

## **GASB 45 Words of Wisdom: Don't Just Stand There – Do Something!**

By Samuel H. Fleet

Few politicians could look at a liability of almost \$50 billion and not be worried. But the chief financial officer for the biggest state in the nation – a state whose economy is so huge that it would place 8<sup>th</sup> in the world if it were a separate country – proved recently that he has both vision and practical political smarts.

California State Controller John Chiang announced in May 2007 that the state's unfunded liability for retiree health benefits over the next 30 years is \$47.88 billion – an obligation that would require setting aside \$3.59 billion a year, instead of the \$1.4 billion currently allocated, if the state wanted to continue its pay-as-you-go strategy.

Numbers like that have induced near paralysis among policy makers and administrators across the nation as GASB 45 has kicked in and brought retiree health care costs out of the basement, where public employers have kept them buried for years.

Who can blame them? Rather than choosing among what they are sure will be unpleasant and unpopular choices – such as reducing retiree benefits or cutting into current budgets to set aside dollars for future liabilities – many are putting off taking any action, secure in the knowledge that GASB 45 mandates no solutions, only transparent reporting.

Chiang apparently is made of sterner stuff. He made it clear that the most important thing California can do today – before the numbers grow even bigger – is to address the challenge systematically and sensibly, without delay. Here's what he had to say:

“These are big numbers, but they are not insurmountable. We need not panic, or rush to judgment. I cannot emphasize this enough: This obligation was not a crisis 30 years ago, it was not a crisis yesterday and it is not a crisis today. And, if we work toward a plan to pay this obligation in a reasoned manner, it will not be a crisis 30 years from now...***As long as we come up with a methodical, responsible plan to pay for these future obligations***, we will satisfy the bond and credit rating agencies, and we will fulfill our promise to state workers and to the citizens who depend on the state for vital public services.”

The likely response of benefit plan administrators everywhere: Easier said than done. But the fact is that many experts are coming forward with a menu of options. Savvy benefit plan administrators are taking the lead in educating their policy-making bodies about the pros and cons of the choices in front of them. And they are partnering with experts to find the right combination of solutions for their situation.

## The Good, the Bad and the Doable

All of the options that public employers should be exploring have pros and cons (see table). The first step toward putting together a plan is to understand – and, where possible, finesse – the potential downsides.

Take the concept of creating a trust and making annual deposits to it that exceed the current pay-as-you-go allocation. This takes current dollars off the table that could otherwise be spent on services to taxpayers and compensation for current employees – never a wildly popular option. But the benefits are overwhelmingly attractive. If the prepaid amounts equal the Annual Required Contribution to satisfy the unfunded liability, the red ink from retiree health care costs disappears entirely from the balance sheet.

| Methods  | Pros  | Cons   |
|--|---|--|
| <b>Increase Annual Payments &amp; Deposit to a Trust</b> | <ul style="list-style-type: none"> <li>★ Least complicated</li> <li>★ If annual budget contribution equals the Annual Required Contribution, no balance sheet liability</li> <li>★ Trust earnings reduce cost</li> </ul>                              | <ul style="list-style-type: none"> <li>★ Annual payments could be substantially higher than current budget</li> <li>★ Contributes to budget stress</li> </ul>        |
| <b>Reduce Benefits or Control Costs of Benefits</b>      | <ul style="list-style-type: none"> <li>★ Reducing or limiting a portion of existing or future benefits can help reduce the liability</li> <li>★ Private sector precedents</li> </ul>  | <ul style="list-style-type: none"> <li>★ Polarization of employer/retiree interests</li> <li>★ May need to be used in conjunction with other options</li> </ul>      |
| <b>Work Actively with Actuaries</b>                      | <ul style="list-style-type: none"> <li>★ Establish framework for assessing liability</li> <li>★ Trust fund treatment can move discount rate to 7-9%, similar to a pension system. This decreases the present value of unfunded liabilities</li> </ul> | <ul style="list-style-type: none"> <li>★ Limit to how much actuaries will allow</li> <li>★ Aggressive assumptions may have negative rating implications</li> </ul>   |
| <b>Issue Bonds</b>                                       | <ul style="list-style-type: none"> <li>★ Immediate budget relief possible</li> <li>★ Can be used along with other strategies</li> <li>★ Potential market gains on additional assets</li> </ul>  | <ul style="list-style-type: none"> <li>★ Potential market losses</li> <li>★ Some entities can't issue bonds to finance these liabilities</li> </ul>                  |
| <b>Continue PAYGO Funding Approach</b>                   | <ul style="list-style-type: none"> <li>★ No immediate negative impact on budget</li> <li>★ "Pre-funding" not required by GASB 45</li> </ul>   | <ul style="list-style-type: none"> <li>★ Lack of trust fund means growing obligation on balance sheet</li> <li>★ Likely adverse credit rating consequence</li> </ul> |

Even if the prepayments are less than the full amount, whatever is put aside can begin earning investment returns that will reduce liability. It should be a familiar concept to policy makers. Remember, employers faced a similar situation when accounting rules forced future pension benefits onto current balance sheets. Creating investment trusts to fund pensions has worked very well. In discussing the potential power of pre-funding, California's Chiang pointed out that the state began prepaying pension benefits in the 1930s. Today, the earnings in that pension fund cover an astounding 75 percent of the current benefits being paid to retirees.

Another option: Reduce benefits for future retirees and find ways to curb the health care costs for those currently on the rolls. These are difficult discussions because public employers have always used the lure of generous benefits to attract talented workers who would otherwise gravitate to the private sector. And the collective bargaining process often is a hurdle to be tackled. But with the private sector substantially altering its approach to retiree benefits, the public employers have models to follow and leverage to use while still retaining a total compensation package that helps them attract high-performing employees.

Even without cutting benefits, public employers can work with experts – Third Party Administrators – to cut costs. TPAs can provide savings through pooled coverage, dedicated claims expertise and reduced administrative burdens. With the help of a TPA, different strategies, including carving out the retiree population from current workers in terms of health care policies, can be shaped to maximize cost savings.

Public employers also need to work closely with their actuaries. None of the estimates are carved in stone because they are made based on certain assumptions about a wide variety of factors – and all are adjustable as strategies and conditions change. No one is suggesting that assumptions be skewed to the point of fantasy – that may invite a negative response from bond and credit rating agencies. But picking and choosing among different scenarios is a legitimate function that the public employer should be engaged in with the actuary.

Issuing bonds to cover retiree health care costs may also be an option, although not all jurisdictions are allowed to do so. Much like re-financing the mortgage on a house, this does nothing to pay down the obligation – but it may restructure it in advantageous ways while jump-starting the effort to fund an investment vehicle. This is particularly attractive at a time of historically low interest rates.

### **Get Moving**

The numbers are big and the headlines often focus on dire predictions about looming bankruptcy or retiree health care costs edging out education, law enforcement and other vital services at budget time. But take Chiang's advice: Don't panic. Instead, begin work on a strategic plan that will balance costs with commitments and priorities.

Many public employers are already doing so. New York City has established an irrevocable health benefits trust fund and has already contributed \$1 billion to cover an estimated unfunded liability of \$50 billion. In 2004, Ohio – looking at a liability of \$18 billion – increased the contribution toward health insurance premiums that employees and retirees with less than 30 years must pay. Alabama has increased health insurance premiums for those who retire with only a limited term of service. The Florida city of Gainesville has issued bonds to cover its \$35 million liability and is planning on depositing the proceeds in an investment trust.

Public employee benefit plan administrators can begin to shape the right solution for their specific context by reaching out to experts. Explore partnering with an organization that can bring together experience and knowledge in all of the potential strategies. Build a team that can deliver the guidance that policy makers need and are looking for. No one expects you to know the answers, but by bringing in the right advisors, you will be recognized as a key player in crafting a sensible solution.

Let's conclude with further insight from California's Chiang, who compared solving the unfunded liability problem with running a marathon as opposed to competing in a 50-yard dash:

“Let me make this clear. The amount of the unfunded liability for state retirees' health care benefits will have no bearing on our credit or fiscal ratings – unless we do nothing.”

What are you waiting for?

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