VANDERBILT Ave.
ASSET MANAGEMENT

Emad A. Zikry, President and Chief Executive Officer

RECENT DEVELOPMENTS IN RETIREMENT HEALTH CARE BENEFITS

Among the benefits that employers have accorded employees the provision of health care, and particularly the provision of health care after retirement has become an expensive and open-ended commitment. This almost uncontrollable aspect of health care benefits has been highlighted recently by the proposal by the Financial Accounting Standards Board to require corporations to recognize the liability they have incurred on their financial statements.

This paper provides some background on the retirement health care issue, it reviews the concerns that have arisen, and it looks at some solutions that may be employed in the future to control and fund this liability.

BACKGROUND ON THE PROVISION OF HEALTH CARE BENEFITS

Corporations began adding health care coverage to their employee benefit programs in significant numbers beginning in the 1940's. As a company paid benefit, this was viewed as another means of attracting and retaining qualified employees. The coverage generally included hospitalization, doctor's fees, and medicine. Now approximately 70 percent of large companies provide this type of benefit. A typical feature of this benefit is that there is no employee contribution.

An important concept for understanding the issue of health care coverage is that it is a defined benefit in the most unrestricted form of the term. Unlike pensions that are a defined benefit in the sense of a specific dollar amount, health care is defined in terms of a real service. In other words, health care, not an amount of money to be spent on health care, is the benefit provided to the employee.

The key implication of this form of defined benefit is that the provider of the benefit has no control over its cost. Inflation in the cost of this benefit, for example, is not controlled. Besides making future costs uncontrollable, this aspect makes future costs unpredictable. Recently, the rate of increase in medical costs has been faster than overall inflation, which means that, if general inflation also is a measure of the growth of corporate revenues, that medical costs are becoming an increasingly larger part of corporate performance.

Besides being an open-ended commitment to employees, there is another difference between health care and other retirement benefits. There is no gradation related to service or salary level. Once qualified, a company's president and its janitor have the same benefit.

In addition, many companies have included family-wide benefits in their coverage. While obviously an attractive benefit, this extends the liability to younger people, and lengthens the exposure to future inflation in medical costs.

DEMOGRAPHIC EFFECTS ON HEALTH CARE BENEFITS

When health care began to be a popular employee benefit, the work force was relatively young and the retired population was small relative to the working group. The cost of health care, therefore, was spread over the output of a large group of people.

As the workforce has matured, this relationship has been changing and is expected to change even further in the future. While there used to be three workers for each retiree, there are now only two. Moreover, people are living longer. Thus the incidence of medical costs for each retiree is rising.

Offsetting the effect of the aging workforce somewhat, is the creation of Medicare, which provides for some health care for those over the age of 65. But, with more early retirements, the period from 55 to 65 is a particularly expensive one for corporations.

THE FINANCING OF HEALTH CARE COSTS

There is little dispute that health care for the aging is an appropriate endeavor for a civilized society. The question lies in which group or groups should bear the cost. The individual can attempt to save for adequate health care in later years. But, the uncertainty of future costs and the randomness of health care needs make individual saving an inefficient approach and require a form of insurance program.

Employer paid coverage has the advantage to the employer and the employee of being tax deductible. As the provision for individuals to deduct medical expenses has been curtailed, the pretax benefit of medical insurance that a corporation can deduct from its expenses is attractive. Although corporations can provide tax deductible coverage, the deduction only occurs when there are actual cash outlays. Hence, there has been no incentive for the corporation to prefund these expenses by creating a reserve when it incurs liabilities.

To the federal government, however, the deductibility of these expenses reduces tax revenue at a time when the budget deficit is still wide. Government financing of medical costs has been partly introduced with Medicare and Medicaid. More extensive programs are in the process of being discussed.

PRESENT VALUE OF FUTURE BENEFITS

The present value of benefits to be paid to retirees in the future is a difficult number to calculate. Included in this figure must be estimates of the amount of health care to be provided in the future, the cost of health care, the timing of those benefit payments, and the discounting of the payments to the present. Estimates of this discounted present value for all corporations range widely, from $250 billion to $2 trillion, the latter figure coming close to the value of total pension liabilities. To put this in perspective, if the present value was thought of as a liability on the books of the corporate sector, it would extinguish about half of the corporate sector's net worth.

THE PROPOSED FASB RULE ON HEALTH CARE LIABILITIES

Bringing the issues of retirement health care to the front burner has been a proposal by the Financial Accounting Standards Board to reflect the commitments made by corporations to their employees on their financial statements. This stems from a concern by the Board about the growing liability and the need to recognize it on the balance sheet as the liability occurs. This would provide some reflection on the balance sheet for the future financial cost of retirement health care benefits.

The proposal would become effective in 1992, after a period for comment and review. It would require corporations to begin showing an annual expense for the retirement health care liability incurred each year. The expense would also include amortization over 15 years of the initial liability outstanding net of any assets held to meet this obligation. The annual expense would affect the income statement for book purposes, but would not affect the tax liability of the corporation.

The proposal provides a uniform method for measuring the cost of future benefits. As with pension liabilities, it uses a discount rate drawn from the yield on a high-quality fixed-income security.

Beginning in 1997, the FASB proposal requires recognition of a minimum liability for future health care on corporations' balance sheets. This will be matched with an intangible asset representing the value to the company of providing this benefit.

CONTROLLING FUTURE COSTS WITH PLAN CHANGES

While outstanding liabilities and the policies of companies will require financial solutions for the payment of future health care liabilities, which will be discussed below, corporations can also begin thinking about ways to change their benefit programs to get control of future expenses.

Corporations are likely to review carefully their medical programs. First, they can divide their employees into three groups: retirees, active employees, and future employees. Changes to medical programs for these three groups can be progressively wider in scope. While collective bargaining agreements, corporate policies, or other factors may limit changes for current retirees and active employees, changes for future employees, while grandfathering current employees, may well be possible.

For current employees, corporations may begin relating future benefits to length of service, possibly by making contributions to the reserve fund based on service.

Other changes that benefits managers can consider range from shifting to a defined contribution approach, to employee cost sharing, and to the development of "wellness" programs for improving employee health habits.

Employees can be offered a cafeteria benefit program in which corporate funds for benefits can be allocated to various programs depending on the preferences of the employee, with retirement health care as one of the options. Simple changes in medical benefit programs can also make modest improvements such as raising the deductible and requiring a mandatory second opinion before surgery.

INVESTMENT RELATED ISSUES FOR PREFUNDING

With respect to investment approaches for meeting the funding requirements of retirement health care, a number of key issues emerge. First of course is the difficulty of estimating future health care needs. Not only do they depend on the longevity of the workforce but also on advances in medical care. In future years, medical treatments that are unknown today may be considered normal and necessary.

A second part of this estimation problem is a projection of cost increases for medical treatment. The expansion of private and public health care insurance has itself put upward pressure on prices and this is likely to continue. The inflation issue suggests that investments should have returns positively related to the rate of growth in prices, and in particular, the growth in medical care prices.

In laying out a program for funding of expenses in the future, critical importance must be paid to the power of compounding. Because costs are expanding at a compound rate, the assets needed to pay for them must also. Hence, as with everything else dealing with the future, the earlier funding can begin the easier costs can be met in the years ahead.

An even more intractable problem is estimation of cash flow timing for benefits in the future. Only very rough estimates based on the age pattern of the employees can be made.

There is also the question of whether there can be a funding integration with a company's pension plan. With many companies having an overfunded retirement plan, there is natural interest in using some of these funds to pay for health care benefits. The new FASB statement will require a separate and distinct pool of assets for health care benefits. Transfers from pension assets to health care accounts may be possible. But, opposition from retirees is likely since these funds are meant to support their benefits and may be the basis for benefit improvements in the future.

INVESTMENT APPROACHES TO FUNDING

There are two prefunding options that a corporation may be able to pursue to set aside assets for the provision of retirement health care. The first allows a tax deduction for a limited contribution. The second offers a promising means for corporations to use prefunding to meet their liability.

The Internal Revenue Service, under section 401(h), will allow a tax-deductible expense for a contribution providing for retirement health care, and these funds can accumulate untaxed. The amount of the contribution, however, can not exceed 25 percent of the corporation's pension fund contribution. This is a major limiting provision, because most pension funds are significantly overfunded. Combined with a maximum that assets can exceed liabilities, the amount of pension contribution is limited and in most cases corporations are not currently making a contribution. With no pension contribution being made, no health care contribution can be made. While there may be some means of circumventing this restriction for some companies, it is unlikely that this will turn into a major channel.

The more interesting potential approach is the use of Voluntary Employee Benefit Associations (VEBAs). These are trusts that have been used for many different types of benefit programs. They have the advantage of having the contribution be tax deductible. They exist under section 501(c)9 of the tax code. While there are restrictions on the amount of the tax-deductible contribution, the limits, which relate to the amount of liability, are not anywhere near as restrictive.

The disadvantage of VEBAs is that income earned on the assets in the trust is taxed at the corporate tax rate. This is a critical problem because over the long period of time that a program like this runs, the income and reinvestment of income are much larger components of the overall value of the fund than the initial principal investment. Corporations may offset this by purchasing tax-exempt instruments such as municipal bonds. The resulting reduction in the earnings from these tax-advantaged vehicles is a negative, however.

An alternative that responds to this problem is an insurance contract held by the trust. Increases in value of an insurance contract are tax-deferred. Making this a flexible approach is the ability to separate the insurance contract, called a wrap-around, from the management of the investments. Thus, the plan sponsor can structure investments that most efficiently provide for the type of liability that retirement health care engenders.

SUMMARY

The commitment corporations have made to provide health care in retirement for their employees has resulted in a large and difficult to estimate future liability. The FASB has proposed greater accounting for this liability. Corporations will begin moving on many fronts to attack this problem. Changes in plan structure, revisions in qualification requirements, prefunding, and development of investment plans will be actively pursued. Recent developments promise an exciting and ultimately beneficial period of activity for those involved in retirement health care benefit planning.

Vanderbilt Research Team