside money to cover the OPEB liability. Typically, that rate of return is around eight percent. If the municipality has not formed an OPEB trust or started to fund it, the actuary is forced to use a much lower rate of return, say around four percent. For this reason, forming an OPEB trust and depositing a minimal amount of assets into it can significantly lower the OPEB liability.

While funding an OPEB trust is a step in the right direction, it has inherent limitations as well. The most obvious limitation is the likelihood that in the current economic climate an OPEB trust fund will achieve a return of eight percent over the next 30 years. Currently, yields on 10-year government bonds are under two percent and the earnings yield on U.S. stocks is under six percent. Assuming a 70/30 stock/bond mix, this would suggest prospective OPEB trust returns of around 4.8 percent. So the likelihood of achieving an eight percent return from those assets is currently pretty slim.

Another significant flaw in the GASB 45 regulation is the triggers under which a municipality can change from a non-funded to a funded rate assumption. All that is required to form an OPEB trust is to put in place a funding "plan" and deposit some money in the trust. The amount can be significantly less than the total OPEB obligation. However, a municipality does not have to fund the trust every year in order to apply the higher assumed rate of return. Going from a four percent to eight percent return/discount rate assumption can drop the OPEB liability as much as 50 percent.

Think about that. The OPEB liability is supposed to accurately reflect the cost of retiree health benefits. Creating a trust with nominal dollar balance does nothing to affect the cost of providing the benefits, but it can reduce the OPEB liability *on paper* by tens of millions to hundreds of millions of dollars for larger cities.

What lessons can be learned from this process for generating the OPEB valuation?

The OPEB valuation itself is generated through a complex process with a number of critical assumptions, which can have a significant impact on the size of the liability. None of these assumptions deals directly with the actual cost of providing healthcare benefits to retirees. If municipal managers are focusing only on the accounting value of the OPEB liability, they are not tackling the real problem—why the costs are rising and how best to contain them. Addressing

those issues rather than manipulating interest rates or healthcare cost growth assumptions will help reduce the real drivers of municipal and retiree healthcare costs.

So how can you legitimately lower your OPEB liability?

One solution overlooked by many municipalities is to structure Medicare prescription drug benefits to take advantage of the Employer Group Waiver Plan subsidy (EGWP, pronounced “egg whip”) instead of the more commonly used Retiree Drug Subsidy (RDS). These are federal subsidy programs available to plan sponsors (i.e., municipalities, in this case). This one shift can save an average of $480-$840 per Medicare retiree per year and also dramatically lower the OPEB liability.

Retiree health insurance is generally funded by municipalities as the benefit payments come due (i.e., a “pay-as-you-go”), in which current costs are funded annually from the operating budget. Because the EGWP subsidy pushes more of the cost of providing benefits onto the federal government, it can significantly lower a municipality’s annual pay-as-you-go costs, leaving more money in the operating budget to fund the OPEB trust, without cutting retiree benefits or shifting a greater share of the costs onto retirees.

Municipalities that structure their Medicare retiree prescription drug benefits to take advantage of the EGWP subsidy receive a higher base subsidy than in the aggregate from RDS subsidies. They also receive free catastrophic reinsurance. With reinsurance, the federal government pays 80 percent of the cost any time a Medicare retiree’s prescription drug expenses exceed the catastrophic threshold, which in 2013 is set at $6,734. In light of the high cost of specialty pharmaceuticals, the savings from a single Medicare retiree could be tens or even hundreds of thousands of dollars. In contrast, the most a municipality would receive per retiree from a RDS subsidy in 2013 is $1,757.

Other EGWP Benefits

Beyond simply reducing costs, the EGWP provides other key benefits. The Government Accounting Standards Board (GASB) has determined that because RDS receipts are considered general revenues to the municipality they do not count as a cost reduction when calculating OPEB liability. In contrast, because the EGWP subsidy and reinsurance directly lower the cost of retiree healthcare benefits, this cost reduction can be factored into calculating the OPEB liability.

This benefit helped the state of Connecticut reduce its OPEB obligation by $4.5 billion when it shifted from the RDS to an EGWP.

Lastly, as explained earlier, reducing the pay-as-you-go costs through an EGWP can leave money in the budget to fund the OPEB trust. As illogical as it sounds, putting some money into the trust can flip the discount rate used to calculate future OPEB liability from two to four percent to as much as six to eight percent. Moreover, by reducing the liability, partly from an
EGWP and partly by funding the OPEB trust, the ARC (Annual Required Contribution) declines as well.

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