Retiree Medical Benefits Generate Unique Cost Drivers And Risks For U.S. States

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Key Takeaways

- Other postemployment benefit (OPEB) plans offered by U.S. state governments have unique features that differentiate them from more clearly defined pension plans.
- A typical state OPEB plan provides health care coverage to retirees and dependents for life but reduces benefits at Medicare eligibility.
- The structure of a state OPEB plan's benefit offerings is important to credit quality given its budgetary effects.

Market discussion surrounding the risks for state governments offering other postemployment benefits (OPEBs) has amplified in recent years following consistent underfunding and a steep rise in reported liabilities. In S&P Global Ratings' view, this raises the question as to whether costs of providing these benefits will become unaffordable for state governments, if they are not already. Factors affecting the future of OPEB-related credit risk vary due to unique plan features that are not widely understood (compared to more clearly defined pension plans characteristics).

To better understand what risks might lie ahead for OPEBs, we believe it is essential to gain insight to the following questions:

PRIMARY CREDIT ANALYSTS

Jillian Legnos
Hartford
(1) 617-530-8243
jillian.legnos
@spglobal.com

Todd D Kanaster, ASA, FCA, MAAA
Centennial
+ 1 (303) 721 4490
Todd.Kanaster
@spglobal.com

SECONDARY CONTACTS

Carol H Spain
Chicago
(1) 312-233-7095
carol.spain
@spglobal.com

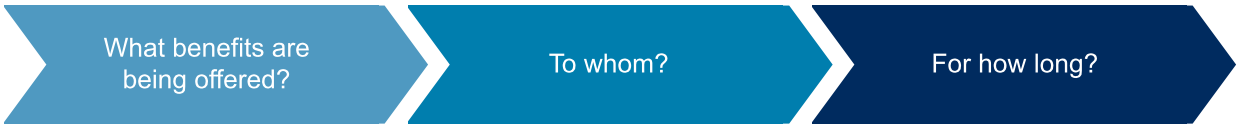
Sussan S Corson
New York
(1) 212-438-2014
sussan.corson
@spglobal.com

RESEARCH ASSISTANTS

Valentina Protasenko
Centennial

Sabrina J Rivers
New York

See complete contact list at end of article.



The answers to these questions drive the scale of the liability and have far reaching implications for the risks borne by states and therefore state creditworthiness.

S&P Global Ratings provides insight into these topics and summarizes findings of its related survey. Specifically, we surveyed 48 OPEB plans offered by state governments--the largest plan within each state--as measured by net OPEB liability (NOL). Two states (Kansas and South Dakota) do not report a liability for retiree medical benefits.

Key Survey Results: The Profile of A Typical State OPEB Plan

According to our survey, a typical state OPEB plan offers an explicit health care subsidy (as a percentage of premium or dollar-specified stipend), which includes spouse and family coverage. Benefits are reduced--but not ceased--following Medicare eligibility.

What Benefits Do OPEB Plans Provide?

Typically, the greatest benefit provided by a state government's OPEB plan is coverage of retiree health care costs. Some plans might provide alternative benefits (for example, coverage for dental, vision, long-term disability, death), but these are usually offered on a much smaller scale. Here, we focus on OPEB plans providing retiree medical benefits.

Are there limits to coverage?

Compared to relatively straightforward stipends that many pension plans offer, most OPEB plans are defined as providing health care coverage, a relatively nebulous and open-ended concept. Therefore, the scope of risks for OPEB plans is wider and more complex. While pension plans incorporate market and other demographic risks, OPEB plans are exposed to health care costs that are rising faster than inflation and are harder to predict in part due to a lack of uniform disclosures of specific benefits they cover. In addition, health care claims are inherently volatile and difficult to predict.

Explicit versus implicit subsidies: What's the difference?

Adding to the complexity, the employer's subsidy for the cost of coverage-based benefits for retiree health care can be categorized as explicit or implicit, both of which are real reported liabilities for the employer.

An explicit subsidy exists when an employer pays for all or a defined portion of a retiree's health care costs. For example, The employer pledges a certain dollar amount per month, or a certain percentage of monthly claims.

An implicit subsidy exists any time premiums paid by plan members are less than the cost of their expected claims. This is most typically expressed as retirees being allowed to join the active employee plan while paying the same premium as active employees.

An implicit subsidy is so named due to the implication that retirees have higher medical costs than younger active participants. Since the cost of funding a retiree's medical care is typically higher than the cost of funding a younger active participant, the difference-- the cost of higher care for the retired group that is not captured by premium payments sized for the active population-- is implicitly subsidized by either active participants or the employer.

Three scenarios illustrate how these implicit employer subsidies might work in practice (see charts 1 to 3):

- Scenario 1: Both active members and retirees pay premiums equal to their expected costs. Members support their own costs.
- Scenario 2: Retirees pay premiums at the same level as the active members. Since it's expected that retiree claims would be more costly than active member' claims, the employer picks up the disproportionately sized premium cost as an implicit subsidy reported as a liability under Governmental Accounting Standards Board (GASB) standards.
- Scenario 3: An implicit subsidy exists (as in scenario two); however, the premiums both active members and retirees pay are slightly higher to lessen the employer's cost burden. This increase to the active premiums is typically small since there are many more actives than retirees receiving health benefits and the reported liability for this implicit subsidy is reduced only incrementally under GASB. However, if active premiums significantly increase, there is a risk that active members will withdraw from the plan, further increasing premiums, and possibly leading to a spiraling effect that diminishes the value of the plan to retirees.

An implicit subsidy exists any time premiums paid by plan members are less than the cost of their expected claims.

Chart 1

Scenario 1: No Implicit Subsidy
(Premiums equal expected claims)

Chart 2

Scenario 2: Implicit Subsidy A
(Retirees pay the same premium as actives and the employer covers the excess retiree costs)

Chart 3

Scenario 3: Implicit Subsidy B
(Retirees pay the same premium as actives and the partipants cover the excess retiree costs)

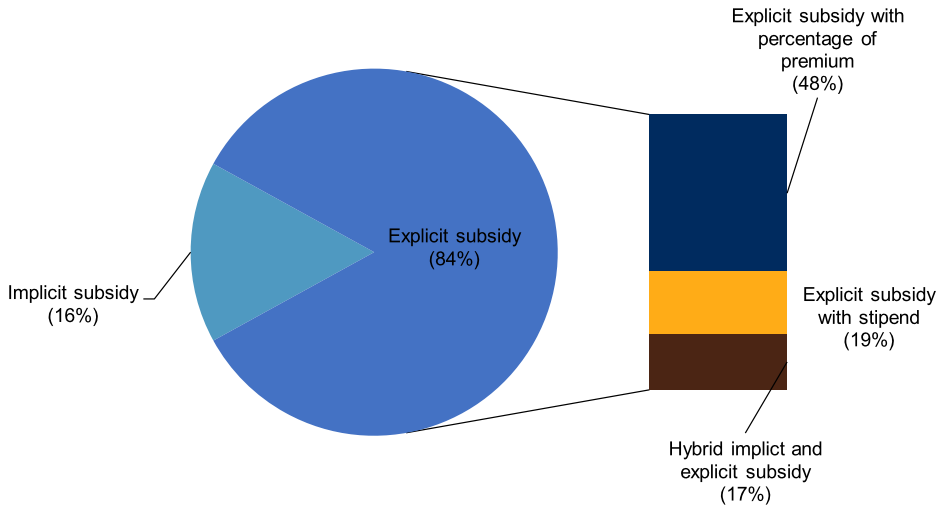
Survey results

While state OPEB plans may be defined as explicit, implicit, or even both, our survey found that nearly three-quarters of states offer an explicit subsidy for their largest OPEB plan. For these plans, states are directly paying all or a portion of the health care costs for plan members and/or dependents. Diving deeper, only 19% of plans impose caps on their explicit subsidies meaning most state OPEB plans are subject to increasing costs due to rising medical costs.

In the long term, we believe it is likely that states that choose to address their unfunded OPEB liabilities by altering benefits will likely consider transitioning from offering broad health care coverage to a pension-like stipend dedicated to health care in an effort to curb their exposure to increasing and volatile health care costs.

Chart 4

Type Of Subsidies



Note: Data are based on 48 states; Kansas and South Dakota do not report a liability for retiree medical benefits.

To Whom Are Benefits Paid?

Are benefits paid to spouses and dependents?

Unlike pension plans, many retiree health care plans offer spousal benefits concurrent with

employee benefits. (Children may also be covered, typically to age 26, but this is generally immaterial to an OPEB plan.)

Spousal benefits for OPEB plans have effectively twice the cost impact as spousal benefits offered in most pension plans. For pension plans, the spousal benefit is typically only paid after the employee is deceased, as a continuation of the annuity, and the cost could be comparatively insubstantial. For OPEB plans, health benefits are paid concurrently and effectively double the cost of a health benefit paid to the employee.

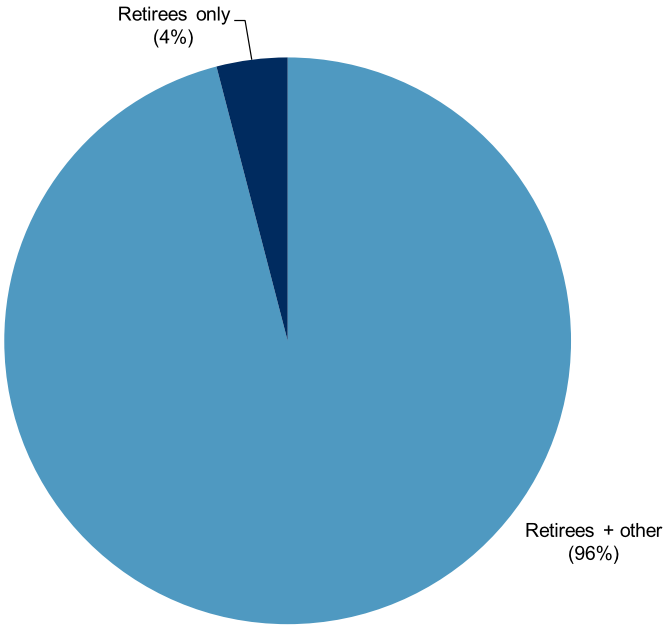
In addition to spousal and/or dependent coverage that runs concurrent to retiree benefits, coverage may extend beyond death of the retiree. We believe states could potentially realize cost savings if spouses chose coverage elsewhere, given that they are likely able to obtain coverage outside of the state-sponsored plan. Another possibility for cost saving is a family stipend that would limit risk to the state while still providing coverage to spouses and/or dependents.

Survey results

According to our survey, nearly all of the states' largest OPEB plans extend benefits to spouses and/or dependents of eligible retirees.

Chart 5

Type Of Participants



Note: The data are for 48 states; Kansas and South Dakota do not report a liability for retiree medical benefits.

How attractive do retirees find OPEB plans?

One can assume that the risk governments will incur from OPEBs will only be realized if employees find a plan's benefits attractive enough to enroll. Since plans may differ in benefits offered, one way to compare an OPEB plan's perceived generosity is to look at the participation assumption. Generally, the higher the plan's assumed participation rate the more likely the plan offers generous benefits coverage.

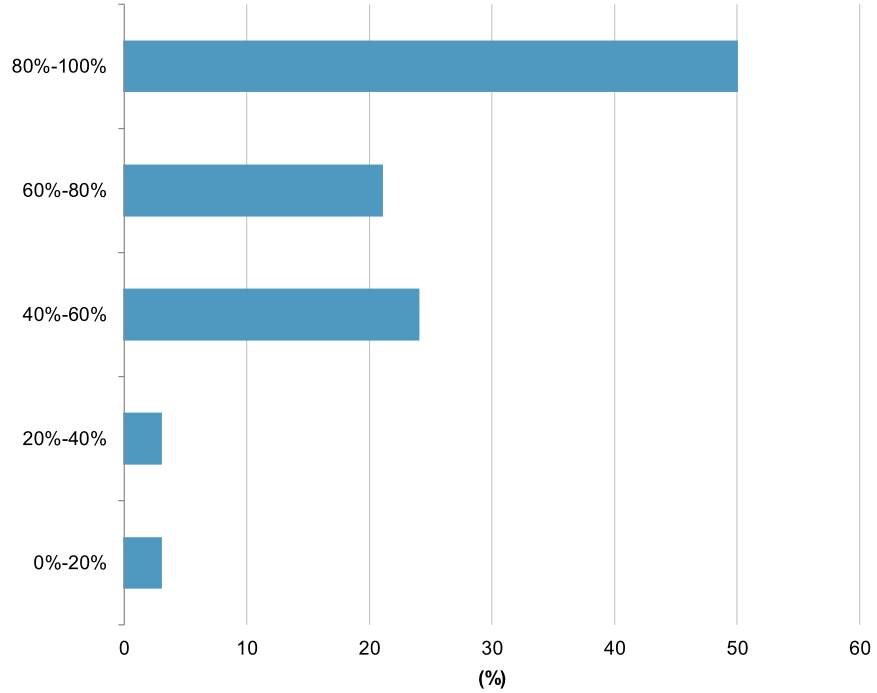
Survey results

Based on the above assumption, we interpreted that most surveyed state plans (for which data is publically available) are currently attractive to participants, with approximately half of the plans assuming 80%-100% participation. Just under 90% of the plans assumed at least half of their members would participate.

However, our survey also found that many OPEB plans expect participation to decline over time. Several report participation based on a range of years of service or age; these plans generally assume workers that are younger today will have a much lower participation rate at retirement. For some plans, the participation rate for this group is reported as low as about 20%. In our view, plans are already forecasting their benefit offerings to become less attractive over time. This aligns with a legal framework for OPEBs in many states that allows for reduction in benefits. For more information, see "OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility," published May 22, 2019, on RatingsDirect.

Chart 6

Participation Assumptions



Data are based on 34 states. Public participation data was unavailable for 14 states. Kansas and South Dakota do not report a liability for retiree medical benefits.

How Long Do OPEB Plans Provide Health Care Coverage?

While pension benefits are typically payable for a participant's lifetime, OPEB plans usually have the legal flexibility to end coverage when participants become eligible for Medicare (age 65). Plans that end at age 65 are referred to as "Medicare bridge benefit" plans since their retiree health care coverage acts as a bridge between active health care and coverage from the federal Medicare program.

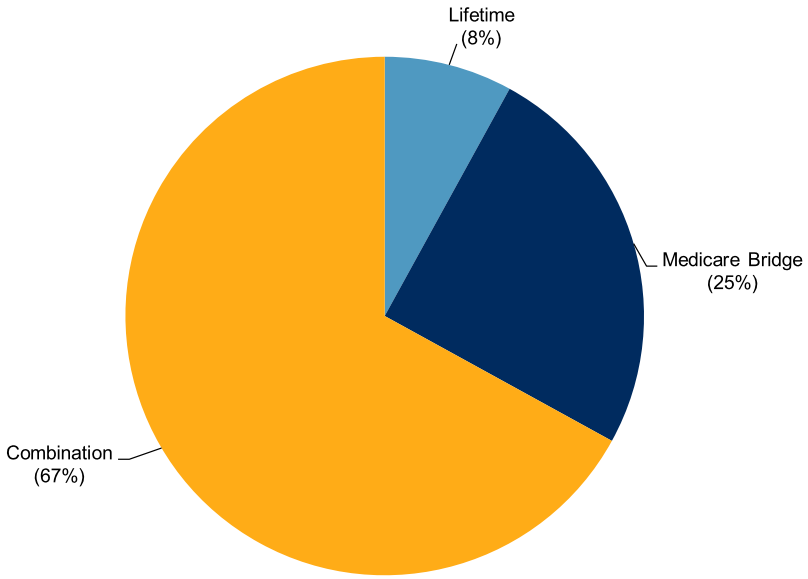
Due to the high correlation between age and medical costs, these bridge plans are typically much cheaper for employers than lifetime benefit plans that not only cover participants for a longer period but eventually cover participants during their most costly years.

Survey results

Our survey found that relatively few state OPEB plans are strictly at either end of the spectrum--either continuing full benefit coverage past Medicare eligibility or revoking benefits at that point altogether. Almost 70% of plans offer some combination of these options, with a reduction in benefits at Medicare eligibility. In our view, more state governments will likely shift benefits to Medicare in the future in an effort to reduce their own cost burdens.

Chart 7

Longevity Of Benefits



Note: Data are on 48 states; Kansas and South Dakota do not report a liability for retiree medical benefits.

A unique risk is introduced to plans that shift all or a portion of retiree health care benefits to the federal government through its Medicare program. Even relatively minor changes to Medicare, such as raising the age for eligibility, could materially affect these OPEB plans. More significant changes to Medicare are less likely in the medium term but could upend the current program entirely.

How A Plan's Structure Affects State Creditworthiness

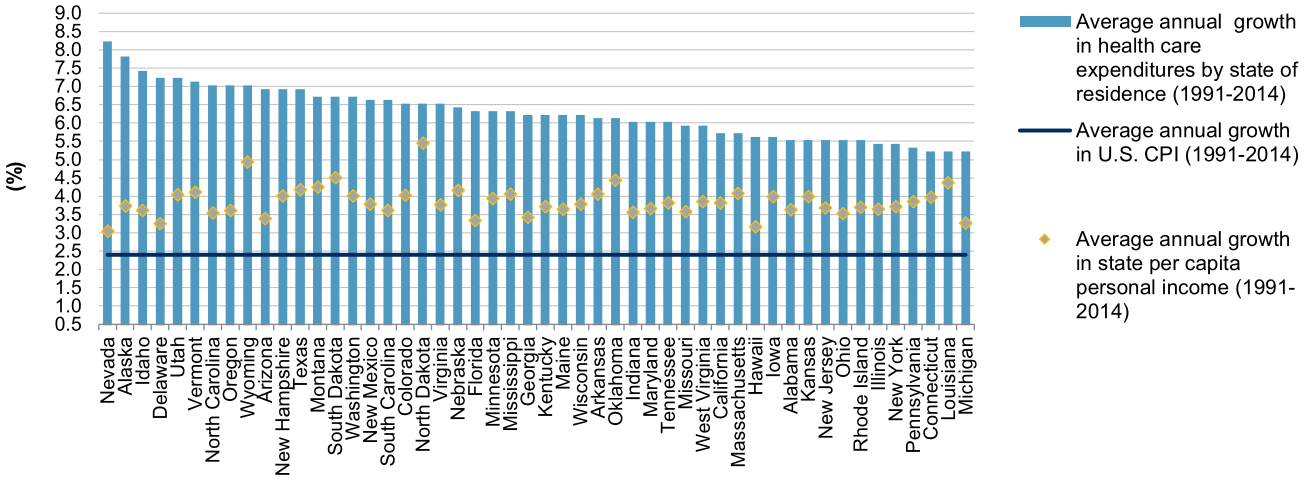
S&P Global Ratings believes the structure of benefits within an OPEB plan can introduce a state government to certain volatility not always present with other types of long-term liabilities. Our survey found that half of the states are exposed to volatile health care costs through their retiree benefit offerings. Furthermore, most plans are structured to be financed on a pay-as-you-go basis, which does not make progress toward reducing the NOL over time. While typically a state's unfunded liability is smaller in scale for OPEBs than for pensions, there are outliers in which a state's NOL is larger than its net pension liability (for example, Delaware and New York). For these states, consideration for management of the NOL is especially relevant.

According to our survey, half of the states' largest OPEB plans provide benefits based on a percentage of premium claims--the state's cost depends on how much its retirees are charged for medical insurance, which in turn, depends in part on the overall cost of health care services.

Historically, growth in health care costs have outpaced growth in both income and inflation (see chart 8) and we expect this trend to continue. In the 23 years from 1991 to 2014, average annual growth in health care expenditures (at 6.3%) was 2.6x higher than average annual growth in the U.S. CPI (at 2.4%) and 1.6x higher than average annual growth in states' per capita personal income (at 3.9%).

Chart 8

Growth In Health Care Expenditures Compared To Personal Income Per Capita And CPI (1991-2014)



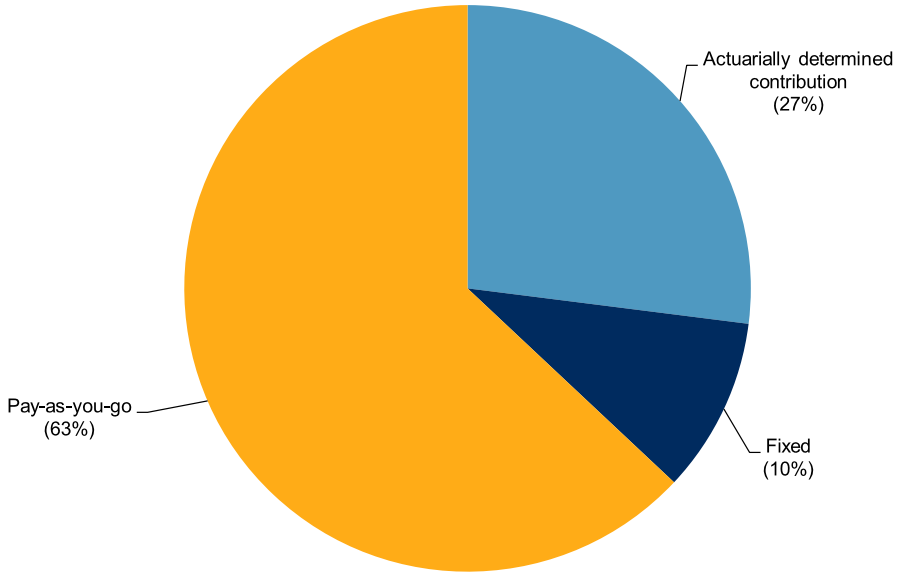
Sources: The Henry J. Kaiser Family Foundation "Average Annual Percent Growth in Health Care Expenditures by State of Residence" Timeframe: 1991-2014. Bureau of Labor Statistics "Historical Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, all items, index averages." Bureau of Economic Analysis "SAINC1 Personal Income Summary: Personal Income, Population, Per Capita Personal Income."

Chart 8 shows that income growth in five states (Alaska, Arizona, Delaware, Idaho, and Nevada) is less than half of the growth in health care expenditures. For these states, residents' health care costs are growing more than twice as fast than their income available to pay for it. Conversely, income growth for several oil states (North Dakota, Wyoming, and Louisiana) ranks closer to growth in health care expenditures for the 23-year period referenced in the chart.

The pace of medical expenditure growth is important to state governments, which must absorb these increases into their budgets indirectly through funding for their OPEB plans. Furthermore, more than half the states are using pay-as-you-go funding, which doesn't incorporate the true cost of unfunded OPEB liabilities. Other factors, including length of coverage and concurrent offering for dependents, also present budgetary implications.

Chart 9

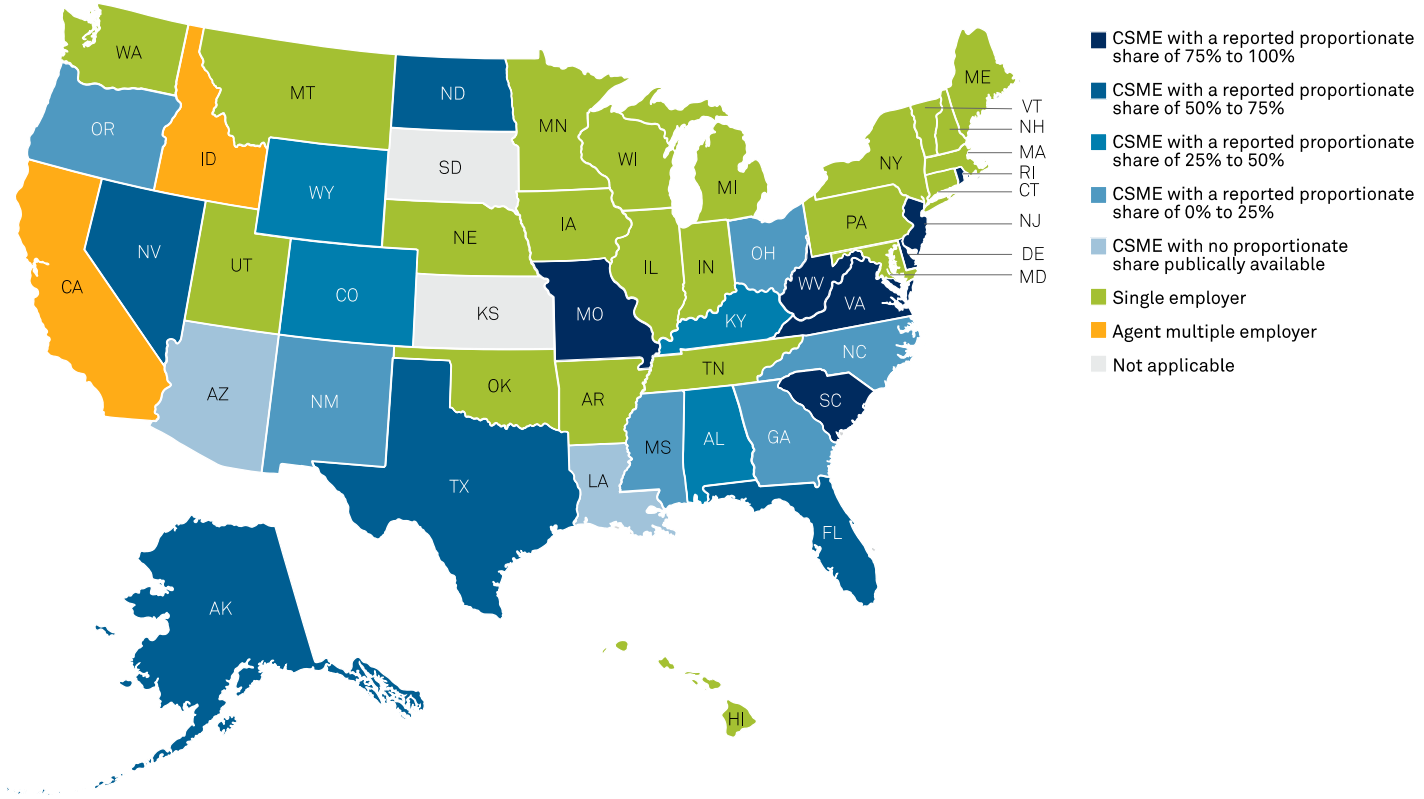
Type Of Funding Method



Note: Data are based on 48 states; Kansas and South Dakota do not report a liability for retiree medical benefits.

With the onset of GASB 75, states now report their proportionate share of their OPEB plan's liability. For some, this has caused a significant reduction of the reported liability of their largest plans. About half of the cost-sharing multiple-employer plans report that the state is responsible for less than 50% of the reported liability.

OPEB Benefits - Plan Type



The map above is based on data for 48 states. Kansas and South Dakota do not report a liability for retiree medical benefits.
Proportionate shares were not publically available for Arizona and Louisiana's cost sharing multiple employer plans surveyed. CSME--Cost sharing multiple employer.
Source: S&P Global Ratings.

How State OPEB Plans Are Structured Will Remain Important

Looking ahead, the structure of state OPEB plans--which benefits are being offered to whom and for how long--will remain important given their budgetary effects. While a plan that cuts benefits becomes more affordable for state governments, we believe that many states--in part for political factors--will choose to pursue a combination of benefit modifications and pre-funding of the liability. S&P Global Ratings believes progress in addressing unfunded OPEB liabilities, by either means, could reduce credit risk to state governments.

Survey Methodology

We surveyed the largest OPEB plans within each state, as measured by NOL. Only plans that offer retiree health care coverage were considered; we did not incorporate plans that do not offer medical benefits (such as plans that only offer death or disability benefits). 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.

Our data were taken from the most recent state comprehensive annual financial reports (CAFRs), benefit plan CAFRs, and benefit plan actuarial reports currently available to us. In most cases, this corresponded with the 2018 fiscal year.

Some states do not perform annual actuarial valuations or OPEB actuarial valuations as often as they perform pension system valuations. We have referenced the most recent OPEB valuations available; in most cases, these will be for 2018 and 2017, but for a few we have used 2016.

Specifically, we gathered data for each state except for Kansas and South Dakota that do not report a liability for retiree medical benefits. Due to non-uniform disclosures of the information surveyed, we made certain assumptions based on the information available.

Related Research

OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility, May 22, 2019

This report does not constitute a rating action.

Contact List

PRIMARY CREDIT ANALYST

Jillian Legnos
Hartford
(1) 617-530-8243
jillian.legnos@spglobal.com

PRIMARY CREDIT ANALYST

Todd D Kanaster, ASA, FCA, MAAA
Centennial
+ 1 (303) 721 4490
Todd.Kanaster@spglobal.com

SECONDARY CONTACT

Carol H Spain
Chicago
(1) 312-233-7095
carol.spain@spglobal.com

SECONDARY CONTACT

Sussan S Corson
New York
(1) 212-438-2014
sussan.corson@spglobal.com

RESEARCH ASSISTANT

Valentina Protasenko
Centennial

RESEARCH ASSISTANT

Sabrina J Rivers
New York

RESEARCH ASSISTANT

Vikram A Sawant
Mumbai