

A Decision Facing Washtenaw County: Funding the County's Retiree Medical Benefit (VEBA) Trust



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Introduction

Introduction

On June 16, 2008, Washtenaw County engaged J.L. Boyle International to opine on the desirability of issuing between \$160,000,000 and \$168,500,000 in Certificates of Participation to fully fund its retiree health care obligations (its Unfunded Actuarial Accrued Liability or UAAL) and to pay the costs of issuance. This report summarizes the results of our research and analysis.

A National Health Care Perspective

A National Health Care Perspective

State & Local Employment Trends

| | YEAR | | | | | INCREASE |
|--|--------------|---------------|---------------|---------------|---------------|--------------|
| | 1960 | 1980 | 1990 | 2000 | 2005 | FROM 1960 |
| | (000) | (000) | (000) | (000) | (000) | TO 2005 |
| | | | | | | % |
| STATE & LOCAL EMPLOYEES | 6,387 | 13,315 | 15,263 | 17,507 | 19,004 | 198 % |
| STATE & LOCAL RETIREES | 660 | 2,607 | 4,026 | 5,506 | 6,903 | 946 % |
| TOTAL STATE AND LOCAL | 7,047 | 15,922 | 19,289 | 23,013 | 25,907 | 268 % |
| TOTAL U.S. POPULATION | 180,671 | 227,726 | 249,913 | 272,945 | 296,940 | 64 % |
| STATE & LOCAL EMPLOYEES AND RETIREES AS A % OF U.S. POPULATION | 3.9% | 7.0% | 7.7% | 8.4% | 8.70% | -- |
| ----- | | | | | | |
| MEMO: | | | | | | |
| CIVILIAN (NON-TAX SUPPORTED) EMPLOYMENT | 55,923 | 82,130 | 99,391 | 113,776 | 119,366 | 113 % |
| FEDERAL EMPLOYEES + RETIREES (EXCL. MILITARY) | 2,936 | 4,573 | 5,248 | 5,255 | 5,142 | 75 % |
| - % of U.S. POPULATION | 1.6% | 2.0% | 2.1% | 1.9% | 1.70% | -- |
| SOCIAL SECURITY BENEFICIARIES | 14,844 | 35,585 | 39,832 | 45,415 | 48,434 | 226 % |
| ----- | | | | | | |
| Source: Statistical Abstracts of the United States | | | | | | |

- From 1960 to 2005, the number of State & Local employees increased by **198%** from 6.4 million to 19 million.
- From 1960 to 2005, the number of State & Local retirees has increased by **946%** from 660,000 to 25.9 million.

A National Health Care Perspective

THE RATE OF INCREASE IN HEALTH CARE WILL COME DOWN

Why? Consider the Following:

- Between 1965 and 2005 national health care costs increased by 4,730 % (47 X) from \$42 Billion to \$2.0 Trillion.
- The average annual rate of increase for health care costs is **10.1%** essentially doubling every 7 years.
- Between 1965 and 2005 America's Gross Domestic Product increased by 1,685% or (17 X) from \$739 Billion to \$12.5 Trillion.
- The average annual rate of increase in GDP was **7.3%** .
- Between 1965 and 2005 health care costs increased from 5.7% of GDP to 16% of GDP.
- If it were possible to continue this rate of increase into the future (it is not), by 2079 health care would consume 100% of GDP.

A National Health Care Perspective

Health Care Costs In America Greatly Exceed Health Care Costs For Every Other Major Free-Market Country

| Country | Health Care Costs % of GDP | Life Expectancy | Infant Mortality |
|----------------------|----------------------------|-----------------|------------------|
| Australia | 9.2 % | 81.2 | 4.4 |
| Austria | 9.6 | 79.8 | 4.4 |
| Belgium | 10.1 | 79.4 | 4.2 |
| Canada | 9.9 | 80.7 | 4.8 |
| Denmark | 8.9 | 78.3 | 4.4 |
| England | 7.8 | 79.4 | 4.8 |
| Finland | 7.4 | 79.3 | 3.7 |
| France | 10.4 | 80.7 | 4.2 |
| Germany | 10.8 | 79.4 | 4.3 |
| Italy | 8.4 | 80.5 | 6.3 |
| Japan | 8.0 | 82.6 | 3.2 |
| Switzerland | 11.5 | 81.7 | 4.1 |
| Avg. Excluding U.S. | 9.3 | 80.3 | 4.4 |
| United States | 16.0 % | 78.2 | 6.6 |



- Average cost for health care among major free-market countries (excluding the U.S.) is 9.3% of GDP.
- The cost of health care in the U.S. is 16.0% of GDP -- highest in the world. (Interestingly, among industrialized countries, the U.S. also has the lowest life expectancy and the highest infant mortality rate.)

Source: Organization for Economic Cooperation & Development (OECD)
United Nations Demographic Yearbook
Statistical Abstract of the United States

A National Health Care Perspective

Health Care Costs In America Greatly Exceed Health Care Costs For Every Other Major Free-Market Country



- The U.S. is paying 72% more as a % of GDP than competing countries.
- These statistics can provide arguments for and against socialized medicine in the U.S. On the one hand, we can suggest that socialized medicine could not be more expensive nor produce worse results than the current system. On the other hand, we might suggest that, if socialized medicine were more expensive than the current system, the U.S. could not afford it.
- Because of the complexity of the arguments pro and con, we do not believe that socialized medicine is likely in the foreseeable future.
- To compete in today's world, the growth rate in health care costs in the U.S. must come down.

A National Health Care Perspective

Estimated Unfunded Actuarial Accrued Liabilities (UAAL)

| | |
|--|------------------------------------|
| Federal Government Social Security Medicare | \$ 6.8 Trillion \$34.2 Trillion |
| Federal Employees (Pension & Health Care) | \$4.8 Trillion |
| State & Local Governments Pensions Health Care | \$1.6 Trillion \$2.8 Trillion |
| State of Michigan Pensions Health Care | \$12.2 Billion \$39.3 Billion |
| City of Detroit Pensions Health Care | \$0.3 Billion * \$8.0 Billion * |
| Washtenaw County Pensions Health Care | ----- \$157.1 Million |

*** In 2005, The City of Detroit funded \$1.4 Billion of its pension UAAL with Certificates of Participation. Detroit has no assets to support its \$8 billion in OPEB (Other Post Employment Benefits) liability.**

Source: Statistical Abstracts of The United States
Social Security and Medicare Annual Reports
CATO Institute, Tax & Budget Bulletin No. 40, October 2006
J.L. Boyle International Source Files

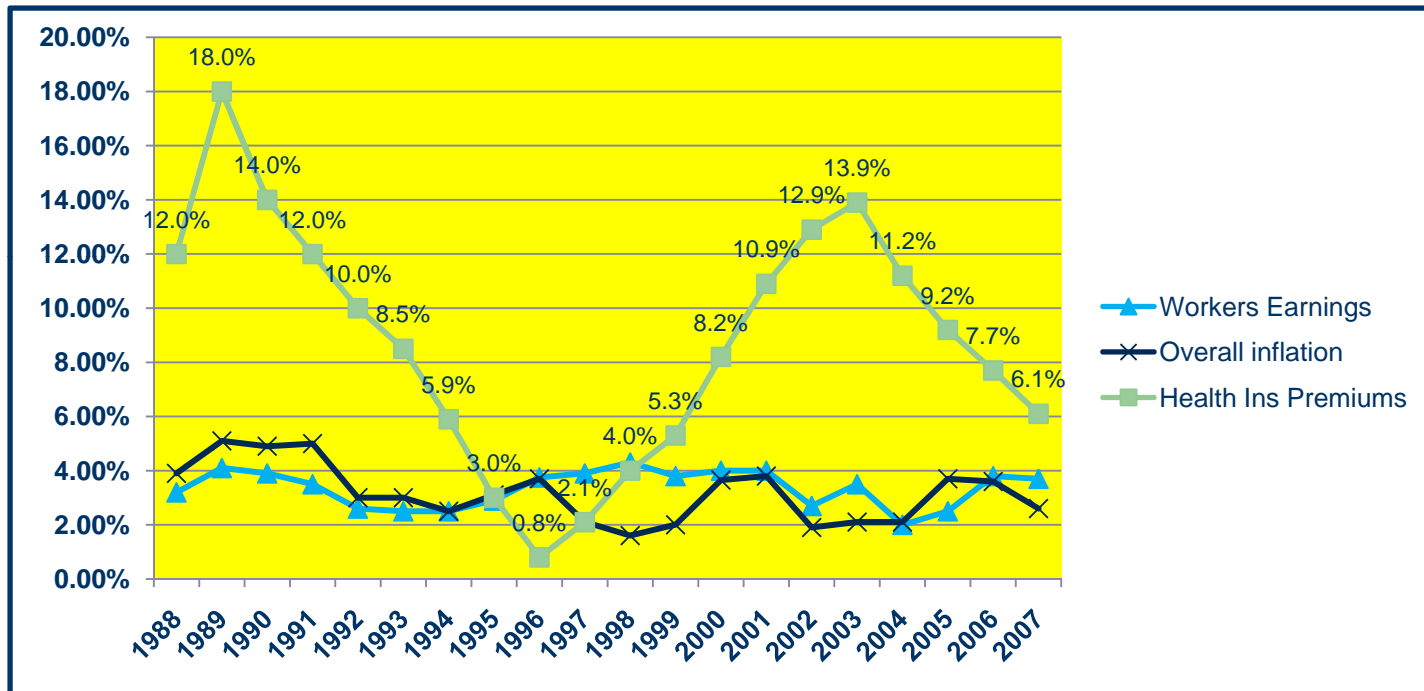
A National Health Care Perspective

As you can see, when it comes to Unfunded Actuarial Accrued Liabilities, Washtenaw County has a lot of company. In fact, most states and large municipalities have significant Unfunded Actuarial Accrued Liabilities.

However, if Washtenaw County funds its Health Care UAAL, it will be in a very select group. A preliminary search by my company produced only one other large county (300,000+ citizens) in the U.S. with no health care UAAL -- Oakland County, MI.

A National Health Care Perspective

Increases in Employer-Sponsored Health Insurance Premiums Compared to Other Indicators, 1998 - 2007



Source: Kaiser/HRET Survey of Employer – Sponsored Health Benefits, Bureau of Labor Statistics

- Health insurance premium increases have consistently outpaced inflation and the growth in workers earnings.
- Where premium increases have been between 6 and 14 percent since 2000, inflation and changes in workers earnings are typically in the 3 to 4 percent range.
- The rates of increase in health insurance premiums have been dropping since 2003.

Washtenaw County Demographics

Washtenaw County Demographics

- Washtenaw County enjoys a growing population and a varied and vibrant economy.
- Moderate unemployment – Washtenaw County’s unemployment rate for April 2008 was 4.2% -- compared with May 2008 unemployment of 8.5% for Michigan and 5.5% for the U.S.
- In fact, the unemployment rate for Washtenaw County actually has been coming down – from 4.9% in February 2008 to 4.2% in April 2008.
- Per capita income continues to rise: Currently \$39,700.
- Still, the County is facing a 2009 structural deficit of \$3 Million.
- The County must pursue opportunities to increase revenue and reduce costs to maintain a balanced budget and to maintain a superior credit rating.
- Fully funding the County’s VEBA Trust at a time when borrowing costs are low is an opportunity to increase revenue – but it is not completely risk free.

Sources: Washtenaw County Annual Financial Report for 2007
Bureau of Labor Statistics – National, State, and local-area unemployment statistics

Note: National and State unemployment statistics are seasonably adjusted .
Local-area unemployment statistics are not seasonably adjusted.

Washtenaw County Demographics

Washtenaw County Statistics

| Year | Population* | County Employment** | | County Retirees (VEBA)** | | |
|---|-------------|---------------------|----------------------|--------------------------|----------------------|-----------------------|
| | | Total Number | # Per 100 Population | Total Number | # Per 100 Population | Retirees Per Employee |
| 1998 | 312,601 | 1,160 | 0.37 | 5 | --- | --- |
| 1999 | 318,270 | 1,320 | 0.42 | 7 | --- | --- |
| 2000 | 322,895 | 1,303 | 0.40 | 12 | --- | --- |
| 2001 | 329,506 | 1,416 | 0.43 | 557 | 0.17 | 0.39 |
| 2002 | 334,191 | 1,412 | 0.42 | 558 | 0.17 | 0.39 |
| 2003 | 337,870 | 1,361 | 0.40 | 566 | 0.17 | 0.42 |
| 2004 | 341,743 | 1,355 | 0.40 | 564 | 0.17 | 0.42 |
| 2005 | 345,214 | 1,352 | 0.39 | 601 | 0.17 | 0.45 |
| 2006 | 347,792 | 1,376 | 0.40 | 615 | 0.18 | 0.45 |
| 2007 | 350,003 | 1,403 | 0.40 | 646 | 0.19 | 0.46 |
| ----- | | | | | | |
| * Sources: Statistical Abstract of the U.S., the U.S. Census Bureau, and SEMCOG | | | | | | |
| ** Washtenaw County VEBA Actuarial Valuations | | | | | | |

- **Washtenaw County has experienced a relatively robust growth in population of 12% from 1998 to 2007 while growth in Michigan was flat.**
- **During the same time period the number of County employees has grown by 21% but has remained constant since 2002.**
- **In the six years ending December 31, 2007, County retirees have increased by 16%.**
- **As the Baby-Boomers retire, the increase in retirees will accelerate and the retiree health care costs (VEBA costs) will increase.**

Funding the VEBA Trust

Funding the VEBA Trust - GASB 43 & GASB 45

New Accounting Standards

- In 2004, the Government Accounting Standards Board (GASB) issued two new statements (GASB 43 and GASB 45) which require municipalities to reflect their total projected retiree health care liabilities into the future in their health care trusts (GASB 43) and in their financial statements (GASB 45).
- For Washtenaw County, GASB 43 took effect in Fiscal Year 2006 and GASB 45 took effect in 2007.
- This is similar to the health care liability reporting requirements for the private sector that became effective in 1993 FY (FASB 106).
- GASB 43 & GASB 45 do not require any minimum funding.
- GASB 45 will result in higher booked liabilities and higher annual required contributions (ARCs) -- because of the use of more conservative investment rates and lower amortization periods for paying down liabilities.

Funding the VEBA Trust - Logic

There are three fundamental reasons to fund Washtenaw County's retiree medical benefits:

1. An unfunded retiree-medical liability essentially makes creditors out of its employees and retirees. With an estimated unfunded liability of \$157.1 million and 2,074 members in the County's VEBA Trust (1,403 employees and 671 retirees), each member has effectively extended a credit line averaging \$75,750 to the County. It is both fair and appropriate for the County to replace the VEBA members with sophisticated certificate-of-participation buyers.
2. By funding this debt (the UAAL), the County reinforces its creditworthiness with the credit-rating agencies (Standard & Poor's (AA+) and Moody's (Aa2)), levels out its payments, and pays the liability off in 20 years.
3. By funding the UAAL with Certificates of Participation (COPs) at a time when borrowing rates (for good credits) are close to historic lows, the County's VEBA Trust has a very realistic – but not guaranteed – opportunity to earn a rate of return (on funds available for investment) which exceeds the average cost of borrowing (currently estimated at 5.55%).

Notes: Funding the UAAL – will eliminate the “past service cost” (Annual Required Contributions (ARC) of \$7.0 million in 2008).

Current service costs (aka “normal costs”) – accrued annually (ARC of \$6.5 million in 2008) – will continue to be due.

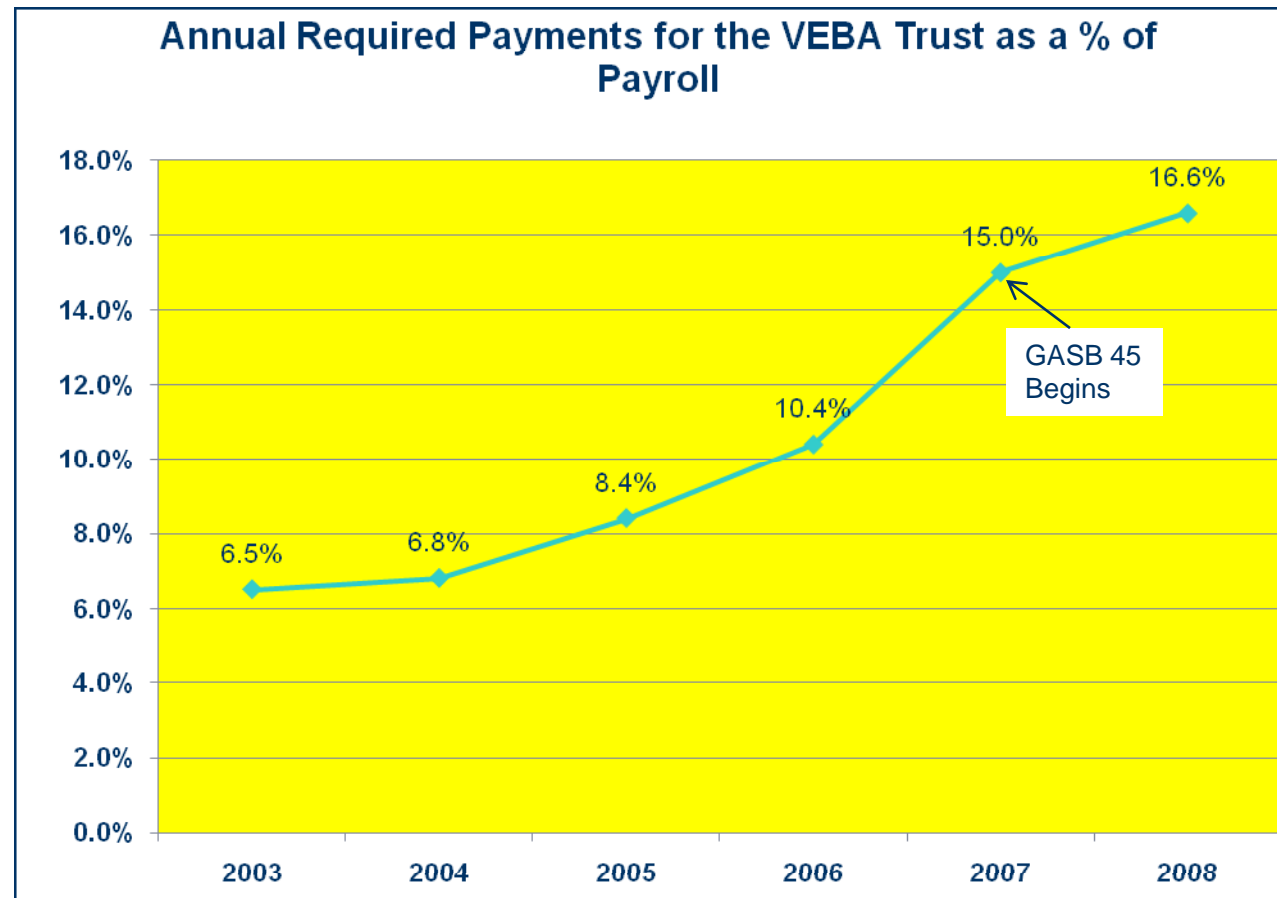
Funding the VEBA Trust - History

| | VEBA Funding - Annual Required Contributions (ARC) | | | | | | |
|--------------|---|-----------------|----------------------------|-----------------|---------------|-----------------|----------------|
| | <u>Current Service</u> | | <u>Past Service (UAAL)</u> | | <u>Total</u> | | <u>Covered</u> |
| | <u>Amount</u> | <u>% of P/R</u> | <u>Amount</u> | <u>% of P/R</u> | <u>Amount</u> | <u>% of P/R</u> | <u>Payroll</u> |
| | (\$Mills) | | (\$Mills) | | (\$Mills) | | (\$Mills) |
| 2003 | \$2.2 | 3.4% | \$2.0 | 3.2% | \$4.2 | 6.6% | \$63.7 |
| 2004 | \$2.3 | 3.4% | \$2.3 | 3.4% | \$4.6 | 6.8% | \$67.1 |
| 2005 | \$2.7 | 3.9% | \$3.1 | 4.6% | \$5.8 | 8.5% | \$68.4 |
| 2006 | \$3.6 | 4.7% | \$4.4 | 5.7% | \$8.0 | 10.4% | \$77.0 |
| 2007 (GAS B) | \$5.3 | 6.7% | \$6.6 | 8.3% | \$11.8 | 15.0% | \$78.8 |
| 2008 (GAS B) | \$6.5 | 7.9% | \$7.0 | 8.7% | \$13.5 | 16.6% | \$81.2 |

In the 5 years from 2003 to 2008

- Annual required contributions have increased from \$4.2 million to \$13.5 Million -- a 221% increase.
- Past service (UAAL) costs have increased from \$2.0 million to \$7.0 million – a 250% increase.

Funding the VEBA Trust - History



| | | | | | | |
|---------------------|--------|--------|--------|--------|--------|--------|
| ARC (\$Million) | \$4.2 | \$4.6 | \$5.8 | \$8.0 | \$11.8 | \$13.5 |
| Payroll (\$Million) | \$63.7 | \$67.1 | \$68.4 | \$77.0 | \$78.8 | \$81.2 |

Source: Annual Actuarial Valuations for the VEBA Trust

Funding the VEBA Trust - History

VEBA Trust Fund Performance

- In the five years ending December 31, 2007, the VEBA Trust grew by 157% -- from \$19.6 million to \$50.4 million.
- While the investment return over the last ten years – 5.5% -- was severely impacted by the market decline of 2000-2002, the investment return over the last five years has averaged 11.5%.
- A national effort to reduce health-care costs combined with cost containment efforts by Washtenaw County suggest that health care cost increases for the County should not exceed 5% per year over the long-term.
- The County's (VEBA Trust's) investment advisor believes that a long-term investment return of 7.50% to 8.50% is conservative.

Funding the VEBA Trust - History

Comparison of COPs Funding to Reduce or Eliminate UAALs

| | Year | Total Liability (\$ millions) | UAAL | | COPs / POCs * | | Interest Rate |
|---------------------------------------|------|----------------------------------|-------------------------|-------|-------------------------|-------------------------|---------------|
| | | | Amount (\$ millions) | % | Amount (\$ millions) | % of Total Liability | |
| City of Detroit Pensions ¹ | 2005 | \$7,241.4 | \$1,696.7 | 23.4% | \$1,440.0 | 19.9% | N/A |
| Oakland County OPEB ² | 2007 | 829.7 | 552.5 | 66.6% | 557.0 | 67.1% | 6.23% |
| Pittsburgh Pensions | 1998 | 519.0 | 401.0 | 77.3% | 256.0 | 49.3% | 6.50% |
| Washtenaw County OPEB | 2008 | 194.8 (est.) | 157.1 (est.) | 80.6% | 160.0 | 82.1% | 5.55%-6.00% |

- 1. Detroit's City Council approved the issuance of the COPs by a vote of 8 to 0**
- 2. Oakland County's Commissioners approved the issuance of the COPs by a vote of 25 to 0**

* COPs = Certificates of Participation
POCs = Pension Obligation Certificates

Funding the VEBA Trust - Analysis

KEY ASSUMPTIONS

Method of Funding: Certificates of Participation (COPs)
Date of Funding: September 2008

| | |
|---|-------------------------------------|
| Amount of Funding | \$ 160,000,000 |
| Balance on VEBA Trust at Time of Funding (est.): | <u>50,400,000</u> |
| TOTAL in VEBA Trust After Funding: | <u><u>\$ 210,400,000</u></u> |

Amortization Term for COPs: 20 Years
Borrowing Rate for COPs: 5.55%

Cost Increases for Retiree Medical Benefits

| | |
|-------------------|-----------------------------|
| 2009: 9.0% | 2013: 7.0% |
| 2010: 8.5% | 2014: 6.5% |
| 2011: 8.0% | 2015: 6.0% |
| 2012: 7.5% | 2016 and later: 5.0% |

Cost Increases for Administrative Costs & Investment Management: 4% per year
Reimbursement Increases for Medicare Part D: 4% per year

Funding the VEBA Trust - Analysis

- Issuing the Certificates of Participation has a goal of maximizing investment earnings potential and minimizing future interest-rate risks.
 - Will reduce amortization period to 20 years (from 30 years)
 - Future budgets more predictable with known annual debt service payments
 - **Conservative Net Present Value (NPV) of savings : \$28.6 million**
 - VEBA UAAL will be fully funded. (Remember : current service costs – \$6.5 million in 2008 – will continue to be due each year.)

Risks and Abatements – County Finances

- **By incurring long-term debt (the COPs), the County is replacing a non-fixed cost with a fixed cost.**
- **As discussed under “Demographics”, the County has a growing, varied, and vibrant economy and, over the next 20 years (the amortization period for the COPs), the County should be the beneficiary of an increasing tax base.**
- **Although the County currently faces a potential structural deficit of about \$3 million in 2009, it has balanced its budget in 19 of the last 20 years. The County’s management is dedicated to maintaining balanced budgets -- and believes it will do so in 2009.**

Risks and Abatements – Medical Costs

Funding the VEBA UAAL in 2008 will not permanently eliminate the UAAL unless the County also tightly controls its medical costs -- and achieves a long-term cost increase of 5% per year or less -- as assumed in the VEBA actuarial reports.

To control medical costs (for employees and retirees), the County has implemented many cost-containment measures and programs – including the following:

- 1. Increase co-pays and deductibles (2009)**
- 2. Commenced a wellness program (2007)**
- 3. Automated benefit functions (2006)**
- 4. Set up flexible spending accounts (1998)**
- 5. Adopted a mail-order prescription program (1996)**
 - Make mail-order prescriptions program mandatory (2009)**
- 6. Added an enhanced voluntary benefits program (2002)**
- 7. Increase tenure to vest for retiree-medical benefits (OPEB) (2009)**
- 8. Added enhanced employee-education programs (2003)**
- 9. Added a managed care/preferred provider program (2003)**
- 10. Maintains all programs under one provider (Blue Cross/Blue Shield)**

Based upon these programs and management’s commitment to audit and control medical costs, it is reasonable to assume that the actuarial assumptions for cost increases will not be exceeded.

Risks and Risk Abatements – Earnings

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THE POWER OF COMPOUND INTEREST

Albert Einstein once stated :

“The most powerful force in the universe is compound interest.”

Consider this:

If Manhattan Island was indeed purchased for \$24 in 1626 by the Dutch – the value today of that \$24 at the average earnings rate for large stocks (10.4%) would be \$ 622,869,800,000,000,000 – that’s \$622.9 Quadrillion. This amount would be sufficient to purchase virtually **all** of the assets in America. Clearly, the Dutch paid too much for Manhattan !!

Risks and Risk Abatements – Earnings

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There is a risk -- it is a small risk, but a risk nonetheless -- that low earnings in the VEBA Trust could result in higher annual required contributions (ARC) by the County.

Mitigating this risk are the following facts:

- **Since 1926, the stock market (as represented by the S&P 500 Index) has averaged annual returns of 10.4%*.**
 - **Since 1926, small-company stocks have averaged 12.5% per year.***
 - **Since 1926, long-term corporate bonds have averaged 5.9% per year.***
 - **If we use the VEBA Trust's current asset mix and apply these long-term rates, the Return on Investment (ROI) is 9.1%.**
- **Stocks and bonds have posted gains in virtually every 20-year holding period since 1926.**
 - **If we use the VEBA Trust's current asset mix and apply the lowest returns earned by stocks and bonds in any 20-year holding period since 1970, the return on investment is 10.2%.**
- **As mentioned earlier, a conservative estimate of the NPV of savings resulting from the issuance of COPs is \$28.6 million. This assumes an 8.0% ROI.**
 - **If we assume a 5.5% ROI over 20 years -- not seen since the Great Depression* -- the County would incur a NPV cost (loss) of \$400,000.**
 - **If we assume a 9.0% ROI over 20 years, the NPV of savings would be \$45.7 million.**

* Source: 2008 Ibbotson Stocks, Bonds, Bills, and Inflation Yearbook

Pros & Cons

Pros & Cons

Pros:

- The County replaces its employees and retirees with sophisticated certificate buyers as creditors.
- The County will reinforce its creditworthiness with the bond-rating agencies – Moody’s and Standard & Poor’s.
- With interest rates at close-to-historic lows, a conservative estimated NPV of savings is \$28.6 million.
- The County will have predictable level payments for past service costs instead of unpredictable and increasing actuarially-determined payments.
- The time and cost associated with actuarial calculations and actuarial reviews will go down.
- Although not economic in nature, Washtenaw County will join an extremely small and exclusive group of counties and municipalities who have eliminated their OPEB UAAL.

Pros & Cons

Cons:

- **The COPs payments are non-negotiable fixed payments (although the COPs are callable after 9 years*) -- while actuarially-determined past-service costs are not mandatory -- and can be partially-paid or not paid at all if money is tight.**
- **Because of the fixed payments, the County's management must assure that the VEBA Trust's investment manager balances reasonable risk with necessary prudence to achieve "appropriate" investment results. Increasing VEBA Trust assets from \$50.4 million to \$210.4 million will improve the Trust's ability to attract top-flight investment management.**
- **If there is a short-term drop in the market in the early years of the COPs amortization cycle, the County could be required to pay more than the ARC (Annual Required Contribution) determined by the actuaries. (Based upon a review of investment returns from 1926 to 2007, it is extremely unlikely that a well-managed and balanced investment portfolio will, over any extended period, earn a rate lower than the fixed rate (5.55%) on the Certificates of Participation.)**

* There is no premium required for this callable feature.

Conclusion / Recommendation

Conclusion / Recommendation

As an advisor to the Washtenaw County Board of Commissioners and also as a citizen of Washtenaw County, based upon my analysis, I recommend that the Board fully fund the County's UAAL by approving the issuance of \$160 million in Certificates of Participation – with a contingency to issue up to \$168.5 million in Certificates of Participation based upon the soon-to-be-issued updated Actuarial Valuation.

John Boyle

Q & A

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