United States General Accounting Office 136835

GAO

Testimony

For Release
on Delivery
Expected at
9:30 a.m. EDT
Thursday
September 15, 1988

Future Security of Retirees Health Benefits in Question

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Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

136835

04326 / 137535

GAO/T-HRD-88-30

SUMMARY

The private sector plays an important role in providing retirees with access to health care coverage. The benefits provided through company plans are especially important to retirees under the age of 65 because most are not covered by Medicare.

Rapid increases in health care costs are causing employers to become increasingly concerned about the current costs and the potential future liabilities associated with providing health benefits to their retirees. In turn, workers are concerned that health benefits may be curtailed or terminated by the time they retire. GAO developed estimates of these costs and future liabilities and discussed with a sample of company officials the health benefits changes already implemented or currently being considered.

GAO estimates that as of 1988 the nation's private employers could have accrued retiree health benefit liabilities amounting to $221 billion, which is about one-twelfth of the total value of the common stock of the nation's corporations. GAO also estimates that there will be an additional $181 billion in liabilities for health benefits earned in the future by current workers. Thus, the total potential liabilities for current workers and retirees are $402 billion, the sum of $221 billion already accrued and $181 billion to be accrued in the future.

GAO estimates that, for plans in existence today, annual benefit payments for retirees' medical care will come to almost $10 billion this year and will grow, in today's dollars, to about $25 billion in 2008. If the nation's employers were to start advance funding their retiree health liabilities, GAO estimates they could be facing $34 billion in annual contributions, an amount equal to one-eighth of the pre-tax profits of American corporations.

In its discussions with officials at 29 companies and its review of recent studies of retiree health benefits, GAO found that companies are reviewing their plans' provisions and cost-sharing arrangements and making changes to control and limit their costs. According to company officials, concerns about rising medical costs have led companies in our survey to modify their health benefits to control costs either by changing plan provisions or reviewing employee and retiree contributions and increasing them as needed. So far, modifications have affected both workers and retirees. Company officials tell us they would like to continue to offer health benefits to their retirees, but are uncertain about their companies' ability to pay for these benefits.

GAO believes the Congress should assess a variety of possible actions, each of which could offer greater security to retirees. These actions could range from requiring employers to offer retirees group rates for health coverage to designing legislation which would impose on employers a regulatory structure similar to that currently used for pension benefits, including a pension-like system requiring advance funding.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our analyses of employer-provided retiree health benefits.

The private sector plays an important role in providing retirees access to affordable health care coverage. Not only is the cost of medical care under group plans generally less expensive than that purchased by retirees individually, but companies often pay some or all of the costs. The benefits provided through company plans are especially important to retirees under the age of 65 because most are not covered by Medicare. In 1988, retirees under 65 comprised one-third of all retirees covered by company health plans, but received about two-thirds of the benefits.

Faced with significantly increasing costs, some companies are taking action to control their current costs and limit their obligations for retiree health care benefits. Retirees now receiving these benefits and active workers who expect to receive retiree benefits have limited protection from benefit modification or termination. For example, 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. Only congressional actions maintained their benefits.

Because the security of some retiree health benefits is in question, the Congress is faced with deciding whether and to what extent the federal government should get more involved.

Mr. Chairman, to help in addressing this issue, you and other Members asked us to (1) estimate companies' liabilities for current and future retirees' health benefits, assuming that companies continue to provide health care as they currently do; (2) estimate the annual amounts needed to advance fund these liabilities and compare them to companies' pay-as-you-go expenses; (3) obtain companies' views on their flexibility to change their health plans to cope with rising costs, and (4) describe how companies are using this flexibility to make changes.

LIABILITIES AND ANNUAL CONTRIBUTIONS TO ADVANCE FUND EXISTING RETIREE HEALTH BENEFITS ARE LARGE

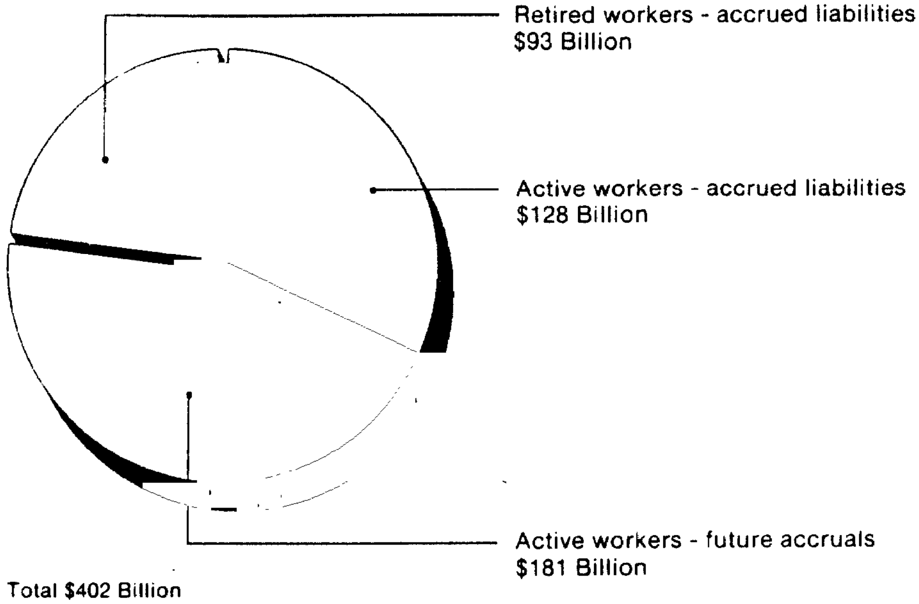
About 7 million retirees are receiving health benefits through company plans and about $10 billion will be paid by companies in 1988 for these benefits, according to our estimates. Assuming coverage and benefit provisions do not change, in 2008 these companies will pay $25 billion in today's dollars for 9 million retirees.

We estimate that the present value of future retiree health benefits accrued to date is $221 billion. This amount is about one-twelfth of the value of the stocks of American corporations ($2.6 trillion) in 1986. This estimate includes accrued liabilities of $93 billion for retirees and $128 billion attributable to the past service of active workers (see figure 1). The remaining $181 billion is for benefits that workers will earn from now until they retire. The amount the nation's private employers would need for investment today to pay future health benefits for retirees and for all covered workers in the years after they retire is $402 billion.

We did not consider employers' savings resulting from passage of the Medicare Catastrophic Coverage Act of 1988 in our estimates. Sufficient information was not available to us to determine how overall employer costs might be affected.

It has been the practice of the Financial Accounting Standards Board (FASB) to require material costs to be disclosed on a company's accounting statements to help ensure that the statements accurately represent the company's financial condition. Since 1979 disclosure of postemployment benefit costs such as those for company health care has been on the FASB's agenda. As an interim step, the FASB required current retiree health costs to be reported on companies' financial statements beginning with accounting periods after 1984.

Figure 1: Private Companies' Estimated Retiree Health Liabilities (1988)



FASB has announced its intention to issue an exposure draft that will detail its rules for recognizing and disclosing retiree health liabilities.

Most companies do not advance fund their retiree health benefits, but rather pay them on a pay-as-you-go basis. Companies and others have expressed concern that the disclosure of unfunded retiree health liabilities could adversely affect their operations, including their ability to obtain capital financing. This could prompt some companies to reduce or terminate their health benefits, require retirees to pay more of the plans' cost, or start advance funding the benefits.

Advance funding of retiree health liabilities would stabilize companies' annual expenditures. Moreover, the accumulation of assets would result in added security for retired workers. However, this would be very costly.

If employers were to start advance funding their retiree health liabilities the way they fund pensions, they would contribute $34 billion in 1988 under current coverage and benefit provisions and under our methods and assumptions[1]. This is about

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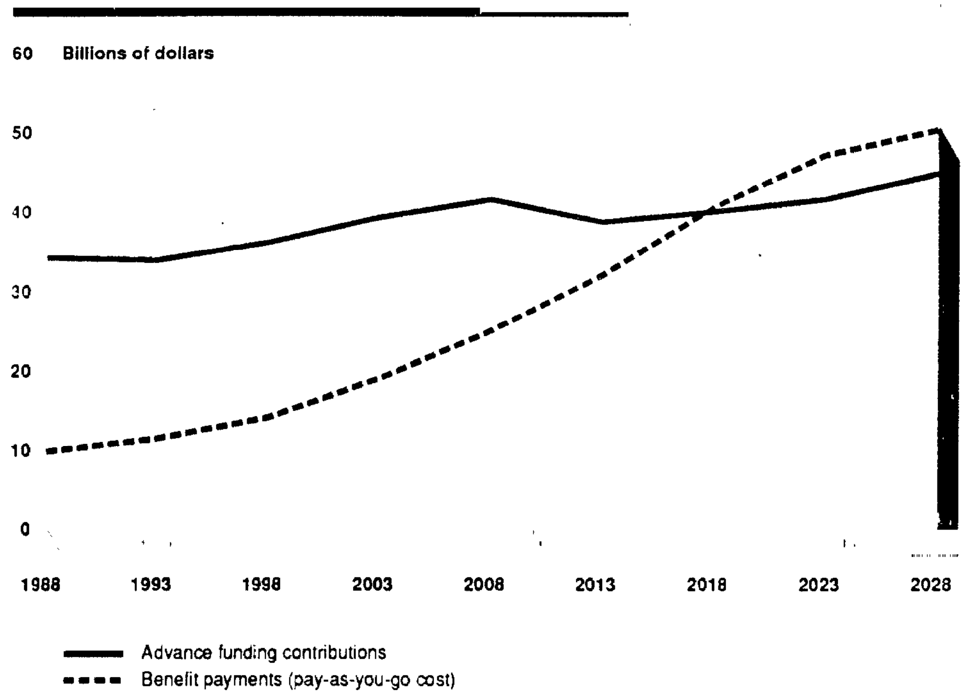
[1]We used different values for selected variables in our model to determine low and high estimates of first-year contributions and accrued liabilities. First-year contributions could range from $26 billion to $47 billion to fund accrued liabilities as low as $174 billion or as high as $295 billion, respectively.

Figure 2: Projected Retiree Health Benefit Payments and Contributions (1988-2028)



Note: Amounts given in 1988 dollars.

three and a half times their current pay-as-you-go costs of $10 billion and one-eighth of the estimated 1988 pre-tax profits of American corporations.

We projected contributions and benefit payments assuming current retiree health coverage and benefit provisions do not change. As shown in figure 2, annual contributions would continue to be higher than pay-as-you-go costs in today's dollars until 2018. Thereafter, pay-as-you-go costs would exceed annual contributions. If companies wait to begin advance funding, first-year contributions will be even greater relative to pay-as-you-go costs.

COMPANIES' CHANGES TO CONTROL THEIR HEALTH COSTS

Recognizing that companies may change or terminate their retiree health plans, we asked company officials about their flexibility to change health plans to cope with rising costs and how they are using this flexibility to make changes. We looked at the retiree health plans of 29 companies in the Chicago area. We selected a sample of companies that had plans in 1984 to determine whether they had reduced or terminated benefits since then. We also interviewed company officials to obtain their views and concerns about the security of these benefits.

Companies can control their costs, short of terminating benefits, by changing health plan provisions and cost-sharing arrangements to (1) limit the services covered; (2) restrict who's eligible to receive coverage, and for how long; and (3) require plan participants to share more of the costs. A comparison of two of the companies we surveyed shows the range of possibilities. One company allowed access to group plan coverage but did not share the costs. In 1987, this company charged retirees and their families enough in monthly contributions to fully cover plan costs. In contrast, another company, which did not require contributions, paid almost $4,000 per retiree.

Company actions to modify or terminate retiree health coverage have been challenged in court. In some cases the courts have ruled that companies may not terminate the benefits being provided persons already retired. In other cases, the courts have upheld the companies' right to modify or terminate the benefits if the companies have previously taken explicit actions to reserve this right.

Officials at all 29 of the companies we surveyed told us they believe their companies have the right to modify or terminate health benefits for active workers and retirees; 27 of the 29 include explicit language to that effect in their health plans. This is not a new development--25 already had plans with this language at least four years ago. Since then one clarified the wording and two others added new language to this effect.

According to company officials, concerns about rising medical costs have led 24 of the companies in our survey to modify their health benefits since 1984. The modifications consisted of (1) implementing cost containment measures to help ensure that the health services provided are medically necessary and economical, (2) increasing deductibles and coinsurance payments, and (3) raising monthly contributions. These changes were directed at both active workers and retirees.

Officials at 26 of the 29 companies told us they are committed to providing health benefits to their retirees, but are uncertain about their companies' continued ability to pay for these benefits. Officials at 16 companies specifically said they were concerned about the effects of the proposed FASB disclosure requirement on their companies' reported financial condition.

Officials at 21 companies said they were considering additional changes to their retiree health plan structures. The current and future costs of providing retiree health insurance may be more than they can afford and future court rulings could reduce their ability to modify plans. Some provisions being considered are much different from those already in place, and would result in new benefit structures. These include offering

(1) health benefits that vary with length of employment, (2) defined dollar benefits that would cap annual medical payments based on years of employment, or (3) flexible compensation packages that would allow workers to choose from among a variety of pension and welfare benefits.

Company officials said they were planning to wait for FASB to publish its proposed guidelines, and for other possible legislative and regulatory actions, before deciding what additional changes are needed. They indicated that expanded tax preference would provide a major incentive for advance funding their benefit payments.

MATTERS FOR CONSIDERATION

The private sector has played an important role in providing retirees with access to company-sponsored health benefits and helping to pay for their costs. However, this role may be changing. Current and future retirees have limited protection against company actions to reduce or stop providing health benefits. In fact, to control their current and future costs, some companies are already taking action to require retirees to pay more for their medical care. Projected future costs and requirements to disclose unfunded liabilities on financial statements may increase such actions and erode retiree benefits.

We believe the Congress should consider the desirability of legislation to preserve retiree health benefits, especially for retirees under 65 who are not covered by Medicare. In considering the type of action it might take, the Congress should be aware of some likely consequences. For example, any broadening of tax preferences will obviously create tax losses for the federal treasury at a time when closing the budget deficit is both extremely difficult and very important. Even with the tax advantages, employers' higher annual contributions under advance funding could affect companies' willingness to offer retiree health benefits.

If the Congress decides it should take steps to increase benefit security, it can consider actions ranging from (1) applying pension policies to retiree health benefits to (2) requiring companies with health plans to allow their pre-65 retirees to purchase coverage at group rates similar to the coverage now provided terminated employees.

To apply pension-type policies to retiree health benefits, the Congress, among other things, will need to (1) define vested benefits, (2) expand tax preferences for advance funding, (3) develop funding standards, and (4) consider establishing an insurance program similar to the one administered by the Pension Benefit Guaranty Corporation. This approach would provide more secure health benefits for some retirees, but may cause some companies to discontinue retiree benefits for others. In addition, the federal government may have to establish additional organizational structures to administer the system.

Another option would be to give companies the choice of maintaining their retiree health plans on a pay-as-you-go basis or advance funding their liabilities within a pension-type framework. Companies that wished to advance fund could take advantage of expanded tax preferences, but would become subject to regulations and restrictions similar to those covering pension plans. Companies that did not want to be subject to pension-type regulations could maintain their pay-as-you-go plans if they desired. Under this option, the benefits of some current and future retirees would be more secure than others.

A less comprehensive approach would be for the Congress to provide more incentives for companies to advance fund their retiree health liabilities on a voluntary basis, but not to impose the full pension regulations. Standards for advance funding and the distribution of plan assets in events such as plan termination would need to be established. This approach lessens burdens on companies but also does less to promote the security of these benefits. Under this approach more companies may be willing to increase benefit security through advance funding, but the absence of vesting rules and other protections lower the level of security provided individual retirees.

Under any of the above approaches, the Congress could also consider adopting current legislative proposals to let companies use excess pension assets to help advance fund retiree health plans.

To avoid some of the adverse effects of requiring advance funding, the Congress might take a less ambitious tack. For example, one approach not requiring advance funding would be to require all health plans to extend coverage to retirees at group rates. Under this approach, retirees would bear all of the cost of their health benefits, although payments would be at group rates which are usually lower than individual rates. An advantage is that this approach might well expand the availability of retiree health coverage.

Other options have been proposed and each needs to be analyzed by the Congress in its deliberations. We would be pleased to assist you in your consideration of this vital issue.

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

OBJECTIVES, SCOPE, AND METHODOLOGY

To prepare our estimates of companies' total and accrued liabilities, we updated and expanded an economic model used by the Department of Labor in a 1986 report on employer-sponsored retiree health insurance. Total liabilities--the present value of future benefits--represent the amount of money one would need to have available for investment to provide currently covered workers and retirees with retiree health benefits. If these benefits were advance funded and assumed to be earned over workers' careers, the accrued liabilities would be the portion of total liabilities assigned to workers' and retirees' past years of employment.

To make our calculations, we made several simplifying assumptions. For example, we based our model on our own and others' estimates of average national retiree health costs and of the number of current and future workers covered by employer-provided retiree health plans. We assumed current levels of coverage and benefit provisions would continue, even though companies can modify or cancel their plans. We treated the 1988 accrued liabilities as unfunded, even though we know a few firms are currently funding these liabilities in advance. Finally, we used a projected unit credit funding method with accruals for service after age 40 and no terminations other than death.

For specific model parameters, we analyzed data on numbers of active workers and retirees with retiree health benefit coverage, health care costs, rates of retirement, life expectancy and interest rates, and we reviewed available studies of retiree health costs. Because precise, up-to-date information does not exist for many of the factors affecting companies' total liabilities and annual contributions, we performed sensitivity analyses of our liability estimates by varying our coverage, retirement, mortality, and inflation assumptions.

To estimate the contributions companies would have to make to start advance funding their liabilities in 1988, we used a closed group of workers and retirees. Our estimates of benefit payout and advance funding contributions in 2008 were based on an open group valuation allowing for new entrants through the year 2032. Annual contributions include an amount to cover accruals for active workers as well as a 25-year amortization payment on initial (unfunded) accrued liabilities.

To assess companies' flexibility to modify retiree health plans and examine recent changes companies have made in these plans, we surveyed 29 medium and large companies with retiree health plans in the Chicago, Illinois, area. These companies had from 186 to over 50,000 active workers; the number of retirees ranged from 12 to 39,000. We also met with company officials and other experts and reviewed recent public- and private-sector studies and court decisions to better understand the kinds of changes that companies were making. Our findings on specific changes cannot be generalized beyond the 29 plans we surveyed.