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Managing Health Care Costs A Case Study: The City of Grand Rapids

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In May 2006, the City of Grand Rapids (MI) announced that for the second consecutive year the city's health care costs remained essentially unchanged, while national health care cost trends increased at a rate of 12%. Between fiscal years 2004 and 2005, the city's health costs actually declined from \$28.9 million to \$27.8 million, and increased slightly to \$27.9 million in 2006.

These results stem from a new health care program developed collaboratively by city officials and union officials, with guidance from their health consultants, which included Shell Freilich, Director of Health Care Consulting at GRS, and Patrick Coleman.

The City of Grand Rapids is the second largest city in Michigan, with a population of about 200,000, and is located in the west central region of the Lower Peninsula. It employs approximately 2,000 full-time governmental employees, with an annual payroll of about \$100 million.

Over its first two years, the new program has saved the city \$12.6 million when compared with prior projected cost increases. Cumulative projected savings through 2009 are conservatively estimated to be \$41.3 million.

For the last several years, this city faced significant budget deficits. It had absorbed double-digit health care cost increases for over five years and its employee health plan had exceptionally low participant cost-sharing. The health plan was self-insured and used a large, dominant carrier for administration and provider network access. Both management and labor were dissatisfied with the lack of accurate and timely reporting from the carrier.

Faced with budget deficits, the city's management and labor leaders sought ways to achieve significant health cost savings, with no increased cost shifting towards employees or other benefit reductions. A detailed analysis identified a number of areas in which administrative efficiencies would produce savings.

Leveraging Vendor Efficiencies

The city's new health benefits program was implemented in April 2004 after the city's Health Care Task Force recommended changes in managing the health care benefits for active and retired employees and their beneficiaries. The program was designed to manage health care costs by coordinating a number of approaches to leverage vendor efficiencies, improve plan administration, better educate plan participants about the use of health care, and find ways to avoid costs by improving the health of the covered population and increasing generic drug utilization.

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The city initiated a Request for Proposal (RFP) process for all lines of health coverage. The RFP process identified more cost effective and responsive vendors for administration, provider network access, and prescription benefit management. Labor leaders were informed and actively involved throughout the RFP selection, evaluation, and transition process.

Prior to 2004, the city's health care plan was administered by a single, large carrier that provided access to the health care network. In 2004, as part of the new program, the city discontinued this approach and entered into separate contracts with "best practice" vendors for plan administration, health care network access, pharmacy benefit management, and health improvement/disease management.

Improving Plan Administration

As a key element in the new program, the city required its vendors to provide timely and accurate information about the health plan, with full and transparent disclosure of all costs. This allows the city to precisely monitor the plan's performance and provides useful information for strategic plan management.

This information is shared with the city's labor leaders to keep them informed about the services and management of the plan. On-going labor involvement has been integral to the program's overall success.

Educating Members and Health Advocacy

Because members' decisions have a significant effect on the costs of a health plan, management and labor recognized the importance of educating members to use the plan wisely. Extensive meetings were conducted to help ensure a smooth transition and inform members about the services available to them. The strong support that labor leaders have shown for the program has encouraged employees to work for the program's success.

In order to assist members with health

Outcomes from the City of Grand Rapids Health Care Program

- *Health plan costs were reduced from a projected \$32.3 million to \$27.8 million in the program's first year, a \$4.5 million savings. Projected savings through fiscal year 2009 are conservatively estimated to be \$41.3 million with no change in benefit plan design or participant cost sharing.*
- *Labor leaders and plan members are highly satisfied with the direction, service, and management of the health plan. Member satisfaction and knowledge has increased significantly.*
- *Accurate, reliable, and timely health plan reporting was instituted, with full disclosure and transparent reporting of all costs. The city has access to useful and credible information for member education and strategic management of its health plan.*
- *Generic drug utilization has increased over the past two years to 50% in FY 2006, from 43% in FY 2004, saving the city over \$700,000.*
- *Innovative programs to improve the health of members are being introduced. A number of disease conditions (such as diabetes) have been identified to be major contributors to health plan costs.*

care and disease management, the program also provides members with a health advocacy service. This service offers access to registered nurses who answer members' questions about health plan benefits and medical care. In addition, the service acts as an advocate for the members with regard to plan benefits.

Members are encouraged to contact a nurse advocate when inpatient or outpatient hospital services are being planned. This helps members to understand how to receive the maximum benefit under the plan, access appropriate network providers, and receive the appropriate follow-up care.

Increasing Generic Drug Utilization

A significant source of cost savings can come from increased utilization of generic drugs. Analysis of the city's costs showed that every 1% increase in generic utilization would result in savings of nearly \$103,000.

The city instituted a voluntary generic drug program and, as a result, generic drug utilization grew from 43% in 2004

to 50% in 2006, saving the city over \$700,000 during the last two years.

Initiating Disease Management Programs

As a result of better information about the plan, a number of disease conditions have been identified to be major contributors to health plan costs. For example, 4% of the membership was found to account for over one-third of the city's drug costs.

The city also discovered that a significant number of employees and their dependents were suffering from diabetes that was not managed effectively.

In response, the city initiated a voluntary diabetic health improvement program to provide thorough evaluation and education regarding the disease. The program was announced through a letter sent to each employee and received a strong positive response.

The program uses evidence-based practice guidelines and is designed to manage the disease effectively so the participants can lead healthy and normal lives.

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The city is currently looking at other opportunities for avoiding costs by improving health, and is considering health improvement programs for heart disease, asthma, and depression. These areas offer significant potential for success.

Conclusions

The costs of providing health care for employees and retirees ranks very high in the challenges facing public employers and employees.

The collaborative efforts of the city's management and labor to control

health care costs have resulted in an effective program that combines administrative efficiencies with voluntary behavioral changes and improved disease management techniques.

This has helped save the city almost \$13 million over the last two years and is expected to save another \$28 million over the next three years.

The GASB's New Research Project on Accounting for Retirement Benefits

In January 2006, the Governmental Accounting Standards Board (GASB) announced a new research project intended to open up a broad discussion about accounting and financial reporting for governmental retirement benefits. Specifically, the project is designed to review GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, although the study's results may be extended to other benefits as well.

The project will review governmental accounting and reporting standards with regard to their usefulness for:

- Assessing the financial implications of governmental pension benefits and managerial decisions regarding those benefits.
- Making decisions about the value of benefits, proposed changes in benefits, and funding of benefits.

Although not specifically discussed in the GASB's announcement, the project will likely examine many of the pension accounting issues currently under review by the Financial Accounting Standards Board (FASB). The FASB's project, begun last year, is a comprehensive examination of accounting standards for private-sector pension and other postemployment benefits (OPEB).

The first phase of the FASB's project is expected to be completed in 2006 and requires that the overfunded or underfunded status of a firm's defined benefit pension and OPEB plans be reported on the firm's balance sheet. The second

phase is expected to take several years and address a broader range of issues, including: actuarial cost methods, actuarial assumptions, and convergence with international accounting standards.

To provide readers with additional background related to the GASB's new research project, this article briefly summarizes several of the GASB's key prior decisions related to pension accounting and reporting as presented in Statement No. 27.

The article also discusses the GASB's recently published white paper on the appropriate differences between public and private-sector accounting and financial reporting.

The GASB's White Paper

This March, the GASB released a white paper titled: "Why Governmental Accounting and Financial Reporting Is – And Should Be – Different" which discusses how fundamental differences between governments and businesses should lead to differences in accounting and financial reporting.

As presented in the paper, a government's primary purpose is to maintain or enhance the well-being of its citizens by providing public services financed through taxes; whereas a business's primary purpose is to benefit its shareholders by creating wealth based on voluntary transactions with its customers. Other differences include:

- Governments serve a more diverse group of stakeholders than businesses, including taxpayers, citizens, elect-

ed representatives, oversight groups, bondholders, and others in the financial community.

- Monitoring actual compliance with budgeted public policy priorities is central to a government's public accountability.
- Governments generally exist longer than businesses and are not typically subject to bankruptcy and dissolution.

As described in the white paper, governmental accounting standards need to provide information that allows stakeholders to assess the government's stewardship of public resources over the long-term. This focus on public accountability is the "cornerstone on which all other financial reporting objectives should be built."

Within this context, the white paper states that some of the most significant differences between governmental and business accounting standards relate to pensions and OPEBs.

While the GASB noted it is appropriate for both governments and businesses to account for such benefits on an accrual basis (since deferred costs should be recognized when the benefits are earned), it also emphasized the need for certain differences in the rules.

These differences relate to the importance for governments of allocating service costs to the period when the service is provided, and the fact that governments generally exist much longer than businesses.

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Key Decisions in Statement Number 27

According to the white paper, the current governmental accounting approach “explicitly harmonizes accounting with the actuarial funding characteristics of public plans.”

The approach makes it possible to “allocate expenses to periods in a way that charges each period with a level percentage of payroll for normal cost” and “equitably spreads the ongoing benefit program among different generations of taxpayers.” This is evident in the GASB’s prior discussions of key decisions presented in Statement No. 27, as summarized below:

Actuarial Cost Methods

Statement No. 27 requires that one of six actuarial cost methods be used in the actuarial valuation of pension benefits: entry age, frozen entry age, attained age, frozen attained age, projected unit credit, and aggregate. After studying the use of these methods by governmental plans, the GASB concluded that “any of these methods, coupled with the other parameters of this Statement, produces an acceptable measure” of the annual required contribution.

The GASB also noted that the majority of plans use actuarial meth-

ods that are designed to calculate normal costs as a level percentage of payroll over time (e.g., the entry age method). It supported this approach, stating it “facilitates budgeting of pension contributions and is consistent with the budgetary concept of intergenerational equity in terms of the burden on citizens.”

Investment Return Assumption

Statement No. 27 requires that the investment return assumption (also used as the plan’s discount rate) “be based on an estimated long-term investment yield for the plan” with consideration given to the “nature and mix of expected plan investments.”

The GASB made this decision in accordance with Actuarial Standards of Practice No. 4 and in the belief that an assumption based on the plan’s estimated long-term rate of return was “consistent with the long-term nature of governmental pension plans.”

The GASB “considered but rejected” using a specified rate of return such as the long-term return on government bonds. Since the investment portfolios of governmental retirement plans are varied, the GASB decided that the best estimate of a plan’s future earnings would be the expected returns given the plan’s asset allocation.

Actuarial Value of Assets

Statement No. 27 also requires that the actuarial value of plan assets be determined on a “market related” basis “consistent with the class and holding period of the assets, the investment return assumptions, and other assumptions....”

“Market related” includes measures that allow the value of assets to be smoothed over a period of time, such as three to five years. In its discussion, the GASB found that while use of the current market value gives precision to the value of assets, it also introduces a substantial amount of volatility. Moreover, it held that smoothing techniques could appropriately measure the asset’s intrinsic value while reducing short-term fluctuations that had “little meaning from a long-term perspective.”

Conclusions

The GASB’s new research study will reopen discussion about the financial measurement of governmental pension benefits and about the intrinsic differences between public- and private-sector accounting and financial reporting. This article is intended as only a brief introduction to that discussion. Government finance officers, plan administrators, and plan participants should monitor this discussion and assist the GASB to ensure the resulting decisions support the proper valuation and funding of public retirement plans.

The Advantages of Risk Pooling for Financing Retirement Benefits

There has been substantial discussion recently regarding how much people must save to ensure a financially secure retirement. Often this discussion assumes the savings will take place through an individual retirement account, as provided by a defined contribution (DC) plan or 401(k) plan.

However, there are significant advantages to using a different approach for funding retirement benefits, one that

pools the related risks among a large group of people. For centuries, mathematicians have known that when risks are pooled over large populations, the cost of the risk for each individual falls to the average cost for the population. This is a key principle of insurance.

This article demonstrates the efficiencies offered by risk pooling through a mathematical model of the annual contributions required to obtain a finan-

cially secure retirement. The model is not intended to represent the features of specific types of retirement plans, but rather to provide a simplified context to better illustrate the two approaches.

The discussion centers on John and Jane, two 25 year-olds with annual salaries of \$25,000 who want to retire at age 65 and replace 75% of the purchasing power of their final salary. Assuming that wages increase 4% per year over their careers,

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their salaries will grow to \$115,409 by the time they retire, and their first year's retirement payment will be \$86,557 (i.e., \$115,409 x 75%).

Further assuming that prices increase 3% per year during retirement, their benefits must also grow by 3% to maintain purchasing power. If the benefits do not increase, the purchasing power of their benefits will fall to 74% after 10 years, 55% after 20 years, and 41% after 30 years. Without protection from inflation, John and Jane's benefits will only be worth half of the original value by the time they turn 89.

Individual Account Approach

We start by determining John and Jane's annual contributions under an individual account approach. Since retirement benefits under this approach are based solely on the amounts contributed to the individual's account over their working career, plus investment earnings, the required contribution rates must properly reflect how long they are likely to live after they retire.

According to the Society of Actuaries' RP2000 mortality table, 50% of U.S. males who reach age 65 will live to age 83, 10% will live to 93, and about 1% will live to 100. If John only contributes enough to pay benefits to age 83, he would have a 50% chance of running out of money during his lifetime.

Instead, his contribution rate should be set high enough so that he has a low likelihood of outliving his benefits. If John is willing to accept a 10% chance of outliving his benefits, his contributions must be sufficient to pay benefits through age 93.

Properly estimating life expectancy is even more important for Jane, since women live longer than men, on average. According to the RP2000 table, 50% of U.S. females who reach age 65 live to age 85, 10% live to age 96, and 2% live to 100. If Jane ac-

cepts a 10% chance of outliving her retirement benefits, her contributions must be sufficient to pay benefits through age 96.

Investment earnings also play a key role in determining how much should be contributed. Recent studies indicate investment returns on 401(k) accounts average about 7% annually. These relatively low returns may be partly due to plan participants' general limited experience in managing their investments.

However, the low returns are also due to annual investment management fees of 1% (i.e., 100 basis points) or more that are typically charged on DC and 401(k) plan account balances.

Consequently, although an individual investor might earn an 8% return on investments, the effective return would only be 7% after deduction of the investment management fees.

Given this information, it is possible to mathematically determine how much John and Jane would have to contribute each year to meet their retirement objectives. Assuming John lives to be 93 and earns 7% on his investments, he would have to contribute 16.8% of his salary annually, totaling \$398,157 over his working career.

Assuming Jane lives to be 96, she would have to contribute 17.7% of her salary annually, totaling \$420,488, or \$22,331 more than John.

Risk Pooling Approach

Given the financial demands most families face, it would be difficult for most people to contribute 17% - 18% of their paychecks throughout their careers to pay for their retirement benefits. However, the required contributions could be significantly lowered by pooling the risks associated with outliving benefits and by improving the management of fund assets to earn higher investment returns.

As stated earlier, when risks are pooled over large populations, the cost of the risk for each individual falls to the average cost for the population. This key principle of insurance has been applied to a wide variety of risks for over 150 years. Defined benefit retirement plans are a classic example of this approach in the context of retirement benefits.

Under the simplified pooled approach presented in this article, a fund would be established to provide retirement benefits for a large group of people, and each individual would contribute enough to pay benefits over the average expected lifetime of the group.¹ (see endnotes)

Consequently, instead of contributing to finance their benefits into their 90s, John and Jane would contribute to pay benefits for the average lifetime of the group, e.g., to age 85.

Applying this approach would reduce both John and Jane's annual contributions to 13.6%, totaling \$323,562 over their working careers. This represents a savings for John of \$74,595 and for Jane of \$96,926 compared with the individual approach.

The pooled approach has other advantages as well. The accumulated assets provide resources allowing the fund to be administered by professionals. Moreover, investment management fees charged to larger institutional investors are lower than those charged to individuals in DC and 401(k) accounts.² (see endnotes)

Consequently, the investment returns earned on the pooled funds will likely be higher, probably by at least 1%. If, in addition to pooling the risks of outliving investments, we also assume the pooled funds earn an 8% annual rate of return, John and Jane's annual contribution rates would fall to 10.0%, resulting in total contributions of \$238,276, or 43% less than they would have to contribute to individual accounts.

The table on the following page compares the contributions under the individual and pooled approaches.

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Contributions Under Individual and Pooled Approaches

	Key Assumptions	Annual Contribution Rate (% Salary)	Total Career Contributions	Cost Difference in Dollars (Percents)*
Jane's Individual Contributions	Benefits paid to age 96 with 7% return	17.7%	\$420,488	N/A
John's Individual Contributions	Benefits paid to age 93 with 7% return	16.8%	\$398,157	\$22,331 (5.3%)
Pooled Contributions 7% Return	Benefits paid to age 85 with 7% return	13.6%	\$323,562	\$96,926 (23.1%)
Pooled Contributions 8% Return	Benefits paid to age 85 with 8% return	10.0%	\$238,276	\$182,212 (43.3%)

* Cost difference is measured as the difference in total career contributions compared with Jane's career contributions of \$420,488 under the individual approach.

Conclusion

This article demonstrates that, in financing retirement benefits, significant efficiencies can be obtained by pooling risks and accumulating assets to obtain higher effective rates of return. While the examples presented in this article focus on financing retirement benefits through employee contributions, the same efficiencies apply when benefits are financed through employer contributions. These efficiencies are fundamental and should be reflected in the current debate over financing retirement benefits.

Endnotes

- 1) For risk pooling to work, the number of participants has to be large enough to allow the risks to be fully averaged over the covered group.
- 2) In this model, higher investment returns are not so much the result of risk pooling as they are the result of accumulating assets and having additional resources to hire professional administrators. As a result they are better able to leverage competition among investment managers in order to lower investment management fees.

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