Public Money

Funding Phobias

States and cities have a lot of reasons for inaction on funding retiree medical benefits. Some of their excuses are pretty flimsy.

By Girard Miller | July 23, 2009

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As I travel around the country working with public officials to redesign their retiree medical benefits (OPEB) plans to achieve sustainability, I've heard a variety of excuses for inaction, indecision and procrastination. Even though many public officials would never think of leaving their pension plan unfunded, or skip a sinking-fund payment on their bonds, they are willing to do so for retiree medical benefits. Some of their reasons are understandable and rational; some reflect naïveté and others are just flimsy. Here are the common themes from the field:

Practical reasons to delay action:
• Our revenues plunged and we're laying-off employees. We'll work on cost reductions in our labor negotiations, but an OPEB trust is simply impossible to fund right now and we have other crises to address first.
• Our labor agreements have two more years to run. We are waiti mid-2010 to develop our strategy so we'll know our bottom line better than now.
• Our elected officials are up for election this fall. It's suicidal for bite this bullet until 2010. But we're educating them now to set th action next year.

Naïve or flimsy excuses
• We think Obama's health care reforms will change the picture, so why start now?
• If we fund an OPEB trust, it's irrevocable and we can never get the money out. We'll lose all our financial flexibility.
• Funding an OPEB trust is an admission that we have a liability. We don't want to formally acknowledge that.
• The stock market is scary and we're afraid of losing money in the markets. If we leave it in the general fund, at least we we'll get our money back even if interest rates are low.

There are other excuses and rationales for doing nothing, but these are the seven I hear most frequently. Before addressing what I call phobias and misconceptions, I'll start with the issue of changing the plan design--since that is ultimately the most important action that public officials can take to get control of their OPEB costs.

If your government is flat broke with no hope of making a meaningful actuarial contribution to your OPEB plan this year or next, the smartest action you can take is to grapple now with your cost structures. When labor organizations have to choose between layoffs, furloughs, payless Fridays, salary freezes and other cost-cutting measures, it's hardly too much to ask for the employees to re-open their retiree medical benefits plans and install cost caps and curbs. I've discussed many of the potential cost-mitigation and cost-sharing measures to demand in a previous column and will not belabor the point here. The essential point is that there will never be a better time to negotiate for benefits reductions than now, as explained separately in a prior column addressing that strategy.

Coming out of this recession, most employers will have no choice but to demand that employees contribute to their retiree medical benefits. As explained below, an OPEB trust is necessary to secure employee contributions toward the funding of retiree health benefits. Without a trust already established at least on paper, an employer cannot reasonably demand that employees make a contribution because their interests would not be properly secured.

OPEB phobias and misconceptions. From my list of naïve and flimsy excuses, let's take a quick look at each of them. None are purposefully deceptive. Often they are presented with good intentions. Typically they reflect a lack of information or real concerns of public officials who are concerned about making a mistake. But each of these excuses fails the test of logic and facts.

"National health care will change everything." The first and flimsiest excuse for procrastination is the hope that the Obama Administration's anticipated health care reforms will somehow magically relieve state and local governments of their $1.5 trillion legacy OPEB obligation to provide health care benefits to retirees. Now that the House democrats have reported out their blueprint from three committees, it's obvious that state and local OPEBs will not be relieved of their burdens. National health care is now clearly irrelevant to local funding decisions.

The problem with this excuse is that national health care will focus on providing coverage for pre-Medicare individuals now outside the employer-based system. Congress has no money whatsoever to help out with retiree medical plans for state and local governments. The Medicare trust fund is going broke in eight years. The latest trustees report says the Medicare payroll tax must increase 134 percent to pay for existing benefits, let alone an expansion of retiree medical benefits. Extending free benefits to state and local government retirees is a local politicians' pipe dream. I discussed this issue more thoroughly in a prior column on "Medicare insolvency and the OPEB good fairy."

For the past year, I have repeatedly asked procrastinating politicians what exactly they think any ultimate national health care legislation might do that would eliminate a state or local government's obligations to provide and fund retiree medical benefits. The only answer I get: "Well, I really don't know, but there could be something." My second question is even simpler: "Has anybody actually asked for this? Is there an organized national lobbying group that has even presented a demand or a plan that Congress bail out state and local governments for their retiree medical liabilities?" To date, nobody has ever named one. Now we can simply ask: "Is there anything in the Congressional committee reports that supports your stalling tactics?"

"An OPEB trust is irrevocable and we can never get our money back." Indeed, an irrevocable trust is a GASB 45 requirement for defined-benefit accounting and a favorable actuarial rate to calculate the obligations. However, the phobia over irrevocability is misplaced.

The first fear is that money placed in the trust cannot be recovered if the national government eventually nationalizes retiree health care. In fact, most OPEB trusts include a simple provision that authorizes the employer to terminate the trust and return contributions in the event the purpose of the trust is fulfilled. Oftentimes, a parenthetical reference to national health care is provided as an explicit example.

Beyond that, a startup OPEB trust can quickly be de-funded simply by making disbursements for ongoing benefits while suspending contributions. So whatever money might be contributed in the early days of an OPEB trust can quickly be spent for current benefits and thereby relieve the general fund of its previous benefits payments.

"We shouldn't admit there's a liability." A second phobia is that the creation of a trust is admission of a liability. Actually, that's just silly. If your auditor did not believe there was a genuine liability, they would have challenged your last financial statement's note disclosures concerning OPEB. In fact, if the auditors truly believed there were no liability, they would be obligated to communicate that to the governing body. GASB's rule on this is fairly simple: report liabilities on the basis of the basic terms of the substantive plan (i.e., the employees' understanding of what they are reasonably promised in exchange for working for your organization--as supported by written documents or oral presentations)

Establishing a trust to pay benefits does not create a greater obligation to retirees or employees than the contingent liability that already exists without the trust. Creating or making contributions to the trust does not obligate the employer to continue making contributions, and well-written trust documents say that. Union groups that try to play that card need to be reminded that they have already taken the position that the promise has been made and must be fulfilled, regardless of the trust arrangement. In fact, a trust is a necessary condition for demanding that employees pay part of the contributions to support the benefit. So a better negotiating argument is that the employer is taking appropriate measures to set the stage for employee cost-sharing. Without a trust, the obligation is unilateral and employees get a free ride. With a trust, the obligation can be shared and part of the liability lies with employees.

"Stocks are too risky right now." One thing that troubles me professionally is the fear-mongering that some private-sector investment advisors have played on their prospective clients by talking them into investing OPEB money strictly in short-term investments (which just coincidentally happens to be their specialty and sole investment advisory capacity). Although long-term investors have been punished by the recession and the malaise in financial markets, the long-term history of pension funds is that they have done better by investing in stocks than bonds, and much better than short-term instruments typically held in the general fund.

In fact, the experience of pension funds over past decades teaches us the lesson: Those who took "contribution holidays" to avoid cash outflows during recessions suffered from lower investment performance than their peers who "dollar-cost averaged" into the stock market during recessionary bear markets. History has repeatedly shown us that asset prices are lowest and future returns are highest when capital is scarce and investors are scared. This benefits long-term institutional investors like pension funds. The same will likely be true of OPEB plans. Those who wait until the economy is back on its feet almost always suffer impaired long-term investment returns because of their delays. They always miss the boat of average (or better) returns because they invest too late.

Be prepared and armed with answers. Hopefully these observations and counter-arguments can help professionals who must cope daily with Nervous Nellies, political gamesmanship and magical thinking that often surfaces when the harsh realities of today's OPEB funding crisis are brought home. I realize it's no fun for public-sector managers to deliver news that politicians would rather avoid, but the longer we wait to stop digging this ever-deepening hole of OPEB deficits, the sooner we will see the light of day.

For those with a few dollars still in reserves, a "ramp up" strategy to start funding an OPEB trust is a good place to start. For those entering labor negotiations, my previous column on pension and OPEB bargaining-table strategies is worth reviewing.

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