

Retiree health care benefits:

How to Manage Your OPEB Liability



PEIRCE PARK GROUP
INVESTMENT MANAGEMENT CONSULTANTS



In the 1960s and 1970s, a number of larger employers, including corporations and state and local governments, offered retiree health benefits as part of their employee compensation packages. At the time, the cost of offering this benefit was negligible because health care costs were significantly lower, people were not living as long, and post-retirement health benefits were all but covered by Medicare. Since then things have changed dramatically. The cost of health insurance surpasses inflation, people live longer, and Medicare typically covers only 40% of retiree health costs. Retiree health benefits have profoundly, and unexpectedly, impacted employer balance sheets, income statements, and cash flow.

In the late 1980s, FAS 106 was passed, which required that corporations providing this benefit reflect it on their balance sheets. Several years ago, GASB (through GASB's 43 & 45) mandated the recording of these liabilities and expenses on the financial statements of the governments that provided them. Prior to GASB 43 & 45, these liabilities were accounted on a PayGo basis, i.e., the expense was recorded as the benefit was paid. PayGO deviates from accrual accounting and the treatment of pension liabilities and expenses. GASB's 43 & 45 now force government entities to account the expense of these benefits as they are earned. Previous earned benefits must also be reflected on the financial statements.

Slightly more than 25% of Pennsylvania counties provide the retiree health benefit to current employees or retirees. In some cases, the liabilities are negligible, but in others, they are significant. Those counties offering the benefit know well, and struggle with, the impact of GASB 43 & 45. What should they do?

1. **Value Liability** – Counties can and must recognize the totality of liabilities, as well as annual ARC.
2. **Benefit Design** – Some counties continue to provide this benefit to new employees, some are considering eliminating it for new employees, and some accomplished the latter years ago. Questions for consideration by counties and benefit specialists include: What was the original benefit promise to the employee? Can the county renege entirely or partially? Is the retiree health benefit promised yearly and therefore cancellable at the end of each year? What is the implication of not cancelling the benefit? What can be used as co-pays? What about growth rate caps? Should the retiree health benefit be treated differently for retirees, current employees, and future hires?

PRE-FUNDING DECISION

What are the pros and cons? Should counties put assets aside for future payment of these liabilities as is done for the pension? Some contend the benefit should be funded as it is paid, but imagine having the pension liability and no assets set aside for it! In these difficult times, however, where does a county find money to pre-fund the retiree health benefit when it is difficult enough to fund the pension ARC?

- **Cons** – finding money to pre-fund; putting too much away in a trust before national health care reform lowers future liabilities.
- **Pros** – having the assets to pay for the benefits when due; the current beneficiaries (our generation) paying for benefits earned rather than projecting payment to the next generation; assuming a higher return rate, which lowers liability and the ARC; demonstrates to rating agencies that the county is fiscally responsible and therefore potentially lowers borrowing costs.

PRE-FUNDING AND INVESTING – FAQ

How should you invest? Pre-funding liability (moving from PayGo to pre-funding), allows for an increase in the assumptions used for investment returns. If you do not pre-fund, the actuary needs to use an assumption equal to approximately money market rates. Most actuaries are using 4% to 4½%. However, if you fully contribute your ARC, then the actuary can use a rate of return similar to that which is used for the pension fund, assuming that your asset allocation mix is aggressive enough to warrant such assumption. Such an asset allocation mix would probably need to be at least 60% in equities to match the assumptions used in your pension fund. If you use an asset allocation mix that has a lower allocation to equities, then the actuary may need to pick a point somewhere between the 4% and the actuarial assumptions for the pension funds, which for most counties is 7½%.

What happens if you partially fund the ARC? Then the actuary needs to pick a return assumption somewhere between the 4% and the 7½%.

What does changing the actuarial assumptions do for the plan? By increasing the investment return assumption, the liability is reduced because the present value of the future benefits, discounted at a higher interest rate, will lower the liability. It will also lower the annual required contribution (ARC).

What other benefits are there to pre-funding? Ultimately, these benefits need to be paid and they either have to come from county contributions or investment returns. The more the investment returns, the less the county has to contribute, which may allow for a greater probability of being able to maintain current benefits, or not have to drop the benefit package as substantially as you may have to do in order to afford what has already been promised.

Should we invest differently than a pension fund? The answer is probably. In most pension plans you have a certain amount of assets set aside to pay for current year benefits, which are typically invested either in a money market or short-term fixed income securities. The amount needed to be left in short-term securities is typically 1% to 3% of the total pension fund assets. For OPEB, the current year benefits are a significant percentage of the amount of assets in the plan, so a high percentage needs to be kept liquid. The rest of the assets could be invested more aggressively and, in fact, very well could be invested more aggressively than your pension assets, since the rate of growth of these liabilities is greater than pension liabilities. This does not mean that your overall investment mix is going to be aggressive, since a high percent of it needs to be in short-term securities, but by bifurcating these two, you can have short-term assets for short-term liabilities, and long-term assets for long-term liabilities. Bottom line: save more now and pay less later assuming you can secure funding in the county budget.

CONCLUSION

The OPEB plan and regulatory environment present county executives with a significant and multi-faceted challenge. There is no longer a choice about reporting the liability – liability valuation, plan design and funding all need to be analyzed – an optimal, customized solution should be implemented based on the unique needs and preferences of the county.