

GASB 45 Task Force

HOWARD COUNTY, MARYLAND

**FINAL
REPORT**

Presented to the County Executive

February 23, 2007

February 23, 2007

The Honorable Ken Ulman
County Executive
3430 Courthouse Drive
Ellicott City, MD 21043

Dear Mr. Ulman:

On behalf of the members of the GASB 45 Task Force, it is my pleasure to present the attached report. As you know, this Task Force was appointed to comprehensively study the pending implementation of the Governmental Accounting Standards Board Statement No. 45 (GASB 45), which deals with how governmental entities are to account for Other Post-Employment Benefits (OPEB) beginning in fiscal year 2008.

The members of the Task Force are pleased for the opportunity to have been of service. While the report does not provide immediate solutions for the enormous financial burden the new accounting requirement will create, it does provide the required actuarial analysis and background necessary for your Administration to make fiscally responsible and prudent decisions as it begins to address this daunting challenge from both short-term and long-term perspectives.

The Task Force members undertook their responsibilities with remarkable enthusiasm and seriousness of purpose, thus, I commend them for their outstanding effort in this endeavor. In addition, I gratefully acknowledge all the hard work and support that Ms. Sharon Greisz, Director of Finance, provided in developing this report.

Sincerely,

Lonnie R. Robbins
Chief Administrative Officer

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Background

The County Executive appointed a Task Force in February 2006 to study issues associated with Other Post-Employment Benefits (OPEB) related to the pending implementation of Governmental Accounting Standards Board Statement No. 45 (GASB 45). The task force was assigned the following responsibilities:

1. Review in detail the requirements of GASB 45 as it relates to the County and its component units.
2. Quantify the liability resulting from the implementation of GASB 45.
3. Review and analyze other post-employment benefits and related eligibility requirements and benefit levels for the County and the component units.
4. Review and analyze the legal constraints to changes to OPEB and related eligibility requirements and benefit levels for the County and the component units.
5. Develop and recommend strategies to reduce OPEB liability and related costs for the successful implementation of the GASB 45 standard.

The following individuals served on the task force:

Lonnie Robbins, Chief Administrative Officer (Chairperson)
Raquel Sanudo, Former Chief Administrative Officer (Retired)
Sharon Greisz, Director of Finance
Barbara Cook, County Solicitor
Nan Shull, Human Resources Administrator
Raymond Brown, Chief Operating Officer, Board of Education, HCPSS
Beverly Davis, Director of Finance, Board of Education, HCPSS
Ronald Weinstein, Budget Administrator (Former County Auditor)
Gale Benson, Assistant Budget Administrator
Tom Mullinex, Budget Analyst
Laura Wetherald, General Employee Representative
Janet Cullison, Director of Finance, Howard Community College
Brian Auger, Associate Director, Howard County Library
Dan Besseck, IUPA Local 86
Dale Chase, Union President, AFSCME Local 3085

The Task Force utilized the services of the County's actuarial and health benefits consultant, Bolton Partners, Inc., to: (1) understand and examine the requirements of GASB 45; (2) quantify the liability resulting from the implementation of GASB 45; and (3) identify and analyze a series of possible options to reduce the County's OPEB liability.

Requirements of GASB 45

In June 2004 the Governmental Accounting Standards Board (GASB) issued Statement No. 45 (GASB 45) “Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions”, which addresses the accounting and reporting requirements for the costs and liabilities associated with such benefits. Other post-employment benefits are collectively referred to as OPEB. The most common type of OPEB is health care for retirees.

The accounting standard applies to all state and local primary governments and their component units and is effective for fiscal years ending in 2008 for entities with more than \$100 million in revenue. Howard County’s (the County) component units include the Public School System (Schools), Community College (College), Library System (Library) and Economic Development Authority (EDA). For purposes of this report, references to the County include the EDA.

Liabilities for retiree medical payments are currently accounted for in a “pay-as-you-go” method. That is, the post-retirement cost for the fiscal year is equal to the cash paid County-wide for retiree medical premiums in the fiscal year. No cost is recognized until the actual payment is made. There is currently no financial disclosure of the potential future magnitude of these liabilities.

In the past, medical benefit payments for retirees were not as significant as they are today. Over time these payments have rapidly increased and in many cases are now similar in magnitude to pension payments. The GASB 45 accounting standard for post-retirement medical benefits is similar to the GASB standard for pension benefits. The general concept is that pension and other post retirement benefits are part of an exchange of salaries and benefits for services rendered. Although pension and post-retirement medical benefits are not paid until retirement they are still considered compensation for employee services. Therefore a cost for these benefits should be recognized while the employee is working. A second goal of the GASB 45 standard is to improve financial disclosure of post-retirement liabilities to allow a reader of government financial disclosures to assess the potential demands on the government’s future cash flows.

Specifically the standard requires the following:

- Disclose the annual cost of the benefits as the Annual Required Contribution (the ARC). The ARC is based on accrual accounting and actuarial analysis. This is the amount of funds that must be included in the annual operating budget to fully fund the OPEB liability over time. GASB does not require that an entity fund the ARC.
- Disclose the Net OPEB Obligation (NOO). The NOO is the cumulative difference between the ARC and the employer’s contributions to a plan and is a liability on the government’s balance sheet. The existence of an NOO indicates that an entity is not fiscally responsible and will be viewed negatively by the credit rating

agencies. In comparison, the County fully funds the ARC for its pension systems and does not have any Net Pension Obligations to disclose.

- Disclose the funding policy with regards to paying for the county-wide post-retirement medical benefits. Options include continuing to fund only pay-as-you-go payments or initiating a plan to gradually pre-fund retiree obligations similar to a funded pension trust.
- Disclose the funded status of the benefit. That is the difference between assets and liabilities. The liabilities are based on an actuarial valuation which is discussed in the next section.
- Disclose the actuarial methods and assumptions used to determine the ARC and the liabilities.

Quantify the Liability

Why Health Care Costs for Retirees Are Projected to Skyrocket

There are two causes for skyrocketing retiree medical costs. First, medical costs in general are skyrocketing. The following are some statistics that document how rapidly medical costs have been increasing. The Office of the Actuary of the Center of Medicare and Medicaid Services compiled these statistics.

| Year | National Health Expenditures | | Private Health Insurance | |
|------|------------------------------|------------|--------------------------|------------|
| | \$ Billions | % Increase | \$ Billions | % Increase |
| 1999 | 1,270.3 | | 70.9 | |
| 2000 | 1,358.5 | 6.9% | 81.2 | 14.5% |
| 2001 | 1,472.2 | 8.5% | 89.6 | 10.3% |
| 2002 | 1,607.9 | 9.1% | 106.1 | 18.4% |
| 2003 | 1,740.6 | 8.2% | 124.9 | 17.7% |
| 2004 | 1,877.6 | 7.9% | 136.7 | 9.4% |

The increase in total health expenditures has been more than twice the increase in GNP. More telling are the increases in private health insurance expenditures, these increases are more indicative of the kind of increases employers (including governmental employers) have been experiencing. They are approximately 10 percent higher than the increases in GNP. How much longer health care costs can continue to increase at this rate is a matter of conjecture. However, the increases have been consistently higher than general inflation for many decades and a true abatement is not yet in sight.

The second reason for the projected increases in *retiree* medical costs is demographic. The number of retirees is projected to increase as current employees age and retire. Also as people live longer (due in large part to improvements in medical technology) the retirees stay retired for a longer period.

The following table shows the projected increases in the number of County-wide retirees with medical coverage and the corresponding pay-go expenditures.

| Fiscal Year | # of Retirees | Health Care Pay-Go Cost \$ millions |
|--------------------|----------------------|--|
| 2007 | 1,652 | 10.1 |
| 2008 | 1,864 | 12.7 |
| 2009 | 2,049 | 15.1 |
| 2010 | 2,243 | 17.7 |
| 2011 | 2,442 | 20.4 |
| 2012 | 2,636 | 23.3 |
| 2013 | 2,840 | 25.8 |
| 2014 | 3,032 | 28.7 |
| 2015 | 3,230 | 32.0 |
| 2016 | 3,428 | 35.4 |
| 2017 | 3,616 | 39.1 |
| 2018 | 3,795 | 42.8 |

Actuarial Evaluation

The first step of an actuarial valuation is to estimate future retiree medical payments. The estimates are based on the data and assumptions that will be discussed shortly. The actuary uses these estimated future retiree medical payments to calculate the following items.

Total Present Value: This is the present value of all healthcare benefits expected to be paid during retirement to current participants (including retirees and active employees.) The Present Value is simply the estimated future retiree medical payments discounted, using the valuation interest rate, to the valuation date. For example, suppose it is estimated that \$15,000 will be paid in medical payments to a retiree in 2026; assuming a 7.5 percent interest rate, the Present Value as of 2006 of the 2026 payment is equal to \$3,531. Another way to look at it is a \$3,531 zero coupon bond paying 7.5 interest would be worth \$15,000 in 2026. The Present Value is very dependent on the interest rate used. If a 4 percent rate is used the present value of the \$15,000 payment in 2026 nearly doubles to \$6,846. The Total Present Value is the discounted present value for all participants for all years each participant receives the benefit.

Actuarial Accrued Liability: This is the portion of the Total Present Value allocated to service to the valuation date. For example, if an individual is expected to have 25 years of service upon retirement and has 10 years of service at the valuation date, the Actuarial Accrued Liability is 10/25^{ths} of the Total Present Value. For someone that is already retired at the valuation date, the Actuarial Accrued Liability is equal to the Total Present Value.

Normal Cost: This is the portion of the Total Present Value allocated to the current year. Using the example from the above paragraph, the Normal Cost is 1/25th of the Total Present Value. There is no Normal Cost for retirees.

Unfunded Actuarial Accrued Liability: This is the Actuarial Accrued Liability minus the market value of assets that have been set aside exclusively for funding retiree healthcare. For plans that are not funded, the Unfunded Actuarial Accrued Liability is equal to the Actuarial Accrued Liability.

Annual Required Contribution (ARC): The annual cost to be included in the operating budget will consist of two parts:

1. Normal Cost
2. An amortization of the Unfunded Actuarial Accrued Liability.

GASB allows some variance in how the Unfunded Liability is amortized. The amortization period can be up to 30 years. The GASB also allows the amortization to be expressed as a level percentage of pay. That is the amortization payments can be increasing at the same rate as salary increases. We have chosen the least expensive amortization option, a 30-year amortization increasing with estimated salary increases of 4 percent per year.

Actuarial Assumptions

The Interest Rate Assumption

The interest rate that is used to calculate the present value of the future benefits (which is used to determine the Normal Cost and Actuarial Accrued Liability) is determined by whether the County chooses to fund the ARC or to continue on a pay-as-you-go basis. Funding the ARC creates surplus cash that can be invested in a mix of equities and bonds. Continuing on the pay-as-you-go basis does not generate surplus cash to invest. GASB 45 requires the interest rate to be based on expected returns for the funds that will pay the benefits. A higher expected return can be used for funded plans because they can invest in a mix of equities and bonds, where non-funded plans must utilize a lower expected return based on the rate realized on the investment of the entity's operating funds.

We have assumed a 7.5 percent interest rate if the plan is funded. This rate is similar to that assumed for the pension plan. If the plan is not funded we have assumed a 4 percent interest rate.

Medical Trend Assumption

The Medical Trend Assumption is the assumed rate of increase in per capita health claim costs over time as a result of factors such as medical inflation, utilization of healthcare

services, plan design, and technological developments. Some have argued that these types of valuations should not be done in part because the future costs are so uncertain. The Governmental Accounting Standards Board did not accept this argument, but the fact is that the actuarial results are considerably more uncertain than pension costs. To assume per capita claim trends will continue to increase indefinitely as they have in the last few years would result in costs that are so large as to be implausible. Increases of this magnitude cannot be sustained indefinitely because, if they do so, health care expenditures will eventually consume an unacceptable percentage of the gross national product. Accordingly, standard actuarial practice (and GASB 43 Paragraph 34.g.) is to assume an initial rate consistent with recent increases decreasing gradually to an “ultimate trend” which is consistent with the best estimate of GNP growth. The Medical Trend Assumption used is an initial rate of 10.5 percent decreasing 1 percent per year to an ultimate increase of 5.5 percent. There is a significant probability, that between now and the next actuarial valuation we will not observe the anticipated amelioration of medical trends. If this is the case, typical practice is to reset the initial trend and to defer the year that the ultimate trend rate is attained. If this occurs annual actuarial losses of 5-15 percent of liabilities due to the revised trend rate can be expected.

Demographic Assumptions

The ARC used the same demographic assumptions as the pension plan in which the employee participates. Demographic assumptions are termination, disability, death and retirement. For each employee, assumptions are made (based on past experience) as to what percentage will leave prior to being eligible to retire. When the employee satisfies the retirement eligibility requirements, assumptions are made as to what percentage of employees retire. These assumptions vary by age, years of service and group (school, general employees, police and fire). For retirees, the only demographic assumption is the mortality assumption. The mortality assumption used incorporates recent increases in longevity that increase the estimated cost.

Percent of Employees Currently Electing Coverage Assumed to Continue Coverage in Retirement

Not all retirees continue medical coverage in retirement. Depending on the years of service, and the group, the retiree may have to pay a substantial amount for medical coverage. The election assumption used depends upon the plan and the amount of the subsidy, and is as low as 50 percent (for Community College retirees with less than 15 years of service at retirement) to 100 percent (for School/County/Library retirees with more than 30 years of service at retirement). These assumptions have been estimated by staff of each county entity based on their experience. They are likely to be refined over time based on emerging experience.

Data

There are two sources of data, demographic data and claims data.

Demographic Data

This includes data for active employees with health care coverage. The valuation is based on their age, service, gender, medical plan, and coverage (employee only, or family). This also includes similar data for retirees currently receiving coverage, their age, gender, medical plan, medical coverage and level of subsidy.

Claims Data

The current per capita medical cost is basically the total number of dollars spent for retirees divided by the number of retirees. These amounts are compared to past years for consistency. Also, adjustments are made for age, and Medicare Coverage. The average cost for retirees younger than age 65 is considerably more than the published cost. The published cost is based on a blend of active and retiree cost. Since actives are considerably less expensive than retirees, the published costs do not reflect the real costs for retirees as a group. The GASB requires that the true cost of retiree coverage be valued. The difference between the true cost and the published cost is called the ***Hidden Cost*** and is approximately 25 percent of the pre-65 cost.

Medicare Part D Reimbursements

Since the beginning of 2006, the County and schools have received a Retiree Drug Subsidy from Medicare for providing prescription drugs to retirees over age 65. The ARC determined by our Actuary has not reflected a credit for anticipated Medicare Part D reimbursement. The GASB issued a technical bulletin in April that does not allow for employers to reduce Annual OPEB Cost for anticipated Medicare Part D reimbursements. GASB deems these payments from the federal government to be a *voluntary non-exchange transaction*. Those funds can be used as a funding source to an OPEB trust.

OPEB Liability and Costs

The OPEB liability and annual costs are calculated in two ways – funded and not funded. As noted previously, GASB 45 does not require that the OPEB liability be funded. However, if the liability is not funded, a lower interest rate must be used to determine the present value of the future liability. A lower interest rate results in a greater liability when measured in today's dollars. The next chart shows the current liability and the

ARC (annual costs) of the OPEB benefits for each Howard County entity under the assumption that the County intends to fund the liability.

| Funded OPEB Liability and ARC | | | | | |
|--------------------------------------|----------------|----------------|----------------|----------------|----------------|
| FY 2008 | | | | | |
| (\$ Millions) | | | | | |
| | County | Schools | College | Library | Total |
| Employees* | 1,766 | 5,667 | 357 | 130 | 7,920 |
| Retirees* | 433 | 1,169 | 24 | 26 | 1,652 |
| Liability | \$143.0 | \$320.0 | \$8.0 | \$5.6 | \$476.6 |
| Normal Cost | \$6.2 | \$16.5 | \$0.5 | \$0.3 | \$23.5 |
| ARC | \$15.1 | \$36.5 | \$1.0 | \$0.6 | \$53.2 |
| Pay-as-you-go | \$4.0 | \$8.3 | \$0.2 | \$0.2 | \$12.7 |

* With health coverage

If the County decides not to fund the liability and to continue on a pay-as-you-go basis, the total liability will increase to \$897.3 million and the ARC will increase to \$91.5.

To put these numbers in perspective, the County’s outstanding long-term debt (principal) is \$660.5 million as of December 31, 2006. At \$897.3 million the non-funded OPEB liability exceeds all other County long term debt.

Credit Rating Agencies – To fund or not to fund

All three major credit rating agencies have stated that they do not anticipate that unfunded OPEB liabilities will result in near-term adjustments to credit ratings. They recognize that the magnitude of the problem and the uncertainty and volatility in the numbers will require time to address. The rating agencies statements make it clear that they expect management to deal with the issue but do not provide specific guidance.

On June 22, 2005, FitchRatings stated “Failure to make actuarially determined OPEB plan contributions . . . are a deferral of financial responsibility. Therefore, over time, a lack of substantive progress in funding and managing OPEB liabilities or a failure to develop a realistic plan to meet annual OPEB contributions could adversely affect an issuer’s credit rating.”

Standard & Poor’s stated “The differences between financing these benefits under the old pay-as-you-go method and the new advance funding method will be significant. As OPEB obligations take on greater urgency, management must respond with thoughtful, long-term solutions.”

Moody's Investors Service stated in July 2005 that it ". . . does not anticipate that the liability disclosures will cause immediate rating adjustments on a broad scale."

Credit ratings are very important and determine the interest rate on bonds sold by the County. It is difficult to predict when and how much our credit ratings could change if the County chooses not to fund OPEB. It is clear that the rating agencies will not take any immediate action on rating levels in response to OPEB liabilities. The rating agencies have responded positively when asked if they think it is reasonable to transition from the current pay-as-you-go level to the ARC over five years.

What is the Bottom Line?

The Committee believes it is important to focus on the bottom line when answering the question about whether or not to fund OPEB. Is it fiscally responsible to promise a benefit in the future without doing what is necessary to ensure funds will be available to pay the bill when it comes due?

It is also important to remember that the sooner funding begins the sooner funds can be invested to generate income dedicated to OPEB costs. The longer it takes the County to fund the liability the more it will have to contribute.

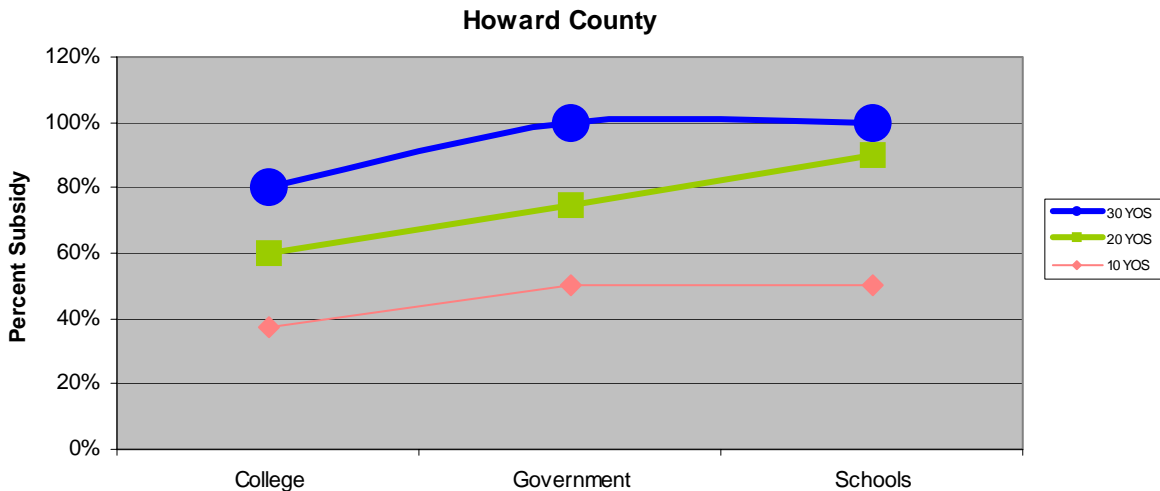
Review and analyze other post-employment benefits and related eligibility requirements and benefit levels for the County and the component units.

Each Howard County entity provides a health care benefit for retirees based on the employee’s years of service. As shown in the chart below, the level of the employer subsidy increases as years of service increase.

| Health Care for Retirees Employer Subsidy Levels | | | |
|---|-------------------|------------------------------------|----------------|
| Years of Service | School | County/ Library¹ | College |
| 10 | 50% | 50% | 37.5% |
| 15 | 75% | 50% | 50% |
| 20 | 90% | 75% | 60% |
| 25 | 90% | 90% | 70% |
| 30 | 100% ² | 100% | 80% |

1/ Percent of Highest Cost Plan

2/ The percent subsidy is 90 percent for retirees less than age 65.

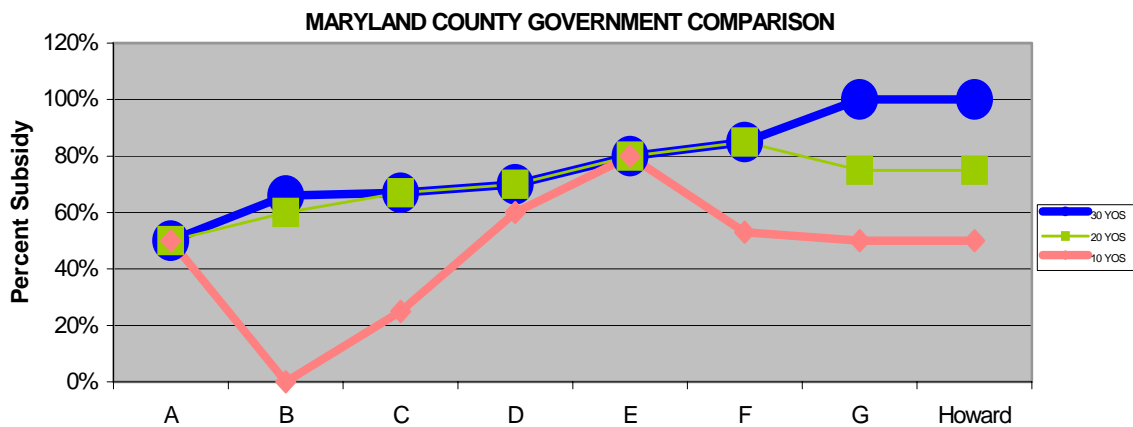


The County and Library also pay 25 percent of the premiums for dependents of their retirees. The Schools provide a life insurance benefit to its retirees.

Howard County Government (and Library) Retirees Compared to Other Counties

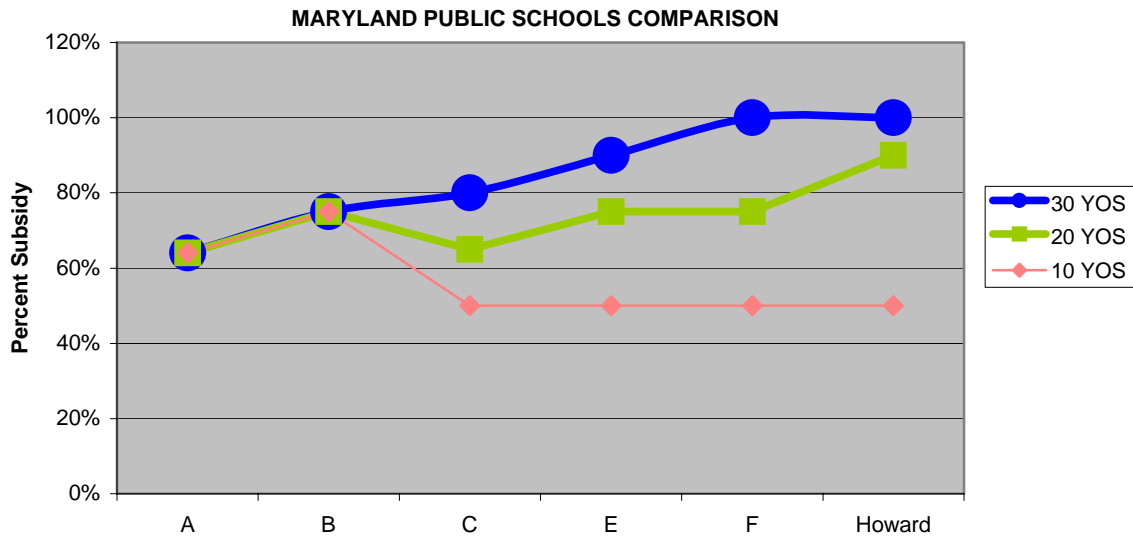
In general Howard County Post-Retirement Medical Benefits are comparable to those provided in surrounding Maryland Counties. Certain features are somewhat more generous than those offered by other counties; however, most counties have some other feature not offered by Howard County.

The effective subsidy in Howard County is somewhat higher than that offered by other jurisdictions because it is based on the highest cost plan. There is no retiree share of the premium for those retirees who elect a less expensive plan. However, Howard County is the only jurisdiction that provides a smaller subsidy for a dependent than for the retiree and is one of four that do not pay for retiree life insurance. The comparisons presented below are based on the benefits provided to retired employees of seven other Maryland Counties



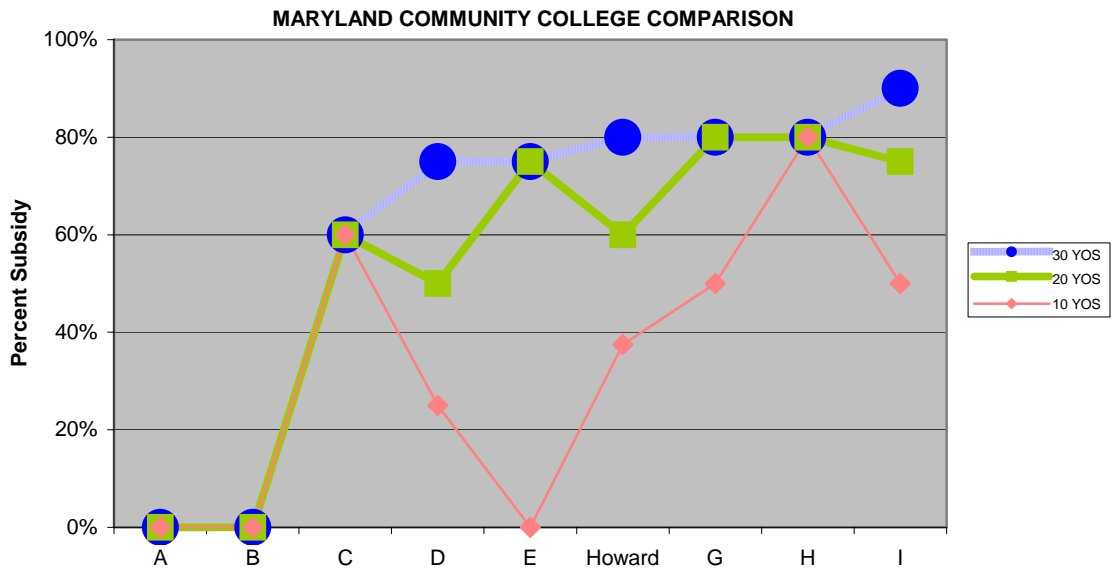
Howard County Schools Compared to Other School Districts

The Howard County Schools' subsidy is somewhat higher than that offered by other schools. For example, the subsidy is at least as high as any other jurisdiction for retirees with more than 20 years of service. Howard County Schools is one of five school systems offering retiree life insurance. However, it is one of only two school systems that do not provide a dependent subsidy.



Howard County Community College Retirees Compared to Other Community Colleges

Two of the community colleges do not offer retiree medical coverage. Howard County Community College subsidies are less generous than the remaining community colleges that do offer retiree medical coverage. Moreover, Howard County Community College is the only jurisdiction that does not provide a dependent subsidy. Two of the other community colleges offer retiree life insurance.



Review and analyze the legal constraints to changes to OPEB and related eligibility requirements and benefit levels for the County and the component units.

GASB 45 is an accounting standard and not a law or regulation. However, the accounting standard will cause governments to reassess the level of benefits they can afford to provide. Part of this reassessment will include potential legal constraints or risks associated with reducing benefits within the County, Schools, Library and College benefit systems. Because each entity has established its retiree health benefits in a different way, the analysis will need to be specific to that entity. For example, within the county system there have been several different “groups” of retirees, each of which will need to be individually evaluated.

Possible legal constraints on reducing OPEB will center mainly on the question of whether there has been a violation of the contract clauses of the US Constitution.

The Contract Clause states that local governments shall not pass laws to impair the obligations of contracts. This raises several issues including:

- Is there a valid contract?
- Is the change material?
- Is the change justified?
- Is there some other balancing improvement?

The Maryland Attorney General has decided that the State does not have a contract between the State and State employees for OPEB benefits. As the County, Schools, Library and College begin reassessing retiree health benefits and exploring possible changes to the level of benefits provided, there will need to be an evaluation of the legal constraints, if any, associated with reducing retiree health benefits within these systems.

Develop and recommend strategies to reduce OPEB liability and related costs for the successful implementation of the GASB 45 standard.

In August 2006, the Task Force prepared a list of over 30 possible plan design changes and requested that Bolton Partners estimate the impact on the ARC in an effort to identify the substantial cost drivers of the benefit. In September of 2006, Bolton presented the estimates of the impact due to the requested plan changes to the Task Force.

Many factors must be considered prior to implementing any benefit reductions. These include:

- Cost reduction to the employer
- Financial impact on retirees
- Ability to offer a competitive compensation and benefits package to attract and retain employees
- Substantial reduction to benefits for active employees may encourage them to retire now to “lock in” the current benefit level. The result could be a shortage of employees in critical areas

Whatever changes to the plan are made could be applied to different groups:

- Future and Current Retirees
- Future Retirees Only
- Future Retirees with some grandfathered groups (for example, employees hired prior to 1997) could keep the current program
- New Hires Only

There is a greater legal risk if the plan is changed for current retirees who are already receiving the benefit. If the plan changes are only applied to some employees there is a smaller reduction in ARC. If the plan changes are only made for new hires there would be no immediate reduction in ARC. It would require several years before any significant cost savings would be realized because new hires initially have a very small liability.

This report does not address other possible effects of these changes. For example, this report does not address the possible adverse effects to employee morale. The report also does not address the possible effects on how the quality of the workforce could be affected, either because it is more difficult to attract employees or because the changes might force employees to work past their years of maximum productivity.

In general, OPEB Liability can be reduced in the following ways:

Funding: A funded trust can generate investment income that reduces the cost of the plan. If the benefit is pre-funded, GASB 45 permits a higher discount rate that reduces liabilities and, thus, the long-term cost of the plan to the County.

Amend the Underlying Medical Plan: The medical plans offered to Howard County employees are competitive. Changes such as increasing the deductibles or co-insurance percentages will only have a minor impact on the ARC. A note of caution, by assuming a lower ultimate medical trend than the historical rates of increases, the actuary has, in effect, already anticipated that incremental changes to the plan design will be made periodically to control the cost.

Change the Percent Subsidy Schedule: Clearly if the County pays a lower percentage of the premiums, the ARC will be reduced.

Eliminate the Hidden Subsidy: Younger less expensive employees currently subsidize the cost of retirees who are under age 65. A separate higher rate could be charged to the retirees who are younger than age 65. The subsidy percentage would be applied to this higher rate, which would substantially increase the retiree's share of the cost. This change would also reduce the cost of employee coverage.

Change the Eligibility Requirements: The County could increase the number of years of service, and or the age requirements for post-retirement medical benefits. Most employees would probably elect to defer their retirement until they are eligible for coverage. However, there would still be savings because the retirees would wait longer to commence coverage. Also, since employees would be working longer, funding of the OPEB liability would be spread out over more years.

Eliminate Benefits: Spouse coverage could be eliminated; another possible change would be to eliminate prescription drug coverage for employees over age 65. Employees over age 65 can now purchase prescription drug coverage through Medicare.

Indexed Caps: Eliminate or reduce the uncertainty of the Medical Trend by setting an inflation cap or limiting the dollar amount of the subsidy. Instead of applying the subsidy rates to the actual cost per year limit how much the subsidy can increase per year and/or set a base amount for the subsidy amount. The Hidden Subsidy would continue to increase with actual medical inflation. Under this approach the retiree contributions would rapidly increase if the medical premiums increased at current rates. Conversely, the County's ARC will be much more predictable because the county would be largely insulated from the risk of medical cost increases that are greater than anticipated.

The table below summarizes the approximate *financial* impact of some of the changes described above. The estimated reduction to the FY 2008 ARC is provided assuming that the plan is funded.

| Design Change | Change Applied to | Reduction to the ARC (\$53.2 Million) |
|--|--------------------------|--|
| 1. Changes to the Percent Subsidy Schedule | | |
| a) Defer the Schedule 5 Years | Future Retirees | \$ 6.1 |
| b) Defer the Schedule 10 Years | Future Retirees | 13.0 |
| c) Defer the Schedule 10 Year | Post 1997 Hires* | 6.2 |
| d) Freeze earned subsidy at 7/1/07 level | Future Retirees | 14.6 |
| e) Freeze earned subsidy at 7/1/12 level | Future Retirees | 7.9 |
| 2. Eliminate the Hidden Subsidy | Future Retirees | 3.4 |
| 3. Eligibility Changes | | |
| a) Require 15 Years of Service | Future Retirees | 2.2 |
| b) Require 20 Years of Service | Future Retirees | 9.0 |
| c) Age 55 Requirement | Future Retirees | 1.4 |
| d) Age 60 Requirement | Future Retirees | 11.6 |
| 4. Eliminate Coverage | | |
| a) No Spouse Subsidy | Future Retirees | 3.6 |
| b) No Post 65 Rx | Post 1997 Hires | 5.7 |
| c) No Post 65 Rx | Future Retirees | 16.2 |
| d) No Post 65 Rx | All | 19.4 |
| 5. Indexed Caps | | |
| a) 3 percent cap | Post 1997 Hires | 6.2 |
| b) 3 percent cap | Future Retirees | 15.7 |
| c) 5 percent cap | Post 1997 Hires | 2.8 |
| d) 5 percent cap | Future Retirees | 7.3 |
| 6. Combo Plan | Future Retirees | 7.1 |

* Active employees with < 10 years of service

Combinations: The list of possible plan changes can be combined. For example, the minimum service could be increased to 15 years or 20 years; spouse subsidies could be eliminated in conjunction with a 4 percent cap on the subsidy schedules. The combination plan presented below takes into consideration changes required to make the benefits offered by each Howard County entity comparable. This approach was taken

because the benefits for the Government, Schools, College and Library are all funded by County tax revenues.

| Benefit Changes to reach parity for Howard County Entities | | | |
|--|------------------------|---|--------------------------------|
| Description | Entity Impacted | Reduction to FY 2008 ARC (\$53.2 million) | Change in Retiree Monthly Cost |
| Eliminate spousal coverage | Government and Library | \$1.1 million | \$107 |
| Eliminate dental | Government and Library | \$0.1 million | \$3 |
| Eliminate life insurance | Schools | \$2.1 million | \$69 |
| Change rate at which benefit subsidy level is earned to match the County | Schools | \$3.0 million | \$60 |
| Change County subsidy from highest cost plan to actual plan selected | Government and Library | \$1.1 million | \$52 |
| Increase College benefit to Government level | College | (\$0.4 million) | (\$67) |
| Total Annual Savings | | \$7.0 million | |

Summary and Recommendations

Pay-as-you go medical costs in general and post-retirement medical costs in particular are placing an increasing burden on Howard County's finances. The GASB 45 accounting standard will change the accounting method for these obligations from a pay-as-you go basis to an accrual method. This change will more than triple the county's cost for these benefits. Other Maryland counties and the state government will see similar increases in their post-retirement medical cost. In addition GASB 45 requires disclosure of the estimated liability of future medical payments. Finally, the new standard places incentives to pre-fund these liabilities similar to a pension trust.

It is not yet clear how much weight the rating agencies will place on these liabilities and what degree of action will be required to avoid a downgrade. It is clear that to fully fund these liabilities will require either a significant increase in spending or potentially very painful benefit cuts which could adversely effect employee morale.

The GASB 45 Task Force Committee recommends the following:

1. Adopt a policy to pre-fund OPEB benefits and plan to gradually increase the annual funding to reach the ARC within five years. It is important to note that every delay in funding the ARC will increase the amount to be funded from current operating revenues.
2. Make minor changes to the OPEB benefit as soon as it is practicable that will reduce the OPEB liability.
3. Create a Trust to accumulate OPEB funds. This will allow the county to use the higher rate of return for investments and to actually invest Trust dollars in investment types that will generate a high rate of return.
4. Exclude retirees currently receiving the OPEB benefit from any benefit changes that have a major financial impact on the retiree. Modification to the underlying plan may continue to be made as it has in the past.
5. Work with all interested parties to redesign the OPEB benefit to make it affordable. This includes employer and employee representatives.
6. Correlate changes to the benefit level to the level of years of service of the employee. Employees closer to retirement have less time to react to a reduced benefit and may be viewed as having earned a greater benefit in exchange for their longer years of service. The committee recognized three groups of employees:
 - Active employees with at least 10 years of service
 - Active employees with less than 10 years of service
 - Future employees
7. Consider programs approved by the IRS that will allow employees to set aside funds to pay for health care in retirement. The current benefit program does not provide for any employee contributions prior to retirement. For example, a Deferred Option Retirement Program could allow employees to accumulate funds to offset a larger health care cost in retirement or employees could be allowed to contribute funds to OPEB as they do for pensions.