

PAST, PRESENT, AND FUTURE

FINANCING HEALTH CARE FOR OAKLAND COUNTY RETIREES

July 2006

INTRODUCTION

The rapid rise in the cost of health care is a major national issue that impacts all employment sectors, both public and private. Ever escalating health care costs have forced many employers to reduce, restructure, or even eliminate health benefits for their employees. All too frequently we read media reports indicating that escalating labor costs, especially those related to health care, have forced another company to either consider to filing for bankruptcy or to actually file for bankruptcy.

In 1980, national health expenditures were approximately \$246 billion and represented 8.8% of the gross domestic product (GDP). By 2003, national health expenditures had grown to nearly \$1.7 trillion, some 15.3% of GNP an amount almost 7 times that spent in 1980.¹ The reasons for cost increases in health care over the years are numerous and include factors such as utilization, diagnostic technology advancements, new and costly medications, accessibility to treatment, and increased life span. Everyone seems to be looking for a solution, a fact demonstrated by a recent Google search for “rising health care costs,” that resulted in 36.6 million web link “hits” on the topic.

Oakland County Government is facing the same challenges as everyone else in funding health care benefits for its employees. This *Oakland County Executive Insight* article focuses specifically on the proactive steps Oakland County has taken over the years to fund its retiree health care program as well as control costs for this benefit.

BRIEF HISTORY – THE RETIREE HEALTH CARE PROGRAM IS CREATED

Oakland County first granted retiree health care benefits approximately four decades ago. Effective January 1, 1965, the County awarded retiree health care benefits for persons defined in the enabling resolution as “present and future eligible retirants [sic] and beneficiaries.” The level of retiree health care benefit in 1965 was equivalent to 50% of the premium cost, which was the same benefit offered to active employees during that time. When the enabling resolution was approved, it was estimated that the additional cost of adding the new benefit of retiree health care was approximately \$15,000.

Two years later, the County was struggling with excessive employee turnover. A survey indicated that Oakland County’s recruiting ability had fallen behind its competition so the County made significant adjustments to salaries and fringe benefits. In the fringe benefit area, the County improved health benefits for active and retired employees to cover 100%

¹ Trends and Indicators in the Changing Health Care Marketplace – Kaiser Family Foundation, www.kff.org

of the premium cost. This improvement became effective January 1, 1967, and is essentially the same in place today. The increase to the budget at that time for this increased level of health benefit for active employees and retirees was \$122,000.

FUNDING OAKLAND COUNTY'S RETIREE HEALTH PROGRAM BASED ON AN ANNUAL ACTUARIAL VALUATION

Oakland County's first independently prepared, annual retiree health care actuarial valuation report was presented in 1985. That report was the first step toward changing how the County funded retiree health care, shifting from a "pay as you go" or cash basis to a full accrual basis. That actuarial report included an estimate of the county's accrued liability, a valuation of assets, unfunded accrued liability, and recommended annual contribution for the County's current and future retiree health care obligation.

The "pay as you go" approach only provides for actual expenses paid for current retirees, ignoring the funding required for deferred but accrued costs that have already been earned by the employee. On the other hand, full accrual basis funding includes not only the current costs but also provides for future retiree health care costs which are "earned" in the current period by employees as deferred compensation for current services rendered. Oakland County government, believing "full accrual" was the more responsible practice, has utilized this method since 1987.

"Full accrual" accounting for retiree health care is not currently required for governmental entities. Unlike Oakland, most governments today still operate on a "pay as you go" basis for funding retiree health care. However, there are new governmental accounting standards coming into play which will soon require governmental units to recognize retiree health care obligations on an accrual basis. These new accounting requirements and the dramatic impact they will have on governmental entities will be discussed in depth at a later point in this article.

In 1987, the County adopted a policy to fund the Annual Required Contribution (ARC) recommended by the actuary to begin amortizing the unfunded accrued liability for retiree health care (similar to payments on a mortgage). In 1988, the first ARC payment into the newly established Retirees' Hospitalization Benefits Fiduciary Fund was approximately \$3.7 million, or 6.99% of the payroll. This was a significant change in funding policy that was not only ahead of its time for government entities but was also ahead of accounting requirements in the business or non-governmental sector (such as for publicly traded companies).

While the Governmental Accounting Standards Board (GASB) sets the accounting standards for governmental entities, the Financial Accounting Standards Board (FASB) sets the accounting standards for non-governmental entities. In December 1990, FASB issued Statement No. 106, which required non-governmental entities to measure and recognize the obligation for post-retirement health care benefits, effective for fiscal years beginning after December 15, 1992. This accounting change was very controversial

when it was issued because companies had concerns about the negative impact it could have on their net worth once the liability was recognized.

The significant point here is to note that Oakland County government voluntarily implemented this “full accrual” accounting practice more than five years before it was required in the business sector and more than two decades before governmental entities were required to implement it. Why? Because Oakland County considered it to be a “best practice.”

We are all fortunate that Oakland adopted this “best practice” when it did. If Oakland County had not started funding the accrued retiree health care liability back in the 1980’s, our obligation to meet the promises made to our employees would have overwhelming financially for the taxpayers and the benefit, threatened.

THE DECISION TO SELF-INSURE

Oakland County made other funding decisions during the late 1980’s relating to health care in its effort to maximize benefits while still controlling costs. Of particular significance was the County’s decision on how to insure health care costs. One of the basic concepts of insurance is premised on the “law of large numbers.” Simply put, under this “law”, if a person has catastrophic health requirements but is part of a large group, that anomaly has less impact on the average cost per person for the overall group of participants. That is why pooling small insurance groups together into a larger group usually results in lower premiums – the average risk is lessened overall across the larger numbers. Since the size of the County’s employee and financial base is large enough to benefit from forming its own risk pool, the County decided in 1988 to self-insure health benefits for active and retired employees. The County contracted with a third party administrator to process claims and receives the discounts that the third party administrator is able to negotiate with providers. By self-insuring, the County financially benefited as a result of:

- greater flexibility in benefit plan design,
- cash-flow flexibility (the County retains the investment income from its own insurance reserve fund), and
- incurring only those costs associated with its own group of participants; thus, not paying an insurance company to share the cost of other groups who may have greater risk factors.

Self-insurance may not be beneficial for all entities. It depends on the size of the insured pool, utilization experience, and availability of sufficient cash reserves.

CHANGES IN ELIGIBILITY FOR RETIREE HEALTH CARE BENEFIT

Another significant decision made in 1985 (besides obtaining an independent actuarial report) was to increase the number of years required for newly hired employees to vest for retiree health care benefits. That decision resulted in the creation of a tiered vesting

schedule for retiree health care benefits depending on date of hire. Basically, employees that were hired prior to September 21, 1985, are fully vested for retiree health care benefits. Under the vesting schedule currently applicable to newly hired employees, last amended in 1995, employees are 60% vested upon completion of 15 years of service, with increments of an additional 4% earned in each subsequent year of service thereafter until fully vested upon completion of 25 years of service.

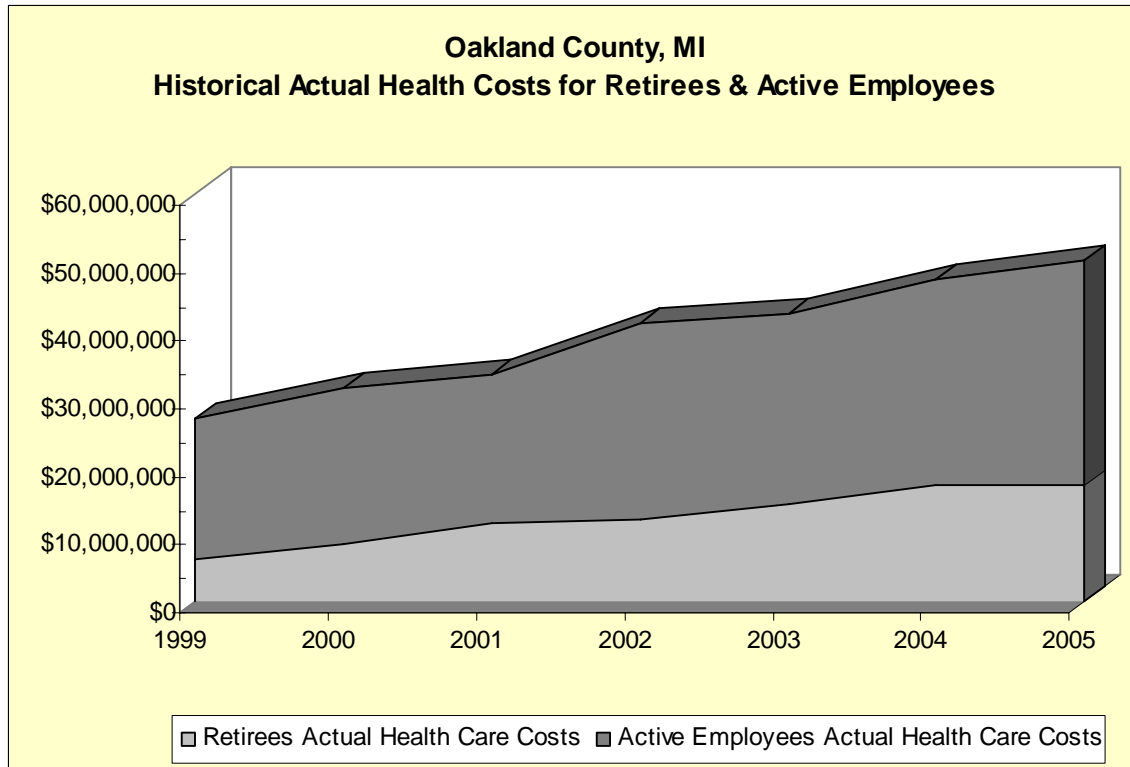
Another cost-saving action was taken in 1994, when the County offered a one-time voluntary option for deferred retirees, i.e., those former employees who had retired and had vested retiree health benefits but had not yet attained the required minimum age to start receiving those health benefits. In exchange for the deferred retirees' waiver of rights to retiree health benefits, the County provided a lump-sum payment to the retiree, which rolled over into a tax-qualified retirement plan or Individual Retirement Account. The estimated annual savings to Oakland County taxpayers for retirees who accepted that option is approximately \$770,000 annually for a total projected savings of \$23 million in avoided payout costs over a 30-year period.

ESTABLISHMENT OF A VEBA TRUST FUND

In 2000, upon the recommendation of the County Executive, the Board of Commissioners authorized the creation of a Voluntary Employees' Beneficiary Association (VEBA) Trust, which is essentially a vehicle to fund health care benefits for retirees. The passage of 1999 Public Act 149, known as the "Public Employee Health Care Fund Investment Act," enabled the County to establish the VEBA Trust Fund. The VEBA is exempt from tax under Section 501(c) (9) of the Internal Revenue Code. The tax-exempt status approved with the creation of the VEBA in 2000 provided Oakland County with the flexibility needed to offer a new tax-exempt investment plan, the details of which are discussed later herein. The VEBA is an irrevocable trust fund, meaning that the assets in the trust may be use only for the purpose of funding retiree health care. In other words, County government cannot use the assets in the VEBA fund for any purpose other than to provide retiree health care benefits.

TRADITIONAL RETIREE HEALTH CARE NO LONGER AFFORDABLE

At the start of the new millennium, health care costs began to soar. Each year from 1999 through 2005, actual health care costs paid by Oakland County for both retirees and active employees grew at an average annual rate of over 14%; a total cumulative increase of 86% during that six-year period. Note however, that the costs paid out for retirees during that time increased at a far faster rate than did the costs for active employees. The following chart shows that from 1999 to 2005, health care costs for active employees increased by 60% while, at the same time, actual retiree health care costs increased by whopping 173%.



The increases illustrated above for retiree health care are for actual claims paid (cash basis) and do not include the advance-funding portion that Oakland County sets aside each year to amortize future post-employment health benefits already earned by employees.

Actually, while the costs for actual claims paid on behalf of retirees remained flat from 2004 to 2005, the Annual Required Contribution (ARC) recommended by the actuary for payment into the VEBA increased significantly in 2006 as compared to the ARC required in 2005. In 2006 the ARC increased by \$8.7 million, moving from \$28.8 million in 2005 to \$37.5 million in 2006, an increase of over 30%. At the time the actuary informed the County of the magnitude of the required increase, April 2005, the ARC amount was \$6 million more than that set aside in the FY 2006 budget plan and required reductions elsewhere in the 2006 budget to accommodate the increase.

The reasons the 2006 ARC increases were required included:

- The inflationary increase for health care continued to significantly outpace general increases for other goods and services.
- Actuarial guidelines changed requiring the projected cost analysis to be based on different cost assumptions for different age groups (previously, the actuaries could use a standard assumed amount for each person regardless of age).
- The unfavorable investment market experienced shortly after the turn of the century impacted the valuation of the plan's assets. Market gains and losses are spread over a multi-year time frame 'smoothing' the impact of market

fluctuations in any single year, with the intent of avoiding huge swings in the ARC payment. Not since the Great Depression have there been three consecutive annual market declines – with the exception of what occurred just after the turn of the century. The actuarial reports are generally on a two-year lag – e.g., the FY 2006 ARC payment is based on the results of the accounting period ending September 30, 2004. Since the September 30, 2004, report was based on investment market returns which were “smoothed” for the period 2002 through 2004, the impact of the negative market during that period did not significantly impact the ARC payment requirement until 2006.

At this point, when the ARC increased so dramatically, it became apparent that the traditional retiree health care plan was no longer affordable.

HEALTH SAVINGS ACCOUNT – A NEW ERA

The battle to manage the escalating cost of providing retiree health care is neither unique nor isolated to Oakland County. Across the country, the number of large employers offering retiree medical benefits dropped from 66% in 1998 to 36% in 2004. Further, 8% of employers eliminated subsidized medical benefits for future retirees last year and it is estimated that 11% are likely to terminate such benefits this year.²

Historically, to help control costs the County’s practice was to impose periodic minor adjustments to deductible and co-pay requirements for both active employees and retirees. However, the rapid acceleration of costs that began in 2000 and which culminated in the huge increase in the required 2006 ARC payment forced a major change in the retiree health care benefit offered to new employees.

Upon recommendation of the County Executive, in 2005, the Board of Commissioners adopted a Retirement Health Savings (RHS) Plan for full-time eligible employees hired on or after January 1, 2006. This tax-exempt RHS plan replaces the traditional employer-paid health, dental, and vision plan for future retirees. Basically, this is a change from a defined benefit type of plan to a defined contribution plan. Under the RHS plan, for eligible employees the County contributes \$1,300 per year (\$50 per biweekly pay period) of pre-tax dollars to each RHS account. Employees may also elect to contribute a portion of their pre-tax pay to their account. The vesting schedule for the County’s contribution remains the same as discussed previously, employees are 60% vested after 15 years of service, with a 4% increment each subsequent year up to 100% at 25 years of service. Going forward, this new plan will limit and fix the amount of retiree health care costs that the County contributes allowing the County to maintain ongoing fiscal stability while still continuing to provide employees with a retiree health care benefit.

² 2004 Kaiser/HRET Survey of Employer-Sponsored Health Benefits

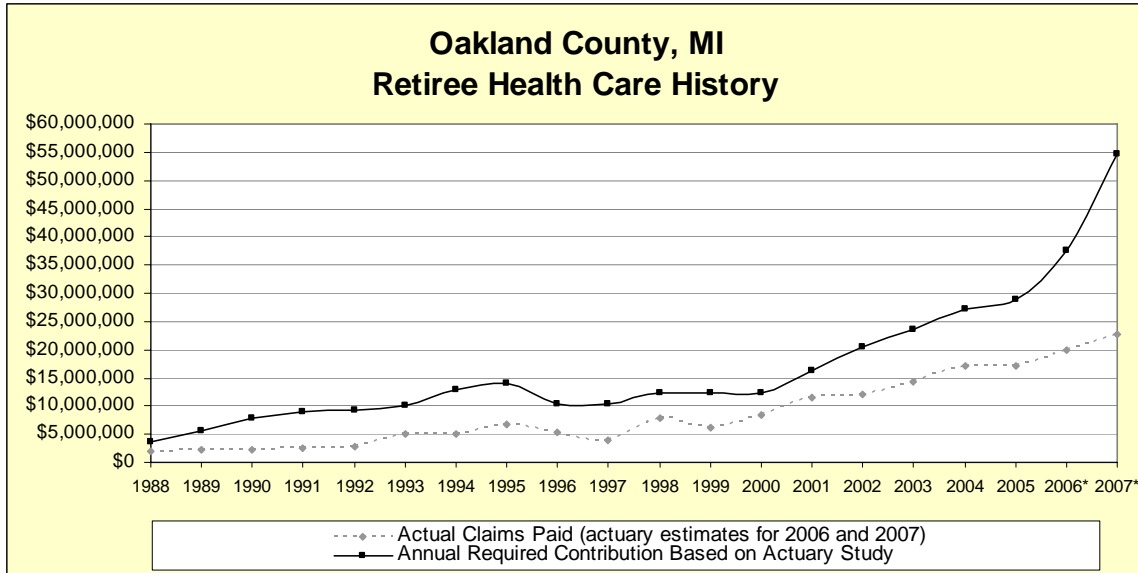
IMPACT ON THE ACTUARIAL ASSUMPTIONS RESULTING FROM CHANGES IN ACCOUNTING REQUIREMENTS

As previously mentioned, there are new accounting changes required by the Governmental Accounting Standards Board (GASB), statements numbered 43 and 45, which will affect those governments not using “full accrual” accounting practices in the retiree health care arena. Since the majority of governmental units across the country are not in compliance with GASB 43 and 45, they will eventually experience a negative impact on their financial statements if they continue to leave retiree health care funding issues unaddressed. (A good article that explains the potential impact on governments that are not already in compliance with GASB 45 is “Funding OPEB Liabilities” written by Parry Young, published by the Government Finance Officers Association in the December 2005 issue of the Government Finance Review [on the web at <http://www.gfoa.org/services/gfr/archives/2005/12/main.pdf>].)

Because Oakland County already funds its retiree health care ARC based on an actuarial study, it has basically been in compliance with these standards for the past two decades. However, the GASB Statements do impact the County’s actuarial assumptions because the accounting changes mandate that the amortization period for the unfunded accrued liability (UAL) be reduced from what was previously used, a 40 year period, down to 30 years, shortening the funding period and thus increasing the amount of the ARC payment.

In addition, as a result of the change to the new RHS plan for new employees, the County’s traditional plan retiree health care plan is considered to be a “closed” plan from an actuarial perspective. “Closed” plan actuarial standards require the traditional plan’s ARC be based on a level dollar payment going forward, rather than the methodology that had been used previously, which was a percent of total payroll method. The percent of payroll methodology assumes a gradually increasing payment amount over the 30-year amortization period (similar in concept to an adjustable rate mortgage) while the level dollar payment assumes that the payment remains the same each year over the 30-year amortization period (similar to the concept of a fixed mortgage payment). So, while the new RHS plan will result in significant savings to the County in the long-term, the immediate effect of the actuarial methodology change was a one-time increase in the ARC.

The following graph illustrates a history of the County’s ARC in comparison with the actual claims paid on a cash basis.



As can be seen from the graph, when Oakland County first began funding its retiree health care obligation on an actuarial basis in 1988, the ratio of the ARC (\$3.7 million) compared to actual claims paid (slightly over \$2 million) was 1.8 times the actual claims paid, with approximately \$1.7 million set aside for pre-funding. Contrast that with the amounts projected for 2007. The ratio of the ARC payment required in 2007 (\$54.8 million) is 2.4 times the actual claims to be paid, estimated at \$22.7 million, with over \$32 million being required to be set aside for pre-funding of the retiree health care liability. The actual cost projected for 2007 is approximately 11 times the actual cost in 1988, with the ARC payment being approximately 15 times the amount required in 1988.

IMPACT ON THE BUDGET

As previously noted, when the required 2006 ARC payment increased by over 30% from the previous year's amount, \$6 million in cuts were required elsewhere in the County's General Fund/General Purpose budget. The necessary cuts were made and the budget was balanced. Today, the increase in the required 2007 ARC payment poses an even larger budget challenge. The required 2007 ARC payment requires an increase of \$17.3 million, more than 46% over the 2006 amount. This means the total ARC increase over the past two-year period is \$26 million. The 2007 ARC is almost double the amount of the 2005 ARC. For perspective, \$26 million represents a 13% increase in compensation for Oakland County employees over two years.

Oakland County operates based on a biennial budget, so prior to receipt of the most recent actuarial report a plan was already in place for the 2007 budget. However, the FY 2007 plan adopted in September 2005 only included funding of \$46.1 million for the anticipated 2007 ARC. This amount was considered to be more than adequate at the time because it provided for a 23% increase in the ARC payment. However, in March 2006 when the actuary presented the 2007 ARC calculation, a potential \$9 million budget shortfall for 2007 presented itself.

Rather than cut \$9 million worth of services to citizens in order to meet the funding requirements of the 2007 ARC payment, other possible options were considered.

One possible option would be to not fund the \$9 million gap. However, for several reasons, this was the least desirable option. First, given the rapid rise in health care costs, it is more likely that the retiree health care liability will increase over time rather than decrease. Second, it would be a \$9 million gap in the only in the first year. If left unresolved, the gap would grow to \$18 million in the second year and \$27 million in the third year, and would compound by an additional \$9 million each year thereafter until resolved.

From 1985 to date, Oakland County has funded 35% of its total accrued retiree health care liability. The Administration believes it would be foolish to start slipping backward by creating a new unfunded liability, one that if left unresolved, would not only jeopardize the County's AAA credit rating, but would also burden future taxpayers with a huge liability. For these reasons, the "do not fund" option is not acceptable to the County Executive.

Fortunately, another, more creative option was developed.

FULLY FUNDING THE RETIREE HEALTH CARE LIABILITY

Historically, the County's practice has been to focus on the required ARC amount due each individual year and then react to it by adjusting our annual budget. Responsible stewardship however, required us to change our approach. Instead of using an annual view, the Administration decided to focus our attention on how best to finance the entire remaining Unfunded Accrued Liability (UAL), which is nearly \$500 million at present value. Given we have a closed plan, funding the UAL is the option that makes the most sense because it will allow the County to achieve a stable funding stream for retiree health care by taking advantage of several converging circumstances as well as Oakland County's financial strength.

Oakland County has a AAA bond rating meaning it enjoys the lowest rates that can be obtained in the government bond market. Oakland County is also well positioned to take advantage of the low rates because it has a very low level of debt, currently utilizing only 4.4% of its legally permissible debt level.

Accordingly, an opportunity exists for Oakland County to issue taxable bonds to fund its entire UAL at a low interest rate, anticipated currently to be approximately 5.5% with the AAA rating. The County will then invest the bond proceeds in legally permissible long-term investments within the VEBA fund, investments which can be expected to earn 7.5% over the long-term. Bonds issued at today's market rate to be repaid over 20 years would result in an annual debt service payment of approximately \$42 million, an amount well within the current budget plan. By investing the \$500 million bond proceeds through the VEBA trust fund at 7.5% over that same 20-year period, the County could

realize net gains (arbitrage earnings) of approximately \$145 million. The 7.5% average annual return is consistent with the actuary assumptions and well within the actual rate of return experienced with the General Employee Retirement System investments, which realized 8.38% over the past 10 years (even including the negative market of the early 2000's). This approach would reduce the funding period for Oakland County by 10 years (a 20-year bond issue versus a 30-year amortization period which the ARC is based on).

But we need to act now, as the low interest rates in general for bonded debt that can be obtained in the current market are unlikely to remain this low for much longer.

Under current law, the County could issue Trust Certificates right now to implement this funding plan. However, such certificates do not sell as well as a bond issue and the result would be a higher interest rate and reduce potential arbitrage earnings. In order to allow general obligation bonds to be issued with a more favorable interest rate a modification to current law is required. State Senator Nancy Cassis has recently introduced such legislation, Senate Bill 1360, to allow bonds to be issued for this purpose. The legislation will also require municipalities to implement a number of safeguards to reduce risk, including requirements to have a plan in place to reduce health care costs and a requirement to have an actuarial report to assure financial accountability. The legislation will allow responsible governments to meet their obligations to employees in a manner that is fair to taxpayers by providing a financing tool that can be used to avoid the alternative, which is cutting necessary citizen services.

This approach to funding retiree health care will also help reduce the interest rate risk because the cost of financing will be locked in at today's low interest rates and the arbitrage earnings will help mitigate potential future ARC increases. In addition, Oakland County will be one of few governments in the country, if not the only one, to have fully funded its retiree health care plan.

Another important point is to note that the bond proposal will allow the county to meet its already-incurred obligations *without raising taxes*. The County is already legally obligated to pay the retiree health care costs for the "closed" plan. The County can have a fully funded retiree health care plan that is sustained by existing revenues if the Administration's bond proposal is adopted by the Board of Commissioners.

During a recent conference with Wall Street analysts the Administration's plan was presented and met with a very positive reaction. The analysts were impressed not only by the fact that Oakland County had been funding its retiree health care ARC based on the actuary recommendations for the past 20 years, but also by the fact that the County was proposing this unique approach to funding the remainder of its long-term liability.

SUMMARY

Retiree health care is a form of deferred compensation promised by employers to employees upon their retirement in exchange for their service during active employment. These are legacy costs that have grown over the years far beyond the expectations that

existed when these benefits were first initiated. Most governments fund these legacy costs on a “pay as you go” basis. Those governments are not financially prepared for the financial challenge to come, a liability they will soon have to recognize in their financial statements.

Oakland County recognized the need to quantify and fund this liability more than 20 years ago when it secured its first actuary study. In doing so, it was able to use the information provided in the actuary reports to make benefit adjustments as necessary over these many years to keep both current and future costs in check. As a result, Oakland County has progressed in advance funding 35% of its retiree health care obligation.

Such advance planning is applied in all areas of Oakland County government, particularly in its financial practices, thus earning the County a bond rating of AAA. Now the County, its employees and its citizens, over the years can once again benefit from our stellar rating by taking advantage of historically low bond rates to fully fund the remaining 65% of its retiree health care obligation.

Once fully funded in an irrevocable trust, our employees, both current and retired, will never face that awful and dreaded notice that their health care benefits upon which they relied in their retirement have been terminated. Nor will the County be forced to consider cutting \$9 million in services that our citizens have come to depend upon in order to pay for a benefit promised to employees, a promise that began over 40 years ago.