STRATEGIES TO CONSIDER AS OPEB COSTS ESCALATE
“If I could figure out how to portray OPEB in a costume, I would go as unfunded OPEB to my next Halloween party. I can’t think of anything scarier.”

—Phil Moore, city manager, Alma, Michigan

Six years have passed since the Governmental Accounting Standards Board (GASB) issued its Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions. During that period, many state and local governments have done little to address their retiree medical liabilities and cost structures. Their escalating unfunded liabilities are shown in the footnotes to their financial statements, but their management teams, and elected officials, have generally not mitigated costs or proactively managed the liabilities downward. As a result, the national total of unfunded liabilities for these benefits alone is approaching $2 trillion in 2011, dwarfing the “public pension problem” that captured national media headlines last year.

Not every governmental employer has a problem with other postemployment benefits (OPEB), but many do. Ironically, the only generalizations that can honestly be made about OPEB plans nationwide is that they are not homogeneous and they defy generalization. Anecdotally, only about a half of all state and municipal employees receive significant lifetime retiree medical benefits before reaching Medicare age. A substantial number of this subset receives generous benefits, while at the other end of the spectrum, many public-sector employers provide little or no financial assistance to help their retirees defray medical expenses, beyond the implicit subsidy of providing access to their group insurance plans at the same premiums paid by active employees.

MISTAKES OF THE PAST

In retrospect, the most common managerial and leadership error of “complacently generous” governmental employers was their failure to begin fully funding their OPEB benefits immediately after GASB issued Statement No. 45. Instead of reining in their...
benefits when the numbers arrived at their doorstep, most made no changes and continued expanding their payrolls with additional employees. Headcounts increased all the way into the first nine months of the Great Recession that began in December 2007. As revenues thereafter plummeted, governments laid off employees, declared furloughs, cut services, and further deferred funding of retiree medical benefits. In addition, the unfunded liabilities of the nation’s public pension funds doubled during the 2007-10 period, making matters more complicated as financial markets tumbled and recovered only two-thirds of their market losses in the ensuing economic recovery.

As a previous Government Finance Review article explained,1 governments that are experiencing OPEB (and pension) funding problems should not expect those problems to be solved by economic growth alone in this decade. The Great Recession brought the worst percentage decreases in economic activity, production, employment, and equity (stock and real estate) market levels since the Great Depression of the 1930s, which lingered for more than a decade. With real property values in many states down significantly, markets suffering a long pipeline of underwater home mortgages that are heading toward foreclosure, and unemployment stubbornly high, given corporate reluctance to expand production in the face of excessive capacity, there is no reason to expect rapid revenue growth any time soon. Tax revenues will eventually recover from depressed levels, but nobody expects a nationwide return to 2007 levels, adjusted for inflation, for another three or four years. Meanwhile, retiree medical costs continue to escalate far faster than general inflation, governmental revenues, and the investment returns on general fund assets. The hole keeps getting deeper for jurisdictions that have procrastinated.

In this context, many public managers and elected officials need to confront the realization that their governments cannot afford the benefits promises made to public employees in the past. OPEB costs under pay-as-you-go financing will automatically double in this decade — and ultimately quadruple,
or worse. Actuarially, most unfunded employer contributions for OPEB plans should be doubled immediately just to put plans on a track toward eventually achieving a proper financial footing. For employers with high retiree medical insurance cost structures, extremely underfunded pension plans, and tax limitations (either because of law, natural economic limits, or taxpayer rebellion), the most likely scenario for this decade will be multi-year hiring freezes and virtually no salary increases.

The answer for most private-sector CFOs was to jettison their OPEB plans quickly after the Financial Accounting Standards Board required them to record actual costs and investors noticed the impending funding difficulties. Only a minority of large corporations (and very few small employers) now provide any retiree medical benefits at all, and most of them limit the benefit to a post-Medicare supplement or a defined contribution. Public officials who are responsible to taxpayers for designing market-competitive compensation and benefits plans need to keep the private-sector experience in mind. So far, however, the major public employers that maintain unsustainable benefits plans have shown relatively limited evidence of serious retrenchment; and bond rating agencies and municipal bond investors have largely failed to penalize issuers that have unsustainable retirement obligations, which allows unsound practices to continue.

**LONG-TERM VERSUS SHORT-TERM STRATEGIES**

What measures can financial professionals recommend to their senior executives? What policy advice should they give elected officials, who are pressured constantly by public employees and their unions to continue often-unsustainable benefits and simply “kick the can” to their successors and future taxpayers? How can public employers balance the dilemma of unsustainable long-term costs and short-term demands for public services and stable employment relations?

Governments that are experiencing OPEB funding problems should not expect those problems to be solved by economic growth in this decade.

The first step is to fully understand and document the cost structure of the jurisdiction’s retirement benefits plans. This means asking actuaries for multi-year projections using discount rates and amortization periods that are consistent with the announced views of the GASB under its formal review of relevant accounting standards. The amortization period for unfunded pension liabilities should be aligned with the average remaining service life of current employees, which could increase employer pension costs by as much as 50 percent in many jurisdictions. Ultimate cost increases for full actuarial funding of retirement benefits will likely range from 50 to 100 percent, especially for employers with major unfunded OPEB liabilities and pension underfunding at current market levels.

Once these data are obtained, the financial staff can then assess whether the employer has any realistic hope of making these actuarially required contributions. In some cases, a combination of pay freezes, personnel attrition, and other cost-cutting measures will be sufficient to fund the catch-up financing required for the pension and OPEB plans. But in many cases, it will become obvious that something has to change.

2. Provide Visual Representations.

Exhibits 1 and 2 depict the kind of visual presentation of OPEB costs that financial professionals can develop to better portray the intermediate and long-term consequences of current funding practices. The same graphics should be developed for pension costs as well, and these can be combined to show the cumulative impact of all deferred retirement plan costs. The first financial exhibit should display the projected path of current contributions over 15 or 20 years, if the employer continues to fund OPEB on a pay-as-you-go basis, as well as the actuarial projection using current assumptions, and the actuarial cost curve if GASB’s preliminary views are implemented to require shorter amortization periods.

The second exhibit should illustrate the resulting projection of the OPEB plan’s unfunded actuarial liabilities in 15 years under the different scenarios. (The third, “ramp-up to full ARC” scenario depicts the projected results of incrementally increasing the funding rate over several years to smooth the budgetary impact.) This will make it clear to elected officials, labor representatives, taxpayers, and the media that the consequences of inaction are a massive increase in unfunded liabilities that will be deferred to the next generation. Constituents can be reminded which of these unfunded liabilities represent the benefits payable to current retirees and employees, in addition to the costs of providing these benefits to replacement workers.

3. Solve for the Long Term First.

The best advice government officials can follow is to begin with the long-term structural problem first. Many public employers have begun to attack the long-term problems of their pension funds’ sustainability by introducing new benefits tiers that roll back benefits granted in the halcyon years of the Internet bubble, leading up to 2000. New benefits tiers usually begin with the new hires first, although some employers also make plan changes for incumbents, if state laws and judicial precedent allow. For OPEB, the best place to begin is also with new employees, for whom the labor market seldom offers a competitive post-retirement medical benefit. A new benefits structure for such employees is often required.

Cost-cutting options for many employers with unsustainable “full-cost” OPEB plans include: 1) trimming the defined benefit back to a post-Medicare supplement, and 2) providing early retirement and spousal/dependent retirement benefits only through a defined contribution plan, for which the employer costs can be better controlled. Even if employers just limit a more-generous defined OPEB benefit to a Medicare supplement of $10 to $20 a month for each year of service (with a CPI adjustment hereafter), the actuarial cost of that benefit for new hires can be made more affordable. Employees can be told that this benefit is available to them only if they bear one-half of the actuarial cost, which further reduces the employer’s cost — while providing a market-competitive benefit. In the current economy, such benefits are increasingly rare in the private-sector markets from which employees are recruited. Some employers might discon-
tinue retiree medical benefits altogether, but this could require adjustment to pension benefits, if they provide insufficient retirement income replacement.

If it is affordable and market-competitive, public employers can then also consider the feasibility of an employer-matched defined contribution plan for OPEB benefits. For example, the employer can provide an equal match to an employee’s fixed-dollar or percent-of-salary contribution toward a retiree medical benefits savings account. This account operates similarly to the employee’s deferred compensation, except that it will be tax-free when withdrawn for qualified purposes, and contributions are mandatory instead of discretionary. If employees wish to decline the benefit and avoid making OPEB contributions, they can be allowed to opt out irrevocably.

4. Require Hefty Employee Contributions. The second step public employers with funding problems can take is requiring that all employees (including current employees) pay a substantial share of the actuarial cost of their retiree medical benefits. Some consultants recommend that employees should eventually bear one-half of the normal cost of their OPEB benefits. This assures that workers appreciate the full value of the benefit. When retiree medical benefits are free, employee demand is unchecked, and it comes as no surprise that retirees make no effort to curb costs. Employers nationwide will eventually have to systematically increase their employees’ share of these costs — often from zero to a number closer to 5 percent of pay for plans with generous pre-Medicare benefits. Even with employees paying half the cost, such OPEB benefits will still exceed those available in the private sector.

Sponsors of the most-underfunded OPEB plans need to consider requiring employees to pay an equal share of the full actuarial cost of all retiree medical benefits that are payable before the employee reaches the Medicare eligibility age of 65. Strategically, these benefits can be characterized as “early retirement medical benefits” to distinguish them from benefits payable after age 65 and those more commonly available in the private sector. For the Medicare supplement, the employee contribution could be set much lower. By pricing the pre-Medicare benefit fully, employers can create incentives for some employees to turn down the benefit and work more years to achieve the lower-cost Medicare supplement. The longer employees work, and the later they retire, the more favorable the outcome for both the OPEB plan and the pension fund.

5. Reform Benefits for Incumbent Employees. The next, and often the most difficult, plan design change is reforming the benefits payable to current employees. Legal issues are likely to arise here, as each state has its own laws (with limited case law) regarding the vested rights of employees to receive retiree medical benefits. In some states, the OPEB benefit is a gratuity and can be cancelled or modified by the plan sponsor. In others, however, the courts might find that employees have vested rights similar to those regarding pension benefits.

Beyond legal concerns, there are also moral and morale issues to consider when modifying benefits of incumbent employees. For example, a fully vested employee who has satisfied all the age and service requirements for a full OPEB benefit has a strong claim that the benefit cannot be reduced. At most, public employers in such cases might attempt to raise the distribution age by a few years, increase the employee contribution, and cap the annual benefit with a CPI escalation limit. Such measures can mitigate costs while still recognizing the employees’ legitimate claims to the core benefits they have already earned through prior service.

For younger workers, the employer has a stronger case and an easier path to modifying the benefit structure, if
state law allows. In addition to raising the age and service eligibility requirements and establishing a cap (based on a dollar amount or CPI/inflation) on the annual benefit, OPEB plan reformers can explore the feasibility of restructuring the benefit to a tax-free monthly retirement medical stipend of $10 to $20 monthly for each year of service. Vesting for such employees should be revised upward, in many cases, to strengthen employee retention.

6. Establish a Defined-Contribution OPEB Benefit. One of the most powerful tools available to public employers seeking to restructure their OPEB benefits is a defined contribution retiree health savings plan feature that can be offered as an alternative or substitute. For most new employees, a defined contribution OPEB benefit will still exceed any comparable competitive benefits they might obtain in the private sector, and younger workers typically prefer the flexibility and vesting features. Finance officers must take into account that any employer share will require an immediate budgetary expenditure that cannot be deferred in the way defined benefit OPEB plans have operated, which could create a cash-flow issue. But to the extent that very few public employees are being hired (as governments use the money to instead pay the escalating costs of retiree benefits), the incremental cost of paying a small defined contribution to a handful of new workers might not be a major issue.

Employers should not deceive themselves that a defined contribution OPEB plan will ultimately provide employees with a benefit of equal value to a traditional defined OPEB benefit. Unlike pension funds, which can usually earn investment income at rates exceeding general inflation, OPEB plans face medical cost inflation that typically outruns the investment rate of return. This forces employers and contributing employees to subsidize the defined benefit OPEB plan at levels that are simply not provided in the private sector. The real issue is not whether a defined contribution plan will replace its predecessor plan— it won’t—but whether it is affordable, sustainable, and competitive.

7. Buy Out Vested Employees’ Benefits. One innovative strategy, used by the City of Beverly Hills, California, is worth consideration by employers with strong borrowing capacity, sufficient short-term cash flow, and a long-term view of their OPEB cost structures. Beverly Hills had provided a relatively generous conventional retiree medical benefit with substantial unfunded accrued liabilities. The city bought out a substantial number of vested incumbent employees for the fair actuarial value of their accrued benefits, on a voluntary exchange basis. The city sold taxable notes (secured by lease revenue on a municipal parking structure), with a borrowing cost of 4.5 percent over 11 years, and it used the proceeds to compensate employees for their accrued benefits.

The city created a defined contribution OPEB benefit for new employees and offered incumbents the option of receiving the actuarial value (using a 6 percent discount rate) of their current OPEB accumulation, in the form of a mandatory contribution of 20 percent of that fair value to a health savings plan, with the balance in taxable cash and/or deferred compensation. Employees who received cash had a one-year waiting and vesting period, and the balance of their exchange value was transferred to either a 457 deferred compensation, a pre-existing 401(k), or a tax-deferred 415(m) benefits plan account, in such amounts as each employee designated, up to the Internal Revenue Service legal limits.

About 58 percent of the city’s eligible workers opted to receive the exchange benefit and disclaim the previous defined OPEB benefit. The city anticipates substantial long-
term savings from a $260 million reduction in accrued unfunded liabilities as a result of this strategy.

As with any bonded strategy, this approach converts a soft liability into a hard liability, but when compared with benefits bonds issued to fund a defined-benefit OPEB trust portfolio, there is less leverage and less inherent investment risk (which is now transferred to the employees rather than the employer). The city viewed the previous soft liability as a rapidly escalating, uncontrollable cost, and the new hard liability as a known, lower, fixed cost.

8. Employ Carrot and Stick Strategies. This gives public employers a powerful enticement to induce incumbent workers to convert from a costly defined benefit program to a less costly defined contribution program for OPEB. For employers that might use a different discount rate or other actuarial assumptions to value the employees’ benefits, the savings could be even greater. Blending the buy-out option strategy as a “carrot” with a “stick” of higher mandatory employee contributions for early retiree medical benefits for vested incumbents might allow public employers to achieve even greater long-run savings.

9. Consider Labor Relations. Experienced financial managers know that benefits plan changes can be disruptive in the workforce and cannot be imposed in a vacuum without major repercussions. In states that have strong collective bargaining laws and traditions, these changes must be negotiated. Even in right to work states that have greater employer discretion, the morale impact of changing benefits must be taken into account.

Employees and their labor representatives must first be informed of the long-term true-cost trajectory of their current benefits plans. If the cumulative costs are unsustainable, employees should be made aware of this unavoidable fact of life and the consequences of inaction. The actuarial data and graphics discussed above should make that picture clear and undeniable. When confronted with the prospect of a “lost decade” with virtually no salary increases and chronic workforce attrition, many public employees will eventually accept the need for change, especially if the reforms are phased in incrementally and designed thoughtfully. A cohesive labor relations strategy should be developed and must be supported by elected officials to be effective.

CONCLUSIONS

Many governmental employers have avoided material unfunded OPEB liabilities, but most of those that provide especially generous early-retirement medical benefits now face a dismal future unless they act soon to mitigate costs. Long-term solutions that affect future employees are helpful, but they typically fail to offset imminent cost increases. Increased employee contributions for OPEB benefits will become far more common in the near future. Where permitted by state law, public employers are likely to begin restructuring benefits obligations to current employees as well as new hires, and the sooner this process begins, the greater the cost savings. Innovative financial strategies can be considered, but they are, ironically, best suited for those whose balance sheets and operating budgets need help the least, and infeasible for employers that need the most help. Many public officials will eventually conclude that medical benefits for public employees who retire before attaining Medicare age can be sustained only through employee matching contributions to a defined contribution plan or a very modest defined stipend based on a full lifetime career of public service.

Notes


2. A 2010 survey report issued by the Center for State and Local Government Excellence showed numerous respondents considering or planning to change their OPEB plans, although it did not systematically document actual plan changes or their magnitude.

3. Presently, an unfunded OPEB plan without a qualifying trust must use the cash-management investment rate, usually 4 percent or less, for discounting future benefits.

4. For additional information on the City of Beverly Hills’ strategy, e-mail Scott Miller, finance director, at smiller@beverlyhills.org.

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