Turning Around Governments, Companies, and Attitudes

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Good morning.

Thank you, Laurie, for that kind introduction, and I thank all of you for coming. It is a pleasure to be here this morning to speak on the subject of "turning around governments, companies, and attitudes." To quote Will Rogers, "I don't make jokes. I just watch the government and report the facts".

As Laurie mentioned, I've spent over 25 of my 40 year finance career in corporate restructuring—airlines, consumer goods companies, auto-parts manufacturers, retailers, just to mention a few industries. Names like Kmart, Polaroid, TWA, Dana and Interstate Bakeries (you know them for Wonder Bread, Twinkies and Devil Dogs). The heart of my work has been to take enterprises that were failing and rehabilitate them; give them a 2nd (sometimes a 3rd) chance. A restructuring firm is called in when an organization or business faces a crisis, such as declining revenue and cash flow, the inability of management and labor to agree on terms that allow the business to function profitably, or excessive leverage that cannot be repaid or refinanced.

The purpose of my talk today will be to apply principles of corporate restructuring to the question of turning around governments, particularly in response to the extraordinary debt held at federal, state, and local levels, further complicated by what is essentially good news, namely the incredible advances in medical technology. This good news makes the problem even more urgent and serious than you thought.

There are three basic steps that are essential to a successful restructuring.

Number one: <u>face the facts</u>. There are many restructuring-isms, one being that denial is not just a river in Egypt. The first rule of restructuring is "we are where we are". Blaming the prior CEO or board may feel good, but rarely achieves a workable solution. When I am called in to restructure a company, the first critical step is to assess as accurately as possible the company's problems. And fast!

The second step is to develop <u>a new business plan</u> as the existing one obviously has flaws or flat out doesn't work. In formulating that new plan, a number of factors have to be taken into account. Have markets or consumer preferences changed? What are competitors doing differently? Are there new laws or regulations that are affecting the industry? Is management incompetent? Have the books been cooked? Are the problems temporary or long term? Is there a simple fix or does the situation require a comprehensive solution?

The new business plan must address core problems and deficiencies. Many of the companies I restructured had operations that were fundamentally unsound, information technology and control systems that were outdated or slow and inaccurate (which made timely adjustments to problems impossible), cost structures that were not competitive, inflexible labor work rules, outmoded products, etc. These shortcomings may be addressed by shedding lines of business, selling non-core assets, negotiating concessions from unions, landlords and creditors, moving production to less costly locations, reducing debt, finding new investors, bringing in new management. The plan has to be realistic and achievable, the assumptions underlying the plan credible and rational, and the process employed to develop the new plan transparent and open to the review of all key stakeholders. All of this is to remake the organization for the future as a viable business for its various stakeholders.

That leads to the third step: the restructuring itself. If you view the first two steps as redefining the pie, step three involves determining how the pie is divided and shared. Needless to say, this is a complex, often confrontational process. Restructuring, if you know anything about it, is full-contact finance and will likely require painful concessions from equity owners/shareholders, creditors, management and employees. The parties must be persuaded that short-term disruptions, uncertainty and pain are necessary for the company to recover and succeed over a longer-term. The medical analogy is frost bite: cutting off extremities to save vital organs. A critical element here is making sure the outcome is successful so that another round of painful measures is not necessary. That is particularly true for unionized labor. Getting agreement on concessions from the rank and file is very hard. Having to go back a 2nd time is almost suicidal.

Also, as you might imagine, when the parties set about revisiting the original contracts, the question of "who was promised what and when" has tremendous bearing on each stakeholder's disposition toward a prospective deal. Fear and greed are the two elements that underlie every restructuring. The stakeholders' main objective is often to determine what weaknesses on the other side(s) can be manipulated to bring it (them) to the bargaining table. This is called the "has, wants, fears analysis". As a simplified example, secured lenders have a pledge of assets as collateral, want to receive principal and interest and a speedy resolution of the case; they fear a degradation of asset and enterprise value, extensive delays, costs and a write down of their loan.

We have now arrived at the point where we pose the question: how does one apply these corporate restructuring principles to our governments? Or, to go along with the theme of this year's conference, what are the attitudes that policymakers must adopt in order to craft solutions to some of our governments' financial difficulties and avoid a politically, financially and socially devastating outcome?

Let's go back to the corporate restructuring play book: face the facts.
The debt problem at all levels of government has been growing for decades. According to the most recent Medicare trustees report, the program faces an unfunded liability of $38.6 trillion. Social security, $8.6 trillion. For state and local government pensions, estimates vary, but the unfunded liability could be as high as $3 trillion. And if you consider commitments like social security, Medicare and Medicaid to be comparable to funded debt, the federal debt to GDP exceeds 100%. One of the lesser known facts to most people is that the Congressional Budget Office (CBO), in scoring proposed legislation, uses a 10 year horizon to cost programs, e.g., Obamacare. This is an entitlement, like social security or Medicare, that was meant to last decades. As a consequence, what we got was the equivalent of a 10-year interest only teaser rate on a 30 year arm. On the 10th year plus 1 day, the whole calculation will change drastically, potentially costing many multiples of the price "sold" to the public at the time of

the law's passage.

Lest you were not already nervous, the positive news of rapidly advancing medical technology should do the trick. When LBJ signed Medicare into law in 1965, medicine was emerging victorious in the war against infectious diseases. For the past several decades, in the industrialized world, viruses and bacteria have ceased to be the main causes of physical impairment. Today, the major health problems tend to arise from issues in people's genetic makeup. Certain individuals are, by nature, more susceptible to cancer, diabetes, heart disease and high cholesterol than others. These kinds of conditions, which can call for different treatments depending on the individual patient, are becoming the primary occupations of doctors. And modern science is now making astonishing inroads on this front.

With the mapping of the human genome and the breakthroughs that have followed, scientists are poised to usher in a new era of individualized, personalized medicine. And we are already seeing it happen. All of this means that people are living not only longer, but better, well into what was once considered old age. You may have seen articles proclaiming that 60 is the new 40—which, at least for me, was nice to learn. Life expectancies into the mid 80's or higher will shock our society.

Most people would say that all of this is good news. The bad news, however, is that our entitlement programs, state and local benefit programs, and even, arguably, our approach to the concept of retirement, are not suited to the reality of people living as long as they are. At the same time, fertility rates have declined significantly, meaning fewer new workers paying into the retirement pot, while the political power of public sector unions and senior citizens have sustained benefits at increasingly generous levels, meaning more people taking out over a longer period than was ever planned for.

In addition, one of the facts we ought to face is the outlook for economic growth. This is particularly critical in thinking about pension benefits at the state and local levels. As the members of this audience know well, the solvency of a pension plan can vary dramatically depending on the discount rate applied to both actuarial payout obligations and earnings on invested funds. Those who tend to favor the status quo—keep public pensions the way they are—often assume investment returns that may have been achieved in the past, but might not be likely in the future, as well as mortality rates lower than may now be the case, i.e., people will live longer.

Those of you who follow developments in state fiscal policy may recall that a year ago, Rhode Island enacted a very aggressive piece of pension reform legislation. But interestingly enough, the architect of the plan, the state treasurer, a democrat, by the way, said that the most acrimonious battle she had was over lowering the assumed discount rate—get ready—75 basis points—from 8.25 percent to 7.5 percent on invested funds. The state treasurer showed outstanding leadership in advancing these reforms. But for many actors whose horizons do not go beyond their next election—and this includes state legislators as well as union leaders—it remains a very powerful temptation to assume a high discount rate. Connecticut assumes an 8 1/4 % rate today and is reluctantly moving to 8%. Mayor Bloomberg recently described a similar move in NY state as going from the “absolutely hysterical” to the merely “totally indefensible”. In Connecticut, moving to a more rational 4.5% discount rate (a rate in the range required by the US government for private sector companies), raises Connecticut’s retirement obligations to $60 billion; $20 billion more than Connecticut reports today.

That leads me to the second step – new business plan. As the military would say, “this is not a drill”. Although governments have more funding options than private business, from taxing authority to issuing bonds to printing money, the capacity isn’t infinite, as cities like Harrisburg, PA, Stockton, CA, and others have discovered. And formerly AAA sovereigns like Spain and Italy lost their access to public capital markets and/or were forced to pay substantially higher interest rates to borrow or rollover maturing loans. The pain from Spain could hit the states again.

What is needed is a strategy that responds to the core problems. My own experience, i think, is particularly germane to developing a new business plan for state and local governments. In certain respects, this is of greater urgency than reforming federal entitlements, as critical as that is. States and municipalities have much less flexibility and ability to run annual deficits. Thus, with the rapidly escalating cost of public-sector retirement benefits, we are now witnessing a dangerous crowding out of spending on vital public services. Cities are having to cut back on their active police and fire departments. Necessary infrastructure projects do not get off the ground. Nursing homes and senior centers, which serve some of our most vulnerable citizens, are also in financial straits. Some cities, such as Stockton, California, and Central Falls, Rhode Island, have been forced to declare bankruptcy.

A plan for restructuring local governments, to respond to the facts on the ground, so to speak, must revise significantly the open-ended promises made to public-sector retirees. Given the demographic realities we face—the increased longevity brought about by advances in medicine combined with the decline in working population relative to retirees, benefits should not start at the young ages that they often do.

The average retirement age for a public school teacher in America today is 59. MTA workers in New York can retire with full benefits at age 55 after 25 years on the job. New York City police officers and firefighters hired today will be able to retire with benefits after 22 years of service, regardless of age. I have the greatest respect and admiration for the public servants who keep us safe, but the ability to retire in one’s 40s and collect benefits into one’s 80s and 90s will continue to drive our states and local governments toward insolvency. This is especially true where employees contribute modestly or not at all, the benefits are constitutionally protected (by the state) and the government entity (eg, NYC) is obligated to fund shortfalls in fund investment returns below a relatively high number like 8%.

Along with pensions, another open-ended promise in need of revision, though perhaps less-well known, is OPEB: other post-employment benefits. Many public employees keep state-funded health insurance until they become eligible for Medicare, and even then, have the supplemental policy paid for by the state or municipality. In New York alone, OPEB constitutes a $250 billion unfunded liability.

Considering the government's OPEB liability, I thought about the restructuring of a tier one auto supplier called Dana Corp of Toledo, Ohio. That company, which had promised healthcare benefits to retirees, faced an OPEB balance sheet liability of $1.4 billion and annual costs of $150 million. What we did was negotiate an agreement between the company and its unions in which the company created a healthcare trust called a voluntary employee beneficiary association or VEBA, to be managed by the union, for the benefit of its unionized retirees. Dana funded the trust with $800 million cash and securities, approximately the equity value of the annual cost savings. In exchange for setting up this trust, the company was no longer liable for its workers' post-retirement healthcare. Approaches such as this one can be a useful benchmark for policymakers to design a new plan to deal with unfunded health care promises.

While politicians often advocate raising local property, sales or income taxes, this should not be part of a business plan that does not also involve structural reforms to open-ended promises. Last year, Illinois raised taxes but did not address the underlying problems. While the state generated an additional $7 billion in revenues, Illinois is right back where it started. Tellingly, Caterpillar, the construction and mining equipment manufacturer, based in Peoria, announced in February that it would not consider Illinois as a location for a new plant. The company cited – quote – concerns about the business climate and overall fiscal health of the state of Illinois – unquote, as one of its reasons. As George Bernard Shaw once said, "a government which robs Peter to pay Paul can always depend on the support of Paul". He didn't add, "probably not from Peter". And as we are seeing, Peter may decide not to stick around.

To really make our governments run more efficiently and at lower cost, here are a few suggestions for a new business plan:

1. At the state/local level – merge smaller towns to eliminate the duplication of administration, fire, public security, education; eliminate county government in many places. These are remnants from revolutionary times.

2. At the federal level, mandate a top to bottom review of the government at least every 10 years. As times and the world change, do we really need the same cabinet departments, agencies, bureaus as existed 10, 20, 30, 50, 100 years ago? Retrain displaced workers and move them to jobs where they can be relevant.

3. Freeze pensions for public employees; lower or eliminate cost of living adjustments for existing employees and retirees.

4. New employees may only receive, and existing employees with frozen pensions must convert to, 401(k) style defined contribution retirement plans.

5. Increase retirement age; start paying pensions at age 65, not from retirement date.

6. Make notes and bonds issued to meet pension funding and OPEB shortfalls tax exempt to boost plan viability and reduce funding costs.

7. Transfer OPEB to unions with a large upfront cash payment so that unions are required to deal with their workers to eliminate dollar 1 coverage and develop better and lower cost healthcare delivery systems. All beneficiaries must have “skin in the game”. Mechanically, the plan would be implemented and funded after the new healthcare arrangements were agreed (i.e., capped benefits, higher deductibles and co-pays, employee contributions to premiums and a tighter link to Medicare).

8. Don’t let the states get away with irresponsible behavior (often politically motivated) in the expectation of getting a federal bailout.

9. Rethink and simplify the whole income tax structure; Simpson-Bowles is one approach and is an excellent starting point. But the first priority is developing a sensible, rational budget (spending) and then figuring out how you get there without taxing the population into extinction, but with the strong possibility of changing forms of taxation (VAT?) And even – gasp – income tax increases where appropriate. This is a ten year or longer transition.

For states that are solvent but have troubled cities unwilling to take on the challenges for political reasons, set up municipal assistance corporation (MAC) or financial control review board (FCRB) type bodies that take decision-making authority away from the city. A variation on that theme, in the event the city files for bankruptcy, would be for the state to agree to provide debtor-in-possession (DIP) financing conditional on the city negotiating substantive changes in labor agreements, reducing the workforce where necessary and selling certain municipal assets to third parties willing to provide the service at lower cost (eg, sewage service, sanitation, water supply, municipal electric utilities, recreational facilities, etc.). It may be possible for the city to sell existing businesses to that third party for an upfront (or staged) payment(s) in addition to entering into new service agreements at a lower cost than if provided by the municipality itself.

This brings me to the third step, which is the restructuring itself. We were able to reach a compromise with the union of the auto parts company by explaining that unless the benefits were reformed, the company could not raise the capital from new investors needed to emerge from chapter 11. Under this adverse outcome, the workers would not only lose their retirement healthcare benefits, but their jobs as well. Only when the realities are made clear is “real compromise” possible.

My unsolicited advice to policymakers, therefore, is to put the facts squarely and transparently before citizens. Policymakers should explain that in the event that no change occurs, we will lack resources to pay for basic vital public services—whether national defense at the federal level, or police and fire protection at the state and local levels. More pointedly, when speaking before public workers, policymakers can talk about the loss of benefits in the city of Central Falls, Rhode Island. When that city declared bankruptcy last year, a receiver was brought in. He slashed pensions, some by more than half. When the old line American steel companies like LTV and Bethlehem closed or shrank in bankruptcy, it wasn't entirely due to competition from new steel mills. Their difficulties were magnified by having 14 retirees for each active worker and carrying multi hundred million dollar current cash OPEB and pension obligations. Tens of thousands of retired workers and their dependents lost healthcare coverage and hundreds of thousands of workers lost their jobs. We are in or very close to that situation with respect of our public employees. As I said earlier about the "has, wants, fears analysis", if public service employees don't fear a diminution of benefits, they should, given how underfunded these plans are. The truth of the matter is that nobody wants to see such drastic benefit cuts: not the retirees, and not the taxpayers, who value the service of public workers, whether teachers, firefighters, policemen or other civil servants. What is needed today are leaders who are ready to step up and make the tough decisions to avoid the draconian cuts that surely must and will happen.

True leadership today means doing the arithmetic right and disclosing the results transparently, telling citizens to look beyond the narrow self-interest of the present moment and accept the concept of shared sacrifice. This is the key to the successful restructuring of companies, and it must be the linchpin of a strategy to successfully resolve the healthcare, retirement and excess debt obligations that imperil our governments. This won't be easy or quick. And all the constituencies affected will fight like crazy to protect their turf. As I heard Governor Jeb Bush say recently, good things come from respectful confrontation. Our system needs a giant dose of castor oil – or a reboot. To try and continue on our present course is to invite tragic consequences.

Thank you very much for listening. I look forward to your questions.