Selling Bonds to Fund OPEB is a Bad Idea

The Michigan Legislature has just passed bill No.1129, which 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 money to cover future obligations for retiree healthcare and reduce the strain on municipal budgets. This well-intentioned law is of dubious value and may be disastrous for Michigan taxpayers in the future.

The law, which does not require voters to approve the issuance of the bonds, requires that prior to issuance a municipality makes available to the public a comprehensive financial plan that includes Section 518 (1) (b) which states: "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."

The underlying assertion that selling enough bonds to finance the unfunded liability will solve the retiree healthcare problem is misguided, because it's impossible to provide adequate evidence that the OPEB (Other Post-Employment Benefit) liability has been eliminated.

The amount of the costs and liability is based on numerous assumptions that are highly likely to turn out inaccurate over the future benefit period.

Big Assumption Number 1: Interest Rates

A fundamental premise of prefunding OPEB liability is that a 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, it is allowed to assume a relatively high rate of return on assets which helps to lower the OPEB liability significantly. The municipality effectively arbitrages its funding rate and the rate of return assumption. However, this spread is likely a mirage. A case in point is what has happened to pension fund assets over the last few years. The market collapse in 2008 had a devastating effect on the funds put aside. The Government Finance Officers Association (GFOA) has been on record for some time recommending caution with regard to this prefunding strategy.

38 Washington Square
Newport, RI 02840
p: 401.490.9350 | www.ktpadvisors.com

There can be no assurance that funds generated by selling bonds will drive returns greater than the cost of the interest on the bonds. Retiree healthcare liability does not go away when bonds are sold, but if the fund loses money the municipality has to pay the healthcare cost and repay the bonds.

Big Assumption Number 2: Medical Cost Trends

The actuary who calculates the OPEB liability number needs to estimate how much the cost of providing healthcare 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 medical cost trends for retirees turn out higher than the trends assumed by the actuary then the OPEB liability was understated when the bonds were sold and the municipality will not have sold enough bonds to eliminate the unfunded liability. That scenario brings to light a critical difference and the increased risk of prefunding OPEB liabilities as compared to, for example, prefunding pension liabilities. When a municipality prefunds pension benefits it runs the risk that the returns generated will not achieve an *assumed* rate of return. An actuary, however, can, at least, project what those pension benefits will cost and within reason estimate the rate of return needed to pay for them. The same is not true of retiree healthcare.

The municipality has promised retirees healthcare benefits in the future. Unlike pension benefits whose future costs can be reasonably estimated, healthcare is a service with a variable cost in dollars. Thus, a municipality's risks are compounded if retiree healthcare costs are more than projected and the OPEB trust does not earn enough of an investment return to fund them.

Conclusion

The OPEB problem will not be solved by financial engineering. The underlying problem is the cost of healthcare benefits promised to retirees. Unless municipalities are doing everything possible to reduce those costs, they are doing their retirees and taxpayers a disservice. There are specific, actionable steps that can be taken to immediately address and reverse the rising cost of providing retiree healthcare without reducing benefits or shifting higher costs onto retirees.

Contact: Barry Eyre, at beyre@ktpadvisors.com or 401 490 9365

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