UPDATE

December 2009

RETIREE MEDICAL CHALLENGES AND OPPORTUNITIES

The rising cost and continuing administrative burden of retiree medical benefits, compounded by the current economic malaise and uncertainty about the details of national health care reform, have put plan sponsors in a quandary. On the one hand, survey respondents reported a feeling of urgency about their retiree health plans and a strong interest in making changes. On the other hand, many appear to be hesitant to undertake major change, concerned with a lack of viable market solutions for pre-65 retirees, and are adopting a wait-and-see attitude on potential changes for the post-65 population. These mixed findings from the fifth annual Towers Perrin–ISCEBS retiree medical survey reflect anxiety about program cost combined with persistent uncertainty about finding fresh solutions that are both effective and sustainable.

Exacerbating this conflict are higher-priority issues associated with managing active workforces during economically stressful times. Even as employers have adopted a wide array of difficult workforce changes — including voluntary and involuntary staff reductions, pay freezes, furloughs, and benefit cuts — retiree health benefits appear to be in a holding pattern. At the heart of the issue, burdensome costs and labor-intensive administration are paired with legacy promises and a lack of clear direction about how to restructure retiree medical programs to achieve cost goals and take advantage of new market opportunities in a way that is minimally disruptive to retiree populations.

This year's joint Towers Perrin–ISCEBS survey, which was conducted in July 2009 and drew responses from 155 companies and nonprofit organizations, seeks to understand both the issues employers are facing with their retiree medical plans and the alternatives they're considering to address long-term cost and HR objectives.

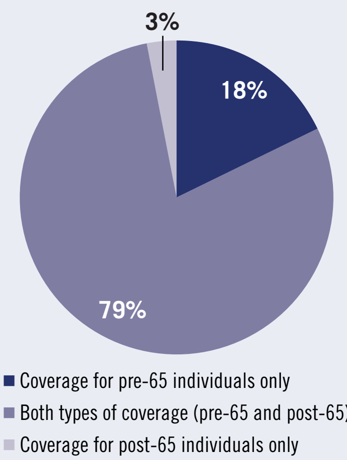
TENSION BETWEEN RETIREE MEDICAL STRATEGY AND WORKFORCE NEEDS

While the current deep economic slump has put issues as extreme as basic corporate survival front and center for many employers, there is no doubt that survey respondents continue to feel the burden of their retiree medical obligations *(Exhibit 1)*. Respondents report a variety of dramatic workforce actions, including layoffs (80%), voluntary staff reductions (32%), benefit cuts (26%) and a litany of other activities, such as hiring and wage freezes, and early retirement windows. However, nearly 70% report that they continue to provide retiree medical coverage to some or all retirees.

EXHIBIT 1

Types of retiree medical coverage offered

(% responding)



About 80% of retiree medical plan sponsors provide some level of subsidy for pre-65 and post-65 coverage. And, contrary to popular belief, about 40% of survey respondents' retiree medical plans are still open to new hires.

Although a pattern of long-term erosion in employer-sponsored retiree medical continues, and may be accelerating due to the current economic environment, many employers are choosing to "stay the course," at least for the time being. In fact, employers view their current commitment to retiree medical in varied ways, such as:

- an opportunity for change that needs to be explored, now or when resources allow
- an acceptable obligation under current plan terms that may limit eligibility and employer subsidy
- an important and continuing part of an effective total rewards program that can help facilitate needed workforce regeneration as baby boomers continue to retire.

Given these broad-ranging perspectives, when it comes to retiree medical, we do not anticipate a consensus on the role of employers anytime soon.

PRE-65 RETIREES STUCK IN LIMBO

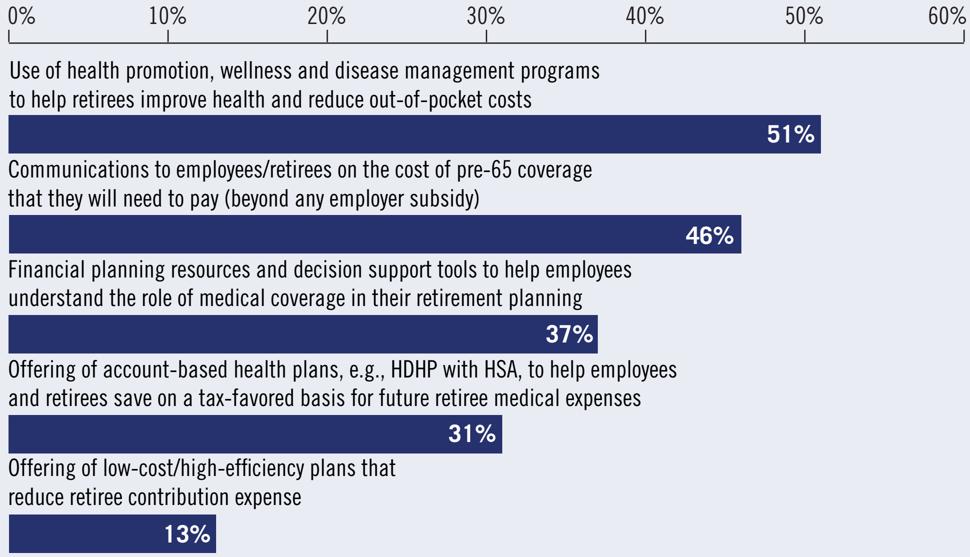
The pre-65 retiree medical landscape has undergone little change over the past year. Employers' static position is likely due to two defining features of medical benefits for this retiree cohort:

- **Lack of access to affordable insurance.** There is no commercial insurance solution for the pre-65 retiree population that corresponds to the robust and successful marketplace for post-65 retirees. At the same time, there is a groundswell of employer interest in market options that would allow them to exit plan sponsorship and better control their financial commitment and administrative burden. Insurers have been reluctant, however, to offer guaranteed-issue products without the assurance of a covered population with a stable, balanced and measurable risk profile. This reluctance has been magnified by the possibility of health insurance reforms that could reshape insurance rules and redefine — possibly in an attractive way — the terms under which insurance plans may be offered to pre-65 retirees. Carriers are also in a holding pattern with regard to the shape of health care reform. Will Washington ride to the rescue for employers, insurers and retirees with reforms that address the twin challenges of access and affordability for pre-65 retiree medical coverage?
- **Delaying retirement to retain health care benefits.** For employees without access to affordable pre-65 retiree medical coverage, the discussion of early retirement is likely a nonstarter. Increasingly, employers recognize their significant ability to influence retirement decisions by offering continued access to subsidized pre-65 retiree medical coverage *(Exhibit 2)*.

EXHIBIT 2

Ability to influence retirement decisions — Steps taken/considering taking, to help employees take actions to prepare for early retirement

(% responding)



Among employers with pre-65 retiree medical coverage, approximately 80% make some contribution toward the cost of coverage. Notably, about 45% of employers that provide a subsidy toward the cost of pre-65 coverage have capped their subsidy, generally at a fixed cost level, although a healthy minority of employers (16%) increase their subsidies at an indexed level to balance company cost with retiree affordability. Not surprisingly, plan costs for a substantial majority of employers with pre-65 caps (69%) already exceed the caps, and nearly half of those whose costs still fall below the cap expect the scales to tip within the next two years. Affected retirees can expect their contributions to continue to rise rapidly as medical inflation drives plan costs further over subsidy caps.

Surveyed employers are not scaling back their pre-65 offerings by reducing caps or terminating coverage to generate savings. Nor are employers terminating plan sponsorship for relief from the hassle and cost of administration. In fact, more than half of employers surveyed stated that plan administration has no influence on potential changes to their current retiree medical programs. By the same token, employers do not seem willing to enrich their plans to provide further incentive for older employees to retire before age 65. Will this benefit change down the road if the economy improves and the labor market tightens? Are new insurance solutions in the offing as an outcome of health care reform?

POST-65 RETIREES

Given the wide availability of Medigap, Medicare Advantage and Part D prescription drug plans, some observers of the retiree medical environment expected to see more organizations weaning post-65 retirees off employer group plans by directing them to the individual insurance marketplace. While there has been some movement in this direction, three-quarters of survey participants continue to deliver prescription benefits through employer-sponsored group plans eligible for the Part D Retiree Drug Subsidy. This suggests that a solid majority of employers have either not looked closely at alternatives to group sponsorship, or have looked and decided not to proceed with changes at this time.

Similar to pre-65 retiree medical, 80% of employers who sponsor post-65 plans pay some portion of plan cost, with more than half of employers paying over 60% of plan cost. About 45% of employers limit their financial support to a capped subsidy level. In the majority (65%) of cases with capped subsidies, plan costs now exceed the cap, leading to rapidly rising contributions.

Only 11% of respondents report moving to a premium reimbursement structure under which retirees purchase individual coverage on their own and then seek reimbursement of their premium up to the plan's dollar limit. What's next? We believe employers' pioneering movement away from group plan sponsorship is likely to gain more traction over time. Medicare coordinators — who provide counseling and enrollment assistance to retirees trying to negotiate myriad plan options that supplement Medicare — represent a key link for employers interested in effectively exiting post-65 plan sponsorship.

While not addressed in the survey, it is likely that the adoption of individual market approaches for post-65 retirees is being impeded by employer concerns about future federal funding of Medicare Advantage plans. Cuts in federal payments for 2010 have resulted in benefit reductions and premium increases. Further long-term payment cuts under consideration as a means of paying for health care reform only add to the uncertainty about the long-term stability of these plans, which now cover over 11 million Medicare participants.

IS RETIREE MEDICAL ON THE BACK BURNER?

Survey data results suggest that responding to urgent business challenges in an adverse economy has taken priority for many HR and benefit executives over less pressing — but still complex and sensitive — issues such as retiree medical redesign. Employers' holding pattern with respect to retiree medical appears to be broad-based and applicable to almost every aspect of plan design, financial configuration and insurance structure — both before and after Medicare eligibility (*Exhibits 3* and *4*).

On the other hand, today's business challenges have motivated employers to adopt changes to active employee benefit programs while absorbing resources that might otherwise focus on long overdue, but less urgent, retiree medical changes. Although maintaining the status quo for retiree health benefits may be acceptable in the short run, it is far from ideal for both employers and retirees over the long term.

EXHIBIT 3

Actions taken or considering taking for retiree medical — Pre-65 benefits only

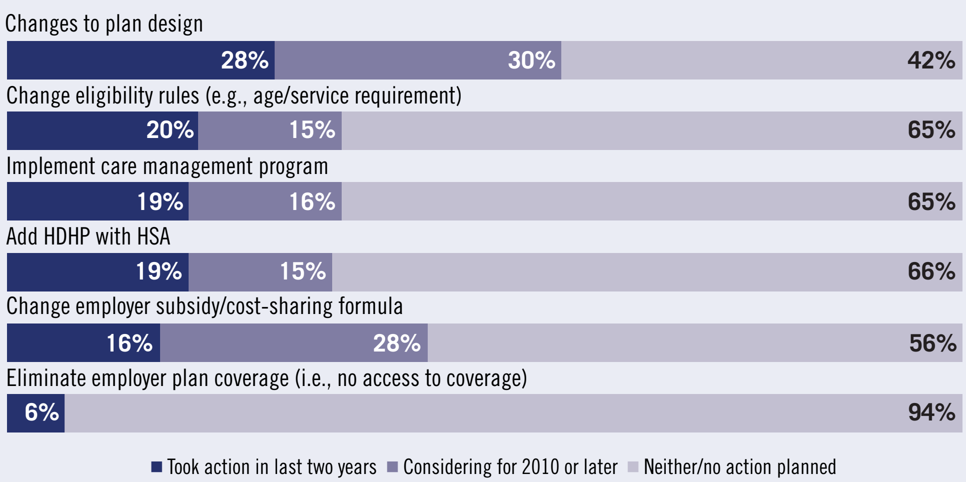
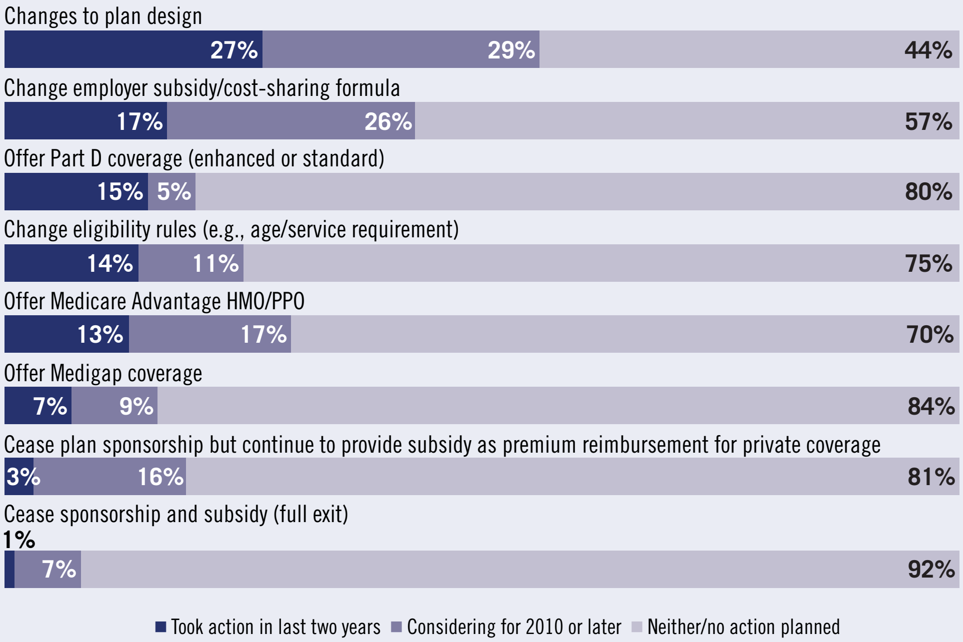


EXHIBIT 4

Actions taken or considering taking for retiree medical — Post-65 benefits only



LOOKING AHEAD

Survey responses suggest that a wave of change is coming. This finding was echoed in a recent Towers Perrin employer pulse survey on health care reform.* In that survey, nearly all respondents told us that they expect to reexamine their health benefit strategy for active employees in a post-reform world, and half expect to reevaluate their health care strategy for retirees. Options for addressing retiree medical may expand under reform rather than diminish. What are some of the strategic trends we foresee for retiree health care in a post-reform world?

- **Retiree medical will resurface as a major and important strategic issue for employers considering what role, if any, retiree medical should play in their total rewards strategy.** While some employers settled this long-term question years ago by eliminating retiree medical eligibility for future retirees, many others who have not yet taken this step may consider doing so after recovering from the economic shock of the past several years. At the same time, employers that view retiree medical as an important component of their reward strategy that supports retention and workforce regeneration goals may opt to stay the course.

- **More employers may design plans with a new approach toward retiree medical funding.** Many employers have moved toward offering account-based medical plans (such as high-deductible health plans [HDHPs] with health savings accounts [HSAs]) over the past several years for active employees. More employers may look to these plans as an important element of a new approach toward retiree medical funding that helps employees capitalize on the link between wealth accumulation (for example, in HSAs) during active years and the need for tax-effective savings to pay for medical coverage in retirement.

*Source: Towers Perrin Health Care Reform 2009: Leading Employers Weigh In — Pulse Survey Report, September 2009

- **Employers continuing to offer retiree medical benefits will likely move more toward the outsourcing of retiree medical delivery, administration and risk, at least for their post-65 retirees.** Insurers of individual Medigap, Medicare Advantage and Part D plans will benefit as more employers move pools of retirees from group-sponsored programs into the individual market. Employers will benefit from reduced administration and genuinely fixed, risk-free financial obligations. And retirees will benefit from significantly expanded choice and enhanced plan value in the individual market.

The wild card at present is the ultimate role the federal government will play in shaping the entire U.S. health care environment as reform efforts continue. At this juncture, it appears likely that large employers will continue sponsoring and subsidizing active health care coverage. The role that vehicles such as HSAs play in linking active and retiree health funding strategies could be diminished by a proposed excise tax on "Cadillac plans." By contrast, insurance reforms and expanded government insurance options could give older employees guaranteed access to affordable health insurance without the need for employer sponsorship. This potential access is an especially important development for pre-65 retirees and employer workforce planning, which may be stymied by pre-65 retiree health care affordability challenges.

SUMMARY

While the prospect of health care reform legislation is ever more likely, its key features are still subject to significant changes as legislation moves toward a final form. Even if major reform legislation is passed this year, it is unlikely that many of its most important and influential features will be effective for at least three or four years. During this time, employers have a window of opportunity to rethink their retiree medical deal and set out principles and defining features that will pay long-term dividends for both cost control and workforce management, irrespective of the particular features of any federal-level legislation.

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