

Haunted by the Ghosts of Future Retirees

Employers struggle with decision over offering retiree benefits while some brokers offer innovative ideas.

Reprinted from Leaders Edge - May 2005

By Molly Butler Hart

To be or not to be in retiree health care. That is the question.

Shakespeare's Hamlet, that dark and dreary Danish prince who is haunted by his father's ghost and wracked with indecision as to how to avenge his father's murder, was written half a millennium ago. But, with some minor editing, the bard might have written a similar story line for today's generation of employers. American business is haunted by the specter of ever-escalating retiree health care costs and grappling with the pros and cons of continuing coverage.

"Underfunded retiree health care liabilities present a significant risk to the bottom lines of many of the U.S.'s major companies," says Lynn Turner, managing director of research at proxy consulting firm Glass Lewis & Co and former chief accountant at the Securities and Exchange Commission.

How much of an impact? General Motors' obligation for post-retirement health benefits is more than twice the company's net worth. GM's post-retirement health-care obligation was underfunded by \$57.5 billion at the end of 2003, according to a recent analysis by Credit Suisse First Boston.

And GM is not alone. A Glass Lewis review of corporate disclosures by 213 large U.S. companies shows many with significantly underfunded retirement health care obligations and, hence, liabilities. "These are having a meaningful impact on current cash flows," Turner says.

Benefit brokers are divided as to how to help their clients grapple with the issue. "I counsel clients to think long and hard about the long-term ramifications of either providing or continuing to provide health care benefits for retirees," says Bob Harnett, senior vice president and director of employee benefits for the mid-Atlantic region of Riggs, Counselman, Michaels & Downes.

Harnett's clients are mid-sized companies with 200 to 6,000 employees. "If a client can withstand the negative public relations fallout or any potential loss of a competitive edge, I generally recommend terminating or not instituting retiree health benefits," he says. The rationale is that by age 65, retirees have access to Medicare.



If an employer is not inclined to take that step, Harnett works to structure a limited self-funded plan that folds into Medicare Part A, which covers inpatient care at age 65, and that requires retirees to enroll in Medicare Part B, which covers doctors visits and outpatient services. Seniors are automatically enrolled in Medicare Part A but must sign up for Part B. By installing time limits and a spending cap, employers can more effectively contain their costs. Employers with more paternalistic leanings can pay for or subsidize premiums for Medicare Part B.

Harnett's approach is not unusual. The share of employers offering retiree health benefits has declined from 66% in 1988 to 36% in 2004 according to a Kaiser Family Foundation survey. "Even when employers are maintaining benefits, retirees are seeing significant increases in premiums and cost sharing, deductibles and co-pays for prescription drugs," says Tricia Neuman, who heads the Medicare division of the Kaiser Family Foundation. Kaiser's annual survey of retiree health benefits showed 79% of firms increased their retirees' contributions for premiums in 2004 and 85% expect to do so in 2005.

The volatility of retiree health care costs makes them particularly difficult for companies to plan for. Accounting rules require employers to accrue a particular amount each year based on projections of future health care costs.

"A 10% increase in short-term cost could result in a much more significant increase in actual expenses in a particular year," says Steve Coppock, health management consultant with Hewitt Associates. "This type of volatility is having a direct negative impact on the bottom line and driving employers away from providing retiree medical benefits."

Carve It Out

Sam Fleet, president of National Employee Benefit Companies, recommends that employers take a different approach by carving the retiree community out from the active employee plan and moving retirees to a fully insured plan. "That way we can pool this group [retirees] with a larger population, thus spreading the risk and stabilizing premium increases," Fleet says.

Insurance benefit brokers and consultants for years have encouraged decision-makers to keep retiree medical benefits combined with active employee populations in corporations' self-funded plans. To Fleet, that strategy made sense when retirees comprised a much smaller portion of the overall employee benefit pie and lived only a few years past 65. "But today the retiree population is growing fast and employer funding liabilities are growing along with it, necessitating a change in strategy," he says.

Financial Accounting Standards Board Statement 106 requires that employers accrue retirement benefits for both active and retired employees and value the cost of all post-retirement benefits in their financial statements as a liability. Typically, claims for retirees are considerably higher than claims for active employees. Moving the retiree population into a separate, fully insured plan allows employers to value the policy premium as the obligation—a number which is fixed and over which employers can exert

more control. “Without the higher risk factors and higher claim levels the retiree population brings, costs for active employees, and hence FASB 106 obligations, can drop significantly,” Fleet says.

As an example, Fleet points to one Fortune 500 automotive supplier whose health care-related costs were estimated to rise from under \$10 million in 2000 to more than \$20 million by 2007 if there were no changes in its current benefit plan. Including accounting amortization and interest expenses, the total costs would rise to close to \$35 million. By segregating retirees and insuring them as a separate group, that company can develop a plan that limits the employer’s contribution to a fixed amount and caps costs at \$10 million the first year, with an additional \$4 million in savings forecast for 2006 and 2007, Fleet explains. “By holding down FASB 106 and interest expenses, the company will save an additional \$20 million by 2007,” he says.

Vince Cerilli, a benefits broker with Retiree Health Benefits in Cranston, R.I., has been successful using Fleet’s strategy, although he adds that it requires a good deal of lead time. “I spend a good amount of time telemarketing and prospecting, looking for companies that have retiree health programs and then running the numbers to see if our program can better their bottom line.”

He structured a program for professionals at Bethlehem Steel and re-organized the retiree health benefit program for Menasha Corp., a packaging company in Wisconsin.

A Plan to Fit the Goal

There is a school of thought that says health care benefits can also serve as an effective workforce management tool, either facilitating early retirement or encouraging employees to stay until age 65—or beyond—depending on a company’s workforce needs and corresponding plan design.

“In considering whether to continue providing retiree medical subsidies, it’s critically important for an employer to answer two simple questions—‘How much can we spend?’ and ‘Whom do we want to spend it on?’” says Allen Steinberg, retirement and financial management consultant with Hewitt Associates.

Employers often suffer sticker shock from their total retiree medical costs and lose sight of the fact that many of those costs are for existing retirees or those near retirement. However, the cost of a well-designed subsidy for the rest of the workforce can be modest—and manageable, Steinberg stresses.

If a company is restructuring its workforce and wants to encourage early retirement, Harnett suggests the program be very carefully structured and targeted to keep costs in line. In his view, this means the plan must be self-funded and therefore subject to ERISA rules rather than to various state mandates.

“If it’s under ERISA, then the client can be very specific about who is covered and for how long, which is critical,” Harnett says.

Prescription for the Future

All agree that the real clincher in retiree health care in the last few years has become prescription drug coverage. The Medicare Modernization Act of 2003 created a new Medicare drug benefit to begin in 2006 and established financial incentives for businesses to continue to provide drug coverage to their Medicare-eligible retirees. Retiree coverage was a key issue in crafting the legislation because of concerns that the new drug benefit could accelerate the erosion of employer-sponsored coverage.

A recent survey by Deloitte Consulting shows that 90% of employers currently offering their retirees prescription drug coverage intend to continue offering it after the new Medicare Part D drug coverage is available in 2006. Of those employers, 55% either have decided on or are leaning toward continuing a prescription drug plan for their retirees and receiving the 28% subsidy offered under Part D for those benefits. About 20% are considering supplementing the Part D drug plan with an employer benefit, usually referred to as the “wrap-around” or “Medicare coordination” option. About a quarter of employers are still undecided.

Brokers play a critical role in helping clients navigate through complex decisions on retiree health benefits. Clearly, one approach won’t fit all scenarios. A company would not insure retirees separately, for example, if their claim costs were less than those of the active population. Nevertheless, many companies never hear about creative solutions like retiree carve-outs from brokers and benefits consultants.

“No one is calling the CFOs and saying I can solve your retirement funding problem,” Fleet says. “By focusing on solutions rather than specific products or services, brokers can break through the crowd.”

The Medicare Part D Drug Formula

First aid for employers who offer retiree benefits.

To encourage employer participation in the prescription drug game, the new Part D drug benefit offers several options. Employers can receive a subsidy for each Medicare eligible retiree who remains in the employer’s prescription drug plan and does not enroll in the new Medicare Part D benefit. To receive the 28% subsidy for the cost of each retiree’s prescription drug plan, the employer’s benefit plan must be equivalent to the Part D plan. Alternatively, employers could simply supplement the Medicare drug benefits by covering part of the Medicare Part D deductibles and co-payments. Employers also could directly create or contract with others to offer a prescription drug plan that would operate under the rules for commercially available Medicare Advantage drug plans.

Court Halts Retiree Health Rule Change

In response to a lawsuit by AARP, a federal judge barred in February the Equal Employment Opportunity Commission from issuing a new rule that would allow employers to drop or reduce health care coverage for Medicare-eligible retirees.

The court's action means the EEOC must wait at least 60 days to publish the rule, which would nullify a 2000 federal appeals court's decision that Erie County, Pennsylvania, violated federal law by providing richer health benefits to retirees who were not yet old enough to qualify for Medicare.

Corporate employer groups, struggling to cover ever rising health care costs, took a blow with the ruling. They warned that not being able to drop coverage when retirees become eligible for Medicare would ultimately create a disincentive for employers to provide health benefits for any retirees, such as those younger than 65. "We took this action to protect our members and all retirees from losing their rights under the age discrimination laws," says David Certner, AARP's director of federal affairs. "This would have put millions of retirees at great risk for losing their retiree health coverage."

Says Mark Ugoretz, president of the ERISA Industry Committee: "If employers are prohibited from coordinating their health benefits and providing a bridge to Medicare, they are more likely to decrease coverage for their entire population."

By the Numbers

Recent Employer Changes in Retiree Benefits

8% have eliminated subsidized health benefits for future retirees in 2004

11% expected to terminate coverage for future retirees in 2005

79% have increased their retirees' contributions for premiums in the past year

85% expected to increase their retirees' contributions in 2005

53% have increased co-payments or co-insurance for prescription drugs in 2004. 49% expected to do so this year.

37% raised deductibles for health care services in 2004. 43% expected to do so this year.

13% changed their plans in the past year to offer retirees access to group health benefits with retirees paying 100% of the costs. 18% expected to do so this year.

Source: Kaiser/Hewitt 2004 study of retiree health care benefits.