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U.S. States Are Slow To Reform OPEBs As Decline In Liabilities Masks Increased Risk

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Key Takaways

- Reported total unfunded retiree health care liabilities for U.S. states fell by 7.3% in fiscal 2018 to $628 billion; however, we expect that unfunded liabilities will likely escalate in the future if meaningful funding progress or benefit reductions are not implemented.
- Funded ratios remain low and are not projected to materially improve given persistent underfunding and minimal pursuit of plan modifications.
- OPEBs are a growing risk for states' credit quality and require fiscal prudence to control higher future costs.

U.S. states continue to severely underfund their other postemployment benefit (OPEB) plans. S&P Global Ratings' latest survey found that for most states, annual plan contributions do not keep up with growth in liabilities. Given the degree of underfunding, unfunded OPEB liabilities will likely escalate absent meaningful reform.

However, most states have not recently pursued reform efforts. Because the size of these unfunded liabilities varies greatly among states, progress toward reducing them is more pressing for some than others. S&P Global Ratings believes it crucial for states to prudently manage plan fiscal health ahead of a tipping point where rising OPEB costs lead to budgetary stress.

Despite contributions that generally fall short of growth in liabilities, S&P Global Ratings' most recent survey data also indicates that total net OPEB liabilities for states fell by 7.3% in fiscal 2018. This drop occurred primarily due to an increase in the discount rate used to measure OPEB liabilities rather than improved funding or OPEB reforms. Generally, state plans have applied a discount rate based on a municipal bond rate due to a general lack of interest earning assets and Governmental Accounting Standards Board (GASB) methodology.

Our survey results show that, on the whole, states have not taken significant action to keep their unfunded OPEB liabilities from rising as contributions to most OPEB plans fail to cover new benefits earned during the year and interest accrued on the unfunded liability. States are even further away from making progress to reduce these unfunded liabilities. The already poor funded status of OPEBs will decline even more, as unfunded liabilities grow, unless effort is made to pre-fund or reduce these liabilities.

Liabilities Are Likely To Grow As Nearly All States Fail To Meet Even Static Funding Levels

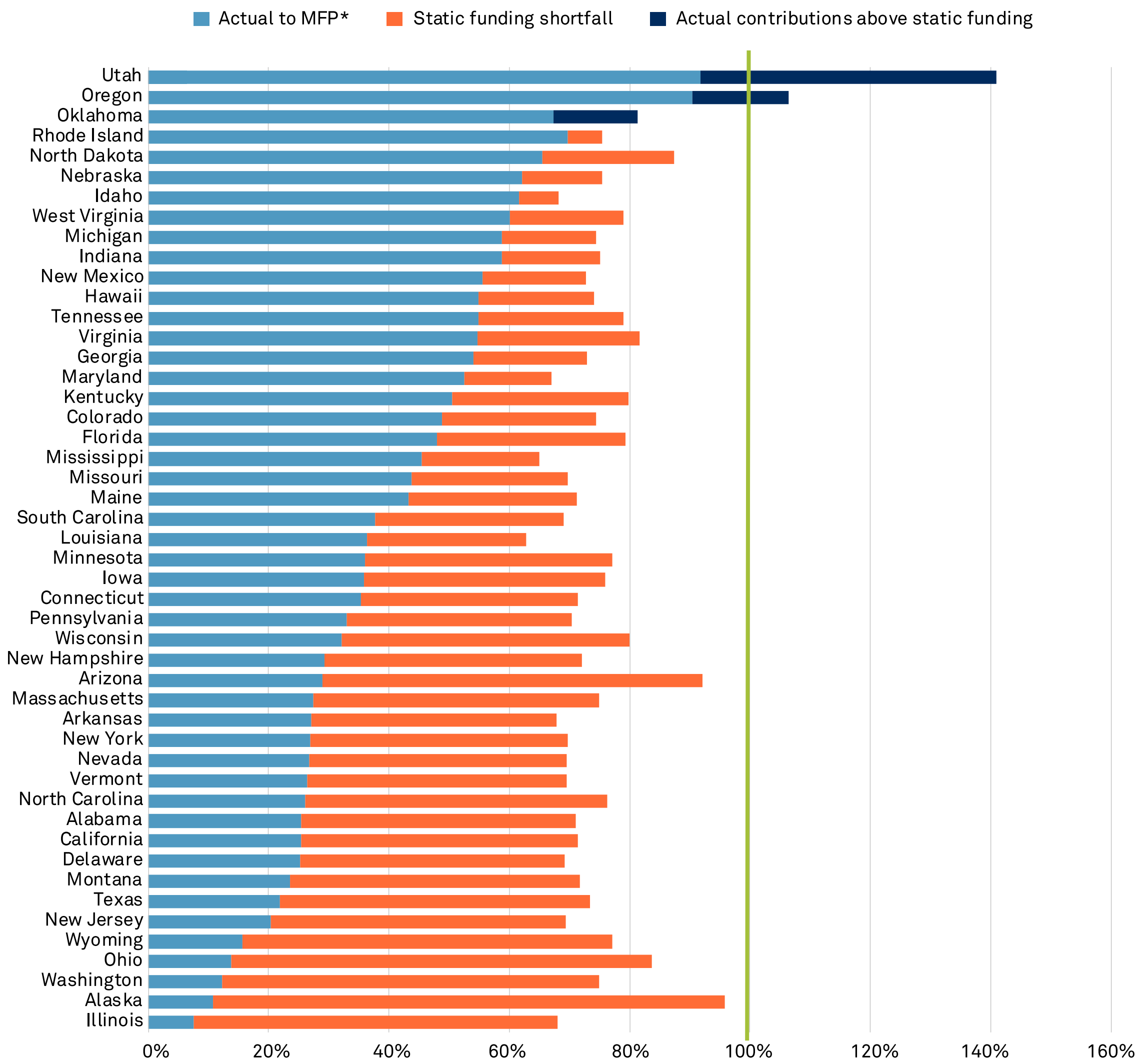
Consistent with years past, most states continue to fund their OPEB liabilities on a pay-as-you-go (paygo) basis in which annual funding is equal to the benefits distributed. In this funding strategy, assets are not set aside in advance to pay benefits in the future.

Our survey found that combined annual plan contributions do not cover new benefits earned during the year and interest accrued on the unfunded portion of the liability for 45 of 48 states surveyed. Kansas and South Dakota do not report liability for retiree health care benefits. By not meeting static funding levels, these states will likely report escalating unfunded OPEB liabilities in future years if reform efforts are not implemented.

Chart 1 illustrates these results by comparing total annual plan contributions to certain costs causing the annual change in the net OPEB liability (NOL). Of the three states that reached static funding levels, only two met our minimum funding progress guideline--a metric we use to evaluate if the most recent year's contributions are adequate for reaching 100% funding within a reasonable time. We believe there is some minimum amount of funding progress if annual plan contributions cover service cost (the value of benefits earned by participants in the year), a portion of the annual total interest cost related to pension liabilities unmatched by plan assets, and 1/30 of the beginning-of-year net plan liability (see Survey Methodology below).

Chart 1

State Plan Aggregate Actual Contribution Funding Progress



MFP—Minimum funding progress. *For plans that did not disclose schedule of changes to fiduciary net position, we typically counted benefit payments less administrative expenses as contributions, when disclosed. Kansas and South Dakota do not report liability for retiree health care benefits. Source: S&P Global Ratings.

Chart 1 shows contributions for three states' combined OPEB plans met static funding and two met minimum funding progress guidelines. These results are in stark contrast to funding for state pension plans where total annual plan contributions for 40% of state plans met static funding and 16% of plans met minimum funding progress. In our view, the strict legal requirements for funding many pension plans, which do not exist for most OPEB plans, are largely responsible for this funding differential.

Meeting static funding might still demonstrate weak funding practices if contributions fail to make measureable progress on reducing the unfunded liability. On the whole, we believe the continued lack of funding OPEBs indicates poor plan management that exposes state governments to rising unfunded liabilities, fixed costs, and budgetary pressure over time.

Funded Ratios Remain Low For Most States Given Sectorwide Underfunding

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. However, many of these trust funds do not hold a significant level of assets compared to plan liabilities.

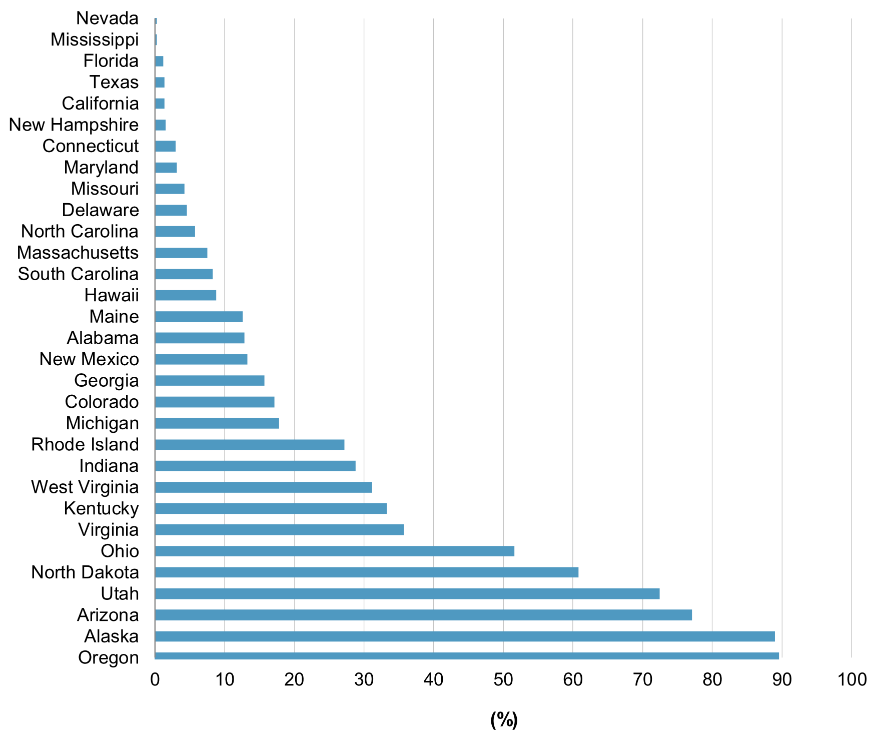
Funded ratios remain low for most states overall, with notable exceptions. Three states have funded ratios above 75%: Oregon (89.4%), Alaska (88.8%), and Arizona (77.0%). Conversely, 17 states have not accumulated any assets to pre-fund their OPEB liabilities.

Funded ratios are expected to remain low in the medium term.

We expect funded ratios to continue to remain low in the medium term given the sector's persistent underfunding.

Chart 2

Combined Funded Ratio For OPEB Funds*



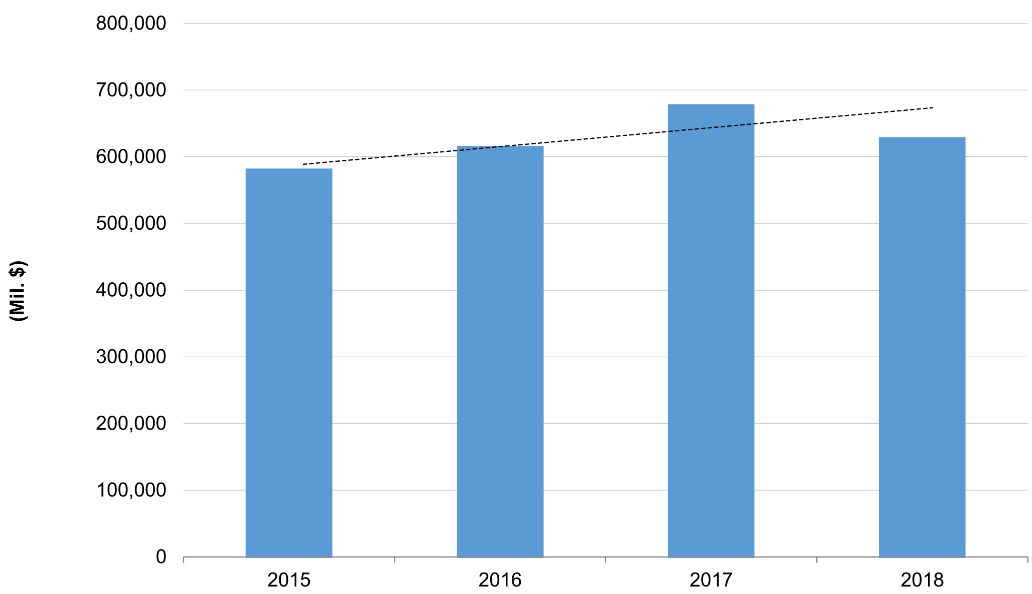
*States without accumulated assets have been excluded from the chart. Kansas and South Dakota do not report liability for retiree health care benefits.

Decline In Liabilities Is Not Driven By Improved Plan Fundamentals

Our survey found that aggregate reported retiree health care liabilities dropped slightly across the states. However, we do not believe this decline generally is evidence of fundamental improvement in plan positions. We believe the reduction mainly corresponds to increases to the discount rate across plans, which reduced reported liabilities. S&P Global Ratings believes that in the near term a lower unfunded liability should mean lower annual funding requirements. However, the bond rate might be volatile from year to year and the unfunded liability for many state plans remains large. We view the increase in the discount rate in 2018 as being within reasonable volatility expectations, so we don't consider it to be a fundamental change in the funded status of the plans.

Chart 3

Aggregate Net (Or Unfunded) OPEB Liability



Data reflect both most recent comprehensive annual financial report available and actuarial valuation. The years 2015 and 2016 are reported under prior Governmental Accounting Standards Board (GASB) standards (GASB 43/45) and 2017 is reported under combed prior and current standards (states reported under either GASB 43/45 or GASB 74/75).

In addition, 16 states that reported under GASB 43/45 standards in our previous survey are now reporting under GASB 75 in the current survey. Of these, just over half reported a decline in liabilities and just under half reported an increase in liabilities compared with our previous survey. However, the level of reported declines was 5.1x greater than the reported increases. Driving this scale was a significant decrease to New York's OPEB liabilities since our last survey. The reduction is largely due to adoption of the updated accounting standards and an updated discount rate. While the state set up a trust fund for OPEBs in the fiscal 2018 enacted budget, the trust has not been funded.

Lastly, reported unfunded liabilities for some OPEB plans holding assets could have benefited from strong investment performance through most of 2018, particularly for plans that do not report at the end of the calendar year. However, we believe market effect is slight for most OPEB plans given minimal assets across the sector.

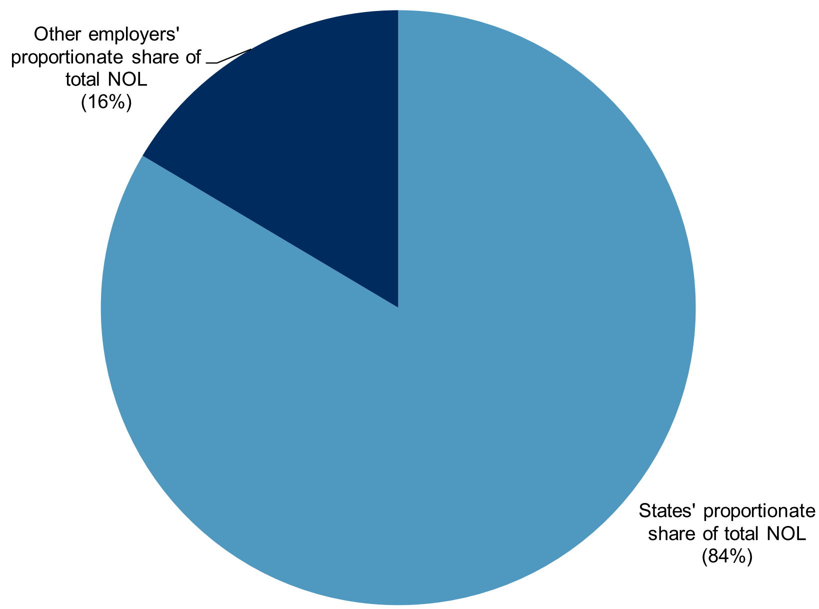
States Report Responsibility For The Majority Of Net Plan Liabilities

More than half the states surveyed participate in at least one cost-sharing, multiple-employer plan, for which GASB 75 requires the disclosure of a state's proportionate share (funding responsibility). For some, this has caused a significant reduction of the reported liability of their largest plans.

Across all state OPEB plans, our survey found aggregate combined state NOL is 16% reduced when accounting for the newly disclosed proportionate share information. Chart 4 illustrates the breakout of responsibility between states and other employers.

Chart 4

Cost-Sharing Between State Governments And Other Employers



NOL--Net OPEB liability.

Understanding Plan Benefit Structure Is Key To Grasping The Credit Story

We believe the structure of state OPEB plans--which benefits are being offered to whom and for how long--is important to understand given their budgetary effects. A typical state OPEB plan:

- Offers an explicit health care subsidy;
- Provides coverage to spouses and family alongside employee benefits; and

- Reduces--but does not eliminate--benefits following Medicare eligibility.

Notably, many retiree medical plans are exposed to escalating health care costs by the way their benefits are structured (for example, many explicit subsidy plans pay for a percentage of insurance premiums), which creates a unique budgetary challenge. Over the past two decades, health care costs have increased by an average of more than 6%, which is approximately 4% faster than inflation. If this trend continues, growth in health care costs will double in 12 years and rise, as a percent of state budgets, by 60% (assuming all else is equal). Some state OPEB plans cap their benefits at a certain dollar level per month; these plans have limited exposure to medical cost growth, though like pensions, risks other risks remain.

In addition, offering spousal and family coverage concurrent to employee benefits effectively doubles the cost of the health benefit paid to the employee.

As budgetary costs creep upward, they will represent an increasing share of state budgets. If a state already faces high fixed costs, these increases could further diminish budgetary flexibility. Because states generally have a legal claim to modify OPEBs, they could have several options to address these rising costs if they become unaffordable. However, waiting until costs become unaffordable to take action is not fiscally prudent, in our view, especially given practical limitations to plan adjustments.

Waiting until OPEB costs become unaffordable before taking action is not fiscally prudent, especially given practical limitations to plan adjustments.

For more information on benefits offered by state OPEB plans, please see "Retiree Medical Benefits Generate Unique Cost Drivers And Risks For U.S. States ," published Sept. 17, 2019.

Lack Of Prudent Fiscal Management Poses The Greatest Risk To State OPEB Plans

Historically, prudent fiscal plan management has included pre-funding the liability and/or reducing or capping benefit levels to a level projected to be affordable (within the legal confines of the state). S&P Global Ratings believes state efforts to address OPEB liabilities have been somewhat minimal in recent years. Some notable exceptions include: Delaware's re-establishment of a retirement benefit study committee to assess options to address the state's unfunded liabilities (although any potential action is currently unknown), North Carolina's budget for fiscal 2018 that eliminated retiree health care for new hires beginning in 2021, and Tennessee's contributions are expected to fully fund actuarial determination.

Ultimately, our OPEB risk assessment focuses on the relative level of unfunded OPEB liability compared to other states, the legal and practical flexibility that a state has to adjust these liabilities, and the overall strategy to manage the cost of these benefits, which will affect future contribution rates and budgetary requirements.

While most states currently lack concrete plans to address their OPEB liabilities, we believe many will eventually attempt to address these liabilities through a combination of benefit modifications and pre-funding of the liability. But 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. Reduction in benefits while maintaining lower wages could make it more difficult for states to attract and retain skilled workers. For these reasons, many states have not taken further action to reduce benefits. For more information on legal flexibility for OPEB plans, see "OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility ," published May 22, 2019.

S&P Global Ratings believes progress in addressing unfunded OPEB liabilities, by either pre-funding or modifying benefits, could reduce state governments' credit risk. Ultimately, we believe material improvement in funding long-term obligations requires a sustained effort. While changes to benefit offerings and increases in funding could mitigate rising annual OPEB costs, which could challenge future budgets for some states, successful reform comes from continuing commitment from policymakers, potentially over many years.

Survey Methodology

We derived our calculation of OPEB liabilities from the most recent state comprehensive annual financial report (CAFR), benefit plan CAFR, and benefit plan actuarial report currently available to us. In most cases, this corresponded with the 2018 fiscal year. Some states do not perform actuarial valuations for OPEBs as often as they do for pensions. In most cases, the valuations incorporated will be for 2018 and 2017, but for a few we have used 2016.

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. We use the combined OPEB for multiple-employer plans when both state and local governments participate but we also disclose the state's combined NOL in our publishing table below, which incorporates the state's reported proportionate share of the unfunded liability. For cost-sharing, multiple-employer plans where the state's proportionate share was not publically available, we assumed the state has sole responsibility for the liability. Some states provide a general fund contribution to local teacher OPEB plans, and for these we have also included teacher OPEB. In most cases, we have not included public university systems' OPEBs, unless a state considers these a direct state responsibility or if they are not reported separately from the state's cost-sharing, multiple-employer plan.

In this survey we have used the same state OPEB plans that we included in our 2017 survey (with some exceptions), validating comparisons we made with the OPEB amounts in that report.

Chart 1 uses the following calculation across all state plans to estimate annual plan funding progress: Total employer and employee plan contributions ÷ the sum of service cost + total interest cost x (1 - average plan funded ratio) + (beginning plan NPL ÷ 30). (See "U.S. State Rating Methodology," published Oct. 17, 2016, paragraph 71, table 27, and glossary.) If the aggregate beginning unfunded OPEB liability across plans is negative, beginning plan NPL ÷ 30 would be treated as zero. Likewise, for funded ratios at or above 100% in fiscal 2018, the interest cost factor would be zero.

U.S. States' OPEB Liabilities And Ratios

State	Combined plan total OPEB liability (mil. $)	Combined plan fiduciary net position (FNP) (mil. $)	Combined plan net OPEB liability (NOL) (mil. $)	Combined plan NOL per capita	State's proportionate share of combined plan NOL (mil $)*	State's proportionate share of combined plan NOL per capita	Combined plan funded ratio (%)	Combined plan total contributions as a % of static funding§	Combined plan total contributions as a % of minimum funding progress†
Alabama	12,737	1,613	11,124	2,276	5,391	1,103	12.7	35.9	25.5
Alaska	11,837	10,512	1,325	1,796	514	697	88.8	11.2	10.7
Arizona	3,016	2,322	694	97	694	97	77.0	31.4	28.9
Arkansas	2,184	0	2,184	725	2,184	725	0.0	40.0	27.2
California	88,269	1,090	87,179	2,204	87,179	2,204	1.2	35.5	25.4
Colorado	1,640	279	1,361	239	459	81	17.0	65.6	48.8
Connecticut	21,445	606	20,838	5,833	20,838	5,833	2.8	49.6	35.4
Delaware	8,592	382	8,210	8,489	7,422	7,674	4.4	36.5	25.3
Florida	21,628	232	12,197	573	9,445	443	1.1	60.5	48.0
Georgia	17,829	2,775	15,055	1,431	2,227	212	15.6	74.0	54.0
Hawaii	10,194	880	9,314	6,557	9,314	6,557	8.6	74.0	54.9
Idaho	100	0	100	57	100	57	0.0	90.3	61.6
Illinois	41,324	0	41,324	3,243	41,324	3,243	0.0	11.1	7.5
Indiana	640	183	456	68	456	68	28.6	78.2	58.7
Iowa	186	0	186	59	186	59	0.0	47.2	35.8
Kansas	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Kentucky	8,783	2,913	5,871	1,314	3,933	880	33.2	63.3	50.5
Louisiana	8,639	0	8,639	1,854	8,639	1,854	0.0	57.9	36.4
Maine	2,639	328	2,311	1,727	2,084	1,557	12.4	60.9	43.3
Maryland	10,901	329	10,571	1,749	10,571	1,749	3.0	78.4	52.6
Massachusetts	16,100	1,191	14,909	2,160	14,909	2,160	7.4	36.6	27.4
Michigan	12,553	2,223	10,330	1,033	10,330	1,033	17.7	79.1	58.8
Minnesota	621	0	621	111	621	111	0.0	46.7	36.0
Mississippi	775	1	774	259	186	62	0.1	70.0	45.5
Missouri	3,164	130	3,034	495	3,026	494	4.1	62.9	43.8
Montana	86	0	86	81	86	81	0.0	32.8	23.5
Nebraska	14	0	14	8	14	8	0.0	82.3	62.1
Nevada	1,303	1	1,301	429	799	263	0.1	38.5	26.8
New Hampshire	2,725	37	2,687	1,981	2,198	1,620	1.4	40.7	29.3
New Jersey	90,487	0	90,487	10,157	90,487	10,157	0.0	29.2	20.3
New Mexico	5,006	658	4,348	2,075	1,049	501	13.1	76.4	55.6
New York	65,058	0	65,058	3,329	63,391	3,244	0.0	38.7	27.0
North Carolina	30,157	1,699	28,458	2,741	5,475	527	5.6	34.1	26.0

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

State	Combined plan total OPEB liability (mil. $)	Combined plan fiduciary net position (FNP) (mil. $)	Combined plan net OPEB liability (NOL) (mil. $)	Combined plan NOL per capita	State's proportionate share of combined plan NOL (mil $)*	State's proportionate share of combined plan NOL per capita	Combined plan funded ratio (%)	Combined plan total contributions as a % of static funding§	Combined plan total contributions as a % of minimum funding progress†
North Dakota	211	128	83	109	5	6	60.6	74.9	65.4
Ohio	30,181	15,522	14,659	1,254	3,203	274	51.4	16.5	13.8
Oklahoma	156	0	156	40	156	40	0.0	120.8	81.3
Oregon	684	612	72	17	158	38	89.4	117.6	106.4
Pennsylvania	22,709	0	22,279	1,740	22,279	1,740	0.0	46.8	32.9
Rhode Island	845	228	616	583	508	480	27.0	92.4	69.6
South Carolina	15,426	1,253	14,174	2,788	3,035	597	8.1	54.6	37.7
South Dakota	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Tennessee	1,283	0	1,283	190	1,050	155	0.0	69.4	54.8
Texas	99,159	1,179	97,980	3,414	75,527	2,631	1.2	29.8	21.9
Utah	367	265	102	32	102	32	72.3	157.6	134.5
Vermont	2,168	(5)	2,173	3,469	2,152	3,436	(0.2)	37.8	26.3
Virginia	5,955	2,119	3,836	450	2,243	263	35.6	66.9	8.5
Washington	5,826	0	5,826	773	5,826	773	0.0	16.3	12.2
West Virginia	3,109	963	2,145	1,188	1,781	986	31.0	76.0	60.0
Wisconsin	719	0	719	124	719	124	0.0	40.1	32.1
Wyoming	805	0	805	1,394	308	533	0.0	20.2	15.5
Total	690,232	52,648	627,955	82,713	524,584	67,463	-	-	-
Median	4,085	230	2,860	1,221	2,191	530	2.9	52.1	35.9
Average	14,380	1,097	13,082	1,723	10,929	1,405	15.3	56.4	41.4

OPEB--Other postemployment benefits. N/A--Not applicable. *Each state's proportionate share of the combined plan NOL is weighted per plan and summed. §Static Funding is calculated as service costs plus unfunded interest costs. †Minimum funding progress is calculated as static funding plus 1/30 of the unfunded liability. We have excluded several minor OPEB plans that do not offer medical benefits. Kansas and South Dakota do not report liabilitiy for retiree health care benefits. Arizona's Public Safety Personnel Retirement System and Corrections Officer Retirement Plan plans plans are excluded from our calculation of static funding and minimum funding progress because a schedule of changes to the NOL was not publically available; both plans are overfunded. California's Trial Courts plan is excluded from our calculation of static funding and minimum funding progress because the state does not disclose schedules of changes to the NOL for the 58 trial courts reported as a part of the primary government in its comprehensive annual financial report.

Related Research

- Retiree Medical Benefits Generate Unique Cost Drivers And Risks For U.S. States, Sept. 17, 2019
- OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility , May 22, 2019
- U.S. State Rating Methodology, Oct. 17, 2016

This report does not constitute a rating action.