Straining higher education finances:

COVID-19's impact on retiree health liabilities and expenses

Unfunded retiree healthcare liabilities are a growing concern in the COVID-19 low interest environment

Defined benefit pension plan liabilities in the trillions of dollars get a lot more attention than retiree health liabilities. Retiree healthcare OPEB* liabilities aren't as large, but they are substantial and are largely unfunded for both public and private institutions. For public institutions, a recent S&P Global Ratings state survey reported nearly $630 billion in unfunded retiree healthcare liabilities.[1] The S&P report indicates that unfunded liabilities will likely escalate in the future if meaningful funding progress or benefit reductions are not implemented.

Directionally, liabilities are likely to trend upward or, at the very least, experience significant volatility. While a number of traditional factors are driving this trend, including an aging population with higher health expenses, medical inflation and the lack of meaningful pre-funding and benefits reform, a new factor has emerged in the low interest environment during the COVID-19 pandemic—lower interest rates mean lower discount rates used to calculate retiree healthcare liabilities and annual expenses. For example, if interest rates fall, retiree healthcare liabilities for an active plan could increase 15-20% for each 1% decrease, with a related increase in annual service costs (assuming a liability duration of 15-20 years). For many institutions already struggling with other major impacts from the COVID-19 environment, an increase in retiree health liabilities and annual expenses will cause additional financial hardships.

$628[1] billion

Unfunded state retiree health liabilities are a burden

*Non-pension benefits paid to a retiree.

Best intentions, but unintended consequences

Left unchecked, retiree healthcare liabilities will continue to grow and create a greater burden. Higher education institutions understand the impact of these liabilities, and many have or will be taking action by:

- reducing benefits
- increasing cost-sharing with employees
- changing plan eligibility criteria
- eliminating benefits for new hires
- moving retirees from employer-based insurance plans to private exchanges

While these efforts may help stem the financial impact of DB retiree healthcare programs, they also have important drawbacks. They may affect your ability to recruit and retain talent, and they could negatively affect your employees' retirement security.

Competing for talent: Higher education institutions are not only competing for talent across the higher education sector, but they are also competing with for-profit organizations. Retiree healthcare benefits are a standard offering at public institutions and serve as a key differentiator with private sector firms. Without this offering, institutions may find themselves at a competitive disadvantage.

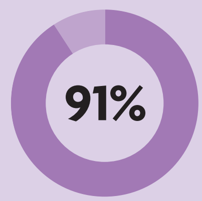
Reducing retirement readiness: Retiree healthcare costs are a leading expense for retirees. Reducing retiree health benefits or significantly increasing employee cost-sharing could negatively impact their retirement readiness.

For many institutions, a DB retiree health offering is proving to be a financial strain, but it's also a valued employee benefit that enhances the retirement security of its employees. A balanced, total benefits approach is needed.

Employees need help with retiree health costs

$270,000

Amount needed for a 65-year-old couple today to cover out-of-pocket retirement healthcare expenses.[2]



of plan sponsors

say that rising healthcare costs are a significant concern for retirement security.[3]

An increasingly common challenge

The following hypothetical case study mirrors the situation many higher education institutions are now experiencing.

The problem

Elaine is the chief benefits officer at a mid-sized public university located in the Northeast. She recently met with the institution's chief financial officer, Jeremy, to discuss the impact that the retiree healthcare benefits program was having on their balance sheet. The finance team just finalized their financial reports, and because of the lower interest rate environment, the full actuarial liability from their retiree healthcare program increased 15%. Jeremy was already concerned with past annual retiree healthcare OPEB liabilities, and this exacerbated his concerns. He wanted to explore ways to get this liability under control either by eliminating the program or reducing costs through greater cost-sharing with employees or benefit reductions.

More than just a financial consideration

Elaine was well aware of the financial considerations but cited the importance of retiree health benefits. It's a competitive necessity to offer these benefits to avoid losing talent to nearby universities, and employees rated these benefits as a key differentiator in a recent survey. Elaine also shared her concerns about how changes to retiree health benefits could negatively affect employee retirement readiness and result in faculty and staff working past traditional retirement ages.

Action is needed

Jeremy was sympathetic to Elaine's arguments, but he remained concerned about the magnitude of current liabilities and how they could ultimately impact their credit rating and ability to borrow funds in the future. Rising medical inflation and aging employee demographics were also likely to result in liability growth. Jeremy also informed Elaine that the university's Board of Trustees was scheduled to discuss retiree healthcare liabilities at their next meeting, and he wanted to present them with some viable options.

A path forward

Elaine considered her options. She knew that retiree healthcare was a valued employee benefit that served as a competitive differentiator. She was also aware that it was a costly benefit, especially when considering the financial strains the university was experiencing due to rising costs and declining public funding. After careful consideration, she decided to evaluate how a DC-like benefit could help address their problem.

Benefits structure determines options

Elaine's story probably resonates with many of you, although the details of your situation could be different. For example, the sponsorship and funding of your retiree healthcare benefits may vary.

- **Elaine's situation:** Her university participated in a voluntary state-sponsored benefit, and her university paid its proportionate share of expenses.
- **Mandatory state-sponsored benefit:** An institution may not have the option to opt out of the benefit, and the state may or may not cover the full expense.
- **Institution-sponsored benefit:** Some institutions may sponsor their own programs separate from the state and have greater autonomy.

In each of these cases, a DC-type retiree health benefit could address many of your institution's challenges. However, the structure of your plan determines how you can approach this challenge, and your benefits consultant can help you evaluate your options.

GASB 75: Public sector retiree healthcare liabilities are no longer hiding in plain sight

GASB Statement 75 requires public sector employers to recognize and disclose their obligations for OPEB—primarily retiree health benefits—on the balance sheet. In addition, an OPEB retiree healthcare expense will need to be recognized in the income statement of the participating employers. Although passed in 2015, GASB 75 went into effect the fiscal year following June 15, 2017, and has significant implications for public institutions.

- **Credit implications:** Full actuarial retiree healthcare OPEB liabilities—not just annual OPEB expenses—are now recognized on the balance sheet. The change in liabilities could affect your institution's credit quality and possibly increase borrowing costs or your ability to secure future funding.
- **Liability calculation:** A new actuarial methodology and discount rate guidance could result in greater retiree healthcare liabilities than in the past.

Balancing financial concerns and effective employee benefits

Finding a cost-effective way to offer retiree healthcare benefits should appeal to both the financial and benefits side of the institution. A preferable solution limits financial exposure liability, strengthens employee retirement security and creates a differentiator for the institution.

A DC retirement health savings program (RHSP) meets all of these criteria. In the following situations, it can especially be an effective solution for institutions looking to reduce future cost risk and existing liabilities as a:

Replacement plan for new hires: New hires are offered an RHSP option, while existing employees remain covered by the DB retiree health benefit option.

Full benefit conversion: The DB retiree health benefit option is converted to a DC benefit either through an optional or mandatory employee conversion.

Benefits of a risk-managed DC approach

Limits financial liability

- Fully funded (no unfunded retiree healthcare OPEB liability)
- Not subject to healthcare inflation
- Flexible funding for employers
- Sustainable benefit

Supports employee retirement security

- Dedicated assets that can't be taken away
- Asset growth opportunity throughout working years
- Allows for tax-free investment earnings and reimbursement for qualified medical expenses in retirement
- Useable for health premiums

Strengthens employer benefits offering

- Demonstrates commitment to employee retirement security
- Serves as a key differentiator in a total benefits solution
- Allows for retiree health insurance plan flexibility that isn't tied to an employer plan

Taking action

Benefits leaders often face difficult trade-offs between the benefits they would like to offer their employees and budgetary constraints. Many of you may be facing such a situation with your institution's DB retiree health offering.

The good news is that a DC RHSP could help you to avoid this trade-off and continue offering retiree health benefits while reducing costs and possibly freeing up funds for other programs.

To learn how an RHSP might benefit your institution, contact us at rhspinfo.org.

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[1] S&P Global Ratings, U.S. States Are Slow To Reform OPEBs As Decline In Liabilities Masks Increased Risk, December 2019.

[2] EBRI At A Glance, June 18, 2020. **Projected Savings Needed for Health Expenses Decreased in 2020. We Explain Why.**

[3] 2018 TIAA Plan Sponsor Retirement Survey.

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