Providing Health Care Benefits in Retirement

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Chapter 2
Introduction to Retiree Health Benefits

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This discussion offers a brief overview of employer-provided retiree health benefits, describing what they look like, who is likely to receive them (and why), and the immediate and long-term issues that they pose for employers, employees and the economy. It also aims to set the stage for those who are not employee benefits professionals, to give a common context for the substantive matters that will be explored in the chapters and commentaries that follow. This overview speaks in generalities, to give a sense of what is "typical." In fact many, and perhaps most, real-life situations depart from the norm to greater or lesser degrees.

Retiree Health Coverage: A Roadmap

Retiree health plans often are continuations of the health coverage that the employer provides for similarly situated active workers, but just as often there are distinctions in the retiree coverage that reflect the special needs of that population. In particular, all employer-provided retiree health coverage is designed around Medicare or its absence.

The 800-pound gorilla in the retiree health coverage field is the federal Medicare program. Virtually all Americans aged 65 and older are entitled to hospitalization insurance under Medicare Part A, paid for by the Medicare Trust Fund. They also are eligible for major medical insurance under Medicare Part B, which is funded in part by premiums paid by enrollees and, therefore, is voluntary.[1] If a retiree has Medicare and other coverage that overlaps it, Medicare is the primary payor, that is, it pays an eligible claim first and the other coverage pays any remaining balance. So, retiree health plans most commonly distinguish between coverage for retirees who are Medicare eligible and those who are not.

Medicare-Covered Retirees

Employer plans for Medicare-covered retirees recognize substantial savings from the fact that Medicare pays its share of a claim first, leaving only deductibles and copays to be picked up by the employer's plan.[2] In addition, employer plans cover items for over-65 retirees that Medicare excludes, such as prescription drugs. Some plans even cover retirees for items that are not part of the employer's general health benefit plans for active employees.

Some retiree health plans reimburse the Medicare Part B premiums for the retiree and, if the plan has dependent coverage, for the retiree's spouse. This is not only a valuable benefit for the retiree, but it also makes it easier for the employer's plan to coordinate with Medicare's primary coverage. In some instances, reimbursement of the Part B premiums *is* the employer-sponsored plan's coverage for retirees.

Early Retirees

Because it is so much more expensive than coverage for retirees who also have Medicare, employer-provided coverage for early retirees has been somewhat less common (except in connection with early retirement windows, as discussed later). Where it is offered, it usually is a simple continuation of the active-employee coverage (perhaps without noncore coverages, such as vision and dental) rather than a specially tailored retiree benefit package.

Financing

Many employers pay at least some part of the cost of the retiree coverage that they offer, at least for the retired employee. Some plans require contributions from retirees that are higher than what active employees have to pay. Implicitly if not expressly, this recognizes that active employees also are "paying" the employer's share, which is offset directly or indirectly against their wages. Even where the employee and retiree contributions are set at the same levels, retiree payments are effectively higher because they are after tax, whereas almost all companies now enable their employees to pay their share of the cost of health coverage on a pre-tax basis.

It is not unusual for an employer to offer retiree health coverage on a retiree-pay-all basis. The plan offered to retirees is ordinarily the employer's active-employee health plan. The ability to buy it at cost (i.e, at age-neutral, large-group rates) could be a substantial benefit for retirees. The employer plan thus becomes another option for retirees who are shopping for Medigap coverage.

Eligibility

Retiree health coverage is typically made available only to people who retire from active employment, with the company sponsoring the health plan. This means that covered retirees must qualify and apply for a pension from that company (i.e., they must have a minimum of five years of service) and that the plan sponsor essentially must be their last employer. Some companies offer retiree coverage to people who move to jobs elsewhere before returning to claim their pensions, but this is not common outside the multiemployer plan arena.

Extent of Retiree Coverage

The federal government, all state governments, and most local governments provide health coverage for early retirees and for those persons who retire after 65. This reflects the traditional pattern of public employers offering richer benefits than much of the private sector in return for lower cash compensation. It also is probably an artifact from the time when many public sector employees were not eligible for Medicare because they were not covered by Social Security.

Private employers' health coverage for retirees is much more narrow. In March 1990, the General Accounting Office (GAO) reported that companies employing 40 percent of the private sector workforce offered retiree health coverage, and that about 5 million retirees (2 million below age 65) were covered at that point by employer-sponsored health plans. Predictably, retiree health coverage was most likely to be found in larger companies: 43 percent of those with 500 or more employees had retiree health coverage, compared with 2 percent of companies with fewer than 25 employees. Retiree health coverage was more common in the manufacturing, transportation, and utilities sectors than in such service industries as construction and retail.

Although multiemployer health plans, set up under the Taft-Hartley Act to cover collectively bargained employees working for a number of employers that bargain with the particular union that cosponsors the fund, cover a much smaller percentage of the private sector work force, a companion GAO report issued in July 1990 reported that about two thirds of those plans offered retiree coverage. According to that report, about 6 percent of current retirees with employer-provided health coverage were in multiemployer plans.

Early Retirees

Despite the costs and the lack of Medicare coverage to cushion them, early retirement incentives, sweetened with promises of continued health

insurance, became an important instrument in the widespread corporate restructurings of the 1980s, continuing into the 1990s.

Some employers that pared back their workforces had labor agreements that bound them to extend the retiree-health safety net to the affected workers. Other companies might have been free, technically, to fire people without making any health care arrangements for them, and many did so. But many other employers chose to avoid the political and legal confrontations that that approach would trigger by attempting to ease people out with the offer of generous lifetime health coverage.

Funding

Employers generally have not prefunded retiree medical coverage. Unlike pensions, employer health plans have no meaningful reserves to cover the costs for retirees if the employer no longer is able or willing to do so. In part, this is because employers have, until recently, viewed retiree health coverage as a current benefit, like the active-employee coverage to which it was appended. This perspective has been shared and reinforced by Congress, which has not set vesting or funding standards for retiree health coverage, and which, in 1984, eliminated the opportunity for tax-favored prefunding for retiree health benefits.[3]

Legal Status

At present, employer-provided health benefit plans are subject to substantial regulation, but only on essentially peripheral aspects of their operations. Private sector plans are covered by the federal Employee Retirement Income Security Act (ERISA), which sets reporting, disclosure, and fiduciary standards but whose main significance in the health plan area may come from the fact that it prevents the states from regulating the plans (ERISA pre-emption). In complex, ambiguous, and often overlooked terms, section 105(h) of the U.S. Internal Revenue Code (IRC) bars self-funded plans from discriminating in favor of certain highly paid employees. Section 125 of the IRC sets ground rules for health plans funded with pre-tax employee contributions and, as noted, sections 419, 419A, and 512 govern the tax treatment of funding for health plans.

Other pertinent federal laws include Title VII of the 1964 Civil Rights Act, which prohibits discrimination in employment, benefits, and compensation based on race, gender, religion, and national origin; the Age Discrimination in Employment Act; the provisions of the Social Security Act that prescribe rules for health plans' coordination with Medicare (MSP, or Medicare Secondary Payor rules); and the Americans with Disabilities Act. On a different note, section 1114 of the Bankruptcy Code was in-

tended to provide special protection for retiree health coverage when an employer goes into Chapter XI proceedings.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), which actually was passed in the Spring of 1986, requires employer plans to give employees and their families the right to continue health coverage that they otherwise would lose when the employee terminates service (a concept that includes retirement), by paying for it themselves. Health coverage continuation under COBRA on this basis can last for up to 18 months, but it is terminable when the individual becomes covered under Medicare. COBRA coverage thus can be viewed as a type of (and prototype for) mandatory, employer-provided health coverage for early retirees. COBRA applies to the private sector and to federal, state, and local governments.

In the middle and late 1980s, employers were alarmed, and employee/retiree advocates were encouraged, by a flurry of federal court decisions that prevented employers from cutting back retiree health coverage. For a while it looked as if ERISA might be read to imply something akin to vesting in the right to retiree health coverage, or even in the right to a particular design of retiree health coverage (i.e., first dollar), if employees had not been warned explicitly, while working or at the point of retirement, that the employer had reserved the right to alter, cut back, or eliminate coverage. In the majority of later cases, the courts have tended to find that the employer has no ongoing obligation if the written plan document and summary plan description include reservation-of-rights language, at least in the absence of express commitments to the contrary in bargaining agreements or elsewhere. Nevertheless, many employers have been reluctant to alter the terms of health coverage for people who already have retired, other than passing through generally applicable plan design changes.

The Cost Spiral

Retiree Coverage Costs in General

Although employer-provided retiree health coverage predated Medicare, which was passed in 1965, its general expansion was spurred by the introduction of the federal program, which focused employees' and society's attention on the health care needs of the over-65 population, and at the same time, made it much less expensive for employers to offer to help meet those needs. As health care costs generally have exploded, however, so has the cost of even the supplementary coverage that employer plans provide for over-65 retirees. For example, the $3 monthly enrollee premium set in 1965 for Medicare Part B coverage climbed to $36.60 in

1993; in 1993, a Medicare-covered hospital patient must pay a $676 for the first-day hospital deductible under Part A, compared to the $40 deductible that applied initially. From a relatively inexpensive add-on to ease employees' transition to retirement, retiree medical coverage has become a major corporate cost item.

And, apart from the direct cost of covering Medicare-eligible retirees, the health care cost crisis has precipitated cutbacks in health coverage for active workers that make it difficult economically and from a personnel-policy perspective to continue to devote available compensation funds to relatively rich retiree coverage.

Demographic Factors

The cost of retiree health coverage is not only driven by the general pace of health care cost inflation. The happy fact is that people who retire are now living longer than they used to, so that "lifetime coverage" entails benefits for a significantly larger total amount of health care, as later chapters discuss. The unhappy implications of this are that older people use a disproportionate share of health care services as their bodies wear out. As life spans increase, many older people seem to stay fairly healthy in their initial retirement years, becoming frailer as their ages climb past 80 and 85. Illnesses and conditions that used to end people's lives fairly quickly, such as infections, certain kinds of cancer, and heart disease, can now be conquered through expensive health care procedures (e.g., heart transplants, chemotherapy and the like) and are replaced by drawn-out, chronic diseases such as Alzheimer's disease, congestive heart failure, and emphysema. Both elements push up health care costs.

FAS 106

These assorted social and political concerns and pressures have been brought to a head by the unlikely agency of the Financial Accounting Standards Board (FASB). Completing a project launched in the early 1980s to rationalize the accounting treatment for post-employment benefits, in 1990 FASB adopted Financial Accounting Statement 106 (FAS 106), to govern employer accounting for post-retirement health benefits.[4]

FAS 106 went into effect for most public companies in 1993. It requires employers that provide retiree health coverage to recognize an obligation to pay for that coverage on their balance sheets, and, in the future, to accrue it as an expense over the careers of the employees who (the employer expects) will be entitled to it. In effect, FAS 106 requires employers to treat retiree health coverage much like pension obligations, for accounting purposes. A company must set a present value on their

expected future outlays for the coverage, which, net of assets set aside to meet those costs, is treated as a company liability.

Aside from the fact that this was revolutionary because health care costs had always been taken into account on a year-by-year, pay-as-you-go basis, the impact has been dramatically different from that of the similar pension accounting requirement (FAS 87) because, unlike pension plans, health plans have virtually no assets to offset corporate America's retiree health obligations. Moreover, given current trends in health care costs, companies that began calculating their FAS 106 exposure found that the total cost of an open-ended promise to pay health care expenses on the traditional health plan model was staggering.

Corporate Response

FAS 106 has precipitated a massive effort at corporate consciousness raising on the cost of retiree health coverage. Whether or not FAS 106 measures it correctly and has the right answer for the expense accrual, there now is no doubt that, even though fewer than half of American workers are in plans that offer them retiree health coverage, employers' exposure for this cost is enormous.

Most employers are looking for ways to reduce that unfunded liability. Funding might be one way, but as noted, there are tax impediments that make it uneconomic, and, in any event, it would be an expensive and drawn-out process. The other way is to reduce the liability by redesigning (read "reducing") the health coverage that companies promise to retirees.

Companies are taking various routes to this end. Most, but far from all, are preserving the current health coverage design for workers who already have retired and are putting changes into place prospectively. Some of the revised approaches being considered or adopted include:

- Terminating of retiree health coverage, sometimes softening the impact by substituting enhanced retirement savings in the form of an Employee Stock Ownership Plan;
- Setting a maximum per-person dollar amount that the company will pay in the future for health insurance premiums or premium equivalents;
- Introducing or increasing retiree contributions and setting a ceiling on the share of future coverage costs that the company will absorb;
- Introducing defined-dollar health coverage "accounts" that increase with the employees' years of service, in lieu of defined benefit type health coverage. The amount in each person's account defines the

maximum that the company will spend for that person's retiree health coverage.

- Linking the extent of company-paid coverage at retirement to the length of the retiree's service.

Overall, the outlook is for less employer-paid retiree health coverage just as the demographic trends converge to create a greater need for it. The chances for a successful national health care reform depend on a creative response to this challenge.

In the chapters and commentaries that follow, the themes touched on here are explored in some depth. This book does not try to come up with definitive solutions for all the problems. Rather, the hope is that the insights and observations presented here will shed some useful light on the issues that now confront those charged with shaping public policy.

Notes

1. Technically, Part A coverage is voluntary as well, in that an individual must enroll to have claims honored. Enrollment is automatic for those who have applied for Social Security benefits.
2. Medicare is secondary when its coverage duplicates that provided by an employer plan for an active employee or the spouse of an active employee.
3. Under IRC sections 419, 419A, and 512, companies can take a current deduction for amounts contributed to reserves for retiree medical benefits but only to the extent that they do not anticipate inflation in medical costs, and earnings on funds held in those reserves are taxable, except for collectively bargained and employee-pay-all arrangements.
4. FAS 106 actually covers all post-retirement benefits other than pensions, but the costs for other benefits, such as life insurance, are so minor in comparison with health coverage that they typically are overlooked in general discussions to focus on the impact of FAS 106 in connection with retiree health care accounting. FASB standards define "generally accepted accounting principles," with which auditors must comply to produce an unqualified opinion on a company's financial statements.