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The Long-Term Cost of Short-Term Thinking: Why Prefunding OPEB Liabilities Matters

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Since many public pension retirement systems are steadily improving their funded status, many employers are shifting their focus to funding for Other Post-Employment Benefits (OPEB), primarily retiree healthcare benefits. Finance officers for governmental entities continually face a balancing act in managing today's budget realities while responsibly planning for future obligations. Addressing the long-term costs associated with OPEB benefits adds another challenge to the complex process. Given rapidly escalating healthcare costs and aging workforces, OPEB liabilities have become a significant and growing financial concern. Additionally, Governmental Accounting Standards Board (GASB) Statement No. 75[1] brought increased scrutiny toward OPEB benefits by moving the associated liabilities from simply a footnote disclosure to directly on the balance sheet.

Employers typically finance OPEB obligations through either: 1) a Pay-As-You-Go (PayGo) approach; or 2) prefunding through a dedicated trust.

In this article, we will compare these two approaches by highlighting their advantages and drawbacks, and comparing their financial impact through a practical case study. This article is intended to increase awareness in the advantages of prefunding OPEB benefits, while also balancing current budget priorities with long-term fiscal sustainability.

Understanding OPEB: Why the Financing Method Matters

OPEB refers to benefits provided to retired public-sector employees aside from pensions, most commonly retiree healthcare benefits. Unlike pensions, which are often funded through established trusts, OPEB benefits frequently lack dedicated funding, resulting in growing liabilities. Over time, these liabilities can significantly impact financial statements, budgeting flexibility, credit ratings, and long-term fiscal health.

Comparing Funding Strategies

The two common methods to finance OPEB obligations are to pay for benefits: 1) at the time benefits are received (PayGo); or 2) at the time they are accrued (Prefunding).

Pay-As-You-Go

Under PayGo, employers pay retiree healthcare expenses annually as they occur, without advanced funding. This approach offers simplicity and near-term budget flexibility. However, there are neither assets to offset future liabilities nor investment earnings to ease the long-term contributions incurred by taxpayers. As retiree populations grow and medical costs rise, annual PayGo expenses continue to escalate, which may strain future budgets and divert funds from other government services.

Prefunding Through an OPEB Trust

Prefunding typically involves regularly contributing to an irrevocable trust, established under Internal Revenue Code Section 115 (or similar arrangements), which is dedicated to providing future OPEB benefits. Contributions are invested so that assets accumulate and generate returns that offset long-term costs. Prefunding helps to ensure financial stability, reduces balance sheet liabilities, and can be reflective of sound financial management to credit rating agencies.

Prefunding requires initial budget commitments, which may reduce short-term flexibility related to government spending. Additionally, funds placed in an OPEB trust are irrevocable and generally cannot be redirected for other purposes.

Evaluating the Trade-Offs: Advantages and Considerations of Prefunding

The Government Finance Officers Association (GFOA) approved a Best Practice titled, *Establishing and Administering an OPEB Trust*.[2] The GFOA advises that governments should create a qualified trust fund to prefund OPEB obligations.

[1] More information on GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* is accessible on the GASB's website.

[2] https://www.gfoa.org/materials/establishing-and-administering-an-opeb-trust

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Some advantages for prefunding include:

- **Long-Term Cost Savings:** Investment returns markedly reduce the amount of future contribution outlay.
- **Liability Impact:** Prefunding can enhance fiscal health and credit ratings through both short-term and long-term impacts to the OPEB Liability reported on the balance sheet.
    - Under GASB Statement No. 75, a strong commitment to prefunding can allow the use of a higher discount rate (reflecting the assumed long-term return on assets) for purposes of calculating OPEB Liabilities. This provides an immediate reduction to the Net OPEB Liability on the balance sheet. Depending on the prevailing municipal bond rate at the time of prefunding, this could reduce liabilities substantially.
    - As the trust continues to accumulate assets from contributions and investment earnings, the Net OPEB Liability reported on the balance sheet will be reduced. When the trust becomes 100% funded, there will be $1 in assets for every $1 of accrued benefit. This results in zero liability on the balance sheet.
- **Budget Stability:** Prefunding strategies allow more predictable budgeting compared to the volatility of the PayGo approach, as illustrated in the case study presented on page 3.
- **Financial Stewardship:** The prefunding approach demonstrates responsible governance, prudence towards taxpayer costs, and a long-term commitment to current and future retirees.
- **Intergenerational Equity:** This refers to the concept that those providing government services today should be funded by today's taxpayers. Under PayGo, it is more often the case that the next generation of taxpayers will bear the retiree medical costs of those providing government services today. In contrast, prefunding matches the retiree medical costs being accrued by government employees today with today's taxpayers or citizens.

Despite the various advantages for prefunding, there are other considerations associated with prefunding OPEB, including:

- **Short-Term Budget Impact:** By definition, prefunding requires a greater contribution effort in the short-term than PayGo.
- **Opportunity Cost:** There may be other services or infrastructure that could provide greater value than the returns offered from an OPEB trust.
- **Irrevocability:** Once contributed, funds cannot be used for any purposes other than providing OPEB benefits to plan members, which may limit the flexibility of these funds in the future.

In addition, not all employers and benefit plans are similarly situated. Some circumstances when prefunding of benefits may not be appropriate include:

- **Plan Size:** If the plan only benefits a few participants, the additional administrative overhead, compliance requirements, and costs of an OPEB trust may outweigh the benefits.
- **Plan Closure:** If a plan has closed benefits to new hires as of a specified date, the plan sponsor has indicated that OPEB benefits are not intended to be provided in perpetuity. Prefunding an OPEB trust can still be compatible with a closed plan, but it is important to note that the benefits ultimately drive the funding, and the trust assets are expected to be depleted over time as the OPEB eligible population declines.
- **Implicit-Only Plan:** Some employers allow retirees to continue on the same health plan as active employees, whereby a single premium is developed by blending experience for both groups. While there is an associated OPEB Liability for this implicit subsidy under GASB Statement No. 75 requirements, there are no explicit costs to the employer for providing these benefits. Therefore, prefunding of these implicit-only benefits may not be suitable.
- **Legal Restrictions:** The governing rules that the plan is operating within may not be conducive toward prefunding. For example, if long-term asset classes (such as equities) are prohibited investment options, this may hamper the trust's investment earnings such that the opportunity cost (using those prefunding dollars toward the next best option) would be excessive.

The **Total OPEB Liability (TOL)** is the portion of the actuarial present value of projected benefit payments that is attributed to past periods of employee service, in conformity with the requirements of GASB Statement No. 75. It represents the present value of benefits from past accruals up to the point in time of the valuation date for active and inactive participants.

The **Fiduciary Net Position** is synonymous with the market value of assets. Assets in a trust may only be recognized for GASB Statement No. 75 reporting purposes if the trust meets all the criteria in paragraph 4 of GASB Statement No. 75, which are: 1) assets in the trust must be used solely for the purpose of providing OPEB to plan members; 2) contributions to the trust are irrevocable; and 3) assets in the trust are legally protected from creditors.

The **Net OPEB Liability** is calculated as the difference between the TOL and the Fiduciary Net Position and is sometimes referred to as the unfunded accrued liabilities. For plans that are prefunding, a common objective is to fund the assets in the trust to the point that there is $1 in assets for every $1 in accrued liability. When that point is reached, the amount reported on the balance sheet for this liability would be zero.

Real-World Insights: The Shift Toward Prefunding

In 2021, S&P Global Ratings released an article showing the funded ratios for pension and OPEB plans across the United States.[3] While national data is not readily available to track how OPEB funded levels are broadly changing over time, there are some examples we can share from some of the clients we serve.

Texas: GRS provides OPEB reporting and consulting services to more than 120 local governments in Texas. In recent years, there has been a noticeable trend in increased implementation of OPEB trusts. After applying the criteria from the previous section, prefunding could be a good fit for about 55 of these employers, and 15 of those 55 are already prefunding with an OPEB trust. The Texas local governments we serve are creating OPEB trusts at the pace of roughly one or two per year. The median long-term return assumption for the OPEB trusts of these 15 employers (at the most recent measurement) was 6.25% and the median funded ratio was 34%.

Michigan: Looking at another state, in 2017, local governments in Michigan under Michigan Public Act No. 202[4] established requirements to prefund OPEB benefits. The Act also required annual reporting to the Michigan Department of Treasury. In the first available report subsequent to enactment of the Act, as of January 27, 2021 for Fiscal Year (FY) 2017, the median funded ratio was 33% for the 310 (of 524) reporting local governments with a trust dedicated to providing OPEB benefits. According to the April 16, 2025 version of the FY 2023 aggregate data report, 405 (of 492) reporting local governments have a trust dedicated to providing OPEB benefits, with a median funded ratio of 74%. This significant increase in both the number of local governments with a trust and their funded ratios over a short time period highlights the extent to which legislation may impact the funded status of OPEB plans.

Financial Impact: A Case Study of PayGo vs. Prefunding

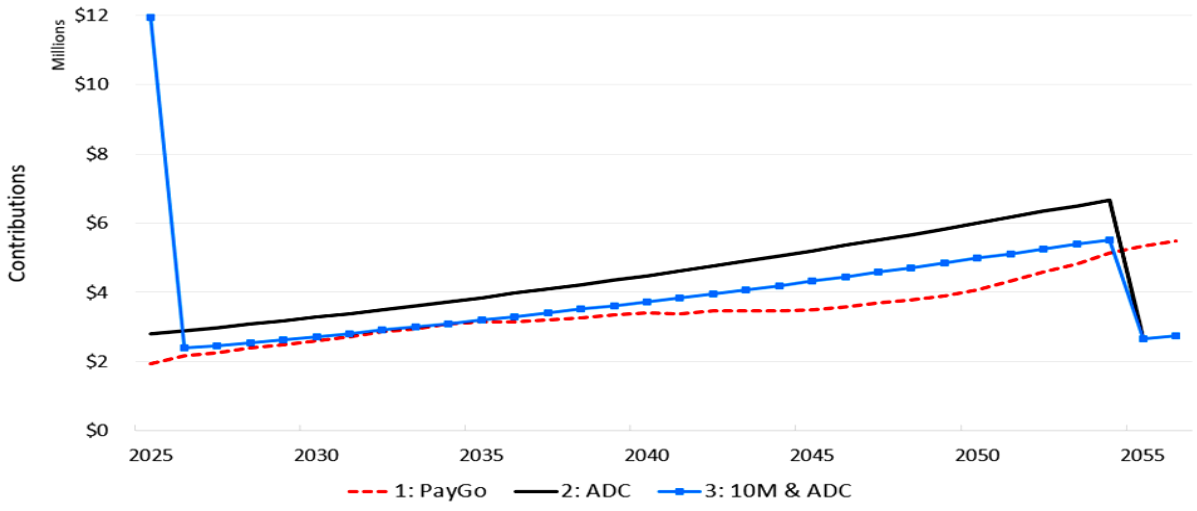
In this case study, we will look at the projected financial impacts of prefunding for a sample mid-sized local government that recently implemented a Section 115 trust. The local government had a current Total OPEB Liability (TOL) of approximately $40 million. This liability is projected to surpass $100 million in the next 30 years due to medical inflation. To explore the impact of the PayGo and prefunding approaches, we modeled the projected impact on both the contributions and liabilities over a 30-year period.

The characteristics for the PayGo scenario (Scenario 1) include: continuing to pay retiree medical costs as they arise, with no accumulation of assets or investment earnings. Two prefunding scenarios were modeled. In one scenario, the Actuarial Determined Contributions (ADCs) would be contributed each year to systematically fund the trust over a closed 30-year period (Scenario 2). The ADC consists of two components: 1) the service cost – the cost allocated to the given year for the service accrual of all active employees that could receive OPEB benefits in the future; and 2) an amortization of unfunded liabilities – an amount determined to methodically close the gap between the assets and accrued liabilities. For Scenario 3, the local government would make a $10 million initial contribution to kickstart funding of the OPEB trust, and subsequent contributions equal to the ADCs over a closed 30-year period. Investment earnings for the trust were assumed to be 6.25% per year (for both prefunding scenarios).

The projected contributions made over the 30-year prefunding period are illustrated in Chart 1 below.

The projected contributions for the ADC strategy (Scenario 2) are consistently the highest, with the gap between Scenarios 1 and 2

Chart 1



[3] https://files.constantcontact.com/701ae45c001/25d28b42-f490-4285-9803-0a1533470cbe.pdf
[4] https://www.legislature.mi.gov/documents/2017-2018/publicact/pdf/2017-PA-0202.pdf

representing the steady incremental cost of prefunding over the 30-year prefunding period. The gap between Scenarios 2 and 3 shows how much the future ADCs can be lowered by the $10 million initial contribution. For both the prefunding strategies (Scenarios 2 and 3), there is a significant drop off in the ADCs after the 30-year amortization of the initial unfunded liability. Contributions for both strategies shift from exceeding PayGo costs, to dropping to roughly 50% of PayGo costs subsequent to the amortization period. Once the unfunded liability has been fully amortized, the ADCs equal the ongoing service costs related to active member benefit accruals.

For the ADC scenario (Scenario 2), the following table provides a breakdown of funding sources over time.

Table 1

Scenario 2: ADC – Percentage of OPEB Costs Funded by Contributions Over Time

($ in Millions)

Years	Investment Earnings	Contributions	Total Funding	PayGo Benefit Costs	% of Benefit Costs Funded by Contributions
	(1)	(2)	(3) = (1) + (2)	(4)	(5) = (2) / (4)
1-10	$ 3	$ 33	$ 36	$ 25	132%
11-20	11	44	55	33	133%
21-30	32	53	85	41	129%
31-40	52	30	82	64	47%
All Years: 1-40	**98**	**160**	**258**	**163**	**98%**

The long-term benefits of prefunding become most apparent after the initial unfunded liability has been funded. After year 30, there are significant changes in both the investment earnings and contributions. Prior to being fully funded, the primary use for investment earnings was to reinvest and continue growing the trust. Once the liabilities accrued in previous years are fully funded by trust assets, investment earnings help pay costs incurred each year. Contributions under prefunding (Scenario 2) exceed the PayGo costs (Scenario 1) throughout the 30-year amortization period. However, beginning with the 31st year, there is a sharp decline in the ADC to about 50% of the PayGo costs. The $160 million of total contributions for Scenario 2 over the 40-year period are close to the $163 million of PayGo costs. It is important to note that while the contribution effort over this period is the same for the two strategies, the prefunding strategy has accumulated a trust amassing over $80 million in assets after 30 years of funding.

Chart 2 shows the breakdown of total funding between investment earnings and contributions over the 40-year period following implementation of each modeled funding policy.

Chart 2

Funding Sources Over 40 Years

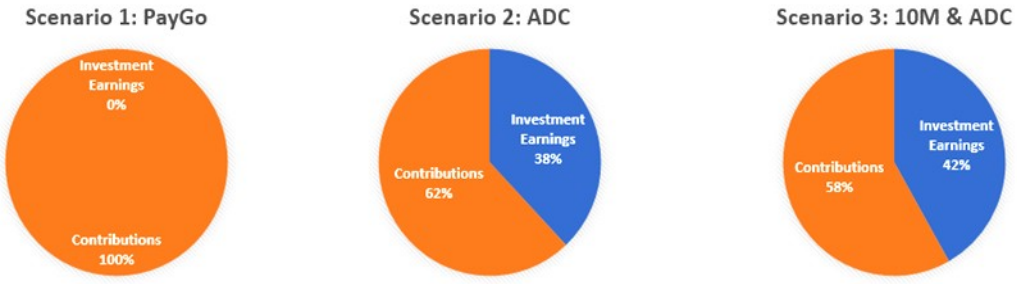
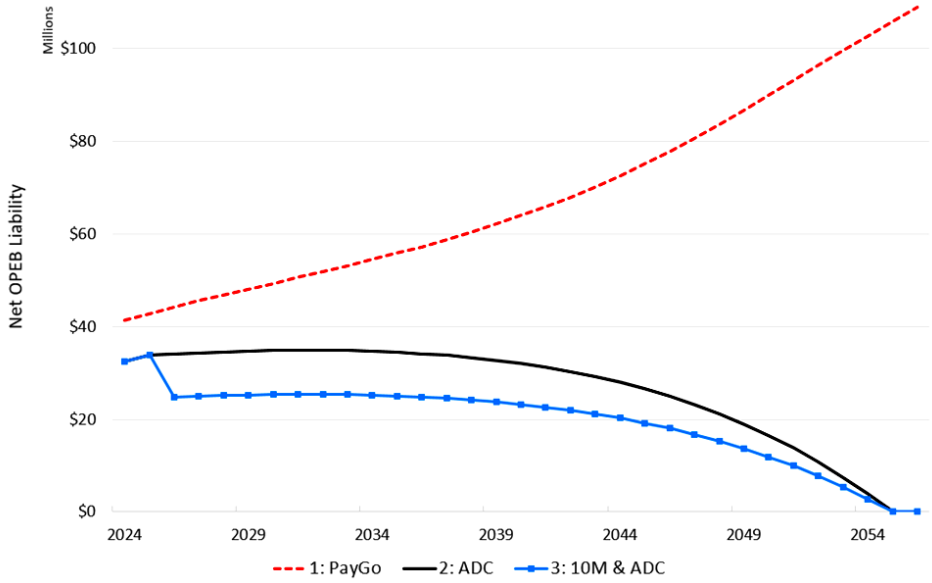


Chart 2 helps underscore how investment earnings due to prefunding can alleviate the burden of long-term contributions. The selected asset allocation for Scenarios 2 and 3 was assumed to earn 6.25% per year, and the corresponding investment earnings would be able to fund approximately 40% of OPEB benefit costs over the 40-year period. After the trust is fully funded, the proportions of investment earnings and contributions are expected to stabilize at roughly 60% and 40% respectively, rather than continuing to shift further in favor of investment earnings.

Chart 3 illustrates the projected Net OPEB Liabilities for each scenario that would be reported on the balance sheet for GASB Statement No. 75 purposes.

Chart 3

Projected Net OPEB Liability



In Scenario 1, the Total OPEB Liability (TOL) increases from $40 million to over $100 million over a 30-year period, driven by continued inflation of healthcare costs along with no trust asset accumulation. In Scenarios 2 and 3, there is an immediate drop in the OPEB Liability related to a change in the discount rate used to calculate it. When there is a strong commitment to prefund, GASB Statement No. 75 allows for the discount rate to reflect the expected long-term return on assets, which is typically higher than the prevailing municipal bond rate. In the case study, this immediately lowered the TOL by approximately 20%. In Scenario 3, there is an additional decrease related to the initial trust contribution; the additional $10 million in accumulated OPEB assets reduces the Net OPEB Liability. Under both Scenarios 2 and 3, contributions continue to be made: 1) to pay current retiree benefits; and 2) to the OPEB trust in order to continue improving the funded status of the plan. At the end of the 30-year amortization period, there are sufficient trust assets to entirely offset the TOL, and the Net OPEB Liability is projected to be $0 at that time.

In summary, the cash outlay to prefund was greater than the cash outlay required for PayGo during the initial 30-year amortization period. However, there is a significant OPEB Trust Fund which has been accumulated under the prefunding approach and the balance sheet has benefited from being able to use a higher discount rate to measure the Total OPEB Liability. Taking both the balance sheet and cash outlay into consideration, it can be argued that prefunding provided more value than PayGo over a 30-year time frame. Additionally, investment earnings will be generated, via prefunding, which can fund approximately 50% to 65% of all future benefit costs. The more short-term the mindset, focusing only on the current set of benefit recipients, the more appropriate it is to default to PayGo. Conversely, prefunding better coincides with a more long-term orientation – considering future generations of taxpayers, employees, and other stakeholders.

Conclusion: Securing Long-Term Financial Health

Choosing between PayGo and prefunding involves balancing immediate budget realities against securing future financial stability. Although prefunding requires upfront investment costs, it yields significant benefits including: 1) easing long-term taxpayer costs; 2) reducing balance sheet liabilities; and 3) enhancing financial health and governance. Financial decision makers, who are entrusted with protecting the financial interests for many stakeholders, should carefully evaluate prefunding as a proactive measure to responsibly manage growing retiree healthcare obligations and ensure fiscal health for future generations.

To further explore any of these ideas or discuss the long-term projected financial impacts of different funding strategies for your OPEB plan, please reach out to your GRS consultant or Contact Us.

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