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*A Mercer Perspective
on Retirement*

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Health & Benefits



Rx for retiree health care: Diagnosing the issues

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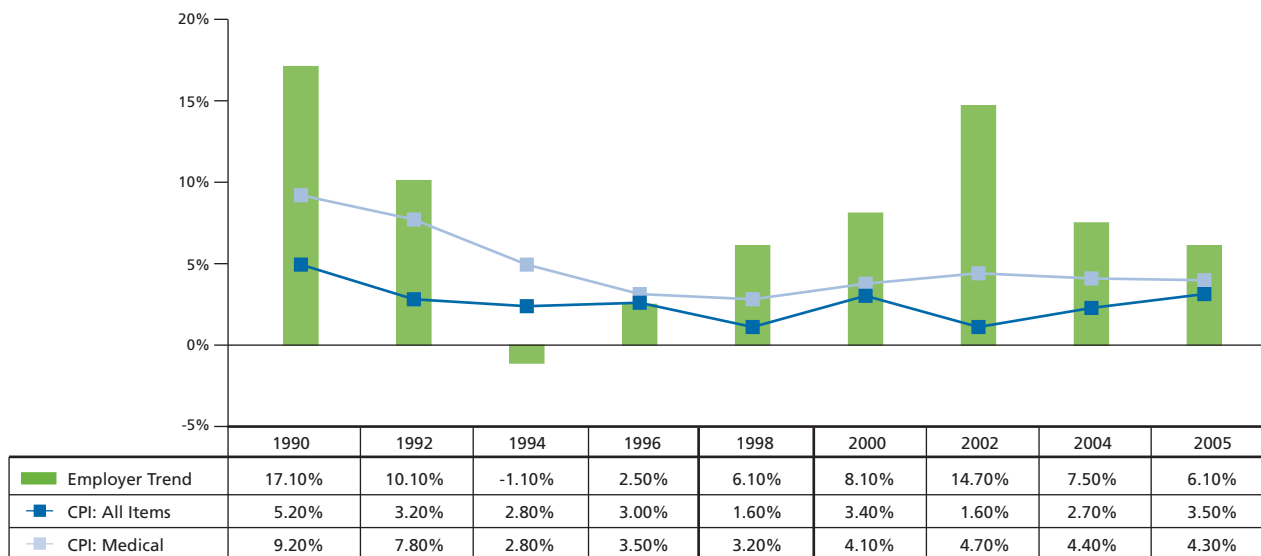
What's the right thing for an employer to do?

Let's start with the good news: Retired Americans are living longer than ever. The major causes of death in the United States – heart disease and cancer – are increasingly amenable to treatment and prevention. And, on average, Americans turning age 65 today are expected to live four years longer than they did 40 years ago. Despite eating more (and, sometimes, better), sleeping too little and generally ignoring doctors' good advice, we are enjoying longer life expectancy due to medical knowledge and technology. For all its flaws, our health care system performs miracles every day. Even as we struggle to pay the bills, we see that in many cases we're buying longer, higher-quality lives for ourselves and our loved ones.

Against this robust picture, employer-sponsored health care for retirees is said to be declining steadily or, at least, stagnating. Why? Health care costs continue to outpace general inflation (see Chart 1 below), devouring an increasing portion of our GDP (see Chart 2 on Page 2). In the face of this inexorable force, some low-margin, competitive or struggling industries are eliminating postretirement health care coverage (see Chart 3 on Page 2), leaving future retirees to patch together their health care safety net from a combination of Medicare, personal savings, private insurance, and the kindness of relatives and charities.

Some blame the Financial Accounting Standards Board for the crisis, citing its 1987 Statement No. 106, which forced companies to measure the amount of their postretirement health care obligations and to account for them like other contractual obligations on the balance sheet. When companies finally took a look at the picture, they realized what these long-range promises (see Chart 4 on Page 2) were costing, and many decided that they couldn't responsibly continue to make these promises. The Government Accounting Standard Board (GASB) is triggering a similar assessment among state and local governments beginning in 2007. Under the new GASB 45 accounting standard, state and local government employers must account for and report postretirement medical expenses, using actuarial life-expectancy evaluations to determine future accounting costs. These must be recorded over the working span of employees.

Chart 1 – Health care cost inflation

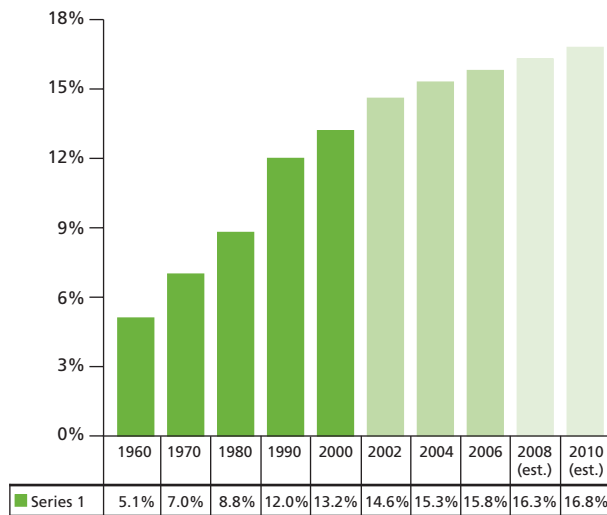


Source: Adapted from United States Department of Labor Bureau of Labor Statistics and "National Survey of Employer-Sponsored Health Plans" Mercer, 2005

As a result, companies are rapidly reducing or eliminating their share of this obligation, for reasons that have been widely discussed. The remainder of the cost will be borne elsewhere – through individually purchased insurance, out-of-pocket expenditures, charitable care or governmental programs.

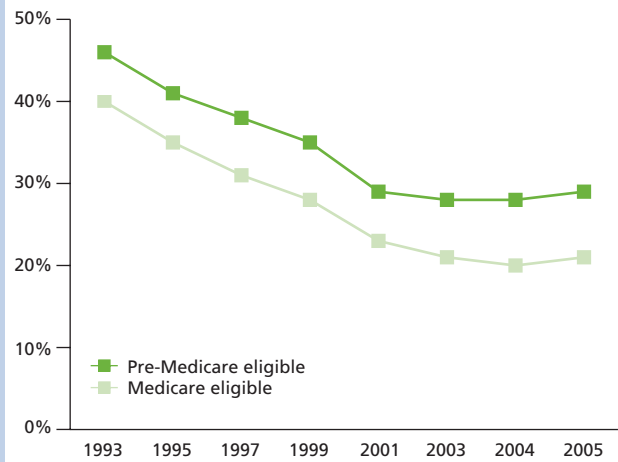
So what's the right thing for an employer to do? If companies no longer have to offer postretirement health care coverage to compete for workers, then why offer it at all? In this *Perspective* we ask the question how should a company determine whether it is right to provide health care benefits for retirees? Is no coverage always the right answer?

Chart 2 – Health care cost spending as a percentage of GDP



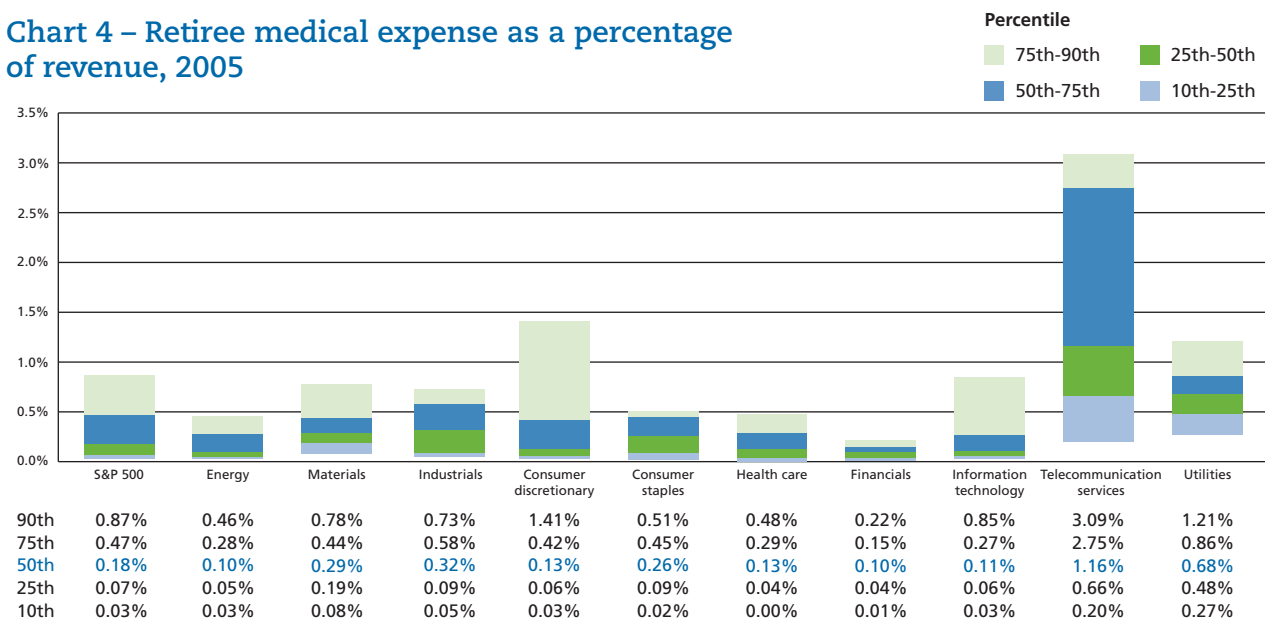
Source: Adapted from Centers for Medicare & Medicaid Services, "An Overview of the United States Health Care System: Two Decades of Change 1980-2000"

Chart 3 – Prevalence of retiree medical plans (for employers with 500+ employees)



Source: "National Survey of Employer-Sponsored Health Plans" Mercer, 2005

Chart 4 – Retiree medical expense as a percentage of revenue, 2005



Source: "How does your retirement program stack up?" Mercer, 2006

The big picture: Analyzing relationships

Let's look at the big picture. Retiree health care coverage is really just part of a larger transaction – the employment transaction – that has two key parties: the employee and the company. Also, the company has an additional role, that of the agent for shareholders.

Companies need employees, and employees are a company's most valuable asset. To lure individuals into employment, a company offers salaries, perks, various tax-advantaged retirement programs and other benefits. Companies also recognize that most individuals value access to subsidized health care coverage during employment. And they acknowledge the mutual advantage health care coverage offers to both employee and employer, providing the employee access to reasonably priced health care and allowing the company to recruit skilled workers to carry out its goals and generate profits. Using an array of vendors – insurers, administrators, consultants, etc., a company ensures that this coverage is competitive and is efficiently and effectively provided. So far, so good.

But when the employment relationship ends at retirement, should the coverage end too? To answer that question, one should consider four key questions:

1. Is there economic value to employer-provided retiree health coverage?
2. Should the employee attribute any value to this promise of postretirement coverage while working?
3. If this retiree health care promise is perceived as valuable, does the employee then act in ways that bring additional value to the company?
4. Is the additional value that the company receives worth the expense of the plan? Is the cost volatility acceptable?

If a company answers “yes” to all these questions, then offering postretirement health care coverage probably makes sense. If one or more of the answers is “no,” then providing coverage may still make sense – but not for reasons that fit into our framework. Let's take them one at a time:

(1) Is the coverage valuable?

This one is easy. Using their purchasing power over insurers (and, by extension, over providers) and spreading health care risks across an employed group that is probably healthier than the average population, companies are able to deliver health care benefits to active employees more cost-effectively than employees could find on their own.

Furthermore, by linking postretirement coverage to a minimum age and service level, the company minimizes the anti-selection that drives up rates for individual coverage. In fact, the large gap between medical costs paid by company-sponsored plans and the higher costs paid by uninsured individuals is viewed by many as one of our system's key flaws.

Extending this logic to retired employees is straightforward. Companies can, and frequently do, contract on behalf of the retirees in the same way that they do for their active employees. Even if a company charges the full cost of the coverage to the retired employee – think of COBRA coverage – many retirees find the coverage to be worth the considerable cost. Subsidizing the coverage in some way, such as by offering reduced premiums to long-service retirees, merely sweetens the deal.

Finally, postretirement health care is generally not taxable, even when received by the employee. Even defined benefit (DB) and 401(k) distributions are taxed upon receipt – but not postretirement medical coverage. So a tax deduction for the company becomes an untaxed benefit for the retiree. And if the company chooses to pre-fund the benefit through the use of a voluntary employees' beneficiary account (VEBA) or another vehicle, it can accelerate the timing of the deduction. Our current tax system encourages companies to provide this benefit.

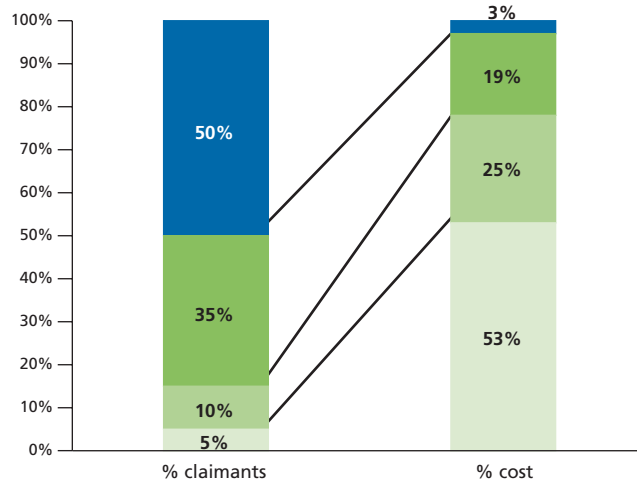
(2) Should the employee attribute any value to this promise of extended coverage while working?

So if the coverage is valuable, then we should agree that the employee will appreciate it during his or her working years – right? Well, not quite. Here are some of the factors that get in the way of employee appreciation:

- In rare instances, retiree medical coverage is written into labor or other employment agreements. In almost all other cases, any communication from the company regarding this coverage carries a reminder that it can be modified, reduced or eliminated at any time at the company's discretion. As a result, an employee will correctly surmise that a breakable promise has less value. If the company is in a competitive industry, with low and unpredictable margins, the employee may conclude that the promise will more likely than not be broken. If the company is financially strong, in an industry with good margins or little or no competition, then the perceived value of the promise should be higher. The fact that a company can eliminate coverage at any time undoubtedly affects the way an employee values the benefit. It's worth noting, however, that FAS 106 (the accounting standard governing postretirement benefits other than pensions) requires that organizations recognize the entire accumulated postretirement liability on their balance sheets, even though this may subsequently reduce their postretirement health benefits.
- In most cases, retiree medical coverage depends on attaining some key age or service threshold. If an employee's life circumstances change, he or she will have to break the contract and forfeit the coverage. Just as the company will adjust its expected obligation for expected turnover, the employee will reduce his or her own estimate of the coverage's value.
- Health care coverage is unlike other forms of compensation in that the value to individual employees isn't predictable. Some will incur high medical expenses through genuine need or an inclination to consume more available services. Health care, in fact, exhibits its own version of the Pareto principle (also known as the "80/20 rule" – 20 per-

cent of the population generates 80 percent of the costs) as Chart 5, below, shows – only 15 percent of consumers account for 78 percent of the costs. And 85 percent of consumers account for only 22 percent of the costs. So if most employees and retirees cost less than the average, then they may value the coverage less as well.

Chart 5 – Few claimants incur the majority of cost



Source: Mercer Proprietary Unpublished Data

The company and shareholder are in a bind. Anything they do to reinforce the perceived value of the promise, to generate the desired employee loyalty, has the undesired effect of reducing their legal flexibility to modify their benefits in the future. The company and shareholder must recognize an expense that likely exceeds the perceived value of the benefit to the employee. Is it any surprise that many companies seem to want to walk away from such a lopsided deal?

But let's try to frame the question differently. What if the company were willing to commit, in writing, to a plan with a capped per capita cost, subject to increases only at the company's discretion, and to specify exactly the circumstances under which this plan could be modified in the future? For example, the company will continue to offer retirees access to their health care program and will pay the first \$100 per month of the premium for retirees who work until

an age/service threshold. The plan could be dissolved only in the event of a bankruptcy filing. While still on the hook for medical inflation, the retiree would receive the \$100 per month in value, plus the considerable value of group purchasing power and pooled risk, plus the tax benefits. The retiree would also rest easier knowing that with a more predictable capped cost, the company would be less likely to view the plan as a financial time bomb and terminate coverage. This capped approach, in fact, has been widely adopted, though its virtues may not have been touted loudly enough. When viewed in this framework, it can make a great deal of sense.

And what about eligibility? Some employers have set their plan eligibility to “backload” the expense recognition. For example, some employers offer postretirement coverage that vests based on achievement of 20 years of service after age 40. In doing so, they reduce their accounting obligation – but also more closely match the expense recognition with the period of greatest perceived value to the employee.

And when viewed in this context, let’s recall that funding retiree medical benefits through a VEBA or 401(h) account can do more than just generate a tax deduction. By putting real dollars behind the employer promise, funding of postretirement health care benefits can build credibility into this promise, enhancing the perceived value of the benefit and generating the desired employee loyalty.

(3) Does the employee then act in ways that bring additional value to the company?

Does the promise of retiree coverage convince valued short-service employees to become valued long-service employees, rather than walk across the street to get a bigger paycheck? Does the plan help smooth the transition to retirement at the right time?

If the looming baby boom retirement wave is really about to pull our most skilled, experienced and connected employees out of the workforce forever, then we should welcome anything that encourages them to stay on the job a few more years. A postretirement medical plan that doesn’t unduly reward early retire-

ment, but instead provides real value and security to retirees of advancing years, will almost certainly be appreciated by older employees, and companies can help them appreciate the value of this thorough well-crafted communication.

As our retirement system continues to move away from the DB model, most companies have lost the ability to use their pension plans as a retention device. A few companies now realize that postretirement medical coverage is a meaningful way to differentiate their benefit programs from those of their competitors and have quietly extended this coverage – carefully crafted to limit their cost exposure – to their employees. For example, one of the world’s leading technology firms provides retirees coverage with a company subsidy of \$1,500 per year, which accumulates during employment and then spends down to pay for postretirement health care coverage as desired. While acknowledging that the coverage is broader in range and more expensive than many individual policies, this company notes that retirees over 65 and those with medical problems will likely find the coverage worth the expense. Certainly this type of coverage is rarely available at other similar companies, and any employee considering a job elsewhere will need to weigh the value that it provides. In an industry where large stock options and other rewards are justified as retention tools, retiree medical coverage may be able to provide a similar hook at a lower cost.

(4) Is the additional value that the company receives worth the expense of the plan? Is the cost volatility acceptable?

This is the key question, and one the company must address based on its own plans and prospects. While the media focus tends to be on outliers – organizations where other postemployment benefits (OPEB) expense is more than 1 percent of revenues – let’s remember that median 2005 OPEB expense for Standard & Poor’s 500 (S&P 500) companies is 0.2 percent of revenues and exceeds 1 percent of revenues for just a small number of companies in the S&P 500. These outliers have, in most cases, committed themselves through union contracts to lifetime “first dollar” coverage for large numbers of retirees.

Let's look at it this way: unfunded postretirement medical obligations show up on corporate balance sheets as debt – money owed by the company, in this case to current and former employees. Debt is widely used by companies to increase their leverage, make needed investments and otherwise improve return to shareholders. By taking on debt in the form of well-crafted, well-defined, cost-constrained and effectively communicated postretirement medical coverage, employers can effectively “borrow” greater loyalty and reduced wages from their employees, with the debt to be paid off in the form of this high-value promise. Much of the value of the coverage doesn't cost the employer anything – it arises through leveraged contracting with providers, risk pooling and reduced anti-selection, and tax efficiency – and in fact it is the “free” part of this coverage that the employee may value most highly. And the higher the value the employee attributes to this aspect of the coverage, the higher in value are the loan's “proceeds” to the employer.

Let's consider the renowned technology firm's program noted earlier. What is the cost to this firm for its broad-based retention program? In 2005, it was less than 2 percent of the amount expensed for stock-based compensation grants, including stock options and restricted stock. And the \$200 million benefit obligation that it represents to the company makes up about 0.5 percent of its shareholder's equity. And as previously mentioned, the program's true value for employees likely well exceeds the cost to the company.

While this type of transaction may not make sense for many organizations – those that can't credibly commit to such a promise, for financial or other reasons – it can make a lot of sense for others. And with the Medicare Modernization Act, the federal govern-

ment is offering to help employers shoulder more of the burden. When we look past the headlines and examine each company's situation on its own merits, we can see the real value of a properly structured retiree medical transaction.

In summary

So what's the best course of action for a company deciding whether to continue providing postretirement health care benefits or even considering adding retiree health coverage? Evaluating the business and social value of a postretirement plan involves many considerations, the most important being whether it supports the company's overall business objectives. This article has described the ways in which these plans can add value to a business. If a company perceives value in offering a plan but would like to limit the costs, it may decide to scale back the benefit. If minimizing cost volatility is an issue, a company can prefund the benefit or use available designs to remove the health care trend risk. Or a company may decide to use the benefit strategically during workforce reduction programs. Developing a strategy tailored to a company's unique business and human capital profile makes sense — for both the employee and the employer.

Options to consider: Health savings accounts and health reimbursement accounts

For employers that have eliminated postretirement medical coverage or are contemplating doing so, setting up health savings accounts (HSAs) or health reimbursement accounts (HRAs) can be a good way to help employees save for future qualified medical expenses. On the following page we provide a brief overview of these savings plans, including the tax implications.

Consumerism, HRAs and HSAs – a better way for retirees?

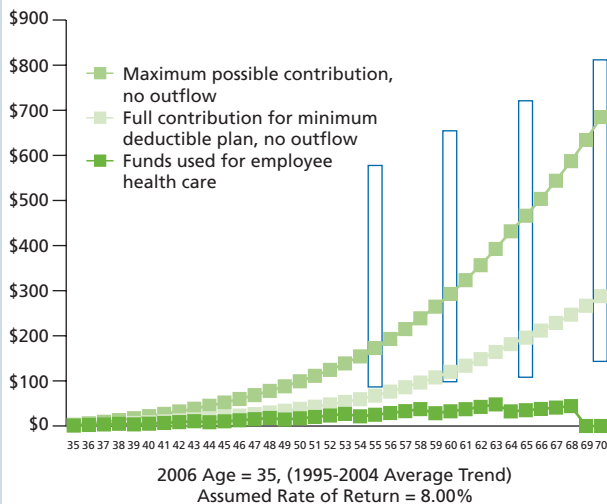
Health savings accounts (HSAs) permit employees to accumulate funds on a tax-free basis to spend on health care, including on postretirement costs. For this reason, some observers have suggested that HSAs might effectively replace employer-sponsored postretirement coverage.

While a defined contribution (DC) approach to retiree medical coverage is consistent with the overall direction of employer-sponsored retirement plans, HSAs aren't yet ready to take up the slack:

- The limit on HSA contributions is low – no greater than the consumer-directed health plan (CDHP) deductible, and sometimes lower. Such amounts cannot be relied upon to grow to the level needed for a full retirement.
- When properly used, HSA contributions will go toward covering deductibles, co-pays, over-the-counter drug costs, etc. Employers can't restrict the use of these accounts to ensure that they are used to cover retiree costs.
- Even the "catch-up" contributions now permitted for those over 55 are capped at \$600 per year and will top out at \$1,000 in 2009. Little time to accumulate investment earnings doesn't allow most retirees to catch up.

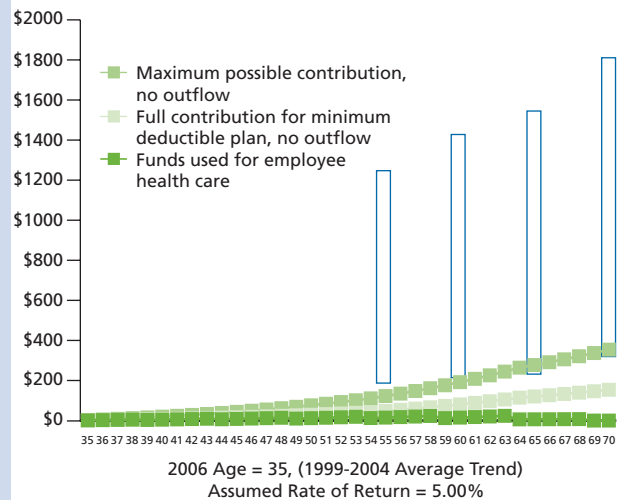
The illustrations below show the accumulation and spend-down patterns of a sample HSA. For this illustrative employee, who diligently puts away the maximum legal contribution each year, doesn't spend any of it to cover ongoing costs, and earns 8 percent each year, the HSA appears to provide the solution; that is, the employee accumulates the right amount to cover future retiree health care costs. But this outcome is only as likely as the circumstances that would make it possible. Which is to say, not likely at all.

HSA accumulation (\$000s) under various savings scenarios



Source: Mercer Proprietary Unpublished Data

HSA accumulation (\$000s) under various savings scenarios



Source: Mercer Proprietary Unpublished Data

But what about health reimbursement accounts (HRAs)? While similar to HSAs in that they can't cover postretirement costs if they are drawn down during active employment, HRAs are not subject to the same contribution limits and coverage requirements as HSAs. Some employers, especially those with union workers, are tentatively implementing HRA arrangements with the intent that they will someday evolve into a credible postretirement medical plan.

Editorial policy

The Mercer *Perspective* on Retirement series contains articles written by senior Mercer consultants that reflect their unique insights and observations on a variety of important topics affecting retirement and benefit programs. The views expressed do not necessarily reflect the views and policies of Mercer Human Resource Consulting, Inc.

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