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Briefing Report to Congressional
Requesters

February 1989

EMPLOYEE BENEFITS

Company Actions to Limit Retiree Health Costs



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Human Resources Division

B-233532

February 1, 1989

The Honorable Edward R. Roybal
Chairman, Select Committee on Aging
House of Representatives

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

This briefing report responds to your requests that we provide information on (1) companies' flexibility to change their health plans to cope with rising retiree benefit costs, (2) how companies have used this flexibility to make changes, and (3) additional changes that might be forthcoming. The briefing report expands on information provided during our September 15, 1988, testimony before the Subcommittee on Oversight, House Committee on Ways and Means.

Background

Company group health plans, generally financed at least in part by the companies, play a major role in giving retirees and their dependents access to life-saving medical services. These plans, according to our estimates for 1988, cover about 7 million retirees at a current annual company cost of about \$9 billion.

Companies generally pay retiree health costs as they become due rather than set aside funds while people are working to help pay for health care costs after they retire. Because of such factors as increasing numbers of people retiring in the future and medical cost inflation, companies' future pay-as-you-go costs will increase drastically if they continue to provide and pay the same share of benefits now provided. We estimate that the annual costs will reach about \$22 billion in today's dollars by the year 2008.

Because retiree health benefits have generally not been funded in advance, the present value of unfunded accrued benefits is large—about \$227 billion¹ by our estimate. The Financial Accounting Standards Board

¹The estimate does not take into consideration savings to employers from additional retiree health benefits being paid in the future under Medicare as a result of the Medicare Catastrophic Coverage Act of 1988. Sufficient information was not available to us to determine how company costs might be affected.

(FASB),² following its established practice of requiring disclosure of material costs on accounting statements, has announced its intention to require the disclosure of health liabilities and their funded status.

The significant and increasing costs, and the potential adverse effects on business operations from disclosing unfunded benefits, could prompt companies to take action to change their health plan provisions by (1) restricting who is covered by (participates in) the plan, (2) limiting the medical services paid for by the plan, or (3) requiring that retirees pay more of the costs for coverage and services received.

Retirees who now receive benefits and active workers who expect to receive them when they retire have limited protection from such action under current law. For example, comprehensive protections now provided to pension plans, but not to health plans, under the Employee Retirement Income Security Act of 1974 (ERISA) include (1) giving workers and retirees nonforfeitable rights to accrued benefits (vesting) and (2) requiring benefits to be funded in advance to help ensure that money is available to pay them.

Methodology

We focused our work on 29 medium and large companies with retiree health plans in the Chicago area. These companies had a total of about 321,000 active workers and 137,000 retirees. We (1) obtained and compared plan documents in effect in January 1984 and January 1988, (2) interviewed company officials, and (3) reviewed court decisions and legal analyses to assess companies' flexibility to make changes, changes made in the 4-year period, and changes that may be forthcoming. Our findings on specific plan changes cannot be generalized beyond the 29 plans we surveyed.

Results in Brief

Our findings indicate that the 29 companies surveyed have the flexibility to change their health care plans to help contain costs. Recent court decisions have generally affirmed companies' right to make such changes. Moreover, all 29 companies made changes to their plans in the 4-year period ending in January 1988 to help limit costs. Future changes may be more drastic because costs are continuing to rise and FASB has announced its intention to require companies to disclose future retiree health costs on their financial statements. Companies are concerned about the impact that such disclosure will have on their operations since

²An independent authority responsible for setting accounting standards for the private sector.

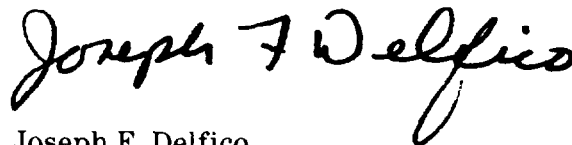
it will result in a less favorable picture of their financial position. More specifically:

- Officials of all 29 companies told us that their companies have the right to modify or terminate health benefits for active workers and retirees. Specific language in the plans of 27 of the 29 companies reserves the companies' right to modify or terminate the plans. Recent court decisions have generally upheld a company's right to modify its plan if the plan contained such language.
- All 29 companies changed their plans during the 4-year period 1984-88 by (1) adding cost-containment measures to help ensure that the health services provided are medically necessary and qualify for coverage or (2) raising the amount plan participants pay for health coverage and medical services received. The changes affected both active workers and retirees.
- Officials of 26 companies told us that their companies were committed to continuing retiree health benefits. However, they expressed uncertainty about the ability to do so because of (1) increasing costs and (2) the adverse effects that health plan related requirements, such as disclosing unfunded benefits, could have. Officials of 21 companies said they were considering additional changes to their plans, but indicated that they planned on waiting until FASB publishes its proposed guidelines, and for other possible legislative and regulatory actions, before deciding on the changes needed.

In our testimony, we presented options the Congress could consider if it decides steps should be taken to increase the security of retiree health benefits. The options ranged from (1) applying ERISA pension policies to retiree health benefits to (2) requiring companies with health plans to allow retirees to purchase coverage at group rates. We pointed out that any action the Congress considers should be weighed against such consequences as the companies' willingness to continue offering and paying for the benefits.

Our findings and the options presented in our testimony are discussed in more detail beginning on page 8 and in appendix II.

We did not obtain agency comments on this report because the report does not deal with the operations of a federal agency. Copies will be made available to interested parties on request. The major contributors to this briefing report are listed in appendix III.

A handwritten signature in black ink that reads "Joseph F. Delfico". The signature is written in a cursive style with a large, looping "J" and "D".

Joseph F. Delfico
Senior Associate Director

Contents

Letter

Employee Benefits: Company Actions to Limit Retiree Health Costs

Background	1
Objectives, Scope, and Methodology	1
How Companies Change Plan Provisions to Limit Costs	1
Companies Believe They Have the Flexibility to Change Plans	1
Companies Have Made Some Changes to Help Contain Costs	1
Future Changes Could Be More Substantial	1

Appendix I Types of Cost- Containment Measures Added by 22 Companies (January 1984-88)

Appendix II Options for Increasing Retiree Health Benefit Security

Appendix III Major Contributors to This Briefing Report

Abbreviations

ERISA	Employee Retirement Income Security Act of 1974
FASB	Financial Accounting Standards Board

Employee Benefits: Company Actions to Limit Retiree Health Costs

Background

Company group health plans play a major role in providing retirees and their dependents with access to hospitalization, physician, surgical, and other life-saving medical services. We estimate that these group plans, which generally provide retirees with health benefits at less cost than they could purchase individually, cover about 7 million retirees. We also estimate that employers generally pay some or all of their plans' costs, and will spend about \$9 billion in 1988 for retiree health coverage. This coverage is especially important to retirees under the age of 65, who make up almost one-third of retirees receiving benefits through company plans, because most of them are not covered by Medicare.

Retiree Health Costs Are Significant and Increasing

The already significant employer costs for retiree health benefits will increase drastically in the future if companies continue to pay the same share of benefits now provided. By our estimate, the present value of unfunded accrued retiree health benefits for active workers and retirees is about \$227 billion¹ if benefit and cost sharing provisions do not change. Under these conditions, we estimate that companies' annual cost will rise to about \$22 billion in today's dollars by the year 2008. Factors causing retiree health cost increases include increased numbers of people retiring in the future and living longer, increased utilization of medical services, more costly medical technology, and medical cost inflation.

Disclosure of Retiree Health Liabilities May Be Required

To help ensure that a company's accounting statements accurately represent its financial condition, the Financial Accounting Standards Board (FASB)² plans to require companies to recognize retiree health liabilities for current and future retirees. Since 1979, the disclosure of post-employment benefit costs, such as those for company health plans, has been on FASB's agenda. As an interim step, FASB required current retiree health costs to be reported on companies' financial statements beginning with accounting periods after 1984. FASB is expected to issue an exposure draft that will detail its rules for recognizing and disclosing retiree health liabilities in early 1989.

Currently, most companies fund retiree health benefits as they come due (pay-as-you-go) rather than set aside funds to help pay for health care

¹The estimate does not take into consideration savings to employers from additional retiree health benefits being paid in the future under Medicare as a result of the Medicare Catastrophic Coverage Act of 1988. Sufficient information was not available to us to determine how company costs might be affected.

²An independent authority responsible for setting accounting standards for the private sector.

coverage to workers after they retire. These companies recognize only the pay-as-you-go retiree health costs on their income statements. The planned FASB accounting standards would require companies to include the value of accrued retiree health liabilities as a liability on annual financial statements. The amount of unfunded accrued liabilities for individual companies could be substantial.

Limited Benefit Protection Under Current Law

The Employee Retirement Income Security Act of 1974 (ERISA) recognized the importance of retiree health benefits, but did not provide many of the protections afforded to promised pension benefits. To help protect participants' pension benefits, the Congress included in ERISA minimum standards for ensuring that (1) employees had an opportunity to become eligible for pension benefits (participation standards), (2) employees did not have to work an unreasonable number of years before having a nonforfeitable right to pension benefits accrued (vesting standards), (3) future pension benefits would be paid when due by requiring them to be advance funded (funding standards), and (4) pension plans are operated in the best interest of their participants (fiduciary standards). Of these standards, only the fiduciary standard applies to retiree health plans.

In the absence of legislated comprehensive benefit protection standards, the Congress has acted to protect retiree health benefits in specific situations. 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. The Congress enacted temporary legislation that required LTV to continue to provide health benefits to these retirees. In June 1988, the Congress enacted the Retiree Benefits Bankruptcy Protection Act to replace the temporary legislation. This 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.

Further, the Consolidated Omnibus Budget Reconciliation Act of 1985 requires companies to offer retiring and other terminated employees the opportunity to continue to participate in the company's group health plan for a limited period of time, generally 18 months, at the former employees' expense.

Concerns about significant and increasing retiree health costs, the effects on business operations of disclosing unfunded liabilities on accounting statements, and the limited benefit protection provisions

under current law have prompted questions about whether, and to what extent, companies will continue to provide these benefits. Because the security of retiree health benefits is in question, the Congress is faced with deciding whether the federal government should take steps to increase the security of these benefits.

Objectives, Scope, and Methodology

The Chairman of the House Select Committee on Aging and the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, asked us to assist them in examining issues and problems concerning company group health plans that provide benefits to retirees. The objectives of this report are to provide requested information on (1) companies' flexibility to change their health plans to cope with rising retiree benefit costs, (2) how companies have used this flexibility to make changes, and (3) additional changes that might be forthcoming.

We focused our review on 29 medium and large companies with retiree health plans in the greater metropolitan Chicago area. The 29 companies had a total of about 321,000 active workers and 137,000 retirees. The number of workers at each company ranged from 186 to 50,000; the number of retirees ranged from 12 to 39,000. We judgmentally selected the companies from plan year 1984 ERISA annual reports filed by retiree health plans.³ In selecting our sample, we considered the type of industry, the prevalence of the industry in the Chicago area, and the number of employees.

To determine the specific changes companies have made to their plans, we compared the health plans the 29 companies offered in January 1984 with those in effect in January 1988. We selected 1984 as the base year for comparison because tax and accounting regulation changes that year affected how employers' costs for retiree health benefits are treated.

We also interviewed company officials to obtain their views on the flexibility the company had to make changes, changes that had been made recently, and changes that might be made in the future. Also, we met with selected employee benefit experts, and reviewed recent public- and private-sector studies and court decisions to obtain a better understanding of companies' flexibility to make changes and the kinds of changes that can be made to limit employer cost.

³ERISA requires most employee benefit plans to file annual reports with the Internal Revenue Service showing various financial, actuarial, and demographic data. Plans report using the Form 5500 series, Annual Return/Report of Employee Benefit Plan.

Our fieldwork was performed from December 1987 through May 1988. Our findings on specific plan provisions and changes cannot be generalized beyond the 29 plans we surveyed.

How Companies Change Plan Provisions to Limit Costs

Companies can limit their health care costs, short of terminating a plan, by changing health plan provisions to (1) restrict who is covered by (participates in) the plan, (2) limit the medical services paid for by the plan, or (3) require that retirees pay more of the costs for coverage and services received.

The plan provisions that restrict who will be eligible for coverage include those that govern (1) the age employees must reach and the years of service that they must work to be eligible initially, (2) the age at which employees stop being eligible, and (3) whether and for how long retirees' spouses and other dependents are also covered.

A company can also reduce or eliminate certain medical services covered by the plan. For example, a health plan that offers such services as vision or dental care to active workers may not provide these services to retirees.

Also, companies can add cost-containment provisions to their plans to help ensure that health services paid for are medically necessary and qualify for coverage. Cost-containment measures include (1) mandatory second opinions for nonemergency or elective surgery, (2) hospital preadmission review and testing, and (3) utilization reviews of care provided.

In providing health coverage, companies either pay premiums to insurance companies who pay for health services provided to retirees, or set up their own plans and pay the cost of health services directly. Companies can limit their costs by requiring plan participants to pay some or all of the costs for coverage.

A comparison of who paid for coverage under plans provided by two of the companies we reviewed shows how much impact decisions on the sharing of coverage cost with retirees can have on companies' health costs. One company allowed retirees access to group plan coverage and charged them the full cost of coverage—\$1,020 for one year's coverage for an individual and \$2,040 for self and dependent coverage. Another company paid almost \$4,000 in annual health care costs per retiree, but did not require retirees to contribute to the cost.

Costs can also be limited by (1) requiring that plan participants pay for a certain dollar amount of covered medical expenses before the plan will pay any health expenses (a deductible), (2) requiring that participants share a specified percentage of the health care expenses (a coinsurance payment), and (3) limiting the amount of an individual's medical expenses that will be paid for by the plan. Further, companies can reduce or eliminate the payment for services covered when a retiree becomes eligible for Medicare.

Companies Believe They Have the Flexibility to Change Plans

Officials at all 29 companies covered by our review told us that they believe their companies have the right to modify or terminate health benefits for active workers and retirees. The plans of 27 of the 29 companies contained explicit language reserving the companies' right to modify or terminate the plans. The inclusion of explicit language limiting their obligation to continue providing health benefits was not a new development for the companies we surveyed. Of the 27 companies that had such language in their plans, 25 had included the language before 1984. The other two had added the language since then.

Recent court decisions have generally upheld a company's right to modify its plan if the plan documents contained such language. For example, in a September 1988 ruling, the court held that Metropolitan Life Insurance Company had the right to raise retiree health plan deductibles because it had unambiguously reserved the right to amend or terminate the plan in plan documents.⁴ The court also ruled that these written materials established the company's right to modify or terminate benefits. The court determined that other, less formal communications which had informed retirees that they had "lifetime" benefits "at no cost" did not prevent the company from amending the plan.

Some courts have ruled that companies have the right to increase retirees' health insurance rates even when their plans do not contain explicit language reserving the right to make such changes. For example, in an April 1988 decision, the court upheld Grand Trunk Western Railroad Company's right to increase the amount retirees had to pay for health insurance.⁵ In 1982, retirees paid \$11 per month for individual coverage; by 1987 this rate had increased to \$107. In its decision, the court found

⁴Moore v. Metropolitan Life Insurance Company, 856 F. Supp. 488 (2d Cir., Sept. 1988).

⁵Petersen et al. v. Grand Trunk Western Railroad Company, 683 F. Supp. 649 (E.D. Mich. 1988).

that the company had reserved the right to terminate benefits in the plan agreement and had not promised that benefits would not be raised.

Companies Have Made Some Changes to Help Contain Costs

All 29 of the companies we surveyed changed their health plans during the 4-year period 1984-88. These changes consisted of (1) adding cost-containment measures, (2) increasing medical service deductibles and coinsurance amounts, and (3) raising the amount plan participants pay for coverage. None of these changes affected only retirees. Instead, the changes affected either the benefits of both active workers and retirees, or the benefits of active workers only.

Twenty-two companies added cost-containment measures. These measures affected both active workers and retirees at 14 companies; at 8 companies the change affected active workers only. Appendix I lists the different types of cost-containment measures added by the companies and the number of companies adding them.

Eight companies increased either the deductible or coinsurance amount that plan participants must pay for medical services received; two of the eight raised both. Generally, the deductible was increased by at least 100 percent.

Officials at the 24 companies that require payments by plan participants for coverage said that they periodically review the amounts they charge and raise the amount as deemed necessary. Of the 24 companies that charged participants for health coverage, 23 increased their charges for coverage during the 4-year period 1984-88.

None of the companies we surveyed reduced services covered or changed the way their plans coordinate costs with Medicare.

Future Changes Could Be More Substantial

Future changes that companies may make to help contain costs could be more substantial. Officials of 26 of the 29 companies told us they were committed to providing retiree health benefits. However, they expressed uncertainty about their companies' ability to continue the benefits because costs are continuing to rise and FASB is expected to require that companies disclose the accrued value of retiree health liabilities on their annual financial statements. Company officials expressed concerns about the impact that such disclosure could have on their operations since it will result in a less favorable picture of their financial position.

Officials of 21 companies said they were considering changing the structure of their plans relating to retiree health benefits. Some of the changes being considered are much different from those previously made. These changes include offering (1) health benefits that vary with length of employment, (2) defined dollar benefits that would place a cap on annual medical payments based on years of employment, (3) flexible compensation packages that would allow workers to choose from among a variety of pension and welfare benefits, or (4) individual medical accounts for active workers that would set aside funds to purchase health insurance when they retire.

Company officials said they were planning to wait until FASB publishes its proposed guidelines, and for other possible regulatory requirements to materialize, before deciding on the additional changes needed. They indicated that expanded tax preferences, such as those now provided for pension plan funding, would provide a major incentive for funding their retiree health benefits in advance.

Under the Internal Revenue Code, contributions within certain limits made by companies to pension plans are tax deductible, and the contributions and earnings on them held by the plans are not taxed as long as the plans meet ERISA standards and certain other requirements. The favorable tax treatment provided to health plan contributions are more limited.

For example, section 501(c)(9) of the Code allows companies some tax deductions to advance-fund retiree health benefits. Under this section, however, the amount of tax deductible contributions allowed for advance-funding retiree health benefits is less than the amount of pension plan contributions allowed under other sections of the Code. Further, unlike the earnings on pension plan assets, the interest income from contributions held by health plans for paying future retiree benefits is taxed.

Types of Cost-Containment Measures Added by 22 Companies (January 1984-88)

Type of measure	Definition	Number of companies adding measure ^a
Mandatory second opinion	A requirement that participants consult another doctor after one has recommended a nonemergency or elective surgery.	12
Preadmission review and testing	An insurer review of the appropriateness of hospital admission and requirement that the patient obtain diagnostic tests before admission.	12
Utilization review	An insurer review of the necessity of medical care provided to hospitalized patients to determine qualification for regular medical benefits conducted before, during, or after care.	7
Preferred provider option	An option for the insurer to reduce its costs by using a group of hospitals or doctors who have contracted with the insurer.	6
Prescription drug program	A program for the insured to obtain prescription drugs from pharmacies or through the mail at a discount price.	5
Mandatory outpatient procedure	A requirement that certain procedures for which there is no medical need for an inpatient stay be done on an outpatient basis.	4
Case management	A process that focuses on coordinating a number of services needed by clients. It includes a standardized objective assessment of client needs and the development of an individual care plan.	1

^aNumber of companies adding specific measures totals to more than 22 because some companies added more than one measure.

Options for Increasing Retiree Health Benefit Security

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, on September 15, 1988 (GAO/T-HRD-88-30), we discussed options the Congress could consider if it decides steps should be taken to increase the security of retiree health benefits. The options ranged 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 temporarily to all terminated employees.

To apply pension-type policies to retiree health benefits, the Congress, among other things, would need to (1) define when benefits become vested, (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 altogether. Expanding tax preferences would create tax losses at a time when reducing the federal deficit is of critical importance. 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.

Another 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 range of pension regulations established under ERISA. 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 lowers the level of security provided to individual retirees.

Appendix II
Options for Increasing Retiree Health
Benefit Security

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.

Requiring advance funding would result in tax losses to the federal government and might discourage companies from offering retiree health benefits. To avoid these adverse effects, the Congress could take a different course of action. 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.

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