ATTACHMENT C

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BENEFITS BEAT

OPEB Deficits: Where are the Rating Agencies?

By GIRARD MILLER September 2008

It's time for a carrot and a stick.

One of the intriguing developments in the already decade-long movement of state and local governments toward recognizing and eventually funding their promises to pay for retiree health care is the lack of aggressive action by the nation's leading municipal bond rating agencies to promote fiscal sustainability.

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For perspective, the entire volume of outstanding state and local government bond issues is $2.7 trillion. In comparison we have unfunded deficits of $1.5 trillion in state and local government "OPEB" plans (accounting jargon for "other post-employment benefits" excluding pensions). Let's translate those numbers to a personal level: Could you get a mortgage in today's market if you owe credit card or home equity debt equal to half your house's value? What would be your credit rating?

Under recent accounting standards set by the Governmental Accounting Standards Board, these OPEB liabilities and the proper actuarially required annual contributions must be reported on financial statements. GASB rules already apply to the largest governments with revenues over $100 million, and they are phasing in the implementation for others this year and next. That's to spread out the work for the actuaries who would otherwise be swamped as 10,000 or more local governments begin

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to report their OPEB deficits.

Once the numbers are known to management and elected officials, one would think that they would start working immediately to properly fund and better manage their OPEB deficits. Well, the sad truth is that many are not. Part of this is simply governmental inertia, and the slow pace of change in making big structural financial decisions. A big part of the delays in funding right now reflects the sorry state of municipal budgets where the economic malaise has clobbered property tax and sales tax revenues, so there simply is no extra money floating around to begin paying the growing bills for OPEB liabilities. Another part of the delay represents the high degree of collective bargaining in the public sector, where state and municipal leaders must negotiate changes in such benefits and even face compulsory arbitration if they cannot reach agreement with the unions.

One of the great ironies in today's world of public finance is that the nation's rating agencies are "walking on eggshells" when evaluating municipal bonds issued by state and local governments that have failed to address and fund their OPEB liabilities.

On the one hand, they should be applauded for not overreacting to a problem that has been out there for decades. There is no need to create an "OPEB crisis" in the muni bond market. On the other hand, the "kid gloves" treatment that raters have given many issuers on this financial management deficiency could easily be a disservice to bond investors. How many buyers of retail mutual funds that allegedly invest only in AAA credits would feel comfortable knowing that the underlying bonds are not the only debt of these agencies, and that OPEB debt rivals the bonded indebtedness? Is OPEB the ticking time bomb in the muni bond market like collateralized debt obligations were in the bond insurance guarantee market?

The rating agencies are caught in a political squeeze this year, as the California state treasurer and other politicians have challenged the municipal ratings system. They argue that a double standard applies and that municipal credits are actually better than corporate credits because of the underlying taxing authority of the issuers. Hence, the default rates on municipal bonds have been much lower than those of equivalently rated corporate debt. The ratings industry is reconsidering its practices and some are discussing a policy of "global credit standards" that treat every AAA and AA credit the same, regardless of whether it's public or private.

In the middle of this debate and internal industry re-assessment, it is natural that OPEB issues would be shelved for a while until the dust clears. But if you think about it, most corporations are ditching their retiree health plans, or like General Motors they have converted them from defined benefit to VEBA plans (see my prior column). Thus, the creditworthiness of the state of California, with massive pension and OPEB obligations, may not really be as comparable to Berkshire Hathaway as the state treasurer would like to assert, because most AAA corporations have shifted to a defined contribution retirement system and addressed their liabilities up-front.

Here's why this matters: As I travel across the country to meet with public finance officers, municipal managers and HR directors, their number one problem is getting

C - 2

elected officials to focus on OPEB liabilities and the promised retiree health care plan designs which they themselves admit are probably unsustainable. These managers know that their long-term finances are messed up and they need to fix things with both funding and OPEB plan reforms. But to give their elected officials a "wake up call," they tell me that they must be able to show that their credit ratings and bond issuance costs will inevitably worsen if they don't take action on OPEB.

So I will forward this column to leaders of the various credit rating agencies with a request that they soon need to draw a line in the sand with municipalities that are dragging their feet on OPEB funding and plan reforms. All the raters make good efforts to evaluate the quality of management, and this could be a clear bright-line test. Why not establish some definitive criteria that provide financial incentives to elected officials and municipal leaders who "take the OPEB bull by the horns" and start fixing their problem? The agencies themselves can help improve the quality of the municipal bond market if they take a leadership role in rewarding sustainable benefits policies.

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