UPDATE

December 2008

EMPLOYERS ARE POISED TO TAKE ACTION ON RETIREE MEDICAL PLANS

Employers continue to show concern about the many complex issues that influence their sponsorship and subsidization of retiree medical plans. Conventional wisdom suggests that employers are making a rush for the door with respect to retiree medical. The evidence from a nationwide survey developed by Towers Perrin and conducted by the International Society of Certified Employee Benefit Specialists (ISCEBS), however, suggests that the situation is far more subtle. Employers are struggling to balance costly legacy retiree groups, rapidly rising retiree contributions, the Retiree Drug Subsidy program and the timely transition of older workers into retirement. In the absence of a panacea, employers are examining ways in which current market offerings can be designed and deployed to help "change the deal" with employees and retirees without undermining workforce management initiatives or inciting undue employee or retiree unrest.

A notable finding from the survey is the number of employers considering bold changes in their plans for the coming year. A relatively small share of survey respondents has actually made dramatic changes in the past year or two. The indication by many respondents that they plan to consider major changes in the coming year, however, shows an interest in finding effective new vehicles for delivering quality, affordable health coverage. Employers appear eager to explore solutions that involve rethinking plan design and accessing private market insurance offerings for both pre-Medicare and Medicare-eligible retirees *(Exhibit 1)*. Concerns remain, however, about resource constraints and possible retiree disruption arising from major program changes.

The joint Towers Perrin/ISCEBS survey, now in its fourth year, seeks to take employers' collective pulse about issues and goals influencing retiree medical strategy and design. This year's survey, conducted in April 2008, drew responses from 155 companies and nonprofit organizations.

EXHIBIT 1

Retiree medical plan changes organizations have implemented or are considering

(% responding — multiple selections allowed)

	Pre-65 Retirees		Post-65 Retirees	
	Implemented 2007/2008	Considering for 2009 or later	Implemented 2007/2008	Considering for 2009 or later
Changes to plan design	45%	29%	41%	24%
Tighten restrictions on eligibility	21%	15%	23%	11%
Changes to employer subsidy/ cost sharing	30%	21%	23%	16%
Cessation of employer subsidy (access only)	7%	12%	10%	9%

THE CURRENT RETIREE MEDICAL LANDSCAPE

While survey respondents confirmed the general shift away from employer sponsorship of retiree medical in the future — only 39% continue to offer retiree medical to new hires — many employers still sponsor plans with costly, long-term obligations. Over 70% of employers offer retiree medical benefits to current retirees as well as at least some portion of the currently active employee population.

Given the absence of viable, affordable private market options, employer sponsorship and subsidization are more prevalent for pre-65 retiree coverage. For post-65 retirees, however, the survey shows that employers are increasingly moving toward private market options that work with Medicare for new and even current retirees.

PRE-65 RETIREES

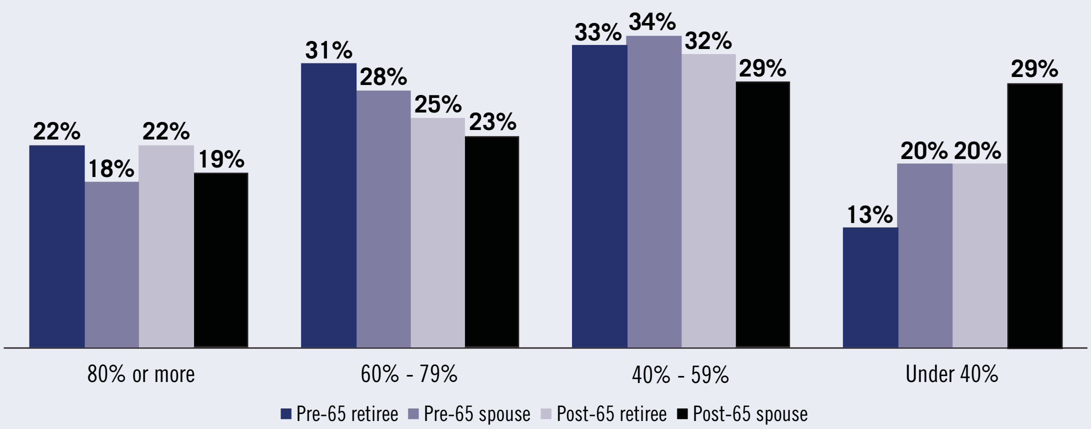
Employers continue to wrestle with their retiree medical strategies for early retirees. Company financial support for retiree medical coverage can have a significant impact on an employee's retirement decision. The absence of access to affordable company-sponsored health insurance prior to Medicare eligibility makes the issue of retirement a nonstarter for many older employees.Nearly three-quarters of responding companies that offer pre-65 retiree medical coverage provide an explicit subsidy toward the cost of coverage. An additional 6% provide a valuable — if somewhat hidden — subsidy by offering eligible pre-65 retirees a benefit that amounts to extended COBRA — continuation of medical plan coverage at full active plan costs. Only 19% of survey respondents require participants retiring today to pay the true full cost of pre-65 coverage, which can range from 50% to 100% higher than COBRA rates.

Among employers providing an explicit subsidy, there is a broad range of subsidy levels, with about two-thirds subsidizing between 40% and 80% of plan costs. There is evidence that employers are being more thoughtful about how they allocate the money committed to subsidizing retiree medical coverage. For example, some employers are paying a smaller share of the cost for dependent coverage than for retiree coverage *(Exhibit 2)*.

EXHIBIT 2

Employer subsidization of retiree medical coverage

(% responding)



Increasingly, employers are setting defined dollar limits (caps) on the amount of financial support they will provide for pre-65 medical coverage. Forty-eight percent of respondents to this year's survey indicated they have a cost cap, up from 43% last year. And among those with caps, an increased number of respondents report that plan costs have exceeded the cap. Once plan costs exceed caps, retiree contributions begin to increase dramatically from year to year, and employers may find that retirement patterns begin to change as older employees facing high retiree medical contributions choose to delay retirement. To encourage appropriate retirement patterns, employers may need to modify caps or find more efficient lower-cost plans for which their prescribed financial support has more buying power.

The survey asked employers to identify changes they have made or are considering making to eligibility, design and cost sharing for pre-65 retirees. While about one-third of employers have focused much attention on changing eligibility — the age/service threshold employees need to meet for access to company medical benefits in retirement — a far greater share (61%) have taken or plan to take action with respect to plan design. Notably, 34% of respondents have introduced, or plan to introduce, a High-Deductible Health Plan coupled with a Health Savings Account (HSA) for pre-65 retirees. These plans can help early retirees pre-fund retiree medical expenses on a tax-effective basis. While only 7% of employers have ceased to provide financial support for pre-65 medical coverage in the past two years, 42% have either changed or plan to change the cost-sharing "deal" between the company and retiree.

POST-65 RETIREES

Employers that cover Medicare-eligible retirees appear to be taking a "go slow" approach to plan sponsorship and subsidization. This is somewhat surprising, given the growth in the private insurance market spurred by the Medicare Modernization Act (MMA). Employers appear to be concerned about two issues: the sustainability of private market alternatives and the increasing cost pressures for employers and retirees. With regard to the cost issue, nearly 60% of employers that have capped their subsidy for post-65 retirees report plan costs in excess of the cap. As a result, employers are showing more interest in alternatives that may rely more on the private insurance market.

An illustration of employers' restlessness about their role in post-65 coverage is shown by the fact that over half have either recently made plan design changes (41%) or are considering making plan design changes in 2009 or later (24%). Almost 40% have or will recast cost-sharing terms with these retirees, and nearly 20% have ceased — or plan to cease — providing any post-65 financial support at all.

ACTIONS BEING TAKEN TODAY BY EMPLOYERS

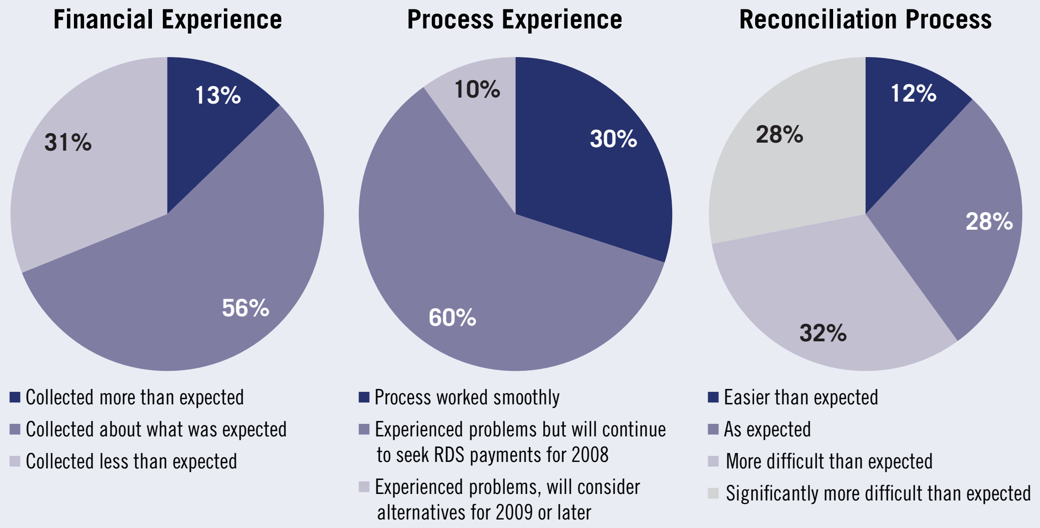
Similar to survey findings for pre-65 coverage, employers who cover post-65 retirees have shown interest in fundamental change, but have generally taken modest actions to date. For example:

- The **Retiree Drug Subsidy (RDS) program** continues to be the most common vehicle for sponsors of actuarially equivalent retiree medical plans to realize the MMA's economic benefit, with 62% of respondents taking the RDS route in 2006 or 2007. By now, RDS applicants have submitted their 2009 applications and have gone through the administratively clunky reconciliation process for 2006. Many have expressed disappointment in the program's administrative, data and reporting requirements. About 70% of respondents who claimed the RDS in 2006 and 2007 reported having experienced problems with the process; only 30% indicated that the process worked smoothly. About one-third of respondents who claimed the subsidy say they are collecting less in payments than originally expected *(Exhibit 3)*.

- Continuing apprehension about the sustainability of price advantages attached to Medicare Advantage **Private Fee-for-Service (PFFS) plans** is reflected in the relatively small percentage of plan sponsors that have gone this route: Five percent of respondents offered a PFFS plan as a retiree option in 2007 or 2008, with another 16% considering a PFFS option for the future. Six percent offered PFFS on a full-replacement basis, while another 12% would consider this approach in the future. Underscoring employer anxiety about the viability of private market post-65 options, this summer's Medicare Improvements for Patients and Providers Act casts doubt on the fate of PFFS plans starting in 2011. Clearly, the government's position on the funding and regulation of private market post-65 options has a direct effect on employer decisions about long-term change. Uncertainty in this area is heightened with the advent of a new Democratic administration targeting changes in Medicare Advantage payments.

EXHIBIT 3

RDS experience



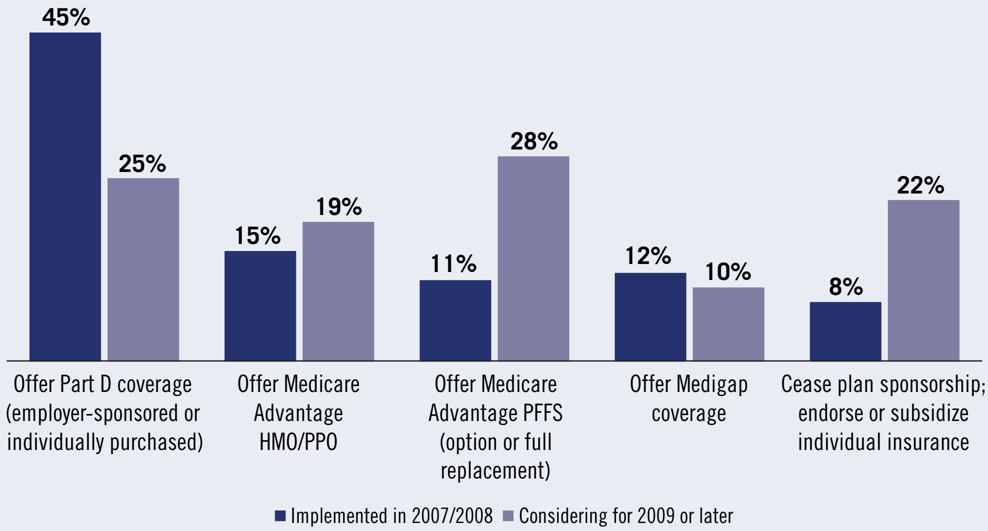
■ Similarly, the offering rate for **Medicare Advantage HMOs and PPOs** is about 15% for 2007 and 2008, with another 19% of employers considering offering these plans in the future. While these plans continue to enjoy substantial membership, most enrollment comes from retirees without access to employer-sponsored coverage.

■ Another approach that some employers are adopting is to **discontinue post-65 plan sponsorship altogether** and convert the benefit to a premium reimbursement account for individually purchased private insurance. This alternative reflects relatively little activity to date (with only 5% of employers using this approach in 2007 and 2008), but interest appears to be growing, with 12% of employers considering this approach in 2009 or later. In addition, a cottage industry — Medicare Coordinators — has arisen to help employers make the shift from traditional employer plan sponsorship to an individual market approach. Medicare Coordinators work with a number of large employers, including GM and Ford, to arrange private insurance coverage and provide administrative services. As more major employers adopt this approach, we expect employer interest to grow further, helping speed the transition to individual market coverage for Medicare retirees *(Exhibit 4)*.

EXHIBIT 4

Medicare retiree medical: Additional plan changes organizations implemented or are considering

(% responding — multiple selections allowed)



WHAT'S CHANGING THE RETIREE MEDICAL LANDSCAPE

Difficulty with the RDS program is one of a variety of factors motivating employers to seek change in their retiree medical plans. Concern about program cost and the corrosive influence of health care cost trend continues to be a strong motivator of change. Seventy percent of respondents cited costs and cost increases as a significant force influencing change in their programs. This factor resonates with another major factor, the current economic environment, which nearly 90% of respondents cite as an influential or significantly influential driver of change. Since the survey was conducted earlier this year, the broader economic pressures have only worsened. Concern about both the level and the variability of costs fuels employers' eagerness for insurers to create viable insurance offerings so that employers can offload trend risk and begin to distance themselves from plan sponsorship and administration *(Exhibit 5)*.

New accounting standards are also having an influence. The Governmental Accounting Standards Board standard on accounting for retiree medical benefits is causing the public sector to do the same kind of number crunching undertaken by private-sector employers in the early 1990s following the publication of FAS 106 (Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*). At the same time, FAS 158 has changed private employers' disclosure requirements in ways that have renewed employer interest in managing or reducing this benefit's presence on both the balance sheet and profit-and-loss statement.

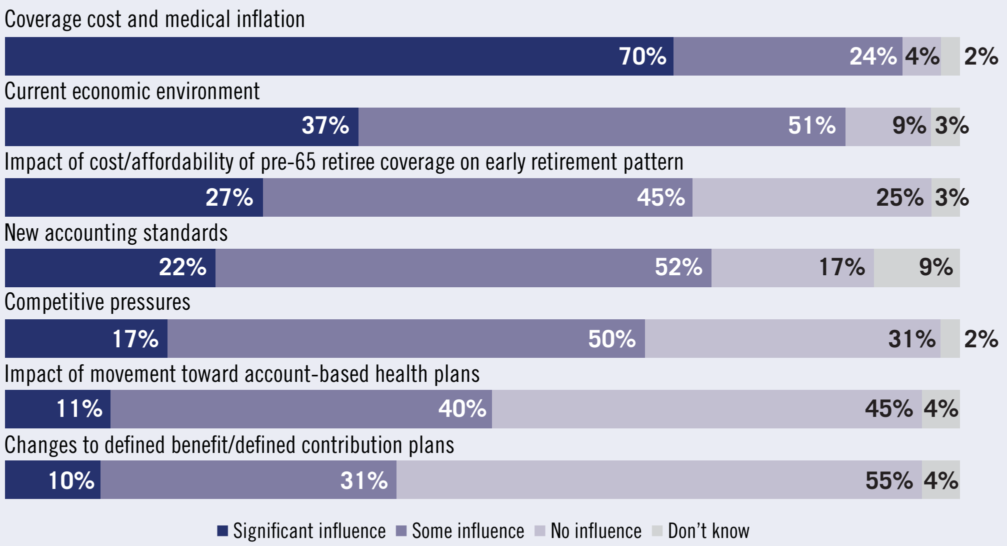
Corporate concern about competitiveness with industry peers is also a significant motivator of change. Whether competitive pressures create a mandate for change or serve as an excuse to make changes in order to "stay with the pack," the effect is the same: strong interest in rethinking the retiree medical deal and increasing willingness to take dramatic action.

The many factors pushing employers toward reducing or eliminating retiree medical coverage are balanced by an awareness that availability and affordability of retiree medical have a significant impact on retirement patterns, especially before age 65. A substantial 72% of respondents acknowledge the influential role of pre-65 cost and coverage availability in their thinking about program strategy.

EXHIBIT 5

Forces influencing change in retiree medical programs

(% responding — multiple selections allowed)



SOLUTIONS TO EASE EMPLOYERS' BURDEN

There is evidence that employers recognize the important and powerful connection between retiree medical design and account-based health plans, such as HSA-qualified High-Deductible Health Plans. Fifty-one percent indicate that their movement toward these types of plans is influencing their thinking about retiree medical. We think this connection — between the wealth accumulation afforded by an HSA and the health security needs of seniors — is a rich opportunity that more employers will investigate in the coming years as they work to wed initiatives to promote smart consumerism and long-term health improvement with financial security in retirement.

As the health care insurance marketplace evolves, economic pressures continue to mount and the political landscape changes in the coming months, we expect employers to pay even closer attention to the influential role of retiree medical plans as an important factor in their HR and benefit strategies. While the pace of change is somewhat slower than expected in the years following the MMA, we believe that fundamental cost and workforce management forces will continue to drive long-term change in retiree medical sponsorship, subsidization and delivery.

ABOUT TOWERS PERRIN

Towers Perrin is a global professional services firm that helps organizations improve performance through effective people, risk and financial management. The firm provides innovative solutions in the areas of human capital strategy, program design and management, and in the areas of risk and capital management, insurance and reinsurance intermediary services, and actuarial consulting.

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