



## **Bonds and Benefits:**

### **The Impact of Retiree Health Costs on Employers' Credit Ratings**

NEA affiliate leaders and staff face increasingly frequent questions about retiree health benefits. Retiree medical plans have come under greater scrutiny recently because of new accounting standards that are pushing state and local governments, including education employers, to focus on the cost of these benefits. This fact sheet explores one of many important topics related to the standards: how to assess statements—in the news media, from politicians, or from employers—that retiree health benefits will negatively affect employers' credit ratings. It finds that credit ratings should be taken seriously but that concern about the impact of retiree health benefit costs is often overblown.

The new accounting standards are contained in Governmental Accounting Standards Board (GASB) Statement 45. For NEA staff and leaders new to the standards, the Association's Collective Bargaining and Member Advocacy Department has produced a series of publications introducing the topic, providing technical explanations, and offering strategic advice. For more detail, see the list of publications and how to obtain them at the end of this fact sheet.

This fact sheet first provides background information on bonds and credit ratings. Then, it answers questions about the way credit-rating companies are assessing retiree health benefit costs and employers' responses to them. Precisely because credit ratings are a serious matter, it is important not to accept generalizations about the retiree health benefit costs will affect the views of credit-rating companies. There are just too many factors that go into a government's credit rating to expect retiree health benefits alone to be decisive in the outcome of a credit analysis. That said, keep in mind that in particular situations, and based on specific information provided by qualified experts, concern about the impact of retiree health benefits on credit ratings could be justified.

#### **Background Questions and Answers**

**Q1: Why are we hearing about retiree health care costs so much these days?**

**A1:** The Governmental Accounting Standards Board (GASB), the organization responsible for developing accounting standards for state and local governments, issued a new set of accounting standards in 2004. The new standards call on governments to calculate and report the value of the retiree health care and other non-pension retirement benefits they have promised to active employees and current retirees (technically, these are called other postemployment benefits, OPEB). The calculations often show long-term liabilities that are far larger than pay-as-you-go figures (the actual payments governments make for health benefits for current retirees). The new standards only call on governments to estimate and report the cost of the future benefits, not to fund the benefits in advance.

**Q2: What are bonds?**

A2: Bonds are agreements in which a company or government that issues the bond receives money from a lender (the bond buyer) in exchange for a promise to pay interest to the lender and, eventually, to pay back the original money that was borrowed.

**Q3: Who issues bonds, and why?**

A3: Many governmental entities, including school districts, counties, and states issue bonds to raise money for new school buildings or to satisfy other financial needs.

**Q4: What are credit ratings and why do they matter?**

A4: A credit rating, sometimes called a bond rating, is a measure of a borrower's creditworthiness. It is a measure of how much risk the investor should expect regarding the borrower's ability to make promised interest payments and to pay back the money that was lent. The more creditworthy the borrower, the lower the interest rate the borrower must pay to investors. Therefore, the better its credit rating, the less costly it is for a government to finance its capital needs. In addition, pension funds frequently use credit ratings to prescribe the types of investments that can be held by the fund. Securities regulators and legislators also have built credit-rating requirements into certain regulations or laws.

**Q5: Who issues credit ratings?**

A5: Credit ratings are issued by companies in the business of analyzing the creditworthiness of companies and public entities. Standard & Poor's, Fitch Ratings, and Moody's Investor Services are the three credit-rating companies commonly cited in this regard.

**Benefits and Credit Ratings**

**Q6: What do retiree health benefits and credit ratings have to do with each other?**

A6: Retiree health benefits and credit ratings are linked because the current and future cost for providing these benefits is one of many things that do (or eventually will) compete for resources in a government's budget. The issue now catching the attention of credit-rating companies is the size of governments' unfunded liabilities for retiree health care. In other words, the companies are looking at how much it is projected to cost governments to pay for the future retiree health care benefits that they have promised to active workers and current retirees but have not set aside money to pay for. Unfunded liabilities are generally many times larger than the annual amount governments pay for benefits for their current retirees. This is because the liabilities estimate the costs over many years and health costs are expected to continue to rise in the future. The new accounting standards call for employers to estimate and report the cost of the retiree health benefits they have promised, although no prefunding is required. Most employers pay for current retirees' benefits out of their annual budget without estimating future costs or prefunding them.

As discussed later in this document, the mere existence of unfunded liabilities does not necessarily hurt a government's credit rating. In part, this is the case because unfunded liabilities must be looked at in a much broader financial and management context. And, in part, this is because a government may be able to handle its current and future retiree health care obligations without creating financial risk. Realistically, however, units of government with weak credit ratings could come under pressure to improve their financial condition, and some employers may determine that cutting retiree health benefits is one way they could seek to do so.

### **The Overall Concerns of Credit-Rating Companies**

**Q7: Overall, what are credit-rating companies going to be looking for when they evaluate a government?**

A7: Given how new it is for governments to be calculating and reporting their retiree health benefit liabilities, credit-rating companies have indicated that they will continue to refine their ratings criteria. And, although they seem to agree on many things, the companies won't necessarily take the same approach on every issue. That said, it seems clear at this point that the companies will take a detailed and nuanced approach, looking at both financial and management-related factors and evaluating each government individually.<sup>1</sup> Overall, they appear to be looking for a reasonable plan to deal with liabilities—whether through prefunding, changing benefit plans, or continuing on a pay-as-you-go basis.

**Q8: To what degree will overall unfunded liability figures be a factor in credit ratings?**

A8: On its own, an unfunded liability figure doesn't say much about a government's ability to pay benefits in the short, medium, or long term. Unfunded liabilities in relation to other factors—the size of a government's budget, its tax base, and the demographics of its workforce, for example—can provide more insight into the potential importance of the liabilities, but even with such relative information, a credit rating would depend on multiple additional factors. A government with a large unfunded liability relative to other indicators and whose liability was projected to increase dramatically in the future would probably stand out. And while it might be hard for such a government to argue that it could indefinitely maintain retiree health benefits without somehow addressing the liability, every government will be evaluated on its own terms, and a government with a credible plan for continuing on a pay-as-you-go basis, regardless of the size of its unfunded liability, is likely to be reviewed on the merits of its plan.

**Q9: In determining credit ratings, will governments be compared on the size of their unfunded liabilities?**

A9: In some cases, maybe. Although unfunded liabilities in the abstract would make for a bad comparison, if two governments shared many characteristics—budget size, tax base, number of employees, existing debt, etc.—but one had a large unfunded liability and one had no liability, that difference could potentially cause credit-rating companies to look less favorably on the government with the large liability. It will probably take several years of accumulated experience with the new accounting standards before meaningful comparisons can be made.

**Q10: Do the companies that issue credit ratings consider the importance to governments of offering retiree health care benefits in order to attract and retain qualified employees?**

A10: Yes, but other factors considered by credit-rating companies could have more weight when particular credit decisions are made. One of the many factors that credit-rating companies take into consideration is the quality of the public employee workforce, and they recognize that governments must continue to be attractive places to work if they are to attract and retain qualified workers. They know that decisions to reduce or eliminate retiree health benefits can have an adverse effect on the quality of the workforce, although they would not presume to suggest what level of benefits is necessary in any particular situation.

**Q11: What kind of impact are credit-rating companies expecting because of the new accounting standards?**

A11: Moody's, Standard & Poor's, and Fitch Ratings have said they do not expect to see large-scale deterioration of credit ratings based on the way governments start to report their retiree health care liabilities. Standard & Poor's put it this way: "We believe that, with or without the prefunding of OPEB liabilities, most employers will be able to continue to meet their ongoing OPEB cost requirements without an adverse effect on credit quality. OPEB costs will be worked into budgets and will need to be addressed, along with other normal costs of providing services."<sup>2</sup>

### **Employers' Plans for Addressing Unfunded Liabilities**

**Q12: To safeguard its credit ratings, does my employer have to hurry to develop and implement a plan to address its unfunded liabilities?**

A12: No. The companies that issue credit ratings want to see that governments are taking OPEB liabilities seriously. However, an employer that rushed to develop and implement plans could cause more problems than it resolved. Indeed, there are no deadlines for employers to develop and implement plans for addressing unfunded liabilities. Credit-rating companies know that governments will need time to study the situation, work with stakeholders, and develop their plans, and they know that it could take years to fully implement plans. There are, however, formal deadlines established by GASB for implementing the new accounting standards, although the GASB timetable refers only to calculating and reporting liabilities.<sup>3</sup>

**Q13: Does my employer have to cut or eliminate retiree health benefits in order to protect its credit ratings?**

A13: No. Blanket statements about unfunded liabilities leading to credit downgrades are not credible, although there may be situations in which a detailed analysis of a government's finances leads to legitimate concern about its credit rating. There are just too many factors in play, and this issue is far too new, for generalizations about credit ratings to be taken seriously.

**Q14: In order to preserve credit ratings, will my employer have to start to prefund its retiree health care liabilities?**

A14: No. Prefunding might be part of an employer's plan, but it doesn't have to be. The companies that issue credit ratings will individually examine a government's plans for addressing liabilities, and one of the factors they will review is the degree to which a government is putting money aside to cover future liabilities. However, the credit-related significance of a government putting money aside for the future will vary depending on many factors. In some cases, putting away money too quickly could cause financial instability, while in others the prudent long-term approach might be to continue on a pay-as-you-go basis. In still other cases, taking some steps to cut liabilities through prefunding might make sense.

**Q15: If my employer shows an unfunded liability on its financial statements, won't that have a negative impact on net assets that will affect its credit rating?**

A15: No. The new accounting standards call for reporting unfunded liabilities in notes to financial statements and in a schedule of funding progress, so the unfunded liability will be reported but not counted against net assets. There is a situation, however, in which net asset calculations would be affected: If full annual prefunding payments are not made every year into an irrevocable trust that meets certain requirements established by GASB, then the amount not contributed (plus interest) will count against net assets. It is important to keep in mind, though, that credit-rating companies do a lot more than look at the numbers in financial statements; net asset figures that reflect accounting requirements rather than poor financial management should be understood that way by the companies.

**Q16: Will unfunded liabilities or unmet annual prefunding payments hurt my employer's budget?**

A16: No. An employer's budget only includes expenditures to be contributed toward a plan or that are expected to be made with expendable available financial resources. Unfunded liabilities and any unmet annual prefunding payments will show up on government-wide financial statements, not budgets. If your employer plans to make a payment of some sort, then the amount of that expected payment will show up on the budget.

### **Want to Know More?**

The NEA Collective Bargaining and Member Advocacy Department has produced several publications that provide Association staff and leaders with what they need to know to protect retiree health benefits. These documents include a detailed report on the new accounting rules, *Defending Retiree Health Care Benefits: An NEA Guide to Understanding and Preparing for the New GASB Standards*, and several fact sheets on the subject: "Myths and Facts about New Accounting Standards for Education Employers;" "Steps for Defending Retiree Health Care Benefits (When You're Not a Technical Expert);" "A Non-Expert's Guide to Actuarial Valuations;" and "Plain Talk about New Accounting Standards for Education Employers." The report and fact sheets are available on the Connect website at <http://connect.nea.org/comp/retireehealthcare.htm>. For further information on the GASB standards, please contact the NEA Collective Bargaining and Member Advocacy Department at (202) 822-7080 or <mailto:collectivebargaining@nea.org>.

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<sup>1</sup> For example, Fitch Ratings has indicated that it will review three overall subjects: the management response (for example, looking for forward-thinking active approaches and timely compliance with the new accounting standards); debt and other long-term liabilities (for example, as a percentage of tax base value, as a per capita figure for local governments, and as a percentage of per capital personal income for states); and finances (in the “context of the entity’s overall financial situation, including revenue-raising and expenditure flexibility, the size of the expense relative to total spending (on a pay-as-you-go and accrual basis), other spending pressures, and reserve levels”). Fitch Ratings, “Old Promises, Emerging Bills: Considering OPEB in Public Finance Ratings,” March 22, 2007, pp. 2-4.

<sup>2</sup> Standard & Poor’s, “OPEB Liabilities Pose Minimal Near-Term Rating Risk for Public Finance Credits,” December 4, 2006, p. 2.

<sup>3</sup> For governments with \$100 million or more in revenue, the standards should be implemented in the first fiscal year beginning after December 15, 2006. For governments with revenues of at least \$10 million but less than \$100 million, the implementation should take place during the first fiscal year beginning after December 15, 2007. For governments with revenues of less than \$10 million, the standards call for implementation for the first fiscal year beginning after December 15, 2008. Governments can opt to apply the standards sooner.