UNFUNDED PUBLIC EMPLOYEE BENEFITS

THE DAY OF RECKONING

U.S. State and Municipal Obligations,
The Impact on Manchester-by-the-Sea
&
Potential Solutions

MBTS UFL Working Group
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CONTENTS

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MANAGEMENT SUMMARY

- New financial disclosure standards are driving the day of reckoning for colossal unfunded U.S. state and local employee benefit obligations. These standards are intersecting with a period of public finance deficits, threatening a 'perfect storm' for public entities which do not plan now on how to pay for them
- Current unfunded liabilities for public pensions and healthcare, taken together, total approximately $3.4 trillion nationally. These legacy obligations have largely not been addressed, but are known. It is not widely-known that the new standards could raise their size by almost 25%, to $5.7 trillion
- Manchester's own unfunded pension and health commitments to future retired employees were last estimated at $38 million (a/o 2008), including its share of the school district's employees. This represents almost twice the Town's annual budget, and is the equivalent of $7,000 per resident
- While public pensions are partially funded with market assets, retiree healthcare commitments have no associated funding, and are increasing rapidly. It is unequivocal that these must be paid, albeit over time
- Massachusetts municipal pension plan contributions are funded 100% locally, but plan design and funding terms are 100% mandated by the State of Mass.- General Laws (Chapter 32)
- By law, all health plan benefits for Massachusetts municipalities must be negotiated with powerful national unions and require 70% union approval for any changes, severely limiting a town's management & cost options

- Massachusetts municipalities have minimal ability to independently manage two of their fastest-growing expense categories, resulting in perpetual crowding-out of other more essential priorities, significant tax increases, increased borrowing, or all three, without prompt action
- The consequences of ignoring or postponing measures now will exacerbate these financial costs, and create further social, political & employee confrontation, voter disenfranchisement, and/or declining responsiveness in municipal services
- Multiple potential solutions for Manchester to reduce current health costs while actually maintaining or improving benefits, and not adding to retiree liabilities, may be available. New plans can be created through embracing alternatives already enacted elsewhere, transferring our plans to a larger risk pool, or creating/partnering on innovations already underway at established health providers and at new collaboratives
- The compelling reason for Manchester to prioritize resolution of unfunded benefits now is to prevent the loss of benefits already earned, and to preserve the share of budgeted monies currently dedicated to schools, safety, utilities, and the many programs that form the character of the community we are fortunate to be a part of
- The advantages of pre-emptive actions substantially outweigh the consequences of endless postponement, as has historically been demonstrated with U.S. private pension failures, and with the Euro Zone public sector crises this past year

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INTRODUCTION

"No other institution in America, public or private, has to do this" [prefund retiree health benefits] . . . .

> Fredric V. Rolando, President, National Assn. of Letter Carriers, objecting to the 2006 U.S. congressional mandate to fund the Postal Service's accumulated health liability now requiring $5.5 billion, annually

New financial accounting standards, long imposed on the private sector, are driving the long-overdue disclosure and prioritization of non-Federal public unfunded employee benefit liabilities. These benefit categories encompass pension, healthcare, disability, life, and related obligations, which were typically granted under binding employee contract agreements. Such benefits have two components- current expenses for active employees, and estimated future costs for post-employment retirees, and often their spouses. While public pension schemes have almost all been funded, the average U.S. plan is still approximately 35% underfunded. Healthcare is a far greater problem as costs for active employees are experiencing above-average growth rates, and funding for retiree health is minimal- in most cases zero. The growth in healthcare retiree liabilities is even more rapid than for actives due to the acceleration of retirees from the U.S. workforce, increased longevity, higher utilization of services in older age groups, and, of course, the rising costs of health services and pharma, in general. The fact that healthcare is not funded exacerbates cost growth further, as there is no investment yield or capital gain to mitigate that growth, unlike with pensions.

The new required reporting and disclosure requirements for unfunded obligations have dramatic implications for U.S. states and municipalities, as they are coinciding with the drawdown of Federal stimulus funds, declining

property value appraisals, state and municipal deficits, and reductions in state aid to cities and towns. Should public entities fail to take strong measures to address unfunded financial commitments, the financial markets, instead of legislatures, may again ultimately force regulatory action, through higher interest rates on bond debt. The timing and magnitude of such non-budgeted debt expenses can be sudden, unpredictable, and onerous, as demonstrated in certain U.S. states, and cities, and in the Euro-Zone this year, effectively taking control of finances out of the hands of local leaders.

In order to sustain programs at the core of community life, such as educational improvements, water, sewer, and safety, as well as the discretionary services and activities which form the character of our towns, unsustainable active and retiree unfunded liabilities must be recognized head-on, and acted on, commensurate with the level of their relative size. Unfunded obligations are a broadly-shared problem. Only by sharing resources and employer/employee partnering will the solutions be achieved. Time is the enemy of this problem- the nature of benefit liabilities is mathematical growth until the plans are permanently altered, transferred to more efficient structures, or funded.

Manchester's unfunded obligations are known up to 2008 and are due to be updated. Changes to the Town and School plans, and the new financial reporting requirements since 2008, could alter the size of the health and pension future liabilities, as well as their priority among other expense categories, and the required timing of payment. Unfunded commitments are not 100% due today and have future payment flexibility. This creates the perception they are not mandatory, often resulting in perpetual postponement. In fact, such obligations are unequivocally mandatory, entered into under employee contracts, enforceable by law, and typically paid for through taxes.

Manchester has been active in taking steps to mitigate health benefit costs, while maintaining the best available reimbursements for its employees, within what are restrictive State bargaining regulations. The Town and School have not yet established a plan to address the future unfunded health promises for retirees. Manchester has been contributing to its future unfunded pension obligations. If actuarial estimates are accurate, the Town and School pension requirements will be fulfilled, but pension design and funding are totally controlled by the State.

It is believed by some experts that a likely scenario for resolving unfunded State and municipal healthcare obligations will be State legislation mandating new annual contributions to invested reserves, potentially permitting the use of over-funded pension reserves. This approach repeats the solution ultimately forced on the private sector for pensions, which, until the passage of ERISA in the 1970's, had no legal funding requirement, and often paid benefits from cash. Under this eventuality, those municipalities which take pre-emptive steps to mitigate plan expenses for active employees, and transfer or fund future commitments, will benefit from lower mandated contributions and/or penalties.

Initiatives to address unfunded liabilities are often interpreted by stakeholders as an attempt to control taxes through wage and benefit reductions. Manchester's employees and teachers are dedicated professionals, who deserve competitive compensation and fair benefits. The Town has been well-managed in the past and enjoys excellent schools and services, at a reasonable tax rate. However, if actuarial estimates continue their trend, any continuation of existing plans and terms will add to an already disproportionate unfunded obligation, and escalate the crowding-out of other Town functions already occurring. The following sections quantify the unfunded problem and consider potential solutions. They are followed by supporting exhibits.

PENSIONS

Δ Private Corporations- The Model for States & Municipalities

2006 Pension Protection Act & FASB #158- (Augments ERISA)

> Mandated 100% funding

> Must use high-grade corporate bond rate to value liabilities

Δ State & Local Employee Pension Benefits- The New Standards

2010 Governmental Accounting Standards Board (GASB) #43 & #45 -

* Must report unfunded liability on balance sheet vs. footnote status

* Mandates valuation of liabilities-

Funded portion- Can use market return assumption (8-8.5%)

Unfunded Portion- Must use municipal bond certain rate (3.5-4%)

Δ Estimated GASB 43 & 45 Impact on Pension Liabilities

	Unfunded	Funded	Total	F/Ratio
Now	$2.0 trill.	$2.6 trill.	$4.6 trill	57%
Revised	$3.1 trill	"	$5.7 trill	46%

Notes: U.S. State & municipal debt currently totals $2.8 trillion
Mass. Pension system is 37%, or $22bil unfunded prior to GAS#45

HEALTHCARE

Δ Post-Employment Health Benefits- The New Proposed Standards

> GAS #45 mandates the valuation & financial disclosure of liability Under "Other Post-Employment Benefits" (OPEB).

> Constitutes a "constructive", accrued, contractual obligation

> SEC exploring regulatory enforcement for municipal bond issuance

Δ Estimated Size of U.S. Healthcare Obligation & Manchester, MA

	U.S.*	Mass.	Manchester (Town+School)
Workforce	10.4 mil	71,900	265 (+125 retireds)
Obligation	$1.4 trill.	$13.3 bil	$29.9 mil ('08)
Per/employee	$135,313	$184,979	$109,434

*Source- Cato Institute-Incl Mass.
65% of state/muni workers covered

Δ Public Health Liabilities now dwarf the Private Sector's

	Public	Private
Employee Population	16 mil	112 mil
Unfunded Liability	$1.4 trill	$450 bil
Per/Employee	$135,313	$4,018

MANCHESTER-BY-THE-SEA

UNFUNDED EMPLOYEE BENEFIT LIABILITIES

A) Unfunded Obligations (a/o 2008, rounded)

	Town*	School*	Total
Pensions	$ 5,000,000	$ 2,875,000	$ 7,875,000
Health/Life	11,000,000	19,000,000	30,000,000
Total	$ 16,000,000	$21,875,000	$37,875,000

*Based on town shares of ERRB & MERSD

B) As with Federal & State debt, obligations are typically measured against several metrics to gauge relative magnitude and capacity to service

MBTS Unfunded Commitments Represent:

Per Resident (5,522) -	$6,859.00
Per Taxable Parcel (2,145) -	$15,459.00
As Share of Receipts ($23.6m) -	160.5%

Property Tax Rate Required to Satisfy @ current appraisals-vs. current $8.14 -	$40.71
Property Appraisals Required to Satisfy @ current tax rate- vs. current $2.3 bil -	$7.0 bil
Annual Actuarial Contribution Required To Begin Funding Healthcare Obligation-	$3,163,309
As % of 2009 budget-	15.7%
vs. current interest on Town debt-	$1,714,602

MANCHESTER-BY-THE-SEA
PROJECTION OF UNFUNDED HEALTHCARE
Ten Years 2009-2019

	Town*	MERSD	Total	
Current Ann. Premiums 2010-				
Actives only	$475,000	$460,862	$933,862	
CAGR	+10%	+9%		
Accrued Liab.- Retirees				
a/o 2008	$10,598,619	$19,340,378	$29,938,997	
Projected-				
2009	11,555,759	19,729,545	31,285,304	
2010	12,530,330	20,127,596	32,657,926	
2011	13,518,363	20,588,458	34,106,821	
2012	14,521,199	21,096,563	35,617,762	
2013	15,537,499	21,650,462	37,187,961	
2014	16,549,411	22,262,852	38,812,263	
2015	17,560,105	22,947,034	40,507,139	
2016	18,561,789	23,706,628	42,268,417	
2017	19,543,723	24,556,467	44,100,190	
2018	20,511,631	25,524,149	46,035,780	
2019	21,464,398	27,846,724	49,311,122	
Ten Yr Δ			+ $18,075,818	(+57.6%)
Plan Terms:				
Eligibility-				
Age	No Min	55 Yrs (also part-timers)		
Service	10 Yrs	10-15 Yrs		
Premiums	$17,110-20,712	$17,410-21,741		
Empl.Share	15-30%	15-25%		

Note: *'08 UAAL + Annual Contrib. @ 4% Disc
Sources: USI Consulting Group Aug, 2009 Report
Angell Pension Group, Inc. Sept, 2008 Report

MANCHESTER-BY-THE-SEA
RELATIVE GROWTH IN SHARE OF BUDGET
HEALTH & LIFE ANNUAL EXPENSES
Town & Regional School Share Combined
Ten Years, 2009-2019
($ in millions)

	MERSD*	Other Depts*	Health& Life#	Total Budget
Estim. AGR	4.0%	2.5%	10%	
2009	$ 9.6 (48%)	$8.1 (40%)	$2.5 (12%)	$20.2
2010	10.0	8.3	2.8	21.1
2011	10.4	8.5	3.1	22.0
2012	10.8	8.7	3.4	22.9
2013	11.2	8.9	3.7	23.8
2014	11.6	9.1	4.1	24.8
2015	12.1	9.3	4.5	25.9
2016	12.6	9.5	5.0	27.0
2017	13.1	9.7	5.5	28.3
2018	13.6	9.9	6.1	29.6
2019	14.1 (45%)	10.2 (33%)	6.7 (22%)	31.0
Change-10 Yrs	+4.5mil	+2.1Mil	+4.2mil	+10.0mil
As % of Budget	-3%	-7.0%	+10%	

Notes: * Health & life backed-out
Combines 100% of Town & 60% of MERSD Costs
Sources: 2009 Town Report & MERSD 2010-11 Budget

Δ Potential Actions to Consider

- Obligations must be communicated to employees & taxpayers. Suspend current wage/benefit negotiations to present alternative plan choices to current and/or new employees. According to the Deloitte Center for health solutions, while 88% of Mass. residents are covered by health insurance, only 23% understand how such plans function. Awareness of plan economics is the initial step in employee agreement to change

- Update actuarial valuations to validate the true scope of the liability, i.e the certainty and timing of debt servicing. Developments since 2008 could reduce or add to the unfunded obligation

- Liabilities must be prioritized in Town financial disclosures, open meetings, warrants, & bond issuance documents, on same footing as outstanding bond debt.

- Form a collaborative working group of all stakeholders, to constructively explore, evaluate & recommend short term cost mitigations and permanent solutions to benefit liabilities

- Seek membership in larger, more flexible State Group Insurance Commission, or other broad risk pools. GIC municipal membership terms & conditions may require a more competitive structure & legislation to enable joining. GIC currently compares adversely with Manchester's plans, and requires 70% employee approval to join

- Join in Mass. Municipal Assn. Local Government Advisory Council's initiative to reconfigure municipal health plans. Engage elected representatives in this effort [Potential State savings $100mil/yr]

- Pursue change in regulations around negotiations & collective bargaining to allow for more choice and flexibility

- Explore new intermediary alternatives to Mass Interlocal Insurance Administration, i.e. municipal purchasing collaboratives, Mass Municipal Assn; and independent benefits consultants

- Engage Collins Center for Public Management- UMass/Harvard-Kennedy/Rappaport Institute- consults to municipalities on benefits solutions

- Explore self-insurance or HSA options for deductable ranges-individually, or in collaboration with School, Essex, and/or other constituencies. Investigate new "Wellness" schemes from existing or new providers

- Evaluate restructuring Town financial governance to enjoin & leverage Town, School & Essex decision-making on common expenses

- Conduct "talent" search of residents for executives and experts who might potentially volunteer & leverage their positions toward solutions

- Broaden responsibility for negotiations with employees to maximize town and external resources, leverage, and expertise

- Establish process to fund reserve account to finance anticipated liability funding amid 3-4 year period of austerity. [Mass. city/town Rainy day funds now total $1.4bil, +50%]

Δ A Revolution in Health Care Management & Delivery- Two Innovations as models for the future?

A) "Wellness" Plans. These plans require active employee participation in holistic health management as a pre-condition to premium provider access at substantially reduced premiums. "Wellness is seen as a new alternative to forcing cost reductions to traditional health reimbursement schemes through "capitation", or other measures, or employee premium-sharing, which may be maxed-out. The objective of "Wellness" is the prevention of, or intervention in, premature chronic disease.

Typical Features of "Wellness" Plans:

- Access to key health providers at discounted premiums, based on individual choice & responsibility within a centrally-managed program
- Confidential annual health risk questionnaire/report, shared with primary MD & affinity group
- Paid screenings, immunizations, counseling, webinars, health information sessions, fitness facility access, lifestyle coaching, outreach/follow-up resources with RN's/clinicians, & free labs & biometric evaluations
- Preventative education & testing for chronic conditions, e.g. smoking cessation, obesity, nutrition, stress & cholesterol

Organizations now offering/expanding comprehensive 'Wellness" Plans:

- Glaxo SmithKline
- Walgreen Health & Wellness Div.
- Humana/Walmart Partnership Plan- pharma
- "Healthy You"- Boston Consortium for Higher Education Plan via Harvard Pilgrim partnership
- Kaiser Health Plans

C) Health Savings Accounts + High-Deductable Insurance

The combination of tax-deductable Health Savings Accounts (HSA's) and conventional insurance with high-deductibles is gaining acceptance. These plans also offer access to lead providers at significantly lower premiums, providing that the employer and/or employee cover the first claim levels. It is estimated that 70-80% of annual claims are under $3,000-4,000. Covering these costs outside the plan allows for significant discounts and greater benefits for major risks. Employees contribute dollars saved through lower premiums to an HSA, pre-tax, creating a savings vehicle available to offset deductibles. In the initial years, employers can share these costs as HSA balances grow, phasing-out sharing after the initial years. Optimal plan benefit/cost balance can be negotiated with providers, looking at various deductable and payment combinations. Employees own their HSA assets which can be used for health expenses until age 59 ½, then for any purpose, thereafter.

CONCLUSION

Consequences of Not Acting for Manchester

- Continued, exponential expansion of annual benefit costs & future debts, especially for healthcare, as long as existing plans continue
- Curtailment of borrowing capacity & lower bond ratings/higher interest costs
- Eventual abandonment of existing plans, and replacement with inferior plans due to adverse experience, ultimately disadvantaging employees
- Tax rate increases and regular annual override attempts
- Layoffs, and/or cessation of operating programs, threatening MERSD superior school ranking, & other town utilities & services

Benefits of Acting Now

- Recognizes fiduciary responsibility to taxpayers and avoids greater costs later
- Pre-emptive steps will advantage Manchester when GASB standards are enforced; new lower discount rates are implemented for the unfunded component of plans, widely-expected State legislation, is introduced, and/or when unfunded payments are mandated by the courts.
- Arrests growth of already-unaffordable obligations
- Establishes plan and mechanism to deal with early- capitalizing on Current, justified voter sentiment to force rational change
- Diminishes future damage to town priorities

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"Controlling the cost of health care in Massachusetts is now the ultimate education issue . . . One of the most dramatic and devastating [reports] I've seen"

Paul Grogan, President, the Boston Foundation- reacting to the Foundation's 2010 report, "A Bargain Not Kept", documenting how health costs have displaced intended education reforms for 17 years

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Δ Recent Election & Legislative Imperatives on Public Benefits Reforms

Benefit reforms once rejected outright, or thought unlikely, are gaining momentum across the U.S. due to the majority of private sector voters whose average wages and benefits have been surpassed by the public sector's, and who pay the preponderance of taxes.

Selected Examples During 2010:

California-	
Menlo Park San Jose Bakersfield Riverside Carlsbad San Diego	Reduced generous benefits for new hires; Shifted design to local jurisdictions; Rejected tax increases to fund existing plan levels
Illinois-	
40 Suburban Municipalities	Approved ballot measures extending pension reforms to safety workers- raising minimum retirement ages & disallowing receipt of benefits during employment
Alabama, Nevada, Wisconsin, New Jersey, Rhode Island-	Proposals introduced/pending to shift from defined benefit to defined contribution pensions raise eligibility standards, & eliminate automatic Cola's
Methuen, MA.-	Negotiated $1.9mil wage & benefit Modifications, keeping staffing intact
15 Mass Municipalities-	Joined State health GIC, saving $35.5mil/Yr
Essex Regional Ret Board-	Transferred investment role to MA PRIM saving estimated $325,000 annually

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Boston College Center for Retirement

Deloitte Center for Health Solutions

Healthcare Systems for Public Entities in the U.S.

Federal Employees Health Benefits Program

Military Health System/TRICARE

State Children's' Health Insurance Program (SCHIP)

Veterans Health Administration

Indian Health Service

Medicaid

Medicare

U.S. Healthcare Law

Emergency Medical Treatment & Active Labor Act (1986)

Health Insurance Portability & Accountability Act (1996)

Medicare Prescription Drug, Improvement, & Modernization Act (2003)

Patient Safety & Quality Improvement Act (2005)

Patient Protection & Affordable Care Act (2010)