Public Money

The OPEB Acid-test

Paralysis must yield to analysis — soon.

By Girard Miller | May 7, 2009

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It has been two years since the Governmental Accounting Standards Board (GASB) adopted its Statement 45, requiring disclosure of liabilities and costs of retiree medical benefits and other post-employment benefits (OPEB). Except for the smallest jurisdictions, which have another year before implementing the new rules, the annual financial report must disclose OPEB benefits just like pension costs and liabilities. In most cases, the actuarial costs of properly funding OPEB benefits will be double the past practice of paying-as-we-go.

The national recession has clobbered state and local government budgets. Revenues are down and are expected to decline yet another year, with 2011 likely to be the earliest that tax receipts will bottom out. Meanwhile, pension costs are surging as investment losses compel pension funds to send higher bills to public employers. That leaves virtually no money available for most jurisdictions to fully fund their OPEB plans on an actuarial basis.

So what are most governments doing? Unfortunately, for many the answer is "nothing." Paralysis has set in, as the absence of sufficient funding leaves many budget offices declining to set up a properly funded OPEB trust. Many public officials have simply put their heads in the sand and decided to wait out the recession before looking seriously at their OPEB problems.

That's a mistake. By taking no action, policymakers and senior administrators are digging a deeper hole in their OPEB deficits. Failure to fund a plan on an actuarial basis does not stop the liabilities from growing, as employees earn another year of benefits for which no money is put aside. It's like skipping an annual contribution to your child's college education fund, as the day of reckoning approaches and the investment income that was expected to pay the bills is not there because the money was spent on the family vacation to Europe. Even worse, the rising costs of medical insurance are outstripping inflation and therefore the hole gets deeper even faster than it does for a pension fund.

At the same time that Moody's Investors Service has announced a nationwide inclination to downgrade municipal credits (in part because of unfunded pension and OPEB liabilities), the National Federation of Municipal Analysts has called for state and local governments to fully disclose their OPEB liabilities. That would include publication of the full actuarial report as well as the management plan to achieve proper funding. Public agencies that don't put this information in their next annual report run an increasing risk that eventually their bonds will be downgraded. So, there is now a serious reason for states and municipalities to formulate an action plan and to install a startup OPEB trust.

As I've written before, an OPEB strategic plan should be adopted by elected officials and should address the following:

- Are the retiree medical benefits now promised actually affordable and sustainable?
- What future revenue sources or near-certain revenue growth will provide the financial resources needed to pay for OPEB expenses?
- Will future budget surpluses be devoted to pay down the unfunded OPEB liabilities, as a first call on those one-time assets?
- How will the next three to five years' budgets provide for increased OPEB costs, and how will that impact other services and tax rates? If money is not available now or next year, how will the "ramp-up" of OPEB contributions be staged to attain eventual full funding?

- Should bonds be used to finance part (e.g., 1/3) of the total unfunded OPEB liability as part of a multi-decade financial plan?

- When will an OPEB funding trust be established? Failure to establish this basic element of the financial plan will eventually result in audit problems and will actually increase the annual required actuarial contribution. Actuarially, the long-term investment earnings assumptions for the OPEB plan must be reduced to short-term interest rates and that means more money must be paid into the plan each year because earnings will be lower.

- What plans and strategies have been discussed to place hard-dollar limits and caps on the retiree medical benefits going forward? This single factor often has more influence on long-term costs than any other feature, especially for plans with full benefits. Putting an end to runaway retirement medical cost inflation is management's job #1.

- Have you redefined a full career to represent 30 or at least 25 years of service, with retiree medical benefits pro-rated for fewer years of actual work time?

- When will employees begin paying for part of their retiree medical benefits?

- Have plans been made to enable employees to start saving for their unsubsidized share of future retiree medical costs? Tax-advantaged programs are available but they require employers with unions to establish a plan and to bargain with labor groups to achieve a uniform group-wide savings rate.

Elected officials should demand that before the end of the year, their administrative teams assemble a plan that addresses these issues. Failure to do so will leave you in a position of "bluffing" the investment community in the coming year, and that will not be a pretty picture. Finance officers who plan to visit New York ratings agencies would best be prepared to answer all the above questions, and preferably have a PowerPoint deck assembled with thoughtful and vetted answers to these questions.

For many employers, a simple first step is to adopt a start-up OPEB trust fund that can receive small scraps of money as they accumulate, including future budget surpluses, as well as any increases in tax revenues that may result from an eventual economic recovery. This OPEB trust fund does not need to receive a full actuarial contribution in order to get started, but having one in place is a big first step that can result in highly advantageous audit and actuarial results. A simple index-fund investment strategy can eliminate the complexity of many of the investment options that might be considered later, and the trustees of the start-up plan can be senior managers with limited powers and limited fiduciary risks.

Public employers, managers and policy-makers seeking more information on how to develop an OPEB strategic plan and implement a startup OPEB trust can e-mail me here.

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