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SPECIAL COMMENT

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US Municipal Governments Can Leverage Federal Medicare to Lower OPEB Costs

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Summary

The availability of federal Medicare health insurance coverage for most US state and local government retirees provides an option for many of these governments to better control retiree health care costs. Commonly referred to as Other Post-Employment Benefits (OPEB), retiree health care costs are rising with the aging of the workforce. OPEB, along with pensions, present an increasing credit risk for many US municipal governments. For retirees over age 65, this liability consists primarily of Medicare premium subsidies and supplemental health insurance benefits.

The option of leveraging federal health insurance coverage for municipal retirees aged 65 and over is an attractive one, especially because Medicare-eligible retirees are growing as a share of government retirees. Even small reductions in the cost of health benefits for Medicare-eligible retirees can have a considerable impact on future costs because savings compound over retirees' increasingly long lifetimes.

» **Cost savings are significant because the unfunded OPEB liabilities of US municipal government are large**. For states, total reported OPEB liabilities of $530 billion rival their outstanding debt.

» **Medicare-eligible retirees will comprise a growing portion of total state and local government retirees, increasing the boon to government finances if costs are controlled for this group.** The relative benefit to state governments is potentially greater than local governments, where police and fire employees tend to retiree younger.

» **Some governments have reduced OPEB liabilities simply by requiring employees to pay a greater share of supplemental health insurance ("Medigap") costs and reducing prescription drug costs**. The latter include employer group waiver plans and Medicare Part D. While not typical, Maryland reduced its liabilities more than 40% almost entirely due to prescription drug savings.

» **The Medicare cushion is advantageous for municipal retirees because governments can more easily reduce or eliminate retiree health insurance than pension benefits.** This cushion is particularly important in stressed municipalities where OPEB reductions have recently been part of bankruptcy plans of adjustment. Stockton, CA has proposed eliminating retiree health benefits in Chapter 9, while Detroit's proposed plan would also sharply curtail them.

Large OPEB Liabilities Rival Debt Outstanding for Some Governments

Many state and local governments can save money by changing health benefits provided to retirees who are eligible for Medicare because they are at least age 65. Nearly two-thirds of state governments offered supplemental health insurance to Medicare-eligible retirees in 2010 (the most recent data available) as did a similar proportion of large local governments, according to survey data from the US Department of Health and Human Services. The survey also shows that smaller local governments are less likely to offer supplemental health coverage to Medicare-eligible retirees, likely due to cost.

Such cost-savings are credit positive for governments able to implement them. Providing health benefits is increasingly expensive as health costs have increased generally and retirees are living longer. Similar to pensions, the promise to provide health and other benefits to retirees in the future results in a long-term liability to the employing government. Referred to as "other post-employment benefits" (OPEB) these liabilities can be significant and consist overwhelmingly of subsidized health insurance costs.

States listed a total of more than $530 billion in unfunded OPEB liabilities in their fiscal 2012 financial reports, although the liabilities are highly variable and concentrated within a subset of states. As demonstrated in Exhibit 1 this amount is similar to the magnitude of total state net tax-supported debt of about $516 billion as of our most recent State Debt Medians report. Local governments are likely to also have a significant collective liability.[1]

OPEB liability accounting presents comparability challenge and can alter behavior

Both governmental and private sector OPEB liabilities are calculated based on the projected future flow of retiree health benefit payments, discounted to arrive at a present value. In the public sector, the factors that reduce comparability of pension liabilities apply similarly to OPEB liabilities: the use of multiple actuarial cost methods, discount rates based on investment rates of return rather than market interest rates, and the lack of reported allocations of cost-sharing plan liabilities to participating employers. Although subject to different accounting rules, public and private sector employers share the need to incorporate forecasts of health care costs far into the future when calculating OPEB liabilities. Because even small forecasting differences when compounded over many years can have a large impact on liabilities, this variable adds to issues of comparability for both public and private sector OPEB disclosures.

Public sector accounting rules do not require that OPEB liabilities be reported on the government's balance sheet: instead they are reported in the notes to the financial statements. A measure of accumulated employer contribution shortfalls to single-employer and agent OPEB plans, known as the "Net OPEB Obligation," is the only liability reflected on government balance sheets. In contrast, private sector accounting rules require that both pension and OPEB liabilities be reported on the balance sheet. The Governmental Accounting Standards Board (GASB) is in the early stages of considering revisions to its OPEB accounting guidelines, which may result in a change to balance sheet treatment and other reporting requirements. New GASB pension accounting guidelines, to be phased in over the next two years, will require pension liabilities to appear on the balance sheet.

As with pensions, the US public sector is late in addressing its OPEB risk compared to the corporate sector. Companies began reducing or eliminating OPEB liabilities in the early 1990s following mandated disclosure under FASB accounting. US municipal governments have only recently started to trim OPEB costs in earnest.

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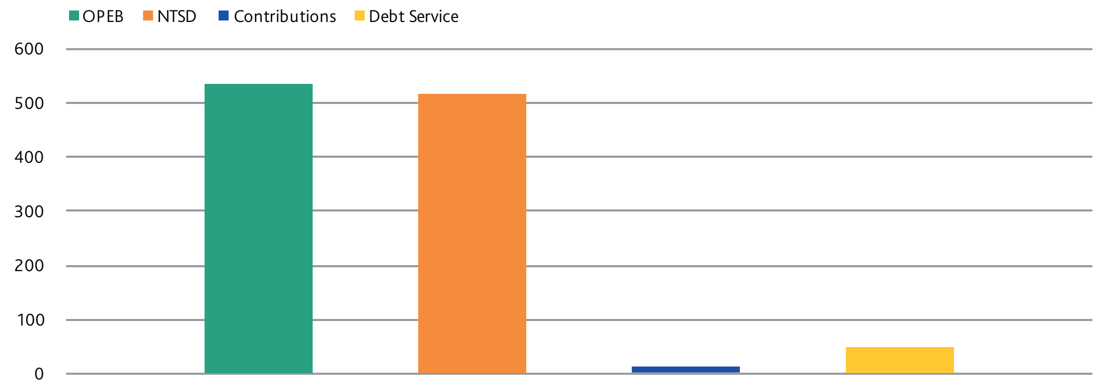
[1] As in the case of pensions, some liabilities reported by states relate to cost-sharing plans in which different levels of government may participate. We have not allocated liabilities of health benefit cost-sharing plans to sponsoring employers.

Exhibit 1 also shows current annual reported budget costs associated with servicing debt and paying for retiree health costs. Although the outstanding liabilities are similar, debt service payments are nearly four times larger than contributions for retiree health costs. In contrast to debt service payments which amortize the principal liability over a fixed period, most governments pay for OPEB on a "pay-as-you-go" basis, paying only an amount sufficient to provide the annual health insurance subsidy for current retirees.[2] Most do not pre-pay the liabilities for future retiree benefits being promised to current employees or an amount to amortize the costs of previously accrued liabilities. At least in the near term, these payments would be considerably greater than the pay-go amount depicted in the exhibit.

EXHIBIT 1
State OPEB Liabilities Rival Net Tax Supported Debt

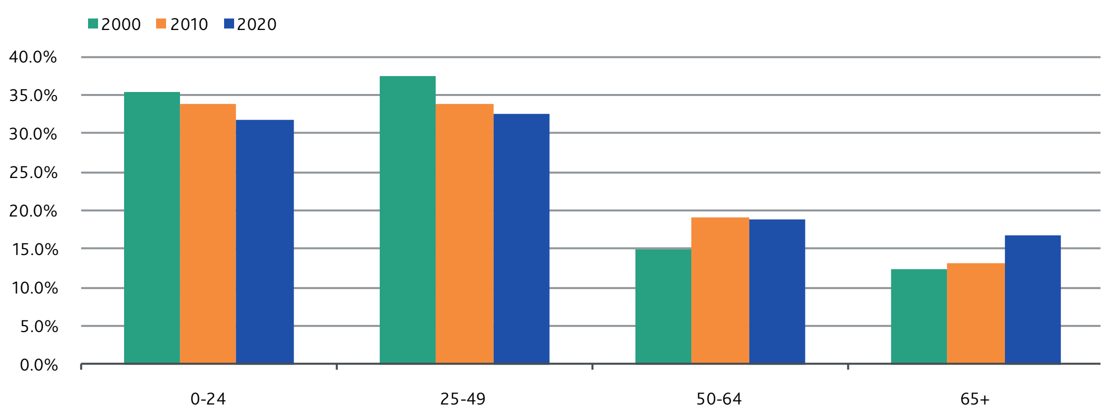


Source: State Comprehensive Annual Financial Reports, fiscal 2012

Demographic Trends and Policy Changes Point to More Liability for 65+ Retirees

In coming years, state and local OPEB liabilities will become increasingly concentrated among retirees over age 65. As the baby boom ages and longevity increases, this cohort as a percentage of the total population is growing nationwide. (See Exhibit 2).

EXHIBIT 2
US Age 65+ Population Grows



Source: US Census Bureau; Moody's Analytics

2 Reported annual payments may include payments for cost sharing plans and on-behalf payments made for other levels of government. The total includes OPEB ARC payments made by a small number of states.

In addition to demographic trends, two policy-related factors will drive down the proportion of retirees who are ineligible for Medicare relative to eligible retirees. First, while ineligible retirees consist primarily of those retiring before age 65, a portion includes retirees entering government service prior to 1986, when Medicare participation for state and local government employees became mandatory. Over time this group will shrink relative to those covered by Medicare.[3] In this regard, the public sector is up to twenty years behind the private sector, given the creation of the federal program and its broader applicability to private sector employees in 1966.

Second, the proportion of retirees younger than 65 will also decline over the longer run due to recent pension reforms by governments that have raised retirement ages. Many governments have already implemented such reforms for new employees, and some are also making changes to retirement age for previous hires, though the legal ability to do so varies based by state. Rising retirement ages will have the effect of reducing the growth of OPEB liability for those younger than 65 and increasing the share of liability related to the Medicare-eligible population.

Local governments have a higher proportion of retirees younger than 65 because they have more retirees from police and fire departments where retirement ages tend to be lower than for other government employees. Benefits provided to younger retirees are generally more comprehensive than those provided to Medicare-eligible retirees and therefore will feature more expensive premiums and may account for a large proportion of total OPEB liabilities. Whether cost changes to benefits for younger or older retirees save more money in the long run will depend in part on the mix of retirees and the relative generosity of benefits.

Exhibit 3 compares the composition of OPEB liabilities for New York City and Maryland. Both entities document liabilities for Medicare-eligible retirees separately from liabilities for ineligible retirees in their OPEB valuations, a useful level of disclosure which is not typical. Nearly half the total present value of New York's $71 billion in fiscal 2013 actuarial accrued liability of retiree health benefits pertain to promises to cover pre-Medicare retirees. New York's liability for Medicare-eligible retirees includes its promise to pay Medicare Part B (outpatient care) premiums, an unusually generous benefit which Maryland does not provide. Without the Medicare Part B liability, Medicare-eligible benefits would account for only 40% of New York's adjusted total. In contrast, Maryland's smaller $9.7 billion accrued liability (in fiscal 2011) is predominantly due to benefits for Medicare-eligible retirees.[4] This difference in the distribution of liability between Medicare and pre-Medicare liabilities is partially explained by the greater presence of police and firefighters among NYC retirees. This difference demonstrates that Medicare-based reforms will provide greater long-run cost savings in some jurisdictions than in others depending on the mix of retirees, posing additional challenges to local governments with more uniformed personnel eligible for early retirement.

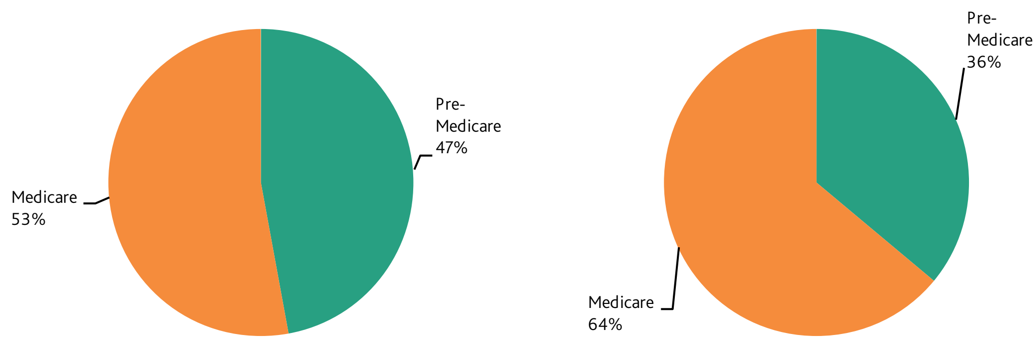
[3] Many municipalities participated in the program prior to 1986 under special arrangements with the US Social Security Administration.

[4] The Medicare share would be considerably larger in previous valuations before Maryland implemented reforms related to prescription drug coverage for Medicare-eligible retirees.

EXHIBIT 3

State Government OPEB Liability Weighted Toward Medicare-Eligibles

New York City State of Maryland



Source: State of Maryland - fiscal year 2011; NYC Office of the Actuary - fiscal year 2013. NYC total net of Cadillac tax.

Many Governments are Trimming OPEB

Many governments have already moved to trim the cost of benefits for Medicare-eligible retirees. These initiatives include cost-shifting, such as requiring increased co-payments or premium contributions from retirees for supplemental benefits, as well as initiatives to reduce the growth of health costs more directly ("bending the curve"). Cost shifting provides more immediate reductions in employer liabilities and annual expenses but does not directly affect growth rates going forward because it merely redistributes some of the existing cost burden to retirees from employers.

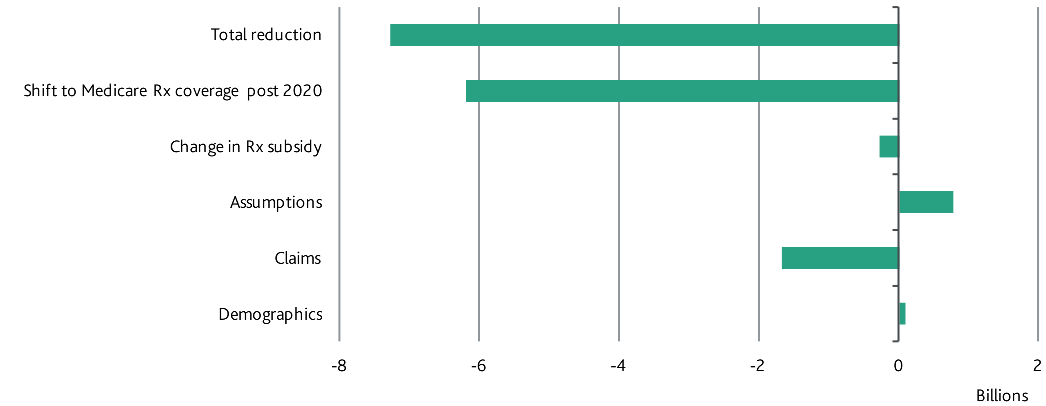
Surveys indicate that state and local governments have widely pursued initiatives to contain retiree health costs. About two-thirds of governments responding to surveys cited by the Center for State and Local Government Excellence indicated that they had made changes to retiree health care in recent years, with the most common changes being increases to retiree premium contributions, co-payments and deductibles.[5] These changes affect all retirees, not just those that are Medicare eligible.

Maryland (Aaa stable) significantly reduced its OPEB liability, to $9.4 billion from $16.1 billion in 2010, with a 2011 change that increased prescription drug copayments, retiree premium payments and out-of-pocket maximums. The reforms also increased the service requirement for retiree health benefit eligibility and will require retirees to enroll in Medicare Part D (prescription drug coverage) in 2020 when the Part D federal coverage is scheduled to improve through eliminating the coverage "donut hole". Even though it will take place several years hence, the shift of prescription drug coverage from state-funded insurance to federally-funded Part D accounted for the bulk of the reduction in liability, as shown in Exhibit 5.

5 Joshua Franzel and Alex Brown, "Spotlight on Retiree Health Care Benefits for State Employees in 2013," June 18, 2013, http://slge.org/publications/spotlight-on-retiree-health-care-benefits-for-state-employees-in-2013

EXHIBIT 5

Medicare Part D Switch Chops Maryland OPEB Liability in 2011



Source: State of Maryland Retiree Health Plan Actuarial Valuation Report as of July 2011

Where benefits in excess of Medicare are most generous there are the greatest opportunities to find savings. While some municipalities provide no or minimal retiree health insurance subsidies, many employers subsidize both Medicare premiums and so-called "Medigap" insurance plans designed to supplement Medicare because it does not provide comprehensive coverage – for example, regular physician well visits are not covered. Some local governments in Rhode Island historically offered retiree health benefits that were generous enough to discourage entirely the utilization of Medicare among eligible retirees. Recent state legislation has enabled local governments to require eligible retirees to use Medicare for their primary insurance, which has been acted upon by financially-troubled municipalities Providence (Baa1 stable), Central Falls (B1 positive) and Woonsocket (B3 negative).[6] In the case of Central Falls, which restructured its liabilities in a Chapter 9 proceeding, implementing this shift and taking other actions resulted in a 55% reduction in the city's OPEB liability.

Medicare Components

Medicare has four components. The Medicare components are associated with various patient premiums, copayments and deductibles.

» Medicare Part A covers hospitalization and some rehabilitation/convalescence costs;

» Medicare Part B covers certain outpatient costs;

» Medicare Part C rolls the different components of Medicare coverage into one plan (essentially an HMO) and may include supplemental coverage;

» Medicare Part D covers prescription drug costs up to a certain level of spending, after which there is no coverage until the recipients exceed a specified level of "catastrophic spending." This coverage gap is popularly referred to as the "donut hole" and is scheduled to be phased out in 2020.

[6] See Moody's report, Rhode Island Municipalities Look to ACA Exchanges and Other Strategies to Reduce Growing Health Care Exchanges.

With pharmacy costs a rapidly growing portion of health spending, savings in this area can have significant impacts. Governments who provide pharmacy coverage for older retirees receive federal subsidies through the Medicare Part D plan. Prior to 2010's Affordable Care Act (ACA), employers received subsidies through the Retiree Drug Subsidy (RDS) program. The ACA created the Medicare Part D employer group waiver plan (EGWP), which provides subsidies and also allows employers to take advantage of manufacturers' discounts. In addition to deepening the annual cost savings on prescription coverage, the EGWP has the added benefit of its treatment under state and local government accounting rules. Under those rules, subsidy savings under the RDS could not be counted against future liabilities and therefore could not be reflected in governmental financial statements. However, EGWP savings can be counted against liabilities because the savings are programmatic rather than based on grants from the federal government. While this shift could be viewed as an accounting gimmick, the subsidy program does provide real savings which should be reflected in the financial statements of state and local governments.

Government employers including New York (Aa2 positive), Maryland, Delaware (Aaa stable) and Louisiana (Aa2 stable) have obtained such waivers. For New York State, implementing the employer group waiver along with other OPEB reforms was reflected in an OPEB liability decline of 9% from the 2010 valuation to the 2012 valuation. In Maryland, a reduction of $356 million in the 2013 OPEB valuation was due to the transition to an EGWP effective January 1, 2014.

Federal Health Insurance Cushion for Retirees Contrasts with Pension Benefits

We believe the less stringent legal protections of retiree health benefits place them on a different footing than pensions when a government is contemplating reductions in its liabilities. At the same time, the availability of Medicare for most state and local government retirees means that many retirees continue to receive health insurance benefits in the event a municipal employer cuts or eliminates its OPEB liability. While the loss of supplemental coverage from the employer may stress retiree households, those age 65 or older who are enrolled in Medicare continue to benefit from the federal program on the same footing as their private-sector counterparts.

In contrast to OPEB, municipalities have less legal flexibility to reduce retiree pension costs, and retirees are more likely to rely heavily on their government pension for retirement security. Pensions typically have stronger protections under contract law than retiree health benefits and in most distressed municipal situations we observe that pension cuts for current retirees have been avoided. In two California bankruptcy cases, Vallejo and Stockton each reduced or eliminated retiree health coverage while leaving pension benefits untouched, although the Stockton plan has not been finalized. Similarly, Detroit's plan of adjustment proposes a slight reduction to pension benefits, but significant cuts to OPEB benefits.

In addition to pensions' legal status, the avoidance of pension benefit reductions may stem from the fact that more than one-quarter of public employees are not covered by social security and rely entirely on government-funded pensions, their savings and spousal eligibility for social security for retirement income.[7] Lack of access to social security benefits is concentrated in a handful of states, including California, Texas, Louisiana, Ohio, and Colorado among others. This circumstance presents an additional barrier to significant pension cost reductions for many governments.

7 US GAO, Management Oversight Needed to Ensure Accurate Treatment of State and Local Government Employees, September 2010.

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