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# Rising U.S. States' OPEB Liabilities Signal Higher Costs Ahead

**November 28, 2018**

## Key Takeaways

- Reported unfunded retiree health care liabilities grew significantly for some state plans under new accounting standards that generally include more conservative liability estimates (compared to prior reporting standards).
- Retiree health care costs will continue to accelerate as states severely underfund their OPEB plans, assuming no action is taken to reduce benefits.
- Plan contributions remain well below levels necessary to materially reduce plan unfunded liability over the long-term.
- Funded ratios remain low for the majority of states with established trust funds.
- OPEB liabilities are likely to continue to escalate without meaningful funding progress or benefit reductions.


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Other postemployment benefit (OPEB) liabilities, which consist primarily of retiree health care plans, are a growing concern for certain states' credit quality and require attention to control higher future costs. Total unfunded state OPEB liabilities have increased significantly for the third year in a row, according to S&P Global Ratings' latest survey of U.S. states. Overall, total unfunded liabilities across all states increased $63 billion or 10% in fiscal 2017. This growth is larger than the 3.9% growth we reported in our fiscal 2016 survey but below the 12% growth reported in our fiscal 2015 survey. We believe this rise in reported unfunded OPEB liabilities is due primarily to continued extensive underfunding and updated OPEB actuarial studies, but also may be partly due to the implementation of updated accounting standards for OPEB plans.

Notably, the majority of state plans fund these long-term liabilities on a pay-as-you-go (paygo) basis, which defers contributions until the moment benefits are due and is intensified by medical cost trends outpacing inflation. The lack of a funded trust also exposes state budgets to medical claims volatility and demographic risk due to aging active populations. Additionally, the costs associated with a paygo strategy are countercyclical as states tend to incentivize retirement and reduce payroll during market corrections, which causes a counter spike in new OPEB costs at the worst possible time.

Plans that do not address OPEB costs in a timely manner may be exposed to large future swings in contributions and an increased likelihood that rapidly increasing benefits become unaffordable if no other action is taken to reduce costs.

## Kicking The Can Down The Road

Most states do not prefund OPEB liabilities or have continued to decidedly underfund their OPEB plans. According to our survey results, plan disclosures under both GASB 74 and prior reporting standards suggest that plan contributions for the majority of states are likely well below levels necessary to materially reduce plan unfunded liability over the long term.

Specifically, just seven states met or exceeded their combined annual OPEB actuarially determined contributions (ADC), according to the most recent data available for our survey (see chart 1). Only five states contributed 90%-100% of their ADC.

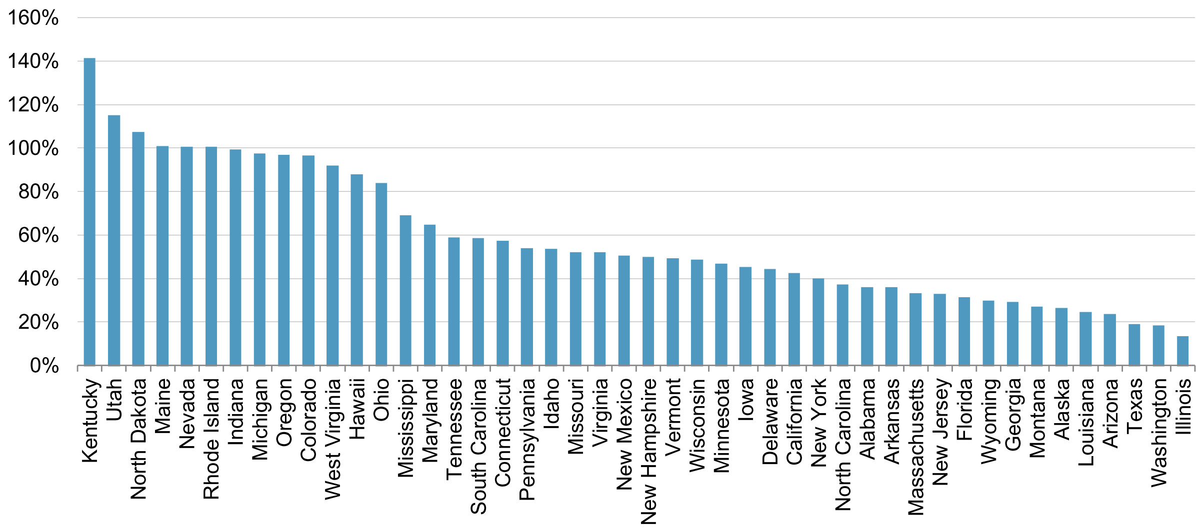
Assuming no other action is taken to reduce benefits, we believe the current lack of funding progress for OPEBs will lead to escalating future contributions and additional budgetary pressure for some states. As states continue to juggle competing priorities with limited financial resources, we expect that many will continue to defer definitively addressing OPEB liabilities in favor of spending in other areas, such as pensions and Medicaid (for more information on state general fund expenditures, see "When The Credit Cycle Turns, U.S. States May Be Tested In Unprecedented Ways," published Sept. 17, 2018, on RatingsDirect). States that ultimately decide to take action to subdue these rising contributions might increase funding, amend plan benefits or adopt a plan that incorporates both options.

While legal flexibility in many states may make substantial benefit reform relatively easier compared to pension benefit reform, we believe practical limitations could still make reducing OPEB benefits difficult. Examples of such limitations include political or social implications, union negotiations, and remaining competitive in hiring and retaining workers.

Many plans have already implemented certain cost saving measures such as requiring some retirees to enroll in Medicare when eligible (or imposing a premium surcharge on those under the age of eligibility) and shifting prescription drug benefits to a Medicare Part D plan.

Chart 1

**Combined Actual OPEB Contributions As A Share Of Combined Annual OPEB ARCs**



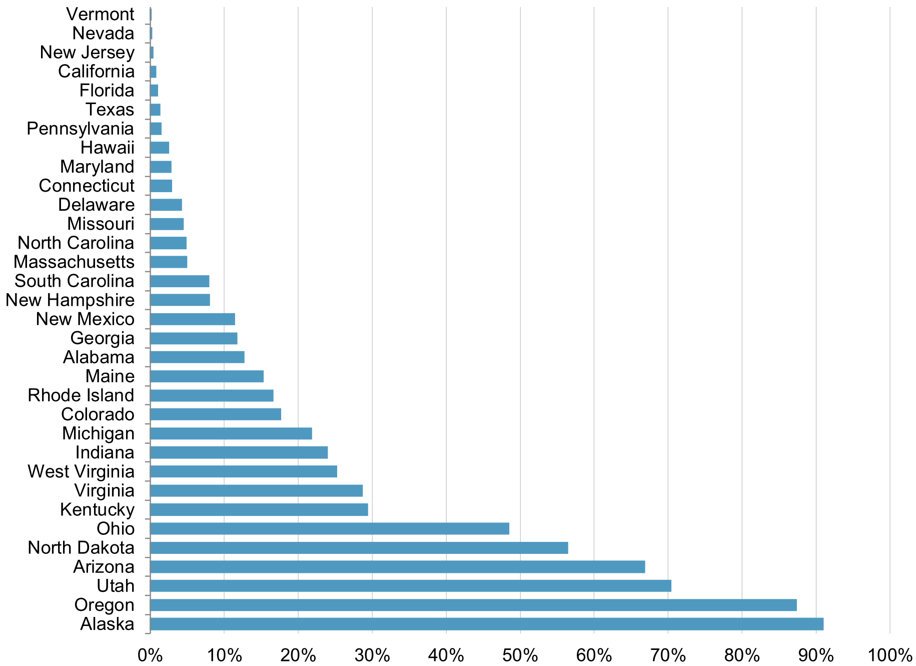

Data reflects both most recent CAFR available and actuarial valuation. Oklahoma does not report implicit subsidy of its retirement plan death and disability benefits as a separate unfunded OPEB. Nebraska and South Dakota have been excluded because they do not offer OPEBs. As of Jan. 1, 2017, Kansas no longer subsidizes non-Medicare participants.


## Funded Ratios Remain Low As States Continue To Favor Paygo Despite Increasing Exposures

Although retiree health care benefits are typically paygo, many states have established trusts in an effort to build assets and pre-fund these long-term liabilities. According to our survey, more than half of the states report at least some level of asset accumulation in an OPEB trust fund. However, our survey also shows that many of these trust funds do not hold a significant level of assets compared to plan liabilities. According to our survey, only five states have funded more than 50% of their liabilities. One state has a funded ratio between 50% and 30% and 26 states have funded less than 30%.

Chart 2

**Combined Funded Ratio For OPEB Funds**




Data reflects both most recent CAFR available and actuarial valuation. For plans that have adopted GASB Statement No. 74, the fiduciary net position as a percentage of the total OPEB liability is reported. For plans that have not yet adopted GASB Statement No. 74, the actuarial value of assets as a percentage of the actuarial accrued liability is reported. States without accumulated assets have been excluded from the chart.


By 2030, all baby boomers will be older than 65, and the size of the older population will be such that one in every five residents will be of retirement age. While this may provide some relief to "bridge" plans which end at Medicare eligibility, plans which provide lifetime benefits may face accelerating costs. In our opinion, those with trust funds and that consistently make actuarially recommended contributions to prefund these liabilities are better positioned to combat rising retiree health care obligations. Those without funded trusts are exposed to volatility in medical claims and risk from demographic trends as the active population for OPEB plans age.

Without action to either prefund OPEB liabilities or reduce benefits, OPEB liabilities will likely escalate

For additional information on demographics for U.S. states, please see "U.S. States Are Showing Their Age: How Demographics Are Affecting Economic Outlooks," published Sept. 25, 2018.

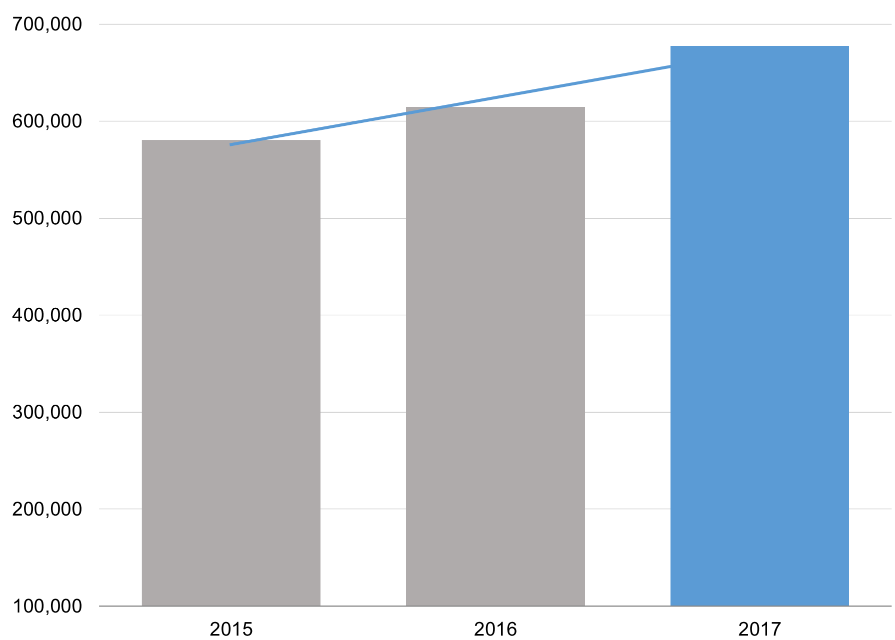
## Unfunded OPEB Liabilities Rise

Across the 50 states, combined unfunded OPEB liabilities totaled $678 billion, a 10.2% or $63 billion increase as compared to our most recent survey. This growth is due in part to the adoption of GASB 74 and 75 which we believe generally includes more conservative liability estimates than those under the prior reporting standards. While accounting standard changes increased the reported unfunded liability for some states, we believe they do not affect the actual underlying liability or cost pressures.

In addition, many states continue to severely underfund their OPEB liabilities, failing to make contributions that meet actuarially determined levels. In our opinion, underfunding continues to be prevalent in the state sector. Without action to either prefund OPEB liabilities or reduce benefits, OPEB liabilities will likely escalate, leading to higher future costs.

Chart 3

**Aggregate Net (Or Unfunded) OPEB Liability**
($ mils.)




Data reflects both most recent CAFR available and actuarial valuation. 2015 and 2016 are reported under prior GASB standards (GASB 43/45) and 2017 is reported under combined prior and current standards (states report under either GASB 43/45 or GASB 74/75).


**Changes To Accounting Standards And Assumptions Affect Reported Liabilities And Costs**

We believe that OPEB liabilities and costs are sensitive to underlying actuarial assumptions, so small changes to actuarial assumptions can have exponential effects on reported liabilities. We have seen this in our current survey as reported OPEB liabilities have significantly risen with new GASB rules that provide specific methodologies (such as the required use of the entry-age normal actuarial cost method) that we believe drive a more conservative liability estimate than those under the prior reporting standards.

Higher assumed medical costs or life expectancy could also increase liabilities across states. Therefore, most states offering OPEB benefits will likely see some trend of cost increase over the next few years. States currently assuming higher ultimate medical trend rates are taking a more conservative approach than those incorporating lower rates, in our opinion.

While the revised reporting standards have lent to a jump in the reported OPEB plan liabilities, we expect that states could report a one-time decline in their unfunded OPEB liabilities based on new disclosure of their proportionate share of the overall OPEB plan liability under GASB 75, similar to trends seen after the implementation of revised GASB 67 and 68 pension reporting standards a few years ago.

## OPEBs Remain Important To Credit Quality

Our analysis of OPEB liabilities is an important factor in a state's overall debt and liability profile and state credit quality. We assess a state's relative OPEB liability, proactive liability management, and flexibility to adjust benefits and plan offerings. We have seen many states demonstrate a legal and practical flexibility to reduce OPEB liabilities, and we expect this trend will continue.

In practical terms, however, alterations to benefits are not always straightforward. Adjustments to OPEB benefits can be subject to many challenges such as negotiations with unions, which have resisted reductions to benefits. Other reforms, such as Illinois' attempt to modify its OPEB obligations, were ultimately ruled unconstitutional. Also, state governments have managed a longstanding tradeoff between lower wages than many private sector positions, but stronger benefits. A reduction in benefits while maintaining lower wages could make it more difficult for states to retain skilled workers. For these reasons, many states have not taken further action to reduce benefits, and it is unlikely that operational constraints will subside in the near future.

We believe material improvement in funding long-term obligations requires a sustained effort. While changes to benefit offerings and increases in funding could mitigate the OPEB challenges many states face, successful reform comes from continuing commitment from state policymakers, potentially over many years.

## Survey Methodology

We derived our calculation of OPEB liabilities from the most recent state comprehensive annual financial report, benefit plan comprehensive annual financial report, and benefit plan actuarial reports currently available to us. In most cases, this corresponded with the 2017 fiscal year. We have combined multiple OPEB plans for each state into one combined funded figure. Our survey includes those OPEB plans that states disclose as a state obligation, although we use the combined OPEB for multiemployer plans when both state and local governments participate. Some states provide a state general fund contribution to local teacher OPEB plans, and for these we have also included teacher OPEB. In most cases, OPEBs of public university systems are not included, unless a state considers these a direct state responsibility or if they are not reported separately from the states' cost-sharing, multiple-employer plan.

Some states do not perform annual actuarial valuations or OPEB actuarial valuations as often as they perform pension system valuations. We have used the most recent OPEB valuations available; in most cases, these will be for 2017 and 2016, but for a few we have used 2015. In this survey, with some exceptions, we have used the same state OPEB plans that we included in our 2016 survey, validating comparisons we made with the OPEB amounts in that report.

### Survey findings include updated GASB accounting standards

According to our survey, 31 states include the majority of their retiree health care liability within plans that report under GASB 74 for postemployment benefit plans with irrevocable trusts (other than pension plans). This statement became effective for the 2017 fiscal year for most plans. States that continue to report under GASB Statement No. 43/45 likely do not have an asset profile that requires them to report under GASB 74.

GASB 75 related to accounting and financial reporting for postemployment benefits, for which employers will begin to report, takes effect for fiscal years that start after June 15, 2017. We expect that our survey next year will reflect reported unfunded OPEB liabilities for most states under the revised GASB 75 standards.

In our opinion, the revised GASB 74 and GASB 75 accounting standards significantly change how OPEB liabilities are accounted and reported in state (and local) governments' financial statements, but we do not anticipate significant rating changes due to the new reporting standards.

For additional information on reporting changes please see our Credit FAQ, "New GASB Statements 74 And 75 Provide Transparency For Assessing Budgetary Stress On U.S. State & Local Government OPEBs," published March 14, 2018.

## U.S. States' OPEB Liabilities And Ratios

**(Mil. $)**

| State | GASB 74 adoption?* | Net or unfunded OPEB liability | Total OPEB liability | Combined funded ratio all OPEB funds (%) | Net or unfunded OPEB liability per capita | Combined actuarial annual OPEB cost | Combined actual annual pmt | % annual actuarial cost paid | Valuation date |
|---|---|---|---|---|---|---|---|---|---|
| Alabama | Yes | 10,547 | 12,064 | 12.6 | 2,164 | 905 | 323 | 35.7 | 9/30/2016 |
| Alaska | Yes | 1,041 | 11,143 | 90.9 | 1,407 | 1,128 | 292 | 25.9 | 6/30/2016 |
| Arizona | Yes | 1,111 | 3,343 | 66.8 | 158 | 145 | 34 | 23.3 | 6/30/2017 |
| Arkansas | No | 2,164 | 2,164 | 0.0 | 720 | 177 | 63 | 35.6 | 7/1/2016 |
| California | Yes | 92,414 | 93,002 | 0.6 | 2,337 | 5,852 | 2,457 | 42.0 | 6/30/2017 |
| Colorado | Yes | 1,300 | 1,576 | 17.5 | 232 | 84 | 81 | 96.1 | 12/31/2017 |
| Connecticut | Yes | 20,861 | 21,467 | 2.8 | 5,814 | 1,210 | 687 | 56.8 | 6/30/2017 |
| Delaware | Yes | 8,256 | 8,611 | 4.1 | 8,582 | 543 | 239 | 44.0 | 7/1/2016 |
| Florida | No | 19,891 | 20,069 | 0.9 | 948 | 801 | 248 | 30.9 | 7/1/2016 |
| Georgia | Yes | 17,739 | 20,077 | 11.6 | 1,701 | 873 | 250 | 28.7 | 6/30/2016 |
| Hawaii | No | 7,833 | 8,024 | 2.4 | 5,487 | 699 | 610 | 87.3 | 7/1/2015 |
| Idaho | No | 44 | 44 | 0.0 | 26 | 9 | 5 | 53.2 | 7/1/2016 |
| Illinois | Yes | 41,324 | 41,324 | 0.0 | 3,228 | 2,617 | 337 | 12.9 | 6/30/2016 |
| Indiana | Yes | 502 | 660 | 23.9 | 75 | 36 | 36 | 98.9 | 6/30/2017 |
| Iowa | No | 192 | 192 | 0.0 | 61 | 24 | 11 | 44.7 | 7/1/2016 |
| Kansas | No | 0.2 | 0.2 | 0.0 | 0 | 1 | 6 | 750.6 | 6/30/2017 |
| Kentucky | Yes | 6,195 | 8,760 | 29.3 | 1,391 | 248 | 349 | 140.9 | 6/30/2016 |
| Louisiana | No | 4,681 | 4,681 | 0.0 | 999 | 15 | 4 | 24.2 | 7/1/2016 |
| Maine | Yes | 1,788 | 2,108 | 15.2 | 1,338 | 110 | 111 | 100.5 | 6/30/2016 |
| Maryland | Yes | 11,085 | 11,392 | 2.7 | 1,832 | 818 | 527 | 64.4 | 6/30/2016 |
| Massachusetts | Yes | 19,776 | 20,775 | 4.8 | 2,883 | 1,662 | 546 | 32.9 | 1/1/2017 |
| Michigan | Yes | 13,581 | 17,345 | 21.7 | 1,363 | 1,108 | 1,076 | 97.2 | 9/30/2016 |
| Minnesota | No | 617 | 617 | 0.0 | 111 | 71 | 33 | 46.4 | 7/1/2016 |
| Mississippi | No | 785 | 785 | 0.0 | 263 | 45 | 31 | 68.5 | 6/30/2017 |
| Missouri | Yes | 2,746 | 2,871 | 4.4 | 449 | 188 | 97 | 51.5 | 6/30/2017 |
| Montana | No | 458 | 458 | 0.0 | 436 | 47 | 13 | 26.6 | 1/1/2015 |
| Nebraska | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| Nevada | Yes | 1,509 | 1,511 | 0.1 | 503 | 38 | 38 | 100.0 | 7/1/2015 |
| New Hampshire | No | 2,740 | 2,780 | 7.9 | 2,041 | 221 | 109 | 49.4 | 12/31/2016 |
| New Jersey | Yes | 94,561 | 94,775 | 0.2 | 10,500 | 6,225 | 2,014 | 32.4 | 7/1/2016 |
| New Mexico | Yes | 4,532 | 5,111 | 11.3 | 2,170 | 318 | 159 | 50.2 | 6/30/2017 |
| New York | No | 87,257 | 87,257 | 0.0 | 4,396 | 4,429 | 1,756 | 39.6 | 4/1/2016 |
| North Carolina | Yes | 32,726 | 34,360 | 4.8 | 3,185 | 2,752 | 1,012 | 36.8 | 12/31/2016 |
| North Dakota | Yes | 91 | 209 | 56.3 | 121 | 12 | 13 | 106.8 | 6/30/2017 |

## U.S. States' OPEB Liabilities And Ratios (cont.)

**(Mil. $)**

| State | GASB 74 adoption?* | Net or unfunded OPEB liability | Total OPEB liability | Combined funded ratio all OPEB funds (%) | Net or unfunded OPEB liability per capita | Combined actuarial annual OPEB cost | Combined actual annual pmt | % annual actuarial cost paid | Valuation date |
|---|---|---|---|---|---|---|---|---|---|
| Ohio | Yes | 17,899 | 34,687 | 48.4 | 1,535 | 2,282 | 1,903 | 83.4 | 12/31/2017 |
| Oklahoma | No | 5 | 5 | 0.0 | 1 | 0 | 0 | 0.0 | 7/1/2017 |
| Oregon | Yes | 78 | 614 | 87.3 | 19 | 68 | 66 | 96.3 | 12/31/2016 |
| Pennsylvania | Yes | 27,568 | 27,944 | 1.3 | 2,153 | 1,555 | 833 | 53.6 | 1/1/2017 |
| Rhode Island | No | 643 | 770 | 16.5 | 607 | 53 | 53 | 100.0 | 6/30/2016 |
| South Carolina | Yes | 13,547 | 14,698 | 7.8 | 2,696 | 810 | 470 | 58.0 | 6/30/2016 |
| South Dakota | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| Tennessee | No | 1,380 | 1,380 | 0.0 | 206 | 134 | 79 | 58.5 | 7/1/2015 |
| Texas | Yes | 88,692 | 89,801 | 1.2 | 3,133 | 8,101 | 1,513 | 18.7 | 8/31/2017 |
| Utah | Yes | 112 | 379 | 70.3 | 36 | 30 | 35 | 114.5 | 12/31/2016 |
| Vermont | Yes | 2,394 | 2,390 | (0.2) | 3,839 | 117 | 57 | 48.9 | 6/30/2016 |
| Virginia | Yes | 5,214 | 7,299 | 28.6 | 616 | 437 | 225 | 51.5 | 6/30/2016 |
| Washington | No | 5,480 | 5,480 | 0.0 | 740 | 530 | 95 | 18.0 | 1/1/2017 |
| West Virginia | Yes | 2,459 | 3,283 | 25.1 | 1,354 | 225 | 205 | 91.4 | 6/30/2016 |
| Wisconsin | No | 942 | 942 | 0.0 | 163 | 79 | 38 | 48.3 | 1/1/2015 |
| Wyoming | Yes | 726 | 726 | 0.0 | 1,254 | 61 | 18 | 29.4 | 7/1/2016 |
| Total | | 677,487 | 729,952 | | 85,274 | | | | |
| Median | | 2,743 | 4,012 | | 1,296 | | | | |
| Average | | 14,114 | 15,207 | | 1,777 | | | | |

ICR--Issuer credit rating. *The data is noted as "Yes" only if the majority of the state's unfunded retiree health care liability is reported under GASB Statement No. 74. **Data only available for state plans reported under GASB Statement No. 74. Oklahoma does not report implicit subsidy of its retirement plan death and disability benefits as a separate unfunded OPEB. Nebraska and South Dakota do not report its other post employment benefits (OPEB) Florida also reports its state share of liabilities, but for consistency with other states, we have included the sum of total plans.

## Addendum: Alaska

In our former survey published in September 2017, Alaska's unfunded OPEB liability was $7.2 billion, or the highest in the nation on a per capita basis at $9,697. In this survey, the state's reported net OPEB liability per capita under revised GASB standards dropped dramatically to $1.0 billion or $1,407 per capita.

We believe the majority of Alaska's decline in unfunded liability stems from a significant increase to the discount rates used for Alaska's Public Employees Retirement System (PERS) and Teachers' Retirement System (TRS) in fiscal 2017. Under GASB 74, plans that project their fiduciary net position to be sufficient to make projected benefit payments are allowed to use a long-term expected rate or return on OPEB plan investments (instead of a specified index rate). In their fiscal 2017 plan CAFRS, PERS and TRS disclosed that they each made such a determination, assuming the plans follow the current funding policies. Therefore, each incorporated an 8.0% discount rate in their reporting (mirroring their defined benefit pension plans)--an increase from prior-year discount rates of 4.55% for PERS and 4.31% for TRS.

Unlike many other states, Alaska's OPEBs are constitutionally protected and the state has a track record of funding its OPEB liability on an actuarial basis. While Alaska maintains a relatively high OPEB funded ratio, due in part to this track record of pre-funding, we consider an 8.0% discount rate for pension and OPEB plans optimistic over the long-run and well above industry standard.

## Addendum: GASB 74

### GASB 74 Glossary

| Terminology | Definition | Related GASB 43 and 45 terminology |
|---|---|---|
| **Assets** | | |
| Plan fiduciary net position (PFNP) | The market/fair value of the OPEB plan's assets. Prior assumptions related to smoothing of assets are no longer included when calculating asset value. To the extent that the OPEB plan maintains a trust, this will increase asset volatility | Actuarial value of assets (AVA) |
| **Liabilities** | | |
| Total OPEB liability (TOL) | This is the estimated amount of future benefits that actuaries determine are due to work already completed by plan participants. Liabilities are calculated using the plan's assumed rate of return to the extent that plan assets are expected to be available to pay for benefits; otherwise, a blended discount rate is used. | Actuarial accrued liability (AAL) |
| **Unfunded liabilities** | | |
| Net OPEB liability (NOL) | The excess of TOL over PFNP. A negative value indicates a Net OPEB asset. | Unfunded actuarial accrued liability (UAAL) |
| **Funded level** | | |
| PFNP as a proportion of TOL | PFNP as a proportion of TOL represents the plan's GASB-funded ratio. | AVA as a proportion of AAL |

Zoya Alam provided research assistance.

## Related Research

- New GASB Statements 74 And 75 Provide Transparency For Assessing Budgetary Stress On U.S. State & Local Government OPEBs, March 14, 2018
- Proposed GASB Changes To OPEB Reporting Could Enhance Comparability But Reduce Information On Funding Progress, Nov. 17, 2014
- U.S. States Are Showing Their Age: How Demographics Are Affecting Economic Outlooks, Sept. 25, 2018

This report does not constitute a rating action.