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CAFETERIA BENEFIT PLANS

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MR. BILISOLY:

I'd like to say a little bit about the way in which we should proceed this afternoon. The panel has prepared remarks that we should be able to get through in forty-five to fifty-minutes. This will allow ample time for questions and discussion. We encourage questions of course. In fact, questions consist of the greater part of this open forum so please feel free to ask questions or make comments that pertain to this subject.

MR. HALL:

Flexible benefits is an approach to the delivery of employee benefits and it encompasses cafeteria plans, flexible compensation, and flexible spending accounts. It is rapidly expanding.

In contrast to the traditional group insurance approach where an employer provides a single plan of benefits for all employees, in a flexible benefits plan, employees are provided with a means of using their pre-tax benefit dollars to select the benefits most suited to their own individual needs. In the last three years, there has been a noticeable increase in the number of companies that have adopted flexible programs. More importantly, many employers are now actively considering this non-traditional approach.

Today we'll look at the reasons behind the growing employer interest in flexible benefits and discuss in some detail several popular plan designs.

Why are employers interested in offering employees a choice of benefits? There are a number of environmental influences. I've categorized them into three major forces.

First, on the employee side are the changing demographics of the workforce. The traditional employee benefits plan was originally developed for a family unit consisting of a male breadwinner with a nonworking wife and children. Today, however, because of lifestyle and demographic changes, only about 20% of all employees now fit this traditional mold. The traditional benefits plan designed to serve what was a more homogeneous workforce is simply no longer as appropriate in serving today's highly diverse workforce. Employers recognize that flexible benefit designs can better meet the many differing needs that are present today.

Second, from the employers' side is the need to control the cost escalation of the total benefit package. Benefits have grown to almost 40% of payroll with few signs of real abatement. In some flexible benefit programs, the employer shifts a portion of the benefit cost escalation problem to his employees. This is accomplished by breaking the direct link between the total cost of benefits provided and the employers' benefit expenditure per employee. Instead, the employer commits to a per employee benefit expenditure level and his employees determine how they each will use this commitment. Some, all, or all plus some of their own money can be used by the employee for his benefits. This benefit expenditure limitation is almost certainly the major force behind the interest and flexible benefits today.

The third major force is the changes in federal tax law. Specifically section 125 "cafeteria plans" and 401(k) "cash or deferred arrangements." These laws permit employees to make more tax effective use of their total compensation. Recently the IRS moved to interpret section 125. Later I'll discuss their actions and the impact it has had on employers' flexible benefit plans.

There are many ways in designing flexible benefit plans. I'm sure a lot of you've heard about most of these approaches. High/low medical options, modular or mini-flex, core plus options and the full cafeteria or free choice arrangements.

In general, these different approaches address the fundamental principle underlying flexible benefits: they all give some degree of choice to employees. The employee becomes a decision maker for his own benefit package.

I would like to give you some idea about the different ways these designs can be used by different size employers. The smaller the case the less freedom of choice permitted. This stems from concerns about selection within small groups and the capacity to administer the more complex arrangements. Below 1,000 lives the very simple approach of the high-low medical options are generally recommended. For employers with 1,000 or more employees, either the modular program or the core plus options program becomes practical.

In the modular approach, the employee chooses from three or four complete packages of benefits. Each package is effectively a self-contained program that usually includes life insurance, medical insurance, possibly a disability plan, each designed for that particular module. The employee cannot move the benefits around within the module, he has to take the entire module intact. The distinct advantages of the modular approach is that it limits the adverse selection of the program and does not require very extended employee records. The clear disadvantage is that it limits the benefit choices that employees may make.

The core plus option arrangement works by establishing a core plan of benefits. This is usually provided on a noncontributory basis and has a life insurance schedule, a basic level of medical

benefits, and some disability insurance. Each employee is covered for that basic core program and then there are credits available that allow the employee to choose additional benefits to supplement those individual programs. This allows the individual employee to have considerable flexibility in structuring his own program.

All of the cafeteria designs present three challenges for underwriters and employers. First, there is the need for comprehensive employee communications. Second, sophisticated systems are needed to administer a flexible benefit program. The system requires recording the individual employee choices that have to be carried through to the payroll for deduction purposes. It has to be carried from that point forward for eligibility so that at the point of claim, the administrator of the plan can determine the benefit level for which the individual submits a claim. Finally the system has to be sophisticated enough to produce the information needed for experience rating purposes. Third is the area of adverse selection. This manifests itself as additional benefit costs that arise under a program when employees have choices among insured benefit plans. Alternatively, rather than an extra cost, this adverse selection can be looked at as producing lower premiums for the coverage on those individuals who have low utilization rates and know enough to select their benefit choices accordingly.

To help address some of these adverse selection and administrative concerns, the flexible spending account was developed. To a large extent, this benefit has been evolutionary. A need arises. A financial mechanism through a tax incentive develops. A vacuum is filled. The flexible spending account is an arrangement which provides a direct reimbursement to employees for certain medical and other expenses through a formal reimbursement account plan. Because it is unstructured and does not involve complex, upfront employee decisions, it is relatively simple to administer and does not produce the adverse selection problem I mentioned before. Consequently, at least as an interim step toward a true cafeteria plan, it has significant appeal to employers.

Now let's look at how a flexible spending account works. The employer sets aside money in a cafeteria plan for each employee. The source of this employer money is either newly committed employer dollars; reduced existing benefits; a portion of employee profit sharing dollars; or probably the most popular method, let employees voluntarily reduce their salary on a pre-tax basis. Each category of benefits available for reimbursement is managed under its particular section of tax code. The four most popular benefits are health care reimbursement, reimbursement for insurance contributions, dependent care reimbursement and reimbursement for legal services. The employee decides, as his needs arise, how and when to draw on these funds. A key feature of a flexible spending account was that at year end, money not used was returned to employees as taxable income. IRS "questions and answers" released on May 2nd, however, preclude such return of employee money. Perhaps Congress will restore this right.

On February 10th of this year, the Internal Revenue Service issued press release 84-22. The effect of this press release was to eliminate one of the spending account designs known as the zero balance zebra account. More importantly, the release indicates that employees must pre-elect and pre-fund their flexible spending account. Most importantly, the release would prohibit employees from receiving any cash back at the end of the year or any further benefit from the end of the year balance. It appears that the IRS is trying to require a total forfeiture of employee money not used in the flexible spending account. Clearly, this will effectively limit the functional value of the spending account as it has presently evolved. The aforementioned "questions and answers" solidify the IkS position.

This IRS announcement, which is their first public statement on cafeteria plans since Section 125 was enacted in 1978, has had a distinct damping effect on employers. Those plans that are now in effect are presumably subject to retroactive penalties if they do not institute required changes within the 120 day period prescribed under the "questions and answers."

In summary, as to the broader concept of flexible benefits and flexible compensation, we are dealing with an evolving and growing area. It is possible that within five to ten years the majority of employee benefit programs will include significantly more elements of flexibility and employee choice. For the moment, the regulations and possibly the tax laws for cafeteria plans are unclear. However, it is reasonable to expect that within the next year, a good deal of clarification will be forthcoming from either the Internal Revenue Service, Congress or both. This then should open up a clearer path for employers to move toward these designs and, in turn, will intensify an already fairly active benefit market.

MR. SHERFEY:

I'd like to talk for a few minutes about potential antiselection on flexible benefit plans. This is a new issue to many of us. The typical plan is where the employer paid all or a very large share of the cost of the plan and everyone or virtually everyone was enrolled. We had no concern about antiselection. Where there were voluntary options, we sometimes evidenced concern but usually it was not too great a concern. Now we have designed a benefit plan which really encourages antiselection and that's the reason for its design, we want to give employees a choice of benefits that they feel they can use. Of course they are going to choose the ones from which they will get the greatest benefit.

Some of you may have heard of the term assessment spiral. It is usually associated with closed blocks of individual health insurance business or association group insurance plans which are offered on a voluntary basis. I think that term may become part of our employer/employee plan vocabulary in the future. Some examples already exist where employees have many choices and are paying a large part of the cost.

I am going to give you a couple of examples which do not come from a flexible benefits plan, but come from a typical insured plan where employee options are available. They are both from the state of Illinois Employees Plan. The plan covers 150,000 employees and retirees, so the experience is fairly credible. First a medical plan example on the program. The state pays 100% of the cost of employee coverage and employees pay nearly 100% of the cost of dependent coverage and they have many choices. Originally there were three choices in the insured plan, a high option and two low options. Now there is one high option and one low option plan. There are currently ten HMO's available for employees in the areas where those HMO's operate and there are also two other dependent plan carriers available on a payroll deduction basis. Just looking at the insured high option plan and the low option plan, the high option plan benefits are worth from 20-25% more than the low option benefits. There are two dependent categories. There is a one dependent category and a two or more dependent category. The experience on the two or more dependent category plan is 80% higher than the one dependent category. The high option plan experience is 80% higher than the low option plan. For one dependent plans, the high option experience is 150% higher than the low option experience. You can see what effect giving employees choices among plans will have on your experience. Of course there are many other things that affect the experience, but this shows the conflict we have in these plans; we want to create flexibility and as a result, we have created antiselection. We should not complain about this antiselection when we have created the opportunity for it.

In my life insurance example I have to describe a change in the plan prior to July of 1980. The state had a very modest life insurance plan. There was a basic plan that was completely paid for by the State and there was an option for each employee to purchase fifty percent of his annual salary. The flat rate regardless of the age was 66¢ per month per thousand. It's the kind of rate on which you might expect an assessment spiral where younger and healthier people can buy coverage for a lower premium elsewhere leaving only the older and unhealthy people in the group plan. But rather than an assessment spiral, the experience was actually very good, and improved each year. The rate was reduced and because of that reduction, more people were attracted into the plan and the experience actually got better. There was a change in the plan in July of 1980 where additional coverage was made available. The employee could select up to four units of additional coverage, each unit equal to a half of the annual salary for a total of two times salary. There was also a change in the rating practice. The rates were to be age bracket rates so there would be no antiselection by age. The new plan did not require evidence of insurability and people could elect as many options as they wished.

The experience on this new plan has shown that per $1,000 of benefits, the cost actually increased by about 9% so on an age adjusted basis, the increase in cost was 21% to 36%. I attribute the increase to antiselection and it has been very persistent. The

costs have been stable in the three years since the change was made. Those are my examples on antiselection. I would next like to share some employee election statistics.

At Hansen, we keep track of our own flexible benefits program statistics and also have a system for keeping track of statistics on plans we administer. We can break down the experience by exempt or nonexempt employees, years of service, salary ranges, age ranges and other categories. These election statistics are affected by many things including what plans were in effect prior to the flexible benefits, how the options are priced, sources of employer encouragement to participate in one or another plan, and for medical plans the availability of HMO's. In most of the medical plans, there's a high option plan, a low option plan and in some cases HMO's. Percentages of employees electing high option medical plans ranged from a low of 21% to a high of 77%, quite a wide range. Similarly for low option plans from 20% to 63%. HMO selection is from a negligible percentage up to 17%. On optional life insurance plans, employee selection percentages range 4% to 33%. I think this is a particularly interesting statistic since many insurance companies are offering voluntary insurance plans which require 50% participation to become effective. You may have some difficultly in explaining the situation to your employees when you have offered them a plan and then have to take it away because participation did not meet the insurance company's requirements. For dependent life insurance plans, participation ranged from 14% to 44%. There are frequently some short-term disability options where either the participation or the benefit level depend upon years of service. We have had from 23% to 43% of employees either purchase or upgrade their short-term disability coverage. Optional dental plans appear to be very popular. Over 85% of employees have elected those plans. We have one client with a cancer insurance plan and 44% of the employees elected to participate in that plan. This is the same employer that had 77% of its employees participate in the high option medical plan. I thought that was quite interesting.

MR. BILISOLY:

My job today is to provide some idea of questions which arise with respect to the pricing of benefit options, allocation of credits, measurements of experience, and assessing the impact of adverse selection. Let's suppose that you are a member in one of these recently implemented cafeteria plans, you receive a workbook and that workbook illustrates a whole array of benefits from which you can choose. Perhaps there are three or four medical benefits or even more than that, as Chuck has sometimes shown, if there are HMO's involved. The workbook illustrates several levels of life insurance that you can take and runs the whole gamut of benefits that are possible. You see a price tag affixed to each benefit option, this is the price it's going to cost you to buy this particular option.

The basic problem is one of determining price tags for each benefit option that is described in the workbook. Then we must have a

system for allocation of credits to each employee. The credits allocable to each employee arise from three sources. First, from monies which the plan sponsor decides to contribute to the cafeteria program. Second, amounts consisting of employees' salary reduction. Third, from certain benefits which employees decide to give up in exchange for benefits they desire. The problem appears to be a very simple one, just ascertaining the prices of these options and giving a certain number of credits to the employees. The process is actually much more complicated because, ordinarily, there are a number of constraints that should be observed in the construction of these price tags and the allocation of credits.

Here are some obvious constraints that come to mind. First, the prices set for the options should result in enough money to pay the benefit costs. Second, the prices set for various options should reflect the actual cost of that option. Now that is a principle or constraint that can probably be deviated from. In fact the very setting of these prices should in some instances be aimed at precluding the selection of certain options that you might not want employees to choose. For example, we've all seen a shift in employee benefits away from first dollar medical plans towards plans that entail higher deductibles and more coinsurance. It might be advisable to put a higher price tag on the first dollar medical plan than would be indicated by your data. Third, when you are examining the cafeteria setting, you have to be careful that the additional amount of money that is put into the plan by employees is not overly burdensome, especially in comparison to what those employees were paying in a pre-cafeteria setting. Fourth, we already talked about the adverse selection that is induced by the very act of having a cafeteria plan. Fifth, employer provided credits should probably be limited to some extent, since one of the motivating forces for employers to institute these plans is the hope of being able to contain cost. Many employers adopt a stance that they would like for their benefit programs to cost a more or less constant percentage of pay. Sixth, employee credits arising from the plan sponsor's contributions will be related to the sponsor's idea of equity. For example, in one plan that we've been working on, the employer's objective was to continue to subsidize married employees. Other employers adopt different points of view and say instead, we want to treat every employee alike and regardless of whether the employee is married or not, we are going to provide the same amount of credit. Once again, the objectives of the employer govern the way in which you are going to allocate these credits.

So, how do you determine these option prices and how do you determine the credit allocations? I have used successive approximations. It is effective to look at the experience that has emerged under the particular plan in the past. Let's say a cafeteria plan is about to be instituted, and there has been a standard benefit plan in-force the last several years. You look at the experience under the existing plan. If it is a sizeable group, you have a pretty good idea of what the claim costs are for each coverage and how those claim costs vary by age or by single and married. Then by looking at other kinds of statistics, you might

have an idea of how these claim costs would be affected if there were various degrees of election into a high plan and into a low plan.

When we look at these statistics, we start with a particular set of option price tags that we think will work. We also develop a means of allocating credits from the three sources that we talked about: employer contributions, employee salary reduction, and benefit give up. We end up with a matrix of prices. We do a good deal of testing. For example, one thing we do is use the initial set of prices to construct a matrix of out-of-pocket costs for employees in various situations. Testing employees earning various amounts and having certain dependency status, we attempt to ascertain how many employees will be affected adversely by the first set of prices and allocations of credit that we have constructed. We develop a frequency distribution. Then we do other kinds of testing; for example the effect on overall costs of election patterns. Associated with each election pattern might be a set of selection costs or savings. Let me illustrate what I mean by that. If you think about it for a minute you can see that if a high proportion of people elect out of the high cost plan, the claim cost per person of that high cost plan is going to increase due to antiselection. There is a strong relationship there. The greater proportion that elect out of the high plan the more antiselection you will have. So recognizing that correlation, we attempt to calculate what will happen to overall costs under the plan if there are varying degrees of election away from and into certain plans. Through this testing, you gain a great deal of insight into the relationship among prices and credits and degree of election.

It is of great importance to measure the experience that emerges under any group plan and it's particularly wise to do so for cafeteria plans. If you have a good body of experience and if you can identify cost increases or decreases due to various factors in a fairly accurate way, you are in a position to see in the following year which options should be added or dropped. You would have more information at your disposal by which you could design new plans.

From reviewing the experience it is exceptionally hard to evaluate cost variations. In many cases, employers implementing cafeteria benefits are simultaneously adopting cost containment procedures. The results are difficult to unravel.

One of hardest things to do is to gauge the true extent of adverse selection. Under some plans that we see, the election out of one plan and into another is governed by other than the desire to present the employer with a lot of claims. For instance, if a certain employee has a working spouse and the spouse has a really good medical plan, that alone might be reason enough for the employee to elect out of the high option.

Let's look at several statistical methods that have been used to measure adverse selection. One method to analyze deviant cost is

as follows. Think of two plans, a high medical plan A and a low medical plan B, with a sizable deductible. After the first year has gone by, suppose you take all of the claims that have been incurred under both plans A and B. Suppose you run all of the claims through plan A only and see what the per person claim cost would have been. Suppose after having done that you take the same claims and run them all through plan B to see what the per person claim cost of plan B is, had it been the only plan in existence. Then you compare these results. Almost always, you will see that the actual claim costs under plan A will be greater than the simulated claim costs of plan A. Also the actual claim costs under plan B will be less than the simulated claim costs under plan B. There are drawbacks to this method. One is that if plan B has a very high deductible, you may not see a lot of the claims that would have come about had plan A only been in effect.

Another method used to measure adverse selection is to take some claim statistics and prepare a graph. We have graphed claims cost as a function of the proportion of employees generating that claims cost. For instance, it might be possible to say that 25% of the employees generated 50% of the claim cost and that 50% of the employees generated 75% of the claim cost, and so forth. If you did this on a number points, you might get a graph that looked somewhat like a logarithmic curve. It would be necessary to determine the extent to which the propensity to incur claims was due to antiselection instead of statistical fluctuation. By performing calculations of this sort and just reviewing the statistics, I think you can learn quite a bit about what is really going on and what the degree of antiselection might be.

Finally, you can make use of actual option election data and estimate selection costs arising from existing plans as a basis for projecting what is likely to happen on our new plans. While the statistics are of some value, the analysis does require intuition and subjective judgment.

MR. SHERFEY:

I have listed six advantages and five disadvantages of flexible benefit plans. Most of these advantages and disadvantages are nonactuarial.

Of the advantages, the primary one is employee relations. All studies have shown that initially employees have positive reactions to these plans. I think it's our challenge to design plans that are sound on a long range basis so that those employee attitudes remain positive. The second advantage is cost savings. If an employer is in a situation where he must make cost dictated cutbacks, this is a way to make those cutbacks more palatable. It is also a way to implement cost containment features in medical plans. The third advantage is this is a tax efficient way of providing some benefits where you use a flexible spending account. Benefits coming out are pre-tax income where under the prior plan they would have been post-tax employee money. The fourth advantage is an employer maintains a progressive image. It is hard to think

of an employer who considers himself on the leading edge and providing fringe benefits that either does not have or is not seriously thinking about a flexible benefits program. The fifth advantage is the opportunity for continual improvements. These plans aren't static. We are going to be changing them in the future and there is the opportunity to modify the plan frequently to meet employees changing expectations. The sixth advantage is the opportunity to standardize diverse plans. Whether an employer has many subsidiaries, or perhaps following a merger, there are diverse plans. Flexible benefit plans give the employer the opportunity to provide a core benefit to everyone and let them buy back their original benefits with flexible credits.

On the disadvantage side, there is, of course, initial implementation costs. These plans require completely different administrative systems than the current plans. There is a lot of work involved in setting up a plan. The second disadvantage is the ongoing administrative costs. Maintaining current employee selections and keeping track of experience is going to require more complex systems. The third disadvantage is the antiselection we have talked about. The fourth disadvantage is the continual improvements in the plan and the cost of making those changes. The fifth disadvantage is that right now there is very little in the way of regulations and guidelines to use when establishing flexible benefit accounts.

The pitfalls an employer wants to avoid are essentially to avoid being surprised by these disadvantages. First, you do not want to have administrative cost surprises. You should figure out what the costs are going to be before you get too far along so that you are not surprised by those costs. A second pitfall to avoid is realizing participation is less than required. For example, life insurance where employee participation in an option, participation might not be sufficient to meet your insurance carrier's requirements. A third pitfall you cannot avoid (but you can plan for it) is the antiselection related to cost increases. In some cases this may be desired, some employers may wish to create two medical plans with the idea that they want to encourage everyone to get into the low option plan to encourage more cost efficient use of medical services. If they can create an assessment spiral in the high option plan, pass those prices on to employees, that will be another way to encourage them to get into the more cost efficient plan.

MR. SHERFEY:

This morning the questions and answers have come out that relate to flexible spending accounts. First 401(k) plans can be an option but flexible spending account balances cannot be rolled into a 401(k) plan at the end of the year. You must use or lose balances in flexible spending accounts. They cannot be rolled over into a 401(k) plan. You cannot carry them over in the future years. You cannot get them in cash. Second, employees must make an irrevocable election unless there is a change in family status. Third, there are three criteria for flexible spending accounts.

One is risk shifting. The second is risk distribution. The third is that benefits must be incurred while you're covered under the plan. You can't go back and pull in some expenses that were incurred prior to your effective date of coverage. Fourth, salary reductions made to create flexible credits will not affect pension plan benefits. Fifth, there are some transitional rules which apparently say that zebra accounts, which receive the bulk of the criticism, are out retroactively. Plans which might not qualify with provisions not permitted by the release have apparently 120 days to take certain steps to correct those plans so that they will not be deemed retroactively nonqualified.

MR. BILISOLY:

Are there any questions or comments?

MR. TROWBRIDGE:

I'd like to ask a question as to the inclusion or lack of inclusion in this cafeteria approach of the retirement income or pension form employee benefits. It seems an employee is given a choice among various kinds of welfare benefits. The next logical step would be to give him choice as to how much of that he'd like to take in the form of retirement. It would seem that any kind of defined contribution pension arrangement would sit very nicely under a flexible benefit plan. To what extent is the cafeteria approach encompassing pension arrangements?

MR. BILISOLY:

I think it was hoped at first that unused money which had been placed in the spending account could at the end of the year either be taken in cash, or could instead be rolled over into 401(k) plan or even be rolled into the following year for additional expense account. But now it appears that all of these are precluded. It is possible to include in your element of choice taking pre-tax income and putting it in a 401(k) plan. Now, I've heard from some of our offices in the eastern part of the country, that there is a tendency for employers to scale down the rate of future accruals under their pension plans, realizing that it would be better to have some of that money going into a thrift plan, profit sharing plan or such. So they're saying in effect to employees, we are going to scale down future accruals under the pension plans so you can put more money into 401(k).

MR. KRANTZ:

I would like to turn the 125 plans upside down and involve the 401(k). I believe in a 401(k) plan if there's an economic hardship, the employee can withdraw funds before he reaches age 59½. The 125 plan as I've heard it described is a front-end type plan where the core plan may be a high deductible plan and the employee has the option of going back to, let's say, a $100 or $200 deductible with his flexible benefit units. Instead of buying the higher cost health plan, can the benefit units be put in a 401(k)

and withdrawn when needed so the deductible can be paid on a pre-tax basis?

MR. BILISOLY:

I'm not aware that they've ever come out with the regulations on what constitutes an economic hardship.

MR. HALL:

This is a relatively complex subject of 125 and 401(k). 401(k), as I understand, is a thrift program and I do not see anyway that you can get any medical expenses involved. It can be used with a cafeteria program. To the extent that the discrimination tests are met, the employee can elect to have certain level of his employer's contributions put into the 401(k) program for his benefit. This is an irrevocable election. I don't see anyway that you can couple any medical program with the 401(k) pension program. I will try and answer Mr. Trowbridge. I do not believe that many employers or benefit consultants have really included in the flexible benefit much in the way of pension outside of the 401(k). I think it is because it gets very much more complex when you start talking about defined benefits as compared to defined contribution arrangements.

MR. NESBITT:

In case of salary reduction, is there any reduction of Social Security taxes or benefits?

MR. BILISOLY:

I believe the general rule in the case of salary reduction that with respect to your pension benefits, it is not necessary to reduce the salary base upon which the pension benefits are calculated. Most employers appear to be taking the approach that they will include amounts by which you are reducing your salary in pension base. With respect to Social Security, my impression is that such salary reduction reduces the amount subject to the Social Security tax.

MR. SHERFEY:

Well I think that, with respect to these questions that have been asked, we are at somewhat of loss because we do not have guidelines and regulations, but I thought it did not reduce Social Security compensation.

MR. C. DEAN:

I think the way it works is that it does reduce the base on which taxes are levied for the purpose of the section 125 benefits, but it is not for the 401(k). Social Security taxes and benefits would be reduced for the money that was used in the section 125 part of the plan and would not be reduced for the 401(k).

MR. BILISOLY:

Despite the cold water poured by the government on the operation of flexible spending accounts, there is not too much abatement in interest among employers. There are certainly lots of inquiries and employers appear to be proceeding under the assumption that all the cutbacks that were announced on February 10th would in fact be implemented. You would have the "use it or lose it" rule, and elections to reduce salary would have to be irrevocable unless there's a family change.

Here were some of the questions that arose during the Atlanta session. How often should option re-election be allowed in a flex plan or in a cafeteria plan? Are there exceptions? Some people in that audience thought that elections might be allowed more frequently than annually, although in the few cases that I've worked on, it appears that almost all the election is done on an annual basis. (Once per year is the rule under IRS questions and answers).

MR. HALL:

When dental is in the program, often you see a situation where the employee has to elect a year in advance if he wants to either add dental, or move from the lower dental option up to the higher dental option or possibly go from a dental program that does not have orthodontia into one that does. It's a device to effectively maximize premium income and minimize the selection against the plan. It is not totally effective but it works in that direction. I think that the answer depends on how much flexibility the employer wants and want is based on administrative capacity. But I would agree that once a year is most typically the universal frequency.

MR. BILISOLY:

One of the main ideas behind a cafeteria approach is to provide flexibility. Certainly you want employees to avail themselves of the coverages that they think they really need and so in a sense, you're asking for antiselection. The question becomes not one of how we knock out antiselection, but how can we contain it and how can we prevent it from being too severe. I have heard of plans in which to change from a low life option to a high life option, it requires some evidence of insurability.

How many of these plans are self-funded? Are insurers resisting providing the needed insurance on options? There are not too many organizations that can handle the administration under such plans. Some of the big insurance companies seem to be among the few that can do it. I suppose there are some TPA's who might be doing such administration too. But certainly that's one concern that needs to be addressed; who can even do the job. Even though they may resist some of the option choices that are presented and the price tags that are put on them, I think they have to stand there and be ready

to do the administration. Any consultant who did not talk to the insurance company before putting in a flex plan would be remiss. Certainly in cases we have looked at, the insurers have been brought into the picture.

MR. HALL:

Your illustration before is probably to the point where you take a look at the richest medical program and estimate the maximum cost that is going to arise under the program. That gives you a fix on what the outside premium should be. It gives you a basis for developing a premium rate that the insurer can look at as being the top side. The final premium rate is something less than he would expect to receive in the way of premium income to cover the entire cost of the plan. That sets up, in a sense, a relationship between the insurance company and the employer. What is critical to the insurance company is keeping them informed while the plan is going into effect, and then subsequently after you have some experience under the program, the insurance company will then be able to take that information and look at it so that credits can be set for the next year. From the experience and the employee elections, the employer can determine the desired subsidy built into the program. At this point, it is testing by trial and error. What the employer really wants to do is end up with a program that subsidizes the areas that he wants to subsidize and get the employees in a position where they have choices that are meaningful to them at contribution rate levels that are both fair and understandable. The goal is balancing the total costs among the different choices and among the different employee groups so that they are getting a program that makes sense to them. It is really not selection so much against the insurance company, but a balance within the group.

MR. SHERFEY:

Any insurance company which has had experience with voluntary plans or voluntary options is familiar with the terms antiselection and even assessment spiral. I think some hesitance on their part should be expected. Another area we have talked about is the administrative requirements for plans like these. Insurance companies certainly do not want to get into a plan that they cannot administer.

MR. BILISOLY:

Do cafeteria plans afford the employer only temporary or transitory relief on cost control? Won't the costs of administration and communication nullify claim savings that appear to come out? Isn't much of the savings due to shifting costs onto employees? Let me talk first about cost containment. One of the perceived advantages of a flex plan is that maybe the plan will provide some element of cost containment. Some of that has gone now that the spending accounts are not as effective as once thought. But I think there's some element of cost containment because you're inducing people to shift to plans with higher deductibles. There are other means of

cost containment that are being put into effect which are independent of the existence of a cafeteria plan such as pre-hospital certification and some PPO activity. There is some cost abatement when all of these procedures are put in place, but then after the cost abatement is once achieved, medical costs may resume their ascendancy into the stratosphere. They may just continue to go up because the American population is aging and the government is attempting to shift cost from Medicare. As more and more of the costs are shifted to private insurance companies and private employers, costs may increase again after this one time abatement.

The costs of administration were once regarded as a real deterrent to the implementation of a cafeteria plan. Now there are computerized systems that appear to be very efficient. Communications cost a lot to begin with, but it is a small proportion of the total amount of money spent and it probably is money well spent. Under almost any circumstances, it is a good investment to spend on communications to let employees know how much money their benefits cost.

MR. MCKAY:

A lot of organizations are not looking to make the savings initially. They allow the employees to get back to the original program but hope the savings will develop over time, specifically in the medical area, by encouraging people to get into low cost, low value medical plans. Also, employers can control how many credits they are putting in, which can be seen as cost shifting to employees. One of the things that can offset adverse selection partially, if not totally, is the utilization savings. People electing the high plan tend to be high users. The people electing the low plan should have lower utilization than random selection would portend. And the statistics (such as the state of Illinois plan) may be actually demonstrating that if the rich plan is 80% higher than the low plan when you're taking ratios, it may be because the low plan is better than you expected and the high plan is probably a bit worse.

MR. SHERFEY:

Once we have hopefully gotten the initial cost savings, costs will go up by the rate of medical care inflation. A significant component of our trend factor is increases in utilization and whether that's 3% or half the inflation rate or maybe, even more than that, I think one of the potential long range savings is holding down that piece of the trend factor.

MR. BILISOLY:

The adverse selection and the implications that it has for employees are the changes that are occurring with respect to income tax. The force perhaps underlying this is environmental change that has to do with demographics. In the long term, demographics will force many employers into flexible benefit programs. When

employers begin laying out credits for employees, they know the employees that will get optimal use from the benefit package. It is forcing employers to deal with the issue as to just where should they put the bulk of their contribution for their employees. Does it continue to go to a very large extent to the employee with a family? Do they continue to subsidize that traditional bread winner to the same extent? I think that flexible benefits will force employers to deal with issues like that. I don't believe it will go away even though there may be a short term savings. It appears that this whole issue of structuring programs that meet the demographics of the workforce is really what will, in the end, push more and more employers into this sort of thing.

Going a little further down the same path, (I'm talking out of the other side of my mouth), but I guess it is true that there are forces that will continue to operate as has just been said. They will continue to operate to keep the costs down. Because of the demographic concepts that Bob just elaborated on, there are many reasons why employers will still want to look at these plans.

I have some thoughts on measures of acceptance of flexible benefit plans. Among the plans that we have worked on, we see that after implementation of the flex benefits plan, a very small proportion of employees elect to stay with the benefits which they had previously. One example is a large bank, I recall that only 6% of the people elected to stay completely with the plan they formerly had. This is some evidence of the acceptance of flexibility.

MR. HALL:

I don't think you see that right away Dick. I think that in the first year, there's a large part of the group which stays with the existing program and maybe some of the group experiments with something new. But in the second year, you see quite a bit of movement away from the original plan if the other plans are relatively attractive and then you're down to that 6%.

MR. BILISOLY:

Maybe this is a reflection of the fact that in the instance that I mentioned, the original plan was not very good at all and anything would have been better.

MEMBER OF AUDIENCE:

If a flexible spending account is going to be used and now we have the "use it or lose it" proposition, won't that tend to make people use up their benefits or their flexible spending account on health care which might otherwise not have been used and, therefore, work against this idea of cost containment?

MR. SHERFEY:

Well that's certainly possible, but another possibility is that if they have to use it, they will use it for wellness, physical

checkups or something which will improve their long run health and hold down costs in the future.

MR. BILISOLY:

I think the answer to the question depends largely on how the whole plan is designed. Let me tell you just a little bit about ours at the Wyatt Company. We have a good set of benefits and we do not have flex benefits plans. We do not have a cafeteria plan. We do, however, have a flexible spending account. Now one purpose of the flexible spending account is to enable us to use pre-tax dollars to pay the employee contributions that are needed for the medical coverage. For that reason alone, I and perhaps almost everyone else, elected to have their salaries reduced some amount. On the other hand, I foresee the need for some expenses that lie outside of our regular plan. For instance, several weeks ago at Easter time, chewing on some of the caramel corn that my wife made, I managed to extract a large part of my lower left molar. I was confronted with some dental expense that I did not foresee. We do have a dental plan, but it has a big deductible. To that extent I'll be filling in the deductible (as well as my tooth). I think a lot of money elected to be taken away from pay will be used for eyeglasses, contact lenses, child care and other items that lie outside the scope of the traditional plans; so maybe it won't disturb the cost saving implications.