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RETIREE HEALTH: Company-Sponsored Plans Facing Increased Costs and Liabilities

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House of Representatives

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SUMMARY

Company-sponsored health plans play a major role in providing retirees and their dependents with access to needed medical services. We estimate that about 9 million private sector retirees and one-third of all private sector workers are in company health plans with retiree coverage. This coverage is especially important to retirees under age 65 who are not yet eligible for Medicare, because they tend to have fewer options than active workers to regain health coverage if a company terminates benefits.

Retiree health coverage has become a major concern for companies because retiree health costs are high and have risen rapidly. Also, a change in accounting standards that will require companies to report on their financial statements the amount of their liabilities for retiree health benefits will compel recognition of large future obligations. Some companies are concerned that the disclosure of these liabilities could have an adverse impact on their financial positions by lowering their stock prices or reducing their ability to obtain capital financing.

GAO estimates that as of 1991, the nation's private employers had accrued retiree health liabilities of $296 billion. About $93 billion of this amount is owed for current retirees and $203 billion accrued by current employees.

Since most companies finance their retiree health costs on a pay-as-you-go basis, most of these liabilities are unfunded. Prefunding the liabilities would be very costly. To begin to prefund their accrued liabilities of $296 billion, companies would have to contribute an estimated $42 billion in 1991--about four times their pay-as-you-go costs. Although the tax code offers several tax-advantaged options which could be used to fund retiree health benefits, each option includes important limitations that restrict the amount of prefunding possible.

Confronted by these issues, companies are re-evaluating their ability to continue providing retiree health benefits. A small percentage of companies that provide retiree health benefits have terminated these benefits. However, companies have shifted some costs to retirees or reduced benefits. Retirees have limited protection from company actions to reduce or terminate benefits. In addition, the laws designed to protect retiree health benefits in bankruptcies do not prevent benefit terminations in all circumstances.

If the Congress wants to preserve retiree health coverage through company plans, it may want to consider several possible legislative actions. These actions could be as basic as requiring employers to offer retirees group rates for health coverage or as complex as designing legislation that would impose on employers a regulatory structure similar to that currently used for pension benefits, including a pension-like system requiring advance funding. Protecting retiree health benefits in bankruptcies represents a special problem, however, because legislative remedies can do little to preserve benefits once companies go out of business.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our analyses of company-sponsored retiree health coverage.

Company group health plans play a major role in providing active and retired workers and their dependents with access to needed medical services. Through group health plans, workers and their dependents may obtain hospitalization, physician, and other health services at less cost than if purchased individually. Retiree health plans usually cover similar services.

With the rising cost of health care in general and retiree health costs in particular, companies are experiencing mounting pressures on their health plans. Also, the Financial Accounting Standards Board (FASB) recently adopted an accounting rule that will require companies to report on their financial statements the amount of their unfunded liabilities for retiree health benefits. This will result in companies reporting on their balance sheets significantly higher expenses for retiree health benefits.

Confronted by cost, accounting, and funding constraints, companies are rethinking their commitment to the provision of retiree health benefits. Some companies have changed their health plan provisions to shift some costs to retirees and/or reduce benefits. Retirees have limited protection under current law against company actions to reduce or terminate benefits. Retirees under age 65 who are not yet eligible for Medicare are especially vulnerable when a company discontinues or reduces benefits because they tend to have fewer options than active workers to regain health coverage. The Congress is faced with deciding whether the federal government should take steps to help preserve retirees' access to health coverage.

Mr. Chairman, to help in addressing this issue, you asked us to provide an overview of issues facing company-sponsored retiree health plans. Today's testimony describes (1) the extent of plan coverage and the cost of benefits, (2) the level of companies' retiree health liabilities, (3) advance funding options, (4) the extent to which companies are modifying their plans, (5) workers' protections under current law, and (6) congressional options.

EXTENT OF COMPANY-SPONSORED COVERAGE

Large companies are the principal sponsors of retiree health coverage. Although only about 4 percent of all companies provide retiree health coverage, approximately one-third of all private sector workers are in company health plans with retiree coverage. Companies provide retiree health benefits to workers either directly, through company plans, or indirectly, through multiemployer (generally collectively bargained) plans. To determine the extent to which companies are providing retiree health benefits, we surveyed a random sample of 5,500 companies and 950 multiemployer plans.[1]

Forty-three percent of companies with over 500 employees have retiree health coverage, but only 2 percent of companies with fewer than 25 employees provide this coverage. We estimate that about 9 million retirees are currently in company-sponsored health plans. About 39 percent of them are under age 65 and not yet eligible for Medicare.

Approximately 32 million workers are in company health plans with provisions for retiree coverage, according to our estimates. If company health plan provisions do not change, these are the workers who may expect to receive retiree health benefits in the future.

COMPANIES FACE RISING HEALTH COSTS

Retiree health coverage has become a major concern for companies because health costs are high and have risen rapidly. In the last two decades, medical care cost inflation has outpaced general inflation and the gap between the two has grown. The Consumer

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[1]The results of our company survey are reported in Employee Benefits: Extent of Companies' Retiree Health Coverage (GAO/HRD-90-92, Mar. 28, 1990). For more information on multiemployer plans, see our report, Employee Benefits: Extent of Multiemployer Plan Retiree Health Coverage (GAO/HRD-90-132, July 17, 1990).

Price Index (CPI), which measures general inflation, is based on prices of several household budget items including food, transportation, housing, and medical care. The CPIMC measures medical inflation--it represents the price of a market basket of goods and services. The CPIMC averaged 0.7 percentage points per year more than the CPI in the 1970s and 2.7 points more per year in the 1980s. Most recently (1986-90), the CPIMC averaged 3.5 percentage points more per year.[2]

The cost of providing retiree health benefits varies considerably among employers, in part because of differences in the average age of retirees. Employers with a higher percentage of retirees age 65 and over tend to have lower costs because Medicare covers a substantial portion of the medical costs for these persons.

Two recent GAO surveys obtained data on retiree health care costs in company-sponsored and multiemployer plans. Based on this data, we estimate that the average per retiree health care cost in 1987 in the company-sponsored plans was $1,309. Approximately two-thirds of this average cost was incurred by the company ($877) and one-third ($432) by the retiree. On average, retirees under age 65 paid more for their health care coverage ($601) than did those age 65 or older ($298). Average per retiree health care costs in

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[2]Economic Report of the President 1991 (Washington, D.C., U.S. Government Printing Office, 1991). Percentages are GAO calculations of data collected by the Department of Labor, Bureau of Labor Statistics.

multiemployer plans were 37 percent greater than in company-sponsored plans ($1,795), but the distribution patterns were similar. Plan sponsors paid about two-thirds of the total cost ($1,219), and retirees under age 65 paid more for coverage than did retirees aged 65 or older ($586 versus $353).

According to a survey of over 1800 employers by a benefits consulting firm,[3] 11 percent of employers offering retiree health benefits had medical plan costs under $1,000 per retiree in 1989, while 16 percent had costs over $3,000.[4] Foster Higgins found that companies' costs for retirees age 65 and over were generally 55 to 60 percent lower than costs for retirees under age 65.

ACCOUNTING CHANGE COMPELS RECOGNITION OF LARGE LIABILITIES

Most companies finance and account for retiree health expenses on a pay-as-you-go (PAYG) basis. The FASB rule will require them to switch to an accrual system of accounting, in which retiree health benefits are recognized as expenses as they are accrued (earned) by employees. Some companies are concerned that the dramatic rise in their balance sheet expenses that will result from this switch may impair their financial position by lowering their stock prices or reducing their ability to raise capital. These concerns could

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[3]A. Foster Higgins & Co., Inc., Health Care Benefits Survey, 1989, Report 4: Retiree Health Care, 1990.

[4]These costs include employer and employee contributions for medical plans only, for all retirees and their dependents.

prompt companies to reduce or terminate their retiree health benefits, or require retirees to pay more of plan costs. On the other hand, such concerns could lead companies to start advance funding their liabilities, which would increase the security of these benefits.

In December 1990, FASB approved FAS 106, which requires companies to record unfunded retiree health liabilities on their financial statements, effective for fiscal years beginning after December 15, 1992. When a company adopts the new standard, it already has an obligation for retiree health benefits attributable to current and former employees' service to that date. FAS 106 stipulates that this obligation be recognized on the balance sheet either as a one-time charge to that year's earnings or as a charge to earnings over the plan participants' average remaining years of service (or over 20 years, if greater).

We estimate that the nation's private employers have accrued liabilities, or "earned" accruals, of $296 billion for retiree health benefits in 1991. This is the portion of their retiree health liabilities that retirees and workers have earned in their past years of employment. About $93 billion of this amount is owed for current retirees and $203 billion accrued by current employees.

Although the FASB rule does not mandate any change in cash flows, it will reduce the level of profits companies report in their financial statements. A 1990 survey of 463 employers by Hewitt Associates found that the total annual expense for retiree medical plans averaged 2 percent of pretax profits. Based on the employers' estimates of their retiree health liabilities, the survey projected that this expense will average 7.5 percent of pretax profits when the FASB standards take effect.[5]

ADVANCE FUNDING COSTLY, TAX-FAVORED FUNDING OPTIONS LIMITED

Advance funding of retiree health liabilities would stabilize companies' annual expenditures and provide added security for retired workers, but would be very costly. Although the Internal Revenue Code (IRC) offers several tax-advantaged options which could be used to fund retiree health benefits, each option includes important limitations that restrict the amount of tax-advantaged prefunding possible.

If U.S. companies were to prefund their retiree health liabilities, their annual contributions would exceed PAYG costs for over 30 years; thereafter, annual contributions would be lower. If all U.S. companies with retiree health plans were to begin advance funding their accrued liabilities of $296 billion,

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[5]Hewitt Associates, Survey of Retiree Medical Benefits, 1990, 1990.

they would have to contribute an estimated $42 billion in 1991.[6] This is about four times their 1991 PAYG costs of $11 billion.

Two tax-advantaged funding options provided by the IRC are (1) contributing to a voluntary employee benefits association (VEBA) under section 501(c)(9) and (2) setting aside excess funds from a qualified pension plan under section 401(h).

Contributions to VEBA trusts for retiree benefits are limited because the cost of health benefits for future retirees used in the calculations must be the same as the cost of health benefits provided current retirees. Since adjustments are not permitted for future medical inflation or increased utilization, companies cannot fund their entire retiree health liability if they limit contributions to the amounts allowed by the tax rules. In addition, investment earnings in a VEBA fund are subject to the tax on unrelated business income, except in certain cases.

The IRC also allows companies to fund their retiree health obligations by setting up a separate account from the excess in their qualified defined benefit pension plan. However, such funds cannot exceed 25 percent of the aggregate contributions made to the pension plan. The 25-percent limit may not permit transfers to this separate account to be as large as needed to fully fund

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[6] If U.S. companies had begun advance funding in 1988, their 1991 advance funding contribution would have been about $34 billion.

accrued health liabilities. Also, because some companies' pension plans are overfunded, allowable pension contributions are very low, in some cases even zero, thereby effectively precluding tax-deductible transfers for retiree health.

In the Omnibus Budget Reconciliation Act of 1990, Congress, however, allowed companies with excess pension fund assets to transfer such assets, notwithstanding the 25-percent limit. However, this option cannot be used to prefund future benefits because transfers are limited to the amount a company will pay out of the 401(h) account during the year for current retiree health expenses. It is too early to determine the extent to which companies will use this option.

COMPANIES ARE MAKING CHANGES TO LIMIT RETIREE HEALTH COSTS

Since 1984, a small percentage of companies that provide retiree health benefits have terminated a health plan which resulted in retirees losing their coverage, or active workers not being eligible for coverage upon retirement. However, companies are taking measures short of termination to limit retiree health costs. Companies have changed health plan provisions to shift some costs to retirees or reduce benefits.

In a February 1989 report,[7] we reviewed the changes that a sample of 29 medium and large companies had made to limit retiree health costs. All 29 companies changed their health plan provisions during the period 1984-88 to reduce such costs. These changes consisted of (1) adding cost-containment measures, such as utilization review and mandatory second opinions, (2) increasing medical service deductibles and coinsurance amounts, and (3) raising the amount plan participants pay for coverage.

When we recontacted these companies in June 1989, we found that 21 of the 29 had made additional changes in 1989. While many of these changes were similar to those made in previous years, a few made even more significant changes to help limit retiree health costs. For example, one company decided to phase out retiree health coverage altogether. New employees will receive no health benefits upon retirement, but current employees and retirees will not be affected. Another company will begin giving retirees a fixed dollar amount for health benefits in 1991. A third company eliminated dental benefits for retirees.

A 1989 survey of over 1,800 employers by the Foster Higgins consulting firm reported that 23 percent of respondents offering retiree health coverage had increased the level of retiree premium contributions in 1988-89 or planned to increase it by 1991.

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[7]Employee Benefits: Company Actions to Limit Retiree Health Costs (GAO/HRD-89-31BR, Feb. 1, 1989).

Seventeen percent indicated they had or would increase the deductible, and 13 percent said they had or would decrease benefits. None of the employers with retiree health plans terminated their plans in 1988-89, but a few indicated they would terminate their plans by 1991.

CURRENT LAW PROVIDES LIMITED BENEFIT PROTECTION

Under current law, retirees who are receiving benefits, as well as workers who expect to receive health coverage after they retire, have little protection from company actions to reduce or terminate benefits. Retiree health benefits are specifically excluded from many of the protections provided to pension benefits under the Employee Retirement Income Security Act of 1974 (ERISA). For example, companies are not required to advance fund retiree health benefits or to give workers and retirees nonforfeitable rights to benefits accrued (vesting).

Recent court decisions generally have upheld a company's right to modify or terminate its retiree health plan if the plan documents contained explicit language reserving the right to make changes. In some cases, courts have ruled that other kinds of evidence (pamphlets, oral interviews, etc.) can be considered part of the contract between workers and employers.

Although it has not legislated comprehensive benefit protection standards, the Congress has acted to protect retiree health benefits in certain situations. When LTV, one of the largest companies in the United States, filed for bankruptcy in July 1986, it attempted to terminate health benefits to over 78,000 retirees. The Congress enacted temporary legislation that required LTV to provide health benefits to these retirees. In June 1988, the Congress enacted the Retiree Benefits Bankruptcy Protection Act to replace the temporary legislation. The act prohibits companies that file for Chapter 11 bankruptcy from modifying retiree health benefits unless they can prove in court that modification is necessary to avoid liquidation.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) also extends protection to employees. The act requires companies to offer retiring and terminated employees the opportunity to continue to participate in a company's group health plan for a limited period of time, generally 18 months, at the former employees' expense. COBRA also requires companies that file for bankruptcy to offer retirees continued health benefits.[8]

In an ongoing study requested by Congressman Coyne, GAO has found that the laws designed to protect retiree health benefits in bankruptcies do not prevent benefit terminations in all

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[8]However, COBRA permits an employer who files for bankruptcy to modify or terminate the retiree health benefits if it does the same to benefits for its active workers.

circumstances. Employees in certain businesses are not covered by these laws. We surveyed 41 companies that reportedly offered retiree health benefits and filed for bankruptcy or took similar actions during the period 1985 to 1990. Eleven companies--banks, savings and loans, and insurance companies--were generally not affected by either the Retiree Benefits Protection Act or the bankruptcy provisions of COBRA.[9] When they filed for bankruptcy, 7 of these 11 companies terminated the health benefits of about 700 retirees.

Retirees sometimes lose their benefits even when companies are covered by these laws. Several companies we surveyed that were subject to the Retiree Benefits Bankruptcy Protection Act terminated retiree health benefits after going through the bankruptcy court, as provided for under the law. Moreover, some companies covered by COBRA's bankruptcy provisions ceased benefits because they either went out of business or no longer provided health benefits to their active workers.

OPTIONS FOR MAINTAINING RETIREES' ACCESS TO HEALTH COVERAGE

Faced with rising health costs and the requirement to measure and record their retiree health liabilities, companies are likely to re-evaluate their ability to continue providing retiree health

[9]These companies' actions were regulated by laws specific to their industries.

benefits. While few companies have terminated benefits, many are requiring retirees to pay more for their medical care and some are reducing benefits. Early retirees and workers close to early retirement age have a considerable stake in the status of their benefits because losing them can imperil access to health care. Members of this group generally face reduced prospects for acquiring health coverage through another employer, and individual health insurance may be unaffordable.

As we have testified previously,[10] if the Congress wants to preserve retiree health coverage through company plans, it may have to take legislative action. At one end of the range of possible actions, the Congress could require companies with health plans to extend COBRA provisions to cover all retirees under age 65. These early retirees would be charged the employers' average cost for retiree health benefits. This would give them access to coverage at group rates, which are usually much lower than they could obtain through purchasing a policy on their own. One disadvantage of this option is that some retirees would have to pay more for their health benefits than is currently the case, because companies would no longer be paying as much of the coverage costs.

At the other end of the spectrum, the Congress could impose a complete set of requirements similar to those now applicable to

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[10] Employee Benefits: Trends in Retiree Health Coverage (GAO/T-HRD-90-51, July 27, 1990).

pension plans under ERISA. This would probably require additional tax preferences for advance funding in exchange for requiring companies to meet minimum vesting and funding standards. This option would make health benefits of current and future retirees more secure, but would create tax losses for the federal treasury at a time when reducing the budget deficit is extremely important. This option also could be costly to companies and could cause taxes from corporate profits to fall.

Protecting retiree health benefits in bankruptcies represents a special problem. Existing laws do not ensure continuation of benefits when companies file for bankruptcy. As a result, the security of retiree health benefits is contingent on companies' financial health. Legislative remedies can do little to preserve benefits once companies go out of business.

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Mr. Chairman, this concludes my statement. I would be happy to answer any questions at this time.