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Facing the Challenge of Retiree Health Care: Liabilities and Responses of State and Local Governments — A conference summary

Abstract
[Excerpt] Beginning in fiscal year 2008, many state and local governments will begin reporting the costs of paying for nonpension retiree benefits on their financial statements in response to new accounting standards issued by the Governmental Accounting Standards Board (GASB). These costs are referred to as other post-employment benefits (OPEB), with retiree health care representing the single largest component.

The challenge facing state and local governments in meeting OPEB liabilities stems largely from the unplanned (and accelerating) increases in health care costs. Recent estimates suggest that state and local governments have OPEB liabilities of between $600 billion and $1.6 trillion, and virtually all of this is unfunded. The historical method of using a "pay-as-you-go" system to meet retiree OPEB costs (where current revenues pay for these costs) would crowd out spending on other key government functions. This will be a particular challenge to governments that face both underfunded pension and OPEB liabilities.

Keywords
Governmental Accounting Standards Board, GASB, other post-employment benefits, OPEB, retiree benefits, retirement, public policy, health care

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Facing the Challenge of Retiree Health Care: Liabilities and Responses of State and Local Governments—A conference summary

by Richard H. Mattoon, senior economist and economic advisor

On March 12, 2008, the Federal Reserve Bank of Chicago and the Civic Federation held a forum on retiree health care for state and local government employees. The participants focused on strategies to finance and administer other post-employment benefits, or OPEB.

Materials presented at the forum are available at www.chicagofed.org/news_and_conferences/conferences_and_events/2008_civic_federation.cfm.

Beginning in fiscal year 2008, many state and local governments will begin reporting the costs of paying for nonpension retiree benefits on their financial statements in response to new accounting standards issued by the Governmental Accounting Standards Board (GASB). These costs are referred to as other post-employment benefits (OPEB), with retiree health care representing the single largest component.

The challenge facing state and local governments in meeting OPEB liabilities stems largely from the unplanned (and accelerating) increases in health care costs. Recent estimates suggest that state and local governments have OPEB liabilities of between $600 billion and $1.6 trillion, and virtually all of this is unfunded. The historical method of using a "pay-as-you-go" system to meet retiree OPEB costs (where current revenues pay for these costs) would crowd out spending on other key government functions. This will be a particular challenge to governments that face both underfunded pension and OPEB liabilities.

Overview of OPEB challenges

Dean Michael Mead, research manager, Governmental Accounting Standards Board, described the rationale behind the new reporting standards in GASB statements No. 43 and No. 45.[1] The GASB wants to improve transparency, so it would like large liabilities to be reflected on government financial statements. In the case of OPEB, the benefits employees will receive in the future are factored into their current compensation. As such, these benefits represent part of the cost of today's services and should be accounted for now, not in the future.

Mead stressed that GASB statement No. 45 does not require that governments prefund OPEB liabilities. They can continue to use a pay-as-you-go approach to fund OPEB, although in practice, Mead said, this would place pressure on a government's balance sheet as the cost of these liabilities accelerates relative to other government expenses. More prudent accounting practices will require a funding level that ensures that a government meets the annual required contribution (ARC). Funding at the ARC means that the government is meeting the normal (or service) cost and the amortized unfunded actuarial accrued liability (UAAL).[2]

Mead noted that the ability of a government to meet OPEB commitments will be greatly influenced by the discount rate that is determined by the government's funding decision. A government that prefunds OPEB will be able to use

a much larger discount rate, and it will be able to reduce its OPEB liability at a significantly faster rate than a government that either continues to use a pay-as-you-go approach or fails to fund at the ARC.

Barbara Bovbjerg, director for education, work force, and income security issues, U.S. Government Accountability Office (GAO), provided an overview of the impact of OPEB and pensions on the state and local government sector. The GAO has issued two recent reports on the subject and found that state and local pensions, with a few notable exceptions, are generally pretty solid. Pensions have been prefunded, and assets appear to be reasonably well matched to cover liabilities. The same cannot be said about OPEB. Very few governments have put any assets aside to meet these future costs, and based on GAO projections of expenditure growth in the state and local government sector, it is unlikely that the current pay-as-you-go strategy is sustainable.

Part of the OPEB problem is that retiree health care benefits were established at a time when the costs were more affordable. The rise in insurance premium costs and general health care inflation were not contemplated by most governments. Governments offered OPEB, believing that they could afford them out of current revenues. One important difference with OPEB liabilities is that, unlike many pensions, OPEB are usually not guaranteed benefits, so governments can modify them over time to help contain costs.

Bovbjerg concluded by quantifying the magnitude of pension and OPEB costs based on a fiscal outlook simulation model developed by the GAO. The model found that to fully fund the state and local obligation for pensions, governments would need to raise their pension contributions from a current level of 9% of employee salaries to 9.3%. However, to fund OPEB, their contribution would need to rise from a current level of 2% of salaries to 5%. She concluded that, given this rapid rise, the most important thing for state and local governments is to have a plan that will put them on the path to addressing OPEB costs.

Bert Nuehring, partner, Crowe Chizek and Company LLC, provided an auditor's perspective on reporting OPEB funding. Nuehring emphasized that the actuary has a critical role in establishing the OPEB liability for any government. The actuarial assumptions establish the future benefit costs. These assumptions include demographic trends (rates of employee termination, retirement, mortality, and disability); economic trends (investment return along with the discount rate, salary increases, and medical inflation); and the implicit rate subsidy from current employees' health insurance premiums to retirees.

Nuehring argued that it is particularly important for a government to provide as detailed an employee and retiree census as possible. This allows the actuary to develop more-detailed and accurate assessments of the required funding.

While OPEB liabilities are largely unfunded, there are examples of governments that have moved aggressively to begin meeting the challenge.

Neighboring states and OPEB

While OPEB liabilities are largely unfunded, there are examples of governments that have moved aggressively to begin meeting the OPEB challenge. The State of Ohio; Oakland County, MI; and Duluth, MN, have all been recognized for their efforts in addressing OPEB.

Karen Carraher, director of finance, Ohio Public Employees Retirement System (OPERS), presented Ohio's OPEB plan. OPERS is a large retirement system with $83 billion in assets and over 900,000 active and inactive members, covering 3,707 government units. OPERS began providing retiree health care coverage in 1962 and established a health care trust in 1974. As the health care liabilities have grown, OPERS has taken steps to control health care costs. Important measures have included providing an HMO (health maintenance organization) and a PPO (preferred provider organization); offering different levels of service, premiums, deductibles, and co-payments; increasing pharmaceutical co-payments; emphasizing preventive services; and adjusting benefit levels to reflect years of service worked.

The key to the OPERS plan has been an active communication strategy with employees. OPERS wants to make certain that employees understand what is driving the funding status of the plan; the retirement system also wants to make sure that any future plan changes are communicated long before they are implemented so that employees will have enough time to adjust.

Carraher noted that, from a funding perspective, the goal of the plan has been to have sufficient assets to meet a solvency target of 15–25 years of liabilities. The plan currently has exceeded this goal and has an estimated solvency of 27 years. This has been accomplished in a relatively short time, given that the fund had 14 years of solvency in 2002. In terms of its funded ratio (the ratio of assets to liabilities), the fund is 39% funded. To help ensure that funding is maintained, the employer contribution rate has been raised from 13% of employee salaries to 14%.

Robert Daddow, deputy county executive, Oakland County, MI, presented the county's plan for funding OPEB. The county began funding OPEB at the ARC in 1987, and has funded at the ARC every subsequent year. Through both its funding practice and modifications to its plan, Oakland County's OPEB liability is fully funded.

Daddow noted that the county has used a variety of cost control strategies to reduce its OPEB liability, including:

- Offering buyouts to deferred retirees in exchange for their renouncing any claims for retiree health care;
- Increasing co-payments and deductibles for health services;

- Implementing tiered pharmaceutical co-payments;
- Issuing competitive bids for pharmaceutical management services;
- Closing the defined benefit health plan to new hires (in 2005) and creating health savings accounts; and
- Increasing the vesting period for new employees, spouses, and dependents.

quite generous. For example, the plan covered dependent children up to age 25.

Bergson began to address this issue by freezing the hiring of new employees to ensure that the estimated liability of between $310 million and $320 million would not grow. He also passed a measure that he and future mayors would not draw a pension. Bergson promised not to run for reelection in an effort to develop support for his reform measures.

The magnitude of unfunded OPEB liabilities is likely to squeeze state and local budgets for some time to come.

On the funding side, while the county has always contributed based on the ARC, there was still a substantial unfunded liability by 2006. To reach full funding, the county issued $557 million in trust certificates of participation in July 2007. This created an annual debt service of approximately $48.5 million over the 20-year life of the certificates. However, the county's trust certificate issuance provided a considerable savings over the estimated $60.2 million annual payment that would have been required to meet the ARC.[3] Daddow estimated that over the 30-year period to fully fund OPEB at the ARC, this will save the county approximately $150 million.

Daddow concluded that issuing OPEB debt may not work for all entities. It was appropriate for Oakland County because it had done significant prefunding, had a favorable bond rating, and had taken steps to limit future benefit costs. Finally, Daddow cautioned that debt market conditions have to be favorable (i.e., the debt rate must be significantly less than the expected return on long-term investments in the retiree health care trust fund) for this strategy to work.

Herb Bergson, former mayor, Duluth, MN, described the political challenges in dealing with OPEB. Bergson ran for mayor on a platform that he would address the city's spiraling OPEB liabilities. The cost of the obligation had reached $4,000 per capita in the city, and the city clearly lacked the fiscal resources to pay for this. Bergson described the defined benefit health plan as being

Ultimately, a six-part plan was implemented. It included:

- Creating an irrevocable OPEB trust;
- Reinvesting money from another fund (the Community Investment Trust) into the OPEB trust;
- Seeding the OPEB trust with $12 million in city revenues;
- Earmarking money raised through the TIF (tax increment financing) district for the OPEB trust;
- Allowing the state board of investments to mange the trust's funds; and
- Requiring union concessions.

Bergson shared that this process was highly contentious. He concluded that it is critical that elected officials recognize the magnitude of OPEB issues and be held accountable for developing plans to meet the challenge.

Illinois and OPEB

Pedro Martinez, chief financial officer, Chicago Public Schools (CPS) system, discussed the OPEB liability facing the system. The CPS is the third largest school system in the U.S. with over 400,000 students and an operating budget of $4.8 billion. The system adopted GASB statement No. 45 in fiscal year 2006. The system's estimated OPEB liability grew from $213 million in fiscal year 2006 to $425 million in fiscal year 2007.

Martinez described a two-part strategy for meeting the CPS's pension and OPEB commitments. The system continues to fund its pension liability, but it is using a pay-as-you-go method for its OPEB liability. The real cost driver for OPEB is retirees under the age of 65 (who are not qualified for Medicare), and this population is growing by roughly 1,500 per year. Another problem is proposed state legislation that will add to the cost of both pension and health care plans. Martinez said that the system is always fighting a defensive battle to prevent plan expansions that are granted by the state legislature. Another significant driver is the shifting state cap for retiree health care costs. Under the current statute, retiree health care costs are capped at $65 million. However, in practice, the legislature has raised this cap frequently, and a goal of the CPS is to see that the cap is maintained. Based on current projections, the CPS will reach the $65 million cap in fiscal year 2008. Finally, finding efficiencies for the retiree health plan will be an important component in funding OPEB.

Brian Caputo, director of finance, City of Aurora, IL, described the city's experience in attempting to meet its OPEB liability. The city has a population of 170,000, a $400 million annual budget, and 1,000 employees. Aurora began implementing GASB statement No. 45 at the end of 2004. It chose to implement

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the GASB standards early in an effort to promote good financial management and to provide a clearer financial picture to aldermen, the mayor, and the city's unions. The city even developed a cost simulation model in an effort to forecast what policy changes would do to the city's future finances.

Aurora has taken an active role in working with its actuary. It has provided participant data, as well as cost and contribution data. In addition, the city adopted an investment return assumption of 3.25% for 2005 and 2006 and increased it to 7% for 2007 and afterward. Aurora also developed a health care cost inflation trend measure, starting at 10% for 2005 and forecasted to fall gradually to 8% for 2009 and afterward.

Aurora's unfunded liability for OPEB as of December 31, 2006, totals $183.6 million. The ARC for Aurora is $18.5 million in 2008, and this compares with the current pay-as-you-go costs of $4 million. However, if the city fails to pay at the ARC, the pay-as-you-go cost will rapidly accelerate. In response, the city has set up an OPEB trust. The trust's board includes both city officials and retired employees. The board has a limited focus that includes receiving city and retiree contributions, investing money on hand, and paying claims. The board can also hire an investment manager or consultant.

Caputo concluded that it will be necessary to ramp up contributions to fund OPEB and that this will also have a significant impact on government operations, given the magnitude of the unfunded liability. Issuing OPEB bonds could provide some immediate relief, but Caputo stated that doing so might also strain other capital needs of the city; the city government would need to explore such options in the context of its realistic bonding capacity.

Mary Ann Boyle, assistant treasurer, Metropolitan Water Reclamation District of Greater Chicago, described the district's retiree medical plan as well as its unfunded liability. This plan is a self-funded medical plan that has been supported on a pay-as-you-go basis. The district pays 75% of medical and prescription drug coverage for its retirees and their dependents. The plan covers 2,000 active employees and 1,900 retirees.

As of January 1, 2007, the unfunded liability was $443 million. The district was granted statutory authority to establish an OPEB trust in 2007; it has adopted a target goal of being 50% funded over a 50-year period. Ten million dollars will be paid into the trust annually for the first five years, and after that, a contribution based on a percentage of payroll will be made. The funds will be invested initially in a 50/50 mix of equities and bonds, with a maximum cap of 65% equities over time. The trust is not intended to begin paying OPEB claims until 2023.

Boyle concluded that the OPEB trust will be managed separately from the pension fund and that the portfolio would be structured to keep administrative costs low. The ultimate goal of the trust is to capture long-term investment returns and help maintain the district's AAA bond rating.

Conclusion

The implementation of GASB statements No. 43 and No. 45 will help clarify state and local government liabilities for providing nonpension retiree benefits. The magnitude of these unfunded liabilities is likely to squeeze state and local budgets for some time to come. What is clear from the forum's presenters is that state and local governments should first develop a plan that considers the funding and expenditure sides of the OPEB equation.

[1] Summaries of GASB statements No. 43 and No. 45 are available at www.gasb.org/st/summary/gstsm43.html and www.gasb.org/st/summary/gstsm45.html, respectively.

[2] The UAAL is the ratio of the excess of the actuarial accrued liability to the actuarial value of the assets.

[3] Because the defined benefit plan was closed in 2005, the ARC will remain fixed at $60.2 million over the amortization period.

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