

July 31, 2003



Financial Management

Controls Over DoD Medicare
Eligible Retiree Health Care
Fund Investments
(D-2003-119)

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of the
Department of Defense

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Article I, Section 9

Report Documentation Page

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Acronyms

DFAS	Defense Finance and Accounting Service
MERHCF	Medicare Eligible Retiree Health Care Fund
MRHB	Military Retirement Health Benefits



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July 31, 2003

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER

SUBJECT: Report on Controls Over DoD Medicare Eligible Retiree Health Care Fund
Investments (Report No. D-2003-119)

We are providing this report for review and comment. This audit was performed in support of the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356), and the Federal Financial Management Improvement Act of 1996 (Public Law 104-208). We considered comments on a draft of this report when preparing the final report. We disagreed with the management comments we received. We request that the Under Secretary of Defense (Comptroller)/Chief Financial Officer provide additional comments on the recommendations and potential monetary benefits by September 2, 2003.

If possible, please provide management comments in electronic format (Adobe Acrobat file only) to Auddfs@dodig.osd.mil. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. James L. Kornides at (614) 751-1400 ext. 211 or Mr. Stuart D. Dunnitt (614) 751-1400 ext. 214. See Appendix B for the report distribution. The team members are listed inside the back cover.

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Office of the Inspector General of the Department of Defense

Report No. D-2003-119

(Project No. D2003FJ-0005)

July 31, 2003

Controls Over DoD Medicare Eligible Retiree Health Care Fund Investments

Executive Summary

Who Should Read This Report and Why? Defense personnel who are responsible for managing funds provided to reduce the Military Retirement Health Benefits (MRHB) liability should read this report. The report discusses how the Defense Finance and Accounting Service invests funds from the Medicare Eligible Retiree Health Care Fund (MERHCF).

Background. This audit was performed in support of the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356), and the Federal Financial Management Improvement Act of 1996 (Public Law 104-208).

The MERHCF was established to provide funds to pay for health benefits for Medicare eligible DoD military retirees, retiree family members, and survivors. On October 1, 2002, the MERHCF received a deposit of \$14.4 billion provided by a Treasury warrant. The \$14.4 billion was intended as the first of fifty annual payments to amortize the present value of \$405.6 billion of the \$592 billion unfunded FY 2002 MRHB liability. The Defense Finance and Accounting Service is responsible for managing the daily fiscal operations of the MERHCF.

In addition, the DoD MERHCF Board of Actuaries determined that the Military Departments needed to provide normal contributions to the MERHCF throughout FY 2003. As of March 31, 2003, the MERHCF had collected \$4.0 billion in normal cost contributions and spent \$2.4 billion on health care. The MERHCF investments in Treasury securities earned \$106.2 million during the first 6 months of FY 2003, and as of March 31, 2003, the MERHCF investments totaled \$16.1 billion. Normal contributions will be approximately \$8.0 billion for FY 2003. On October 1, 2002, 20-year securities were yielding 4.8 percent, 10-year securities were yielding 3.7 percent, and 3-month securities were yielding 1.6 percent.

Results. As of March 31, 2003, the Defense Finance and Accounting Service (DFAS) invested the initial \$14.4 billion contribution to the MERHCF in short-term securities instead of long-term securities. As a result, the MERHCF did not realize \$206.7 million in potential investment income during the first 6 months of FY 2003 and continues to not earn at least \$34 million a month in investment income. By investing in long-term securities versus current practices, DoD can realize an estimated \$6.9 billion in additional investment income over the next 6 years. The lost investment income will have a direct and material effect on the size of the Military Retirement Health Benefits liability in future years.

Management Comments and Audit Response. The Under Secretary of Defense (Comptroller)/Chief Financial Officer nonconcurred with the recommendations. The Under Secretary stated that DFAS is complying with the current investment policy. The Under Secretary also stated that the MERHCF Board of Actuaries provides oversight of DFAS implementation of the investment policy and that additional oversight procedures are not necessary because there is no indication that the current oversight is not working. We respectfully disagree that DFAS is complying with the investment policy because a strategy of investing in only short-term securities is not the most prudent course of action. Further, the Board of Actuaries does not provide true oversight of DFAS implementation of the investment policy because the Board is advisory and not accountable for DFAS investment decisions. The continuing loss and potential future loss of interest revenue to the Fund indicates the process is not working. We request that the Under Secretary of Defense (Comptroller)/Chief Financial Officer provide additional comments by September 2, 2003. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

This audit was performed in support of the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356), and the Federal Financial Management Improvement Act of 1996 (Public Law 104-208).

The Medicare Eligible Retiree Health Care Fund (MERHCF) was established on October 1, 2002, with the deposit of \$14.4 billion provided by a Treasury warrant. The \$14.4 billion was intended as the first of fifty annual payments to amortize the present value of \$405.6 billion of the \$592 billion unfunded Military Retirement Health Benefits (MRHB) liability. The Defense Finance and Accounting Service (DFAS) is responsible for managing the daily fiscal operations of the MERHCF.

In addition, the DoD MERHCF Board of Actuaries determined that the Military Departments needed to provide normal contributions to the MERHCF throughout FY 2003. As of March 31, 2003, the MERHCF had collected \$4.0 billion in normal cost contributions and spent \$2.4 billion on health care. The MERHCF investments in Treasury securities earned \$106.2 million during the first 6 months of FY 2003, and as of March 31, 2003, the MERHCF investments totaled \$16.1 billion. Normal contributions will be approximately \$8.0 billion for FY 2003. Similar outlays and normal contributions are projected to continue into the future.

FY 2003 is the first year that DoD is using accrual budgeting to pay for health care for beneficiaries who are eligible for Medicare. In an accrual budget, costs including pensions and medical benefits for retirees are recognized during the years in which the employees are working, not when the benefits are actually paid.

Objectives

The objective of the audit was to determine whether DoD established effective quality controls over the estimation of the MRHB liability. We also reviewed compliance with applicable laws and regulations. See Appendix A for a discussion of the scope, methodology, and management control program review.

Investment of Funds

As of March 31, 2003, DFAS invested the initial \$14.4 billion contribution to the MERHCF in short-term securities instead of long-term securities. The investments in short-term securities occurred because DFAS did not comply with trust fund investment policy that required investments to be made in 10- to 20-year securities. As a result, the MERHCF did not realize \$206.7 million in potential investment income during the first 6 months of FY 2003 and continues to not earn at least \$34 million a month in investment income. By investing in long-term securities versus current practices, DoD can realize an estimated \$6.9 billion in additional investment income over the next 6 years. The lost investment income will have a direct and material effect on the size of the Military Retirement Health Benefits liability in future years.

Criteria

Public Law. Title 10, chapter 56, “DoD Medicare Eligible Retiree Health Care Fund,” January 2, 2001, established the MERHCF.

Title 10, section 1111 states:

There is established on the books of the Treasury a fund to be known as the Department of Defense Medicare Eligible Retiree Health Care Fund (hereafter in this chapter referred to as the Fund), which shall be administered by the Secretary of the Treasury. The Fund shall be used for the accumulation of funds in order to finance on an actuarially sound basis liabilities of the Department of Defense under Department of Defense retiree health care programs for Medicare-eligible beneficiaries.

Title 10, section 1117 states:

The Secretary of Treasury shall invest such portion of the Fund as is not in the judgment of the Secretary of Defense required to meet current withdrawals. Such investments shall be made in public debt securities with maturities suitable to the needs of the Fund as determined by the Secretary of Defense, and bearing interest at rates determined by the Secretary of Treasury, taking into consideration current market yields on outstanding marketable obligations of the United States of comparable maturities. The income on such investments shall be credited to and from a part of the Fund.

The Department of the Treasury has delegated responsibility for development of an investment strategy to each program agency. The Department of the Treasury Operating Circular, "Responsibilities Relating to Government Investment Accounts and Investment on Government Series Treasury Securities," December 23, 2002, requires a program agency to develop an investment strategy as follows:

In developing the investment strategy, the program agency should practice a 'buy and hold' policy. The program agency should, not less frequently than annually, estimate the timing and amounts of disbursements of the federal program over the following year, and develop a strategy for purchasing Treasury specials in principal amounts and having maturities that approximately coincide with those disbursement estimates (e.g., market-based Treasury bills for short-term disbursing needs; market-based Treasury special notes and bonds for longer-term disbursing needs).

DoD Directive 6070.1, "DoD Medicare Eligible Health Care Trust Fund," July 17, 2002, requires the Under Secretary of Defense (Comptroller)/Chief Financial Officer to direct the Director, DFAS to coordinate with the Treasury to establish other appropriate procedures to manage the daily fiscal operations of MERHCF.

DoD Operational Policy. The following investment policy was applicable to the MERHCF according to DFAS and the Office of Actuary, DoD.

- Investments shall consist of U.S. Treasury nonmarketable market-based certificates, bills, notes, and bonds. Investments of 1 year or less may be required to cover short-term needs. While maximization of return on investments shall be pursued, liquidity with low risk is important for monthly forecast requirements.
- The majority of the investment portfolio shall consist of securities in excess of 1 year. Investments shall be made to maximize the total return on investments, given the term structure of interest rates.
- Investments shall normally be in the 10- to 20-year range. This will give the Fund the benefit of higher long-term rates and allow the Fund some liquidity in its long-term portfolio.
- The purchase and sale of securities will be made to coincide with the needs of the Fund, but deviation shall be allowed at the time of major yield shifts in the market.
- Estimated monthly receipts and expenditure of the Fund shall be compared to actual data so as to minimize idle cash and maximize investments.

Investment of Annual Contributions to the MERHCF

The MERHCF was established on October 1, 2002, with the deposit of \$14.4 billion from a Treasury warrant. The \$14.4 billion was intended as the first of fifty annual contributions to amortize the present value of \$405.6 billion of the \$592 billion unfunded MRHB liability. For FYs 2003 through 2009, actuarial estimates showed that \$111.8 billion in contributions to the MERHCF are planned (see Table 1)

<u>Fiscal Year</u>	<u>Amount (in Millions)*</u>
2003	\$ 14,369.0
2004	14,871.9
2005	15,392.4
2006	15,931.2
2007	16,488.8
2008	17,065.9
2009	<u>17,663.2</u>
Total	\$111,782.4

* The contribution to the fund increases by 3.5 percent each year based on the decisions of the MERHCF Board of Actuaries.

The contributions are intended to reduce the MRHB liability and provide funds for health care benefits for DoD Medicare eligible military retirees, retiree family members, and survivors.

In addition to the contributions, the MERHCF will receive payments from the Military Departments for Service members who are not retired in order to accrue expenses as their future health benefits are earned. The normal contributions are determined by the DoD Actuary at the beginning of each fiscal year. For FY 2003, the MERHCF will receive normal contributions from the Military Departments based on the number of Service members and their future benefits.

As of March 31, 2003, the MERHCF received \$4.0 billion in normal contributions and made \$2.4 billion in payments from the MERHCF to direct-care treatment facilities (\$1.0 billion) and purchased-care providers (\$1.4 billion). As a result, the MERHCF balance increased from \$14.4 to \$16.1 billion because normal contributions exceeded payments by \$1.6 billion (\$4.0 billion less \$2.4 billion), and the MERHCF earned \$106.2 million during the first 6 months of FY 2003.

Normal contributions will be approximately \$8.0 billion for FY 2003 based on the first 6 months contributions and should increase in the future unless force levels are reduced.

The Office of Management and Budget projected \$4.4 billion in outlays from the MERHCF in FY 2003. The \$4.4 billion in expected FY 2003 outlays is \$3.6 billion less than the expected FY 2003 normal contributions. The Office of Management and Budget projected that outlays from the MERHCF will be \$4.8 billion in FY 2004 and \$5.0 billion in FY 2005. As a result, annual normal contributions will continue to cover the disbursement needs of the MERHCF for the foreseeable future.

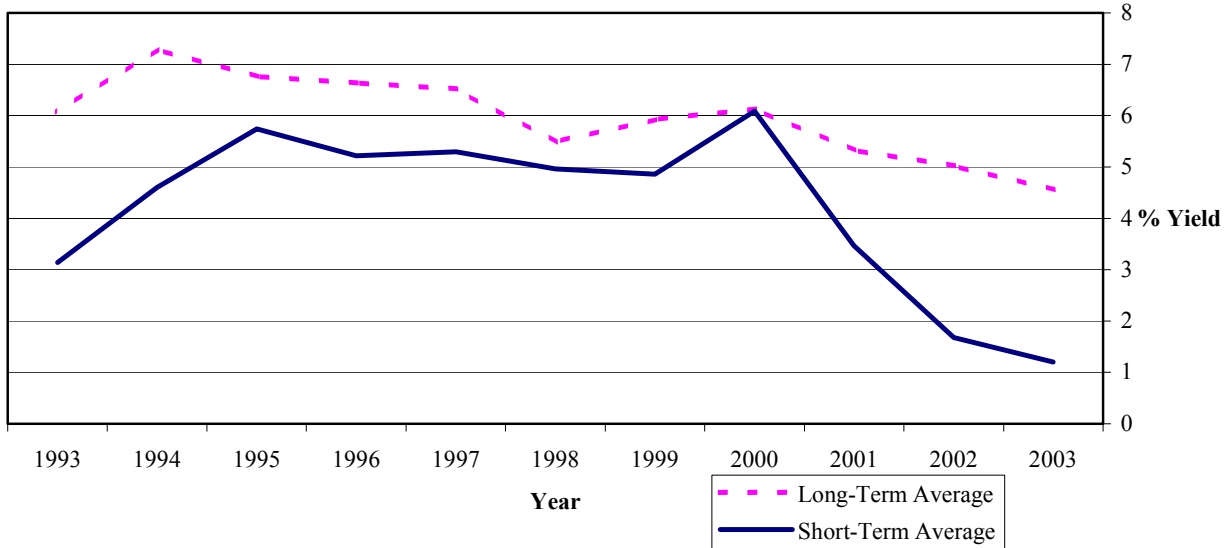
Despite the projections indicating the needs of the fund would be met through normal contributions, DFAS invested all of the \$16.1 billion that will not be needed to meet upcoming requirements in short-term Treasury bills with maturities of less than 1 year.

Compliance with Investment Policy

DoD investment policy was consistent with the Public Law provisions that required investments to be made in public debt securities with maturities suitable to the needs of the MERHCF. However, DFAS did not comply with the DoD investment policy that required the majority of the MERHCF to be invested in 10- to 20-year Treasury securities. As of March 31, 2003, DFAS invested the initial \$14.4 billion contribution to the MERHCF in daily and other short-term (3- to 6-month) securities instead of a mixture of 10 - to 20-year long-term securities as required by DoD investment policy. DFAS believed that long-term interest rates would rise in the future. DFAS believed that the gradual decline in long-term interest rates over the last 10 years (see graph) represented a major yield shift in the market and wanted to wait for the rates to rise.

The graph shows that the more dramatic shift was related to yields in short-term securities. Specifically, during FYs 2002 and 2003, 10- to 20-year interest rates experienced a gradual decline. However, short-term interest rates experienced a much steeper decline.

Treasury Yields - Short Term vs. Long Term



The long-term average is composed of 10- and 20-year securities. The short-term average is 3- and 6-month securities. Table 2 provides the data that were used in the graph except for FY 2003. Table 2 also shows a calculation of the average of the differences between the long- and short-term rates during the past 10 years. During that period, long-term rates were on average 1.613 percent greater than short-term rates.

Table 2. Average Percentage Yields on Securities (Past 10 Years)

<u>Year</u>	<u>Short Term</u>		<u>Average Short Term</u>	<u>Long Term</u>		<u>Average Long Term</u>	<u>Difference Between Averages</u>
	<u>3 Month</u>	<u>6 Month</u>		<u>10 year</u>	<u>20 Year</u>		
2002	1.635	1.716	1.676	4.613	5.432	5.022	3.346
2001	3.479	3.453	3.466	5.021	5.632	5.326	1.861
2000	6.000	6.174	6.087	6.030	6.231	6.131	0.044
1999	4.778	4.946	4.862	5.646	6.198	5.922	1.060
1998	4.907	5.020	4.964	5.263	5.716	5.489	0.526
1997	5.201	5.390	5.296	6.354	6.687	6.520	1.225
1996	5.146	5.291	5.218	6.444	6.826	6.635	1.417
1995	5.660	5.818	5.739	6.574	6.955	6.764	1.025
1994	4.372	4.827	4.600	7.085	7.490	7.288	2.688
1993	3.066	3.219	3.143	5.866	6.286	6.076	2.934

Average Difference (1993-2002) 1.613

On August 23, 2002, the DoD Medicare Eligible Retiree Health Care Board of Actuaries questioned DFAS on how it intended to invest assets from the MERHCF. Although it had not consulted with economists or investment advisors, DFAS did not plan to follow the DoD investment policy of investing in long-term securities. DFAS informed the Board of Actuaries that it planned to invest the MERHCF in 2- to 3-year securities until interest rates rise in the future. However, DFAS did not invest the MERHCF in 2- to 3-year securities. It continued to invest in daily and short-term securities.

Potential Investment Income

DFAS should not have invested the \$14.4 billion initial contribution to the MERHCF in daily and short-term securities. DFAS should have adhered to the DoD investment policy by investing in 10- to 20-year Treasury securities. By remaining invested in short-term securities, the MERHCF lost \$206.7 million in potential investment income during the first 6 months of FY 2003 and continues to lose at least \$34 million a month in investment interest. In addition, if long-term interest rates do not increase in future years to a level acceptable to DFAS, DFAS plans to continue to invest annual contributions to the MERHCF in short-term securities. However, DFAS was unable to provide us with a rate that would be acceptable.

In contrast, DFAS is also responsible for administering investments in the Military Retirement Fund but invested those funds in longer-term securities. As of April 2003, DFAS invested 82 percent of the Military Retirement Fund in securities with terms greater than 1 year according to Treasury records. Specifically, DFAS invested 18 percent of the Military Retirement Fund in securities with terms less than 1 year, 41 percent of the Military Retirement Fund in securities with terms greater than 1 year but less than 10 years, and 41 percent of the Military Retirement Fund in long-term bonds with terms of at least 10 years.

During the first 6 months of FY 2003, the MERHCF earned \$99.7 million on the initial \$14.4 billion contribution and \$106.2 million for the entire MERHCF. The MERHCF would have earned \$306.4 million if the \$14.4 billion had been invested in 10- to 20-year securities as required by DoD policy. The lost investment income averaged \$34 million per month (\$206.7 million divided by 6) and continued as of April 30, 2003.

In addition, unless action is taken, DFAS will invest future contributions to the MERHCF in short-term securities. Because short-term securities earn 1.613 percent on average less than long-term securities, DoD will lose an estimated \$6.9 billion in investment income over the 6-year Future Years Defense Program beginning in FY 2004 (see Table 3).

**Table 3. Future Contributions That Are Not Needed to Meet Projected Requirements and Their Potential Additional Investment Income if Invested in Long-Term Securities (10-20 Year)
(\$ in millions)**

<u>Fiscal Year Contribution</u>	<u>Amount of Contribution</u>	<u>Number of Years</u>	<u>Compound Interest Factor</u> ²	<u>Potential Investment Income</u>
2003 ¹	\$ 14,369.0	6	.10077	\$1,447.9
2004 ¹	14,871.9	6	.10077	1,498.6
2005	15,392.4	5	.08329	1,282.1
2006	15,931.2	4	.06610	1,053.0
2007	16,488.8	3	.04917	810.8
2008	17,065.9	2	.03252	555.0
2009	<u>17,663.2</u>	1	.01613	<u>284.9</u>
Total	\$111,782.4			\$6,933.3

¹ FYs 2003 and 2004 are subject to 6 years of investment because both contributions will be available for investment for FYs 2004 through 2009.

² This factor is calculated using the standard mathematical formula for the compounding of interest assuming a 1.613 percent difference between short-term and long-term rates. The factor increases for the number of years of the investment. For example, funds invested in FY 2009 will earn 1.613 percent additional interest for 1 year whereas funds invested for FY 2008 will earn 3.252 percent additional interest (1.613 percent compounded for 2 years).

The MERHCF will receive approximately \$8.0 billion in normal cost contributions from the Military Departments during FY 2003 that will be sufficient to cover FY 2003 payments for health care. The normal contributions will continue in the future. However, the loss of \$6.9 billion in estimated investment income will have a direct and material effect on the size of the MRHB unfunded liability in future years because DFAS will not have the additional interest income to invest that could reduce the liability. DFAS did not present a target interest rate or time frame when it would change its investment strategy. DFAS informed us it planned to continue to invest in short-term securities until interest rates rise.

Accordingly, we concluded that the Under Secretary of Defense (Comptroller)/Chief Financial Officer should direct DFAS to comply with DoD investment policy for the MERHCF that focuses on the long-term needs of the MERHCF. The Under Secretary of Defense (Comptroller)/Chief Financial

Officer should also issue oversight procedures to ensure that DFAS complies with the investment policy.

Recommendations, Management Comments, and Audit Response

We recommend that Under Secretary of Defense (Comptroller)/Chief Financial Officer:

1. Direct the Director of the Defense Finance and Accounting Service to comply with DoD investment policy for the DoD Medicare Eligible Retiree Health Care Fund.

Management Comments. The Under Secretary of Defense (Comptroller)/Chief Financial Officer nonconcurred and stated that the Department's investment policy does not require investments to be made in 10- to 20-year Treasury securities. The Department's investment policy states, "The purchase and sale of securities will be made to coincide with the needs of the Fund, but deviation shall be allowed at the time of major yield shifts in the market." The Under Secretary stated that the DFAS Trust Fund Accounting Directorate considered the approximately 7 percent decrease in yields from the mid-1980s to September 30, 2002, a major yield shift in the long-term market. Because long-term yields were so low at the time, the DFAS Trust Fund Accounting Directorate made the decision to purchase short-term U.S. Treasury securities and overnight securities. Further, the Department is trying to maximize its investment yield during a period of low long-term rates.

The Under Secretary of Defense (Comptroller)/Chief Financial Officer stated that the MERHCF has no historical data to track expenditure data. Thus, if the total \$14.4 billion was invested in long-term securities and estimated expenditure data accounted for higher than expected amounts, the possibility exists that the long-term securities would have to be sold to cover the shortfall, which could produce a loss of principal to the fund.

The Under Secretary stated that DFAS uses a publication from Bank Credit Analyst (BCA) Research as a guide for strategic planning of its investment portfolio. With yields at all time lows, DFAS purchased short-term securities with the anticipation of rates going higher in the near future. The Under Secretary stated, "Our contention is we are not experts in predicting future yields, but we want to make sound financial decisions based upon relevant data available to us."

Audit Response. We do not agree with the Under Secretary's comments. DFAS investment personnel stated that they were calculating the yield shift over a 20-year period. We believe that the use of a long span of time to show a major yield shift is not realistic. Federal Reserve research indicates that major yield shifts in the rates are normally evident when short-term rates are equal to or greater than long-term rates rather than when the rates fluctuate over a long period of time. As shown in the Graph on page 6, a major yield shift occurred in the year 2000 when

short-term and long-term rates were nearly equal. Since 2000, the yields from long-term rates have shifted higher versus short-term rates and as of June 30, 2003, the yields from long-term rates were 3.1 percent higher than the yields from short-term rates.

The Department's investment policy allows DFAS to select investments having maturities suitable to the cash disbursement needs of the program financed with the account. Additionally, the MERHCF had no historical data to track expenditure data. However, we believe there is low risk that long-term securities would have to be sold to cover a shortfall that could produce a loss of principal to the fund. Actuarial projections provided to the Fund managers show that funds will be available. Specifically, in addition to the annual direct contributions from Congress of \$14.4 billion for 2003 and \$14.9 billion in 2004, the MERHCF will receive approximately \$8 billion in normal contributions during FY 2003 and \$8.3 billion in FY 2004. These normal contributions will continue in future years and are more than sufficient to cover anticipated disbursements from the MERHCF. We included data in the report that show that the Office of Management and Budget projected \$4.4 billion in outlays from the MERHCF in FY 2003. The \$4.4 billion in expected FY 2003 outlays is \$3.6 billion less than the expected FY 2003 normal contributions. The Office of Management and Budget projected that outlays from the MERHCF will be \$4.8 billion in FY 2004 and \$5.0 billion in FY 2005. As a result, annual normal contributions will continue to cover the disbursement needs of the MERHCF for the foreseeable future. DFAS needs to determine how much of the surplus normal contributions should be invested in long-term securities.

We continue to believe that DoD should have invested the initial \$14.4 billion amortization contribution in accordance with DoD investment policy that states, "Investments shall normally be in the 10- to 20-year range. This will give the Fund the benefit of higher long-term rates and allow the Fund some liquidity in its long-term portfolio." The DoD investment policy allows more liquidity by recommending 10- to 20-year investments rather than 30-year investments. The investment policy is also consistent with Department of Treasury policy and would ensure that investments were matched to the long-term needs of the MERHCF.

We also do not agree with the decision to purchase short-term securities with the anticipation of long-term rates moving higher in the future. DFAS made its decision for FY 2003 based on its interpretation of research provided by a private company. However, on December 11, 2002, the research company warned that the Federal Reserve Board was concerned with deflation and stated "Moreover, contrary to market expectations, the Fed is unlikely to raise rates in 2003." In June 2003, the research company also provided warnings of possible deflation and lower interest rates. The research company warnings were consistent with Federal Reserve Board pronouncements and economic forecasts. On June 25, 2003, the Federal Reserve Board reduced the Federal Funds rate by another .25 percent.

We do not agree with the DoD position to continue to invest in daily and other short-term securities throughout FY 2003. DoD needs to formulate a strategy that focuses on the long-term needs of the MERHCF. We ask that the Under Secretary of Defense (Comptroller)/Chief Financial Officer reconsider his position and provide additional comments.

2. Issue oversight procedures to ensure that the Defense Finance and Accounting Service complies with the investment policy for the DoD Medicare Eligible Retiree Health Care Fund.

Management Comments. The Under Secretary of Defense (Comptroller)/Chief Financial Officer nonconcurred and stated that the MERHCF Board of Actuaries reviews the investment strategy and its results annually. Additional oversight procedures are not necessary since there is no indication that the current oversight is not working.

Audit Response. The MERHCF Board of Actuaries is an advisory board and does not have authority over DoD investment decisions. The Board of Actuaries is not accountable for DFAS investments and so it does not provide oversight. Further, annual reviews do not constitute adequate oversight. For example, on August 23, 2002, DFAS provided information about the DFAS investment policy and strategy to the DoD Medicare Eligible Retiree Health Care Board of Actuaries. However, as indicated in the report, the Board was informed in the August 2002 briefing that DFAS planned to invest in 2 to 3 year securities. This was never done, and the Board did not provide the oversight necessary to ensure that the decision was implemented. DFAS also did not provide details about its investment policy to the Board.

We believe that the oversight should be performed by the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. The Under Secretary needs to issue oversight procedures that ensure that there is adequate monitoring of the DFAS investment decisions. Specifically, oversight procedures should ensure that DFAS complies with Department of Treasury guidance. DFAS is required to estimate the timing and amounts of disbursements from the MERHCF not less frequently than annually. Additionally, the oversight procedures should require oversight and review of any determination of major market yield shifts, ensure DFAS has a strategy to properly manage risk, contain written decision rules on when to invest, and provide procedures that specify that DFAS must retain enough of a contingency to protect against any potential shortfall that would result in the loss of principal.

We ask that the Under Secretary of Defense (Comptroller)/Chief Financial Officer reconsider his position and provide additional comments.

Appendix A. Scope and Methodology

The objective of the audit was to determine whether DoD established effective quality controls over the estimation of the Military Retirement Health Benefits liability. However, on April 21, 2003, Deloitte and Touche LLP (Certified Public Accountants) was awarded a contract to audit the Medicare Eligible Retiree Health Care Fund for FY 2003. The statement of work on the contract requires Deloitte and Touch LLP to complete an assessment on the Military Retirement Health Benefits liability. As a result, we limited the scope of our audit to an issue that will not be addressed by the Deloitte and Touche LLP contract. We also reviewed compliance with applicable laws and regulations related to the MERHCF.

We reviewed the DFAS procedures related to the day-to-day management of the MERHCF. We completed analyses of prevailing interest rates. We estimated the amount of potential investment income for the MERHCF for the 6-year Future Years Defense Program. We used actuarial documents provided by the Office of the DoD Actuary in our analyses.

We performed this audit from October 2002 through May 2003 in accordance with generally accepted government auditing standards.

Use of Computer-Processed Data. We verified DFAS trial balance records as of March 31, 2003, to Department of Treasury reports. The data were reliable enough for our audit objectives. We did not complete a formal assessment of DFAS systems or Department of Treasury systems. We also did not test the general and application controls.

Use of Technical Assistance. The Quantitative Methods Division of the Office of the Deputy Inspector General for Auditing reviewed the methodology we used in determining the potential lost investment income.

The methodology we used to estimate the lost investment income over 6 years employs the average difference between long-term and short-term interest rates as a constant. If this difference were greater than the average in the first years of the timeframe, then the actual lost income would be greater than our estimate. Conversely, if the difference were smaller in the first years, the actual loss would be less than the estimate. We recognize the existence of more sophisticated methodologies that would address the potential variability of the difference in interest rates from year to year. However, considering the relatively short time period over which we estimated, we believe that the methodology we used adequately illustrates the potential loss.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the DoD financial management area.

Management Control Program Review

DoD Directive 5010.38, “Management Control (MC) Program,” August 26, 1996, and DoD Instruction 5010.40, “Management Control (MC) Program Procedures,” August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provide reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of the Management Control Program. This is the first year of the MERHCF, and DoD was in the process of establishing management controls. Therefore, the MERHCF was not included in prior-year management control reports.

Adequacy of Management Controls. We identified a material weakness for the Under Secretary of Defense (Comptroller)/Chief Financial Officer as defined by DoD Instruction 5010.40. Management controls were not adequate to ensure there was a prudent investment strategy for funds contributed to the MERHCF. Recommendations 1 and 2, if implemented, will allow the MERHCF to realize appropriate investment income in the current year and future years. A copy of the report will be provided to the senior official responsible for management controls for the Under Secretary of Defense (Comptroller)/Chief Financial Officer.

Adequacy of Management’s Self-Evaluation. This is the first year of the MERHCF, and DoD was in the process of establishing management controls. Therefore, the MERHCF was not included in prior-year management control evaluations.

Prior Coverage

The General Accounting Office issued GAO-02-1061R, “Health Care Fund Regulations (DoD),” on August 30, 2002. The report is available on the internet at www.gao.gov.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Health Affairs)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Defense Finance and Accounting Service

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Under Secretary of Defense (Comptroller)/Chief Financial Officer Comments



COMPTROLLER

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

JUN 26 2003

MEMORANDUM FOR DIRECTOR DEFENSE FINANCIAL AUDITING SERVICE, OFFICE
OF THE INSPECTOR GENERAL

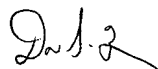
SUBJECT: Draft Audit Report on Controls Over Department of Defense (DoD) Medicare
Eligible Retiree Health Care Fund Investments

Your draft audit report recommended that I:

- Direct the Director of the Defense Finance and Accounting Service (DFAS) to comply with DoD investment policy for the DoD Medicare Eligible Retiree Health Care Fund; and,
- Issue oversight procedures to ensure that the DFAS complies with the investment policy for the DoD Medicare Eligible Retiree Health Care Fund.

I appreciate the opportunity to comment on your draft report, however, I do not concur with your recommendations. The DFAS is complying with the current investment policy. The MERHCF Board of Actuaries provides oversight of DFAS implementation of the investment policy. Additional oversight procedures are not necessary since there is no indication that the current oversight is not working. More detailed comments on the recommendations are attached.

My point of contact for this matter is Mr. Jim Ariail. He may be reached by e-mail: ariailj@osd.pentagon.mil or by telephone at (703) 693-5657.


Dov S. Zakheim

Attachment:
As stated

INSPECTOR GENERAL, DEPARTMENT OF DEFENSE (IG, DoD) DRAFT REPORT
MAY 27, 2003 (PROJECT NO. D2003FJ-0005)

CONTROLS OVER DOD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND
INVESTMENTS

DEPARTMENT OF DEFENSE (DOD) COMMENTS
TO THE IG, DOD RECOMMENDATIONS

RECOMMENDATION 1: The IG, DoD recommended that the Under Secretary of Defense (Comptroller) direct the Director of the Defense Finance and Accounting Service (DFAS) to comply with DoD investment policy for the DoD Medicare Eligible Retiree Health Care Fund.

DOD RESPONSE: Nonconcur. The IG, DoD based the draft report on one major issue. The IG, DoD states that the trust fund investment policy “requires” investments to be made in 10 to 20-year Treasury securities and that we are not following that policy. The Department’s investment policy “does not require” investments to be made in 10 to 20 year Treasury securities. The Department’s policy mirrors the Department of the Treasury Operating Circular, “Responsibilities Relating to Government Investment Accounts and Investment in Government Account Series (GAS) Treasury Securities.” The Treasury guidance states that “A program agency for a government investment account shall, to the best of its ability, develop its investment strategy so to select investments having maturities suitable to the cash disbursement needs of the program being financed through the account.” The Department’s investment policy states “The purchase and sale of securities will be made to coincide with the needs of the Fund, but deviation shall be allowed at the time of major yield shifts in the market.”

During the mid-1980's, U.S. Treasury securities were yielding more than 12 percent. On September 30, 2002, 20-year securities were yielding 4.70 percent and 10-year securities were yielding 3.62 percent. Based upon approximately a 7 percent decrease in yields from the mid-1980's to September 30, 2002, the Trust Fund Accounting Directorate considered this decrease a major yield shift in the long term market. Since long-term yields are so low at this time, the DFAS Trust Fund Investment Directorate made the decision to purchase short-term U.S. Treasury securities and overnight securities. Currently overnight securities are yielding more on a daily basis than securities maturing in 6 months and DFAS immediately reinvests the interest on a daily basis. It is noted that current 10 to 20-year yields at 4.7 percent and 3.62 percent are higher than the current short-term yields. However, prudent investing by purchasing the highest yields in the shortest period provides the Fund Manager the flexibility to earn interest and position funds for future long-term investments. The Department is not engaging in investment practices prohibited by the Operating Circular, such as day trading that may result in windfall gains or losses. The Department is trying to maximize its investment yield during a period of low long-term interest rates.

The MERHCF has no historical data to track expenditure data. Thus, if the total \$14,369 million was invested in long term securities and estimated expenditure data accounted for higher than

expected amounts, the possibility exists that the long term securities would have to be sold to cover the shortfall, which could produce a loss of principal to the Fund.

The Treasury Operating Circular states that it is the responsibility of the program agency to select the particular Treasury specials in which to invest. The Operating Circular further states those financial pages of newspapers and other financial news media, and on-line connections to investment banking firms may be used. The DFAS Trust Fund Investment Directorate subscribes to a publication called the "U.S. Fixed Income Monthly Report." The Chairman of the Military Retirement Board of Actuaries recommended this publication for DFAS to subscribe to and follow when appropriate. The Bank Credit Analyst (BCA) Research, who is an independent research company established in 1949, produces the product that provides a monthly forecast and analysis of trends in U.S. interest rates and fixed-income markets. It has been in publication since 1979. Subscribers include banks, money managers, savings institutions, insurance companies, governments, and corporations around the world. The emphasis of BCA is to provide an early warning of the major turning points in interest rates and bond yields. Their overview is devoted to the outlook for interest rates, the economy, inflation and Federal Reserve policy, as well as to the highlights of bond strategy. DFAS uses this publication as a guide for strategic planning of its investment portfolio. With yields at all time lows, DFAS purchased short-term securities with the anticipation of rates going higher in the near future. The BCA Research Executive Summary for June 2003 believes that recent economic indicators (i.e., deflation trend, dollar depreciation, and the belief that the Federal Reserve may actively purchase long-term bond yields) have pushed Treasury yields to new lows and likely near the bottom. The BCA also believes that Treasury yields will rise later this year as evidence emerges of a pickup in economic activity. Our contention is that we are not experts in predicting future yields, but we want to make sound financial decisions based upon relevant data available to us.

RECOMMENDATION 2: The IG, DoD recommended that the Under Secretary of Defense (Comptroller) issue oversight procedures to ensure that the DFAS complies with the investment policy for the DoD Medicare Eligible Retiree Health Care Fund.

DOD RESPONSE: Nonconcur. The MERHCF Board of Actuaries reviews the investment strategy and its results annually. Additional oversight procedures are not necessary.

Team Members

The Defense Financial Auditing Service Directorate, Office of the Assistant Inspector General for Auditing of the Department of Defense prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

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