COUNCL AGENDA: 06/21/11
ITEM: 2.29

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Kay Winer
Jennifer A. Maguire

SUBJECT: SEE BELOW

DATE: May 31, 2011

Approved

Date 6/8/11

SUBJECT: AGREEMENT WITH FBMC BENEFITS MANAGEMENT, INC. (FBMC) FOR FLEXIBLE SPENDING ACCOUNTS, INCLUDING INTERNAL REVENUE CODE SECTION 125 PLAN ADMINISTRATION, AND ADMINISTRATIVE SERVICES FOR THE VOLUNTARY INSURANCE BENEFITS FOR THE PERIOD OF JANUARY 1, 2011 TO AUGUST 31, 2015; AND APPROPRIATION ORDINANCE AND FUNDING SOURCES RESOLUTION AMENDMENTS IN THE BENEFIT FUND AND GENERAL FUND FOR FISCAL YEAR 2010-2011 AND FISCAL YEAR 2011-2012.

RECOMMENDATION

1. Approve an Agreement with FBMC Benefits Management, Inc. (formerly Fringe Benefits Management Company) to provide City's medical and childcare flexible spending accounts (FSAs), including Internal Revenue Code (IRC) Section 125 compliance management services, and third party administrator (broker) services for the City's voluntary insurance benefits program for the period of January 1, 2011 to December 31, 2011, with two (2) one-year options to renew the Agreement through December 31, 2013, and (1) twenty-month option to renew the Agreement from January 1, 2014 to August 31, 2015, for pre-funding costs not to exceed $15,220 for plan year 2011 and $42,000 for each subsequent plan year (2012, 2013 and 2014), and for total pre-funding costs not to exceed $141,220 for the total fifty-six (56) month term, subject to appropriation of funds by the City Council; and

2. Adopt the following Appropriation Ordinance and Funding Sources Resolution amendments in the Benefit Fund (Fund 160) for 2010-2011;
    a. Increase the estimate for Earned Revenue in the amount of $9,450;
    b. Increase the estimate for Transfers in the amount of $4,770; and
    c. Increase in the Flexible Spending Account appropriation to the Human Resources Department in the amount of $14,220.

3. Adopt the following Appropriation Ordinance and Funding Sources Resolution amendments in the General Fund (Fund 001) for 2010-2011;
    a. Decrease the Wellness Program Reserve in the amount of $4,770; and
    b. Establish a Transfer to the Benefit Fund (Fund 160) in the amount of $4,770.

4. Adopt the following Appropriation Ordinance and Funding Sources Resolution amendments in the Benefit Fund (Fund 160) for 2011-2012;
    a. Increase the estimate for Transfers in the amount of $8,700; and
    b. Increase in the Flexible Spending Account appropriation to the Human Resources Department in the amount of $8,700.

5. Adopt the following Appropriation Ordinance and Funding Sources Resolution amendments in the General Fund (Fund 001) for 2011-2012;
    c. Decrease the Wellness Program Reserve in the amount of $8,700; and
    d. Establish a Transfer to the Benefit Fund (Fund 160) in the amount of $8,700.

OUTCOME

Approval of the recommendations provides the City Manager authority to execute an Agreement with FBMC previously authorized by the City Council on October 5, 2010 that satisfies the vendor's requirements for seed money, funding for possible plan losses in 2011-2012, and to extend the Agreement from December 31, 2014 to August 15, 2015 to provide adequate time to close the claims processing and bank reconciliation efforts.

EXECUTIVE SUMMARY

Flexible Spending Accounts (FSA's) are mutually beneficial to the City and to employees. Greater participation in FSA plans results in an increase in pre-tax payroll deductions, which reduces taxable income and the City's expenditure for payroll taxes. Employees who contribute to FSA's with pre-tax dollars experience greater spending power for dependent and medical care expenses.

Subsequent to Council action in October 2010 that authorized negotiating and executing a contract with FBMC, a number of revisions were identified by FBMC, resulting in a number of recommendations to the Agreement with FBMC. The changes are summarized below and discussed in greater detail in the body of this memorandum.

1. Increase the 2010-2011 FSA appropriation to address the increased cost of the FBMC Agreement. The addition of a debit card to the program dictates the need for increased upfront funding to support withdrawals, prior to receipt of payroll deductions.
2. Increase the 2011-2012 appropriation to account for projected Medical Reimbursement Account (MRA) plan losses.

3. Change the term of the Agreement by an additional eight (8) months to allow for close out of claims and reconciliation efforts.

The first item responds to the pre-funding amount required under the MRA plan in order to cover the cost of claims that are submitted to FBMC before the City funds the account with the first payroll deductions of the plan year. As will be discussed in detail later in this memo, the amount required for pre-funding has increased significantly and unexpectedly since October 2010 when the Council authorized the City Manager to negotiate and execute an Agreement with FBMC.

The second item is the result of a risk assessment of the MRA plan that was recently completed by the Risk Management Division of Human Resources. The risk assessment projects that the MRA plan will experience a loss for the 2010 plan year, which will be incurred during the 2011-2012 fiscal year. Additional funding in the FSA appropriation is necessary to cover this loss because of the City's responsibility to keep the plan whole.

As noted in the third item, the term of the Agreement with FBMC is being extended for eight months, at no additional cost, in order to cover the final plan year's claims run-off and reconciliation period, which FBMC is expected to perform.

Funding for the increases to the FSA appropriation, including potential funding losses, is recommended to come from the City's Wellness Program Reserve, which has been funded in part by FSA forfeitures from prior plan years.

BACKGROUND

FSA plans are a "win-win" for the City and its employees in terms of cost reduction. More employee participation in the FSA plans means an increase in pre-tax payroll deductions, which reduces taxable income and thus reduces the City's expenditure for payroll taxes. Employees contribute to the FSAs with pre-tax payroll contributions in return for the ability to submit after-tax medical and dependent care expenses for reimbursement from their pre-tax payroll contributions. This benefits an employee by reducing their annual taxable income and results in greater spending power for dependent and medical care expenses.

On October 5, 2010, the City Council authorized the City Manager to negotiate and execute agreements with FBMC to provide the City with compliance management services related to Internal Revenue Code (IRC) Section 125, and to provide third party administrator services for the City's voluntary insurance programs and the City's Flexible Spending Accounts (FSAs), which include the Medical Reimbursement Account (MRA) and the Dependent Care Assistance Program.

The FBMC Agreement requires the City to establish a new bank account for the FSA plans and to establish a pre-funded claims reserve from which initial FSA reimbursements will be issued. Additionally, the Medical Reimbursement Account (MRA) includes the new addition of a debit card.

The new MRA debit-card permits participants to pay for qualified medical expenses that can be electronically adjudicated directly from the City's FSA bank account established for the reimbursement of eligible claims. While not all medical expenses can be electronically adjudicated, the debit card is very useful for the most commonly submitted claims, such as health plan copayments for medical office visits and prescriptions. Any claim that cannot be substantiated through the electronic adjudication process would be submitted on a paper form for reimbursement. The debit card reduces administrative costs and streamlines the reimbursement process to "real-time." This new feature, however, requires the City to provide "seed" money to insure that the City's FSA bank account is able to fund submitted expenses which occur before payroll contributions are deposited.

Since the City Council's October 2010 meeting, the following changes must be included in the Agreement:

- Change the amount estimated for pre-funding: FBMC notified staff in late December 2010 that the formula previously provided by FBMC for calculating the pre-funding required from the City for the Medical Reimbursement Account (MRA) program was incorrect. Therefore, the City was required to deposit ("pre-fund") a greater initial amount the first year into the City's bank account used for the MRA plan reimbursements than previously anticipated. Additionally, the City must ensure that the account from which MRA claims are paid has sufficient reserves at the beginning of each additional plan year to cover claims before initial payroll contributions are deposited.

- Change in Term of Agreement: An additional eight (8) months are needed to cover the entire period of FBMC's services, including completion of all final claims and reimbursements to MRA participants and to the City after the end of the 2014 plan year. This term of agreement provides a smooth transition to a new vendor if necessary.

While the total amount of City funds to be expended is less than $250,000, Council authorization for this Agreement is required because the total value of employee payroll deduction dollars expended by the City and managed by FBMC during the full term of this Agreement is approximately $6,000,000.

Additionally, IRC Section 125 rules require that the City, as employer, assumes the risk, essentially acting as the insurer, for the maximum amount of claim reimbursements at any time during the period of coverage, regardless of whether or not the amount contributed by participants is sufficient to pay the claims.

<u>Change in Initial Pre-funding for City's New FSA Bank Account</u>

The Agreement with FBMC authorized by the City Council on October 5, 2010 includes a new debit-card option for the MRA. Prior to the October 5, 2010 Council meeting, FBMC provided a calculation to determine the amount of pre-funding necessary at the beginning of each calendar year, and from that formula, staff determined the amount necessary would be an amount not-to-exceed $1,000 per year, with a maximum amount not-to-exceed $4,000 for the entire term of the Agreement. The debit card is a new service for the City; therefore, Benefits staff relied heavily on FBMC for determining the City's pre-funding requirements for the MRA plan.

On December 23, 2010, FBMC notified staff that the formula they originally provided to staff was incorrect, and FBMC provided a new formula. Based on the new formula and actual employee plan elections of $791,399 for 2011, FBMC advised that the pre-funding amount needed by January 1, 2011 to begin the MRA was $30,438. This pre-funded amount would provide the "seed" pre-funding for January 1 to January 14, 2011. Payroll contributions collected from employees in pay period 1 of 2011 were scheduled to be transmitted on January 14, thus pre-funding was required for the period of January 1 through January 14, for 2011.

Because FBMC had already issued debit cards to participants, and to meet the requirement that the City make the MRA contributions immediately available to MRA plan participants on the first day of the plan year, the account had to be funded prior to January 1, 2011. Based on FBMC's new formula, the new pre-funding requirement for 2011 was initially $30,438, but due to the late notice, the City was able to pre-fund half of that amount, $15,220. The City deposited $15,220 on December 29, 2010 into the City's FSA bank account.

<u>Change in Term of Agreement</u>

The term of the Agreement with FBMC authorized by the City Council on October 5, 2010 was January 1, 2011 to December 31, 2011, with three (3) one-year option periods extending through December 31, 2014.

Staff recommends adding eight (8) months after the close of the 2014 plan year to allow FBMC to continue to provide bank reconciliation, claims processing and reimbursement services through the City's FSA bank account through August 2015. This is necessary to complete payment of all claims and reimbursements to the City related to the 2014 plan year.

ANALYSIS

To ensure adequate funding for the MRA account in the future, staff recommends that the Council approve an Agreement with FBMC that sets forth the following pre-funding amounts:

1) For the 2011 plan year, the actual pre-funding amount of $15,220 that the City has deposited into the FSA account for 2011, and
2) For the 2012, 2013, and 2014 plan years, a projected claims reserve amount of $42,000 at the beginning of each calendar year to ensure sufficient funds are available to pay MRA claims based on FBMC's new formula and staff projections, for a total recommended not-to-exceed amount of $141,220 for the total fifty-six (56) month term of the Agreement.

This recommendation will cover anticipated future participation growth due to the popularity of the MRA debit card with current participants and anticipated increased enrollment in the MRA as it permits participants to pay planned medical costs with tax-free dollars.

The City's FSA account is offered through the employee benefits package, and participants determine an annual election amount that cannot be changed unless there is an Internal Revenue Code Section 125 qualified mid-year event. The annual maximum that may be elected for the MRA is $2,500, though an employee may elect less. Once an election is made, automatic payroll deductions begin and a participant may submit claims during the coverage period. Claims submitted are limited to the participant's annual election regardless of when payroll contributions are collected and placed in the MRA account. Any available benefits that are not used during the period of coverage are forfeited by the participant.

The City does assume reasonable risk with this plan, as the MRA is a self-insured medical plan, and must satisfy the requirements to provide the City and employees tax savings. As such, the reimbursement arrangement cannot have the effect of eliminating all, or substantially all, risk of loss to the employer maintaining the plan, and sufficient funding must be available at all times during the period of coverage. At the close of a plan year, historically, the City receives a net forfeiture amount which is the difference between the forfeitures from participants whose elected contribution exceeds their claims as well as the losses that occur when an employee terminates employment and their payroll contributions were less than their reimbursed claims.

Under IRC Section 125 rules, forfeitures may not be reimbursed to participants, but forfeitures may be used to pay plan benefits and to defray reasonable administrative expenses, such as pre-funding the MRA debit card in future years.

As will be explained in the Cost Implications section of this memo, sufficient funding is available in 2010-2011 to cover the expense required for pre-funding the MRA for the 2011 plan year. Staff recommends using previous flexible spending account forfeitures to cover the 2011 plan year pre-funding amount of $15,220.

The Risk Management division of Human Resources recently conducted a risk assessment of the City's MRA plan based on plan history for the 2007 through 2010 plan years. The risk assessment was conducted to assess the City's future liability to owe funds to the MRA plan at the end of the plan year in the instance that plan losses exceed forfeitures. Based on the analysis of trend over the last four years, it was determined that the MRA plan may experience a projected loss of $8,700 for the 2010 plan year. Therefore, it is recommended that the City provide additional funding for the 2011-2012 fiscal year in the amount of $8,700 to the FSA appropriation to account for projected plan losses for the 2010 plan year.

Based on current projections of plan losses for the 2011 plan year, including consideration of plan impacts due to anticipated lay-offs in June 2011, it is expected that there will be sufficient funding in the FSA bank account and no additional City funding will be required to keep the plan whole in 2011-2012 besides the amounts requested in this memorandum. The Administration plans to evaluate the risk the City assumes by offering this benefit over the next year and potential ways to mitigate possible losses to the City in the future.

Future years of the contract period are subject to the appropriation of available funds.

EVALUATION AND FOLLOW-UP

Not Applicable

POLICY ALTERNATIVES

Alternative #1: Discontinue the use of debit cards for the MRA flexible spending account for the plan year beginning January 1, 2012.

Pros: Discontinuing the use of debit cards for the MRA will relieve the City of its responsibility for pre-funding the bank account for this plan, thereby reducing the cost to the City for the Agreement with FBMC.
Cons: Discontinuing the use of debit cards for the MRA will reduce participation in the plan and increase the City's expense for payroll taxes. Because FBMC has already issued 610 debit cards to City employees who are currently using the City's MRA plan for the 2011 plan year, staff does not believe that discontinuing the debit card benefit at this time is advisable or administratively feasible.
Reason for not recommending: Allowing the use of debit cards makes the MRA more attractive to employees and increases participation. In 2011, the plan participation grew by approximately 100 employees. More participation means an increase in pre-tax payroll deductions, which reduces taxable income and thus the City's expenditure for payroll taxes. This plan is a "win-win" for the City and its employees in terms of cost reduction. Based on historical performance in the FSA program, the revenue provided by plan forfeitures and remaining plan year fund balance is anticipated to more than cover the pre-funding requirement for the 2011 plan year, thereby reimbursing the City for its up-front expenditure.

PUBLIC OUTREACH/INTEREST

- ☐ **Criterion 1: Requires Council action on the use of public funds equal to $1 million or greater. (Required: Website Posting)**
- ☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- ☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This memorandum is posted on the City's website for the June 21, 2011 Council Agenda.

COORDINATION

This memorandum has been coordinated with the Office of the City Attorney.

COST SUMMARY/IMPLICATIONS

In the City's MRA plan, any available benefits that are not used during the period of coverage are forfeited by the participant typically resulting in a net forfeiture amount to the City at the close of every plan year. Forfeitures may be used to pay plan benefits and to defray reasonable administrative expenses, such as pre-funding the MRA debit card in future years. Staff recommends using a portion of previous flexible spending accounts forfeitures of over $41,000 which were allocated in the 2008-2009 Mid-Year Budget Review to the Wellness Program Reserve and 2009 plan year flexible spending accounts forfeitures of $9,450 to provide sufficient funding for both the 2011 plan year pre-funding requirement of $15,220 ($1,000 is already appropriated in 2010-2011) and the projected 2010 plan year loss of $8,700 to be expended in 2011-2012. The 2008 plan year forfeitures had been placed in the Human Resources Wellness Program Reserve in the General Fund and a portion of these forfeitures are recommended to be transferred from the General Fund to the Benefits Fund (Fund 160) in this memorandum. The 2009 plan year forfeitures have been deposited directly in the Benefits Fund and a corresponding increase in the estimate for Earned Revenue is recommended in this memorandum to reflect this.

The City's pre-funding cost for future plan years is a maximum of $42,000 per year. Benefits staff anticipates these costs to be covered by any MRA balance which is available due to a lag in claims submissions. Future years of the contract period are subject to the appropriation of available funds.

BUDGET REFERENCE

The table below identifies the fund and appropriations to fund the Flexible Spending Account Agreement for active employees recommended as part of this memo.

Fund #	Appn. #	Appn. Name	Total Appn.	Amt. for Agmt.	Adopted Budget (Page)	Last Budget Action (Date, Ord. No.)
160	3864	Flexible Spending Accounts	$1,000	$15,220	N/A	10/5/10, 28821

Actions recommended in this memorandum would increase the Flexible Spending Accounts appropriation to $15,220 to ensure sufficient funding for this Agreement in 2010-2011 and establish an appropriation of $8,700 in 2011-2012 to account for projected plan losses for the 2010 plan year.

CEQA

Not a project, File No. PP10-068 (b), Municipal Code, Title 3.

/s/
KAY WINER
Acting Director, Human Resources

JENNIFER A. MAGUIRE
Budget Director

I hereby certify that there will be available for appropriation in the Benefit Fund monies in excess of those heretofore appropriated there from, said excess being at least:

2010-2011	$14,220
2011-2012	$ 8,700

JENNIFER A. MAGUIRE
Budget Director

For questions please contact Jeanne Groen, Benefits Manager, at (408) 975-1428.