Date: February 5, 2018

To: Self-Insurance Trust Board

Through: Michael Kennington, Chief Financial Officer

From: Candace Cannistraro, OMB Director

Subject: Employee Benefit Trust Fund Balance Policy
Citywide

Purpose and Recommendation

To manage the Employee Benefit Trust (EBT) Fund, staff recommends adopting a policy maintaining at least 30% of the next year's projected expenses in reserved fund balance. Under the recommended policy, If the City went below the minimum 30% fund balance, staff would need to create a plan to return the fund to the proposed minimum fund balance target within two fiscal years.

Background

The City is self-insured for providing medical benefits to employees and retirees through the EBT fund. Medical claims, insurance premiums, and administration expenditures related to providing health benefits are paid from the EBT fund and funding for the EBT fund comes from contributions from employees, retirees, and the City. Maintaining a healthy fund balance in EBT is necessary to ensure the City provides competitive health benefits while ensuring medical rate increases for current employees and retirees are reasonable. Currently, the EBT fund does not have a guiding fund balance policy to defining a healthy fund balance. After conducting multiple scenarios and researching the policies of other self-insured governments, staff recommends a 30% minimum fund balance for the EBT fund. In the recommended policy, if the City went below that minimum 30% fund balance, staff would need to produce a plan to return the fund to the 30% fund balance level.

The City's other two trust funds, the Public Property Liability trust fund (PPL) and Workers Complementation (WC) trust fund, both have fund balance policies to ensure sufficient resources to adequately protect the City. The PPL maintains a $10.0 million flat dollar amount balance. The WC trust balances annual contributions from the City so that enough fund balance is maintained to cover the following year's estimated total expenses.

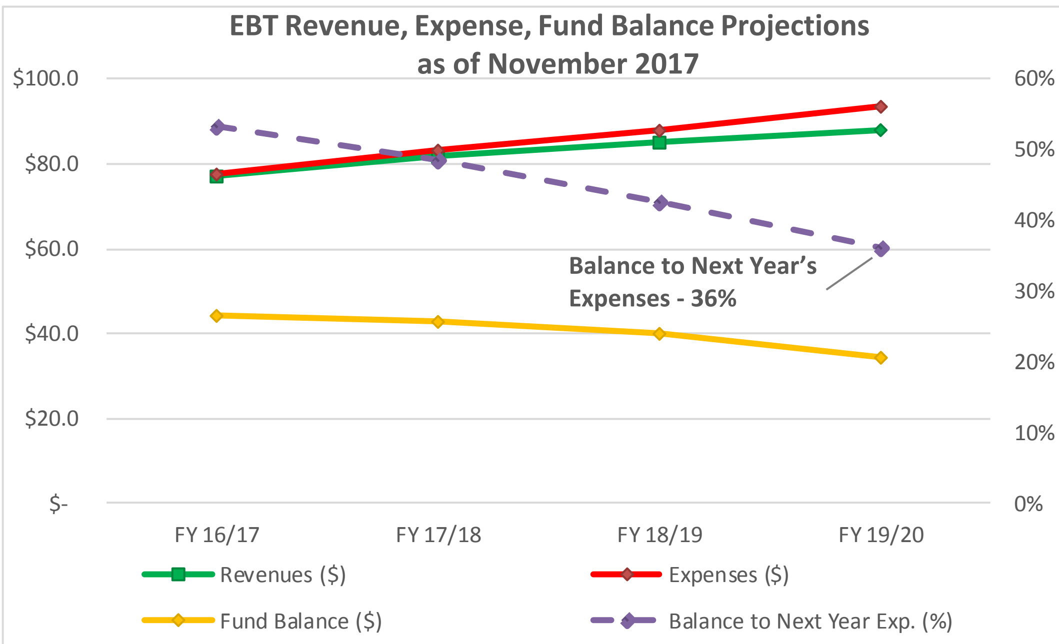
Discussion

<u>Current State</u>

The ratio of EBT fund balance to the next year's estimated expenses has fluctuated between 75% and 35% over the past 10 years, with the prior three-year average of

64%. The current fund balance is 47%. The main controllable variable in the fund are the contributions from the City and plan members. Expenses are driven by factors outside the City's control, such as the cost of prescription medication and medical care. The revenues are comprised of employee and retiree contributions (26.3%), City contributions (73.6%), and other revenues (<%.01). Recommended contribution levels for members and the City are determined based on the current projected costs of medical plans, medical cost trends, and current EBT fund balance.

Below is a graph that shows the current trajectory of revenues and expenses, as well as the projected fund balances (the purple line is the fund balance as percentage of following year's expenses and the yellow line is the dollar amount of the fund balance). The EBT fund balance percentage is declining due to projected expenses increasing at a higher rate than contributions.



EBT Revenue, Expense, Fund Balance Projections as of November 2017					
FY	**Revenues ($)**	**Expenses ($)**	**Fund Balance ($)**	**Fund Utilization**	**Balance to Next Year Exp. (%)**
FY 16/17	$ 77.4	$ 77.8	$ 44.3	$ (0.4)	53%
FY 17/18	$ 81.8	$ 83.2	$ 42.9	$ (1.4)	49%
FY 18/19	$ 85.2	$ 88.1	$ 40.0	$ (2.9)	43%
FY 19/20	$ 88.0	$ 93.7	$ 34.3	$ (5.7)	36%

Figure A Current EBT Revenue, Expense, Fund Balance Projections

Other Cities

As part of the research, staff surveyed other self-insured governments with EBT funds to see how those governments managed their EBT funds. The governments compared were the cities of Gilbert, Chandler, Tempe, Surprise, Tucson and the State of Arizona (see Attachment A). The City of Phoenix was contacted, but did not respond. All cities that responded have written fund balance policies for trust funds. The policies regarding fund balance range from retaining a fund balance of 100% of the next year's estimated claim expenditures (City of Scottsdale) to a minimum of 10% of next year's estimated claims (City of Tempe) of the next year's estimated claims costs. Most cities that were researched retained fund balances higher than their written fund balance policies.

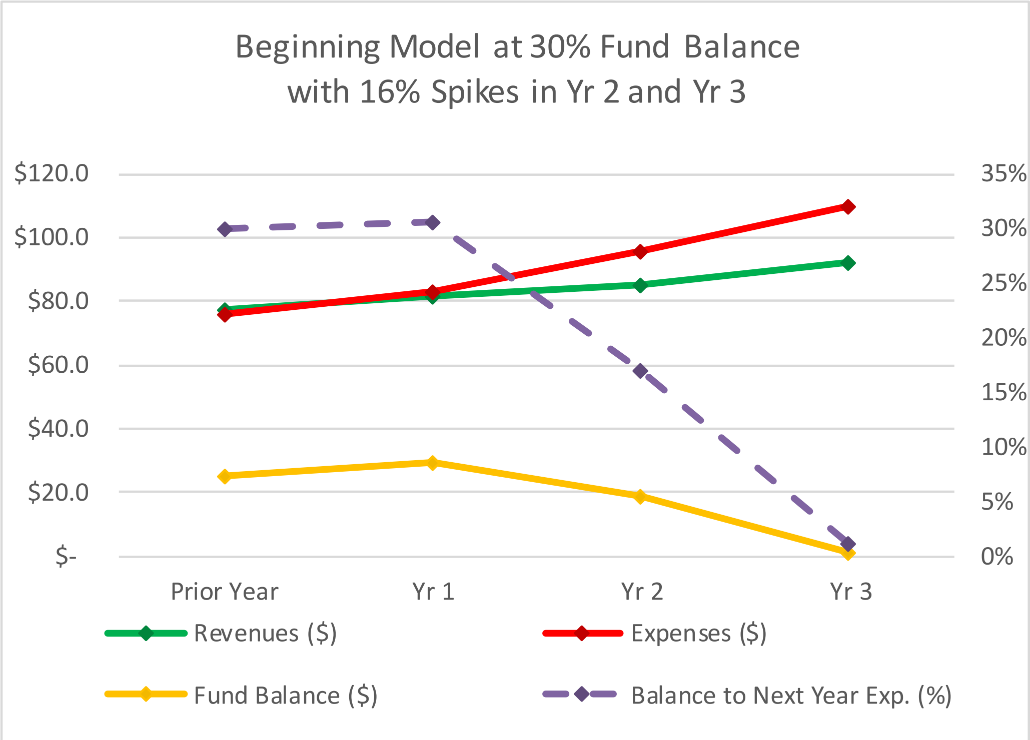
Proposed State

Staff recommendation is to adopt a policy of maintaining a minimum fund balance of 30% of the follow year's total estimated expenses in the fund. A **minimum** fund balance policy, as opposed to either a range (30%-50% for example) or a cap, allows staff to control contributions that would bring the fund balance above 30%, but maintain a lowest fund balance level of 30%. In the face of consecutive costly years, the minimum fund balance policy would require staff to create a plan to build the fund balance in EBT back to the 30% threshold. A minimum fund balance policy would help guide decision making related to contributions to avoid the worst-case scenario of depleting the EBT fund and having to borrow General Funds to support the EBT.

Why 30%?

A fund balance minimum of 30% of the following year's estimated expenses provides (a) cushion for unanticipated fluctuations in revenues or expenses, and (b) provides a reference for deciding to either raise or lower contribution rates. If the EBT fund balance is approaching the proposed minimum, staff can align contributions to meet the current expenditure pressures in the fund.

If the EBT fund balance was reduced to the 30% threshold, the fund balance could endure two consecutive years of significant fund balance impact while avoiding going into a negative balance or utilizing General Funds. Figure B shows the fund balance impact in the face of two consecutive extremely elevated years of 16% expense growth with increases of 8% in contributions. In the third year of this scenario, the fund balance drops to 1%. This worst-case scenario demonstrates that even with consecutive years of extreme inflation of medical expenses, having a 30% reserve maintains a positive fund balance.



Beginning with a 30% Fund Balance 8% Revenue, 16% Expense Growth					
FY	Revenues ($)	Expenses ($)	Fund Balance ($)	Fund Utilization	Balance to Next Year Exp. (%)
PY	$ 77.2	$ 75.9	$ 25.0	$ -	30%
Yr 1	$ 81.8	$ 83.2	$ 29.3	$ 4.3	31%
Yr 2	$ 85.2	$ 95.7	$ 18.8	$ (10.5)	17%
Yr 3	$ 92.4	$ 110.0	$ 1.2	$ (17.6)	1%

Figure B 30% Fund Balance - Severe Expense Growth, Low-Moderate Revenue Growth

Maintaining at least 30% fund balance reserve in EBT also has the benefit of smoothing medical contribution rate increases and protecting against double-digit employee and City contribution rate increases. The 30% minimum balance offers clarity and consistency on how to judge the health of the fund, as opposed to the current state where minimum fund balance thresholds are ambiguous.

For the past five years, EBT fund balances have been between 40% and 60%. The 30% minimum fund balance policy to serve as a **minimum** tolerance level for the fund, as opposed to a target fund balance to achieve. The EBT has approached 30% fund balance in years FY 05/06 (33%) and FY 09/10 (35%), but rebounded above 40% within one to two years following those years. Using historical record of fund balances as reference, we can reason that the 30% threshold is a reasonable minimum and any fund balance below that amount would carry additional risk.

Despite having a proposed fund balance minimum, the EBT fund balance could conceivably go below the minimum balance of 30%. Should the fund go below a 30% fund balance, staff will recommend a plan for stabilizing the EBT fund balance to 30% within two fiscal years.

Alternatives

The City could continue to manage the EBT fund balance with no minimum fund balance policy.

The City could also choose a different fund balance threshold. Staff recommends setting any fund balance minimum as a percent of next year's expenses. A flat dollar amount minimum, like how the City manages the Public Property Liability is not advisable due to the high inflation on medical expenses. A minimum fund balance of $40 million might be the equivalent of a 30% fund balance now, but equate to a 15% fund balance in 10 years due to inflation.

Fiscal Impact

The 30% EBT fund balance policy will have the impact of smoothing medical rate increases to the employees and the City year-to-year.

Staff does not anticipate any immediate fiscal impact to the EBT balances or medical contribution rates as projected EBT fund balances reside above the 30% fund balance minimum that is proposed.

Coordinated With

This policy was coordinated with the Human Resources Department.

<u>Attachment A</u>

Medical/Dental Self-Insurance Trusts - Other Cities' Policies

Municipality	Fund Balance Policy	Policy in Practice	Notes
Town of Gilbert	1-Times Incurred But Not Reported (IBNR)	3-4 times IBNR	- FYs 10-12 had premium holidays, although the fund had to borrow more than $1M from GF in FY 16 - Fund created in FY04 - High claims and "mega claims" are hurting fund and increasing costs
City of Scottsdale	85% confidence interval as determined by third party actuary.	Essentially, the City puts into the fund, what they anticipate for the following year's expenses.	- The trust board sets a confidence level and subsequent target. They started with a healthy fund balance, and will get to a ~$18M fund balance over several years, rather than all at once. - Requires Council approval for burndown of fund balance - 85% Confidence level of full annual costs
City of Tempe	Between 10 - 25% of expected annual claims amounts.	Aligns with fund balance policy.	- Policy was developed in FY 15/16, but practice was more or less in place prior to adoption of formal policy. - Range allows staff to hold off on raising medical rates. - High claim volume, "mega claims," and cost of specialty drugs are hurting fund and increasing costs
City of Surprise	25% of expected claims amount.	Aligns with fund balance policy.	Historically, the fund balance policy had been 10%, but was raised up to 25% recently
City of Chandler	70% of outstanding claims, equivalent to .7 times IBNR	Chandler seems to have a 1-to-1 ratio, in practice, in their self-insurance funds	Medical and dental funds are separate. The term "outstanding claims" seems up for interpretation. But it seems as though they try to replenish the fund at 100% of expected expenses

State of Arizona	1 1/2 times IBNR	1 to 2 times IBNR	- The State is comprised of several constituent departments, much like municipalities, so this practice is applicable to the City. - State has/uses option to use/sweep self-insurance fund

Attachment B. Employee Benefits Trust History Thru November 2018

	Revenues	Expenditures		Fund Balance	
Fiscal Year	**Total Revenue**	**Total Expenses**	**Net Fund Gain/(Loss)**	**Ending Fund Balance**	**Ending Fund Balanc**
10/11 Actual	$ 62,412,391	$ 56,511,900	$ 5,900,491	$ 25,687,637	49.2%
11/12 Actual	$ 65,615,336	$ 52,200,823	$ 13,414,513	$ 39,102,150	69.4%
12/13 Actual	$ 60,691,472	$ 56,317,164	$ 4,374,309	$ 43,476,459	74.5%
13/14 Actual	$ 63,697,574	$ 58,342,274	$ 5,355,300	$ 48,831,759	71.4%
14/15 Actual	$ 68,625,080	$ 68,350,967	$ 274,113	$ 49,105,872	63.8%
15/16 Actual	$ 72,145,058	$ 77,013,149	$ (4,868,091)	$ 44,757,258	57.1%
16/17 Adopted	$ 77,835,482	$ 84,493,221	$ (6,657,739)	$ 38,099,519	46.1%
16/17 Actual	$ 77,880,662	$ 78,438,741	$ (558,079)	$ 44,199,179	53.5%
17/18 Adopted	$ 85,436,333	$ 90,536,269	$ (5,099,936)	$ 39,099,243	47.3%
FY 17/18 Actual Per 1-6	$ 41,184,916	$ 38,645,108	$ 2,539,809	$ 46,738,988	
17/18 Projected	$ 83,798,118	$ 82,584,218	$ 1,213,901	$ 45,413,080	51.2%
18/19 Projected	$ 88,810,000	$ 88,746,000	$ 64,000	$ 45,477,080	48.1%
19/20 Projected	$ 92,218,000	$ 94,521,000	$ (2,303,000)	$ 43,174,080	42.9%