OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility

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(***Editor's Note:*** *This commentary applies to state and local government pensions within U.S. public finance and is not intended to describe or represent S&P Global Ratings' methodology for analyzing pensions in other sectors.)*

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Key Takeaways

- We consider OPEB liabilities, like pensions, to be fixed costs unless a credible plan is in place to reduce costs.
- Reduction in OPEB benefits can be an effective cost management tool.
- Legal flexibility to reduce retiree health care benefits varies across states.
- Even where the law permits benefit changes, political, social, and other factors may hinder practical benefit flexibility.

Despite often being poorly funded with sizable liabilities, retiree health care benefits (OPEB) have not been in the spotlight to the same degree as pensions. One typically cited reason is that because these benefits are more "flexible" than pensions, they contribute less credit risk. The word flexible implies a general understanding that, due to legal framework as well as the many variables associated with retiree health care, accrued benefits can be reduced or eliminated, mitigating the risk that costs would lead to budgetary stress. However, in S&P Global Rating's view, legal flexibility may not translate to practical benefit reduction. Therefore, we account for the credit risk of projected OPEB liabilities and associated costs unless benefits are explicitly reduced.

OPEBs are generally not as cut and dry as pensions with regard to benefit inviolability. The legal framework of retiree medical benefits is unique within each state, with some benefits collectively bargained, others defined in statute, and still others not entirely well defined and awaiting legal precedent. When weighing risks tied to OPEB benefits, we recognize that legal flexibility varies across states. However, we do not assume just because a state permits benefit reductions that the state or local government will reduce benefits. Benefit reductions face significant political and social resistance, and such measures can run counter to other state policy objectives, such as retirement security. Additionally, protracted legal challenges often follow legislative action on reforms. Therefore, we consider pension and OPEB liabilities as fixed costs until the plan demonstrates credible action to reduce benefits.

Cost Management: Ways In Which OPEBs Can Be, Or Have Been, Reduced

For long-term viability, OPEBs can be reduced or eliminated for new entrants, governmental and social implications notwithstanding. Plans may look to reduce medical costs by altering deductibles, co-pays, and coinsurance, which may provide avenues for passing costs on to retirees. Benefits covered by a given plan may be also subject to change, such as the elimination of a specific expensive procedure, especially in light of how medical advances and technological or procedural changes affect underlying costs. A concept that appears to be gaining steam around the country is the stipend, or dollar cap, which looks similar to a defined benefit pension because it is not based on medical costs. This may be a workable avenue to address risks of claim volatility as well as compounding cost increases related to medical trend. Additionally, for plans that extend beyond Medicare eligibility, shifting current and future eligible retirees to Medicare may be a simple and clear way to control some costs while possibly avoiding risk of corresponding lawsuits to benefit reductions.

Ways in which governments have managed OPEB costs through benefit changes include the following:

- North Carolina eliminated benefits for members hired after 2020
- South Dakota shifts costs to retirees: South Dakota eliminated its implicit OPEB liability by adjusting retiree premiums from a blended rate to one commensurate with the age of the retiree.
- Saginaw, Mich. eliminates OPEB liabilities: In 2017, Saginaw changed the retiree benefits program so that retirees under 65 moved to a health care savings plan and retirees 65 and older were moved from self-insured claims cost payments to Medicare Advantage premium subsidies. These changes directly control increasing costs while limiting volatility and tail risk. In September 2017, we noted in our rating report that costs were expected to decrease immediately from $10.6 million to $7 million.
- Ohio P&F shifting to stipend: Beginning Jan. 1, 2019, the Ohio Police & Fire (OP&F) plan will change its retiree health care model to a stipend-based model from the current self-insured plan. This changes the risk profile to one similar to that of a defined benefit pension by eliminating some of the additional risks posed by health care such as claims volatility, compounding medical trend-based cost increases, and tail-risk associated with self-insured medical plans. The change is expected to extend the solvency of OP&F's health care funding to 15 years from less than nine years under the previous plan; however, not-surprisingly, a class-action lawsuit has been filed that introduces legal risk and general uncertainty for sponsoring employers.
- Pennsylvania Public School Employees' Retirement System caps benefits: One OPEB plan PSERS provides is the premium assistance program, designed to help offset medical premiums for employees. Participating annuitants receive the lesser of $100 per month or the monthly premium amount. This dollar cap limits exposure to claims volatility or medical trend for PSERS.

Legal Provisions Can Vary Widely Across States

Not all employers can legally and realistically reduce or eliminate benefits or have the ability to pass costs on to retirees. The ability to reduce benefits is also not a black or white matter, with significant ambiguity around the extent to which benefits may be altered. Unlike pensions, medical benefits are not described as a clear-cut dollar amount, making the inviolability of a benefit unclear.

Plans for controlling costs may face established legal roadblocks. Such legal uncertainties may be considered as a possible event risk or a drag on budgetary projections if it appears as though the courts might strike down reform.

- Illinois benefits are supremely protected: In 2014, the state Supreme Court ruled that retiree health care benefits for state and university employees are protected by the pension protection clause of the state constitution as benefits of membership. Within the rating, OPEB and pensions both contribute to the large and increasing state budgetary stress.
- Maryland alters the deal: Employees hired after June 2011 have more restrictive minimum eligibility standards for coverage and increased premium payments. In addition, retirees were moved from a state sponsored prescription drug plan to a federal plan that requires much higher copayments. The prescription drug change is currently at the center of a lawsuit brought on by retirees, which may lead to a sharp increase in costs for the state.

Legal challenges to benefit reductions are highly likely but not highly predictable, leading to legal risk for entities attempting to control costs. Sometimes, where legal flexibility is not completely clear, reductions to benefits are successfully challenged, resulting not only in higher than anticipated future costs, but also back pay.

- Michigan pays large refund to employees: In 2010, Michigan enacted a law (Act 75) that reduced state liabilities by requiring teachers and other school personnel to contribute 3% of their salary to maintain their retiree health care premium subsidy. After many legal battles, the state supreme court ruled this unconstitutional and a subsequent law (Act 300) provided a choice in 2013 between contributing 3% of salary for the premium subsidy or not contributing 3% of salary in favor of a defined contribution retiree health care fund. The total amount contributed between 2010 and 2013 due to the law ruled unconstitutional had grown to $550 million by 2017 and this amount was returned to employees in 2018.

Notably, even where the state allows flexibility to reduce OPEB benefits, it is possible that other legal challenges could prevent local governments from addressing OPEB risks. New York, for example, prohibits municipalities from forming OPEB trusts to pre-fund retiree medical benefits. This leaves local governments with not only the complications involved with addressing liabilities of this growing burden, but with obstacles to building asset reserves as well.

Beyond Legal Risk: Political, Social, Or Other Hindrances Could Block Reform

While the reduction of medical benefits may be legally allowable, it may be impractical as lawsuits are not the only roadblocks to OPEB cost reductions. Many public safety employees, such as police officers and firefighters, retire before they reach Medicare eligibility. It may be politically infeasible to reduce medical benefits to those who risk their health in the line of duty. In addition, collective bargaining with unions may provide a strong hindrance against benefit reductions even if legally viable.

Wisconsin spares police and fire: Collective bargaining rights were curtailed via Act 10 in 2011, leading to the reduction or elimination of retiree health care benefits for most local government employees. While the elimination of these benefits for police officers and firefighters is legally permissible, the state has kept them intact and this sizeable liability remains with municipalities.

- New York City government versus unions: Mayors in New York City are noted to have attempted to restructure retiree benefits in the past, only to be rebuffed by strong union representation.

The Rating Impact Of Retiree Health Care Flexibility

A government can pursue many avenues with regard to the cost management of retiree health care benefits, all of which are likely to face legal, political, or social resistance. Although we consider that legal flexibility can somewhat mitigate the risk of costs increasing to a point of budgetary stress and negative credit impact, in our view liability remains a credit risk until a plan is specifically in place to reduce current and future costs.

Related Research

- Rising U.S. States' OPEB Liabilities Signal Higher Costs Ahead, Nov 28, 2018
- OPEB Brief: The Credit Impacts Of OPEB Obligation Bonds, March 11, 2019

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