Slaying the OPEB Dragon

Retiree medical costs can be tamed, but it requires effort. Some solutions are obvious, others are at the cutting edge of innovation.

BY: GIRARD MILLER | DECEMBER 2011

There's a crisis in retiree health-care funding, and it continues to get worse for state and local employers. It's one thing to pay this year's premiums, but it's even harder to come up with the money for the future costs of the benefits now promised to today's employees -- not with the costs of health insurance outpacing state and local revenues and the general inflation rate.

As other post-employment benefits (OPEB) liabilities keep piling up, public leaders are grasping for solutions. Several states have taken action. Some of the moves are obvious and well-accepted as the new norm; others are at the cutting edge of innovation. Not every city or state approach is replicable elsewhere -- state laws may preclude action and some solutions might not be viable for other reasons. But here's a summary of some of the current approaches to the OPEB crisis and how they are working out:

Change the plan for new hires. The easiest long-term reform for retirement benefits is to reduce them for new employees. Unfortunately that won't save much money for years to come, but it's a start. With private-sector employers rapidly abandoning retiree medical benefits, there is little competitive pressure to maintain traditional OPEB plans. A modest defined contribution plan for retirement health savings is usually all the market requires. Some employers are providing employee-only coverage for new hires.

Cap the benefit. With medical costs outstripping general inflation by two or three times each year, the biggest move employers can make is to put a dollar ceiling on the benefit and index it to the CPI. This single action has huge actuarial cost-reducing benefits.

Require employee contributions. Most public employees, especially the older ones, know the value of their OPEB benefits. It's only fair that they pay part of the costs. If you are freezing salaries, you can't ask for much, but a symbolic sliver of cost-sharing can be expanded later when the economy gets better.

Fund the plan actuarially. Most public employers with massive OPEB liabilities have not even set up a trust fund to pre-fund the benefits. This ostrich-like behavior guarantees that the problem will worsen. Even if budgets are tight, it makes sense to make partial payments toward the actuarially required contributions and then "ramp up" a little each year. Employees can't be asked to contribute if there's no trust fund in place.

Install a "narrow network" HMO. Along with higher deductibles and co-pays, which everybody seems to be doing this year, many employers have also installed a narrow-network HMO as the primary health-care benefit for their employees. Narrow networks exclude high-cost medical providers and thus cut premium costs. Almost half of private employers have gone this route, a 200 percent increase in just a few years. This can then become the basis for the retirees' OPEB benefit as well, which can cut costs by 25 percent |in some locations.

Sell bonds to fund one-third of OPEB liabilities. Nobody can tell for sure whether the stock market's latest swoon was a bottom, but interest rates are now near their lowest levels in a century. That enables some public employers to sell taxable municipal bonds for as much as a third of the total OPEB plan liability, and invest the money in the stock market at depressed levels. For more on this strategy and pitfalls to avoid, see my article, *Benefits Bonds Revisited*, in the Public Money section on Governing.com.

Buy out the benefits. Beverly Hills, Calif., won national attention and a professional association award for its innovative solution to skyrocketing OPEB costs. The big idea: Get out of the business of guaranteeing retiree medical benefits the city can't afford. First, the city set up a defined-contribution OPEB plan for new employees. Then it sold a bond issue at 4.5 percent and used the money to fund a voluntary exchange program in which current employees could cash out the actuarial value of their previously earned OPEB benefits and receive an employee health savings account plus a package of cash and deferred compensation. More than half of the eligible employees made this election, which will save the city millions of dollars. It's been so popular that employees who didn't take the original deal now want in.