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CAFETERIA BENEFIT PLANS

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- Reasons sponsors implement cafeteria plans. Prevalence.
- Basic design options - benefit choices.
- Measuring experience - cost of options - determining.
- Pros and cons, pitfalls of cafeteria plans, credits.

MR. ALLAN J. GROSH: We are all aware of the bulging cost of traditional benefit programs. A recent Chamber of Commerce survey shows that the average cost of benefits for nonexempt employees climbed from 25% of payroll in 1957 to over 40% of payroll currently. These figures include voluntary and statutory benefit plans.

Faced with the prospect of further increases, a large northeastern industrial company, for example, in an attempt to hold benefit cost to their current percentage of payroll level, installed for its salaried employees what they called a flexible benefits program. They essentially accomplished this by first shaving their traditional programs back to a core of basic noncontributory coverages consisting of retirement, medical, disability and death benefits and paid vacations. Secondly, they inserted several cost control devices. The company put deductible limits on the basic medical plan, which up to this point had provided first dollar coverage. It established a social security offset in the pension plan, which up to this point had been a nonintegrated plan, and it made dental coverage optional, which up to this point was a mandatory benefit. Thirdly, it determined the difference between the cost of the core benefits and those in the original program, and then allocated those differences back to employees in the form of credits on the basis of age, pay, family status and years of service. So at this point employees were still getting the same compensation value that they had before the program was changed.

The company allowed the employees to use those credits ranging anywhere from 2% of pay up to 14% of pay to buy optional benefits not included in the core package. One of the options was to use all of those credits to buy back the program they had before the changes took place. The allocation of these credits in future years was at the discretion of the employer, and that was the cost control mechanism. If a benefit became too costly for the company, the employee had to give up something else or make plan contributions to get it. Alternatively, the employee could accept a reduction in the benefit level.

This type of program has been called everything in the book ranging from cafeteria compensation, smorgasbord compensation, supermarket compensation to flexible benefits. It is unfortunate that such an important concept should have such unappetizing nicknames. To us, cafeteria, supermarket or smorgasbord brings to mind memories of long lines, small portions, wrong choices and dyspeptic after effects. A more professional, less colorful term is flexible benefits.

What are flexible benefits? Conceptually, if you take them to their ultimate extreme, it is a plan under which employees have the opportunity to determine where, over a wide range of alternatives, their company can spend their individual compensation dollars that up to this point have been spent in a uniform manner for the average employees needs and preferences. There are several variations of these plans that have existed for many years, so that flexible benefits or cafeteria compensation is not really new. It has been around for years. The various forms we have had in the past include employee paid voluntary supplements, under which employers provide, in addition to basic coverages, optional amounts which the employees have the option of taking by paying for them with after tax dollars (e.g., supplemental life insurance coverage, after tax contributions to profit sharing plans or savings and thrift plans, and dependants coverage). The forms also include employers subsidized options. Under these types of programs, the employee and the employer share the cost of additional programs (such as dependant coverage under medical programs where the employee picks up part of the cost).

The unique thing about the two approaches mentioned is the willingness of the employee to spend his own money to pay for them. Typically what he is spending is after tax dollars and not pretax dollars which really leads us to a third approach, what we customarily call flexible benefits today. Under this approach, the employee chooses a package of benefits on a pretax basis, or in broader terms, he makes a selection about the distribution of employer dollars that are not currently taxable to him. This approach is not new either. For example, many companies allow employees to trade unused vacation days for employer contributions to profit sharing plans. Other companies have what we call cash deferred profit sharing plans under which an employee has a choice between a portion of the employers contribution to the profit sharing plan and cash. In states such as Minnesota and California, where health maintenance programs are very popular, employees have the right to elect participation in a health maintenance organization instead of a typical medical plan. And of course in the executive compensation area, deferred compensation and optional executive perquisites, which could be consdiered a form of cafeteria compensation, have been around for many years.

Why the renewed interest in flexible compensation? This interest is really sparked by the Revenue Act of 1978, which carried with it Section 125 of the Internal Revenue Code, saying in effect that a cafeteria plan is a plan under which at least two options were provided (a combination of taxable and nontaxable benefits). The law itself didn't talk about the combination of taxable and nontaxable benefits. It was the committee reports that quantified this. What the law essentially said was that if an employee had a choice between a taxable and a nontaxable benefit he wasn't in constructive receipt of the proceeds, he didn't have to pay taxes on the taxable benefit until he actually elected it.

So you can come up with some very basic and limited versions of cafeteria compensation. For example, if I had a medical plan and all I wanted to do was give the employees a choice of having family coverage under the plan, then the choice could exist between a taxable or a nontaxable benefit by allowing the employee to have his salary reduced by the amount of the contribution required to pay for the family coverage. If he chose the taxable benefit, he didn't have his salary reduced. He also didn't get the family coverage. If he chose the nontaxable benefit, he got the medical coverage but he gave up the cash for it. And of course, if he took the latter approach, he didn't pay any tax on the contributions. The net result - he just paid for his family coverage under the medical plan with pretax dollars. That's a very limited form of flexible compensation. A more extensive form is a comprehensive plan that would have several options and trade-offs.

Companies adopt and implement flexible benefit programs for several reasons, and as sort of a prelude to our presentation, I'd like to give you some of these reasons. Some companies who have traditionally been very paternalistic in the past have changed their thought process in realization that employees can make intelligent choices and have a better handle on the benefits that would best suit their individual needs. Second, there are those that believe that when you give employees involvement in the flexible benefit process, or at least involvement in terms of picking and choosing what is best for them, there is a greater degree of employee satisfaction because of it. Third, when you offer employees a choice of benefits, many companies believe that in order to make a choice you have to understand what you have right now and you also have to understand what those choices are. The consequence of course is a better understanding and appreciation of existing and alternative benefit programs.

Four, some companies have actually implemented flexible benefits because it forced them to get their administrative act together (administration, enrollment, recordkeeping, reimbursement, etc). One of the reasons given for the current popularity (I didn't purposefully put this down as the fifth reason - it is probably up near the top of the list) is cost control. Many companies look to flexible benefits as a vehicle through which they can control their costs. They can draw a circle around the 35% of payroll that they are presently spending on benefits and to the extent that costs escalate beyond that level, they can pass those costs on to employees. It becomes much easier under a flexible benefits program because what they are giving employees is not really benefits, but credits to spend on benefits to some extent.

Next, many companies that have union and nonunion employees look to flexible benefits as the wedge which separates the salaried from a nonsalaried employee. For example, companies traditionally have bargained with their union employees and then they grant to some extent those benefits to their salaried employees. Flexible benefits allow companies to distinguish between salaried and nonsalaried employees. Finally, flexible benefits have assisted companies in the merger and acquistion area where one company acquires another company and they have radically different benefit programs. Flexible benefits is probably a very effective vehicle in terms of standardizing a benefit package, at least at a core level, and then allowing companies to strike differences beyond that core level with supplemental benefits.

The actuarial challenge in flexible benefits for all of us is to recognize that when employees select options that are most likely and pass up those that are least likely, benefit costs are obviously going to rise unless we, as actuaries, can grab a hold on things such as anti-selection and appropriately price and structure option prices.

MR. DALE L. GIFFORD: Flexible compensation was first introduced in 1974, a full decade ago. Most of you know that TRW Systems and Energy Group and Educational Testing Service were the first companies to implement flexible compensation plans. Probably, you have heard about or read about the experiences of American Can, Northern States Power, or PepsiCo or others of the pioneers in this area. But beyond that most of you might be hard pressed to name too many companies that have actually implemented flexible programs. Flexible compensation gets a great deal of publicity on a very macro level; even Time, Newsweek and the CBS Morning News and the Today program have all discovered "flex" at one point or another. We read a lot of information, but much of it is theoretical. My principal goal in the next few minutes is to provide an update on the current state of events in the flexible compensation area; the prevalence, some of the design approaches, employee reaction to choice making, how it can be successful in implementing some particular management objectives, and to talk a little bit about the future of flexible compensation.

There were approximately 88 flexible compensation plans implemented by the end of 1983, and this number is expected to exceed 150 in 1984; it can very well be in the neighborhood of 200 to 300 programs by January 1, 1985. There is a considerable interest in flexible compensation and it has been growing very rapidly over the last three or four years and it has clearly moved well beyond the exploratory stage.

Back in the early days of flexible compensation programs, the initial motivations were basically to try and meet employee needs and improve employee relations by hitting employees where they were at with their specific preferences and trying to increase their awareness of benefit values by enhancing the companies image as an innovative and progressive employer. The basic thinking was that each employee had their unique circumstances, and that it just didn't make sense for an employer to dictate how benefit dollars could be best allocated for each individual. The underlying cause of this desire to fit individual needs was the far reaching changes that had occured in the demographic characteristics of the typical employee in the work force over the last couple of decades.

As we stand today:

- Almost half of the work force is female.
- The "traditional" household has really given way to the "two-paycheck" household. Today almost two thirds of households with two adults are supported by two incomes, rather than a single income.
- The "traditional" household with working father, non-working mother and dependent children represents only about 15% of all households.
- In addition, the age composition of the American work force is changing rapidly. A growing majority of the people in the work force

now falls in the group of 25 to 45. And older employees, particularly women whose children have left the home, are coming back into the work force in increasing numbers.

It's really those changing demographics that initially motivated many companies to explore and introduce greater choicemaking--recognizing both the different needs of the individual and the changes in those needs over time due to marital and family status changes, compensation changes and increases in age and service.

Today, there are some different underlying objectives that are motivating employers to implement flexible compensation programs. Appealing to the diverse needs of the workforce is still considered to be a worthwhile objective, but it has taken a back seat to the objectives of cost control and tax effectiveness. So, what really started as a method to please employees in the mid 1970's has for many companies become a system of delivering specific management strategies for benefit programs in the 1980's.

I'd like to focus on the cost containment objective for a few minutes because that is a very critical one for most companies. In the past, an employer who was looking to control these escalating benefit costs that Allan referred to really had three choices:

- Freeze the current program and not add new benefits,
- take away or cut back on existing coverages,
- ask employees to contribute more for existing coverages.

Obviously, none of those alternatives are particularly palatable to employees, and most companies have been quite reluctant to push too hard in any of those directions although a significant number have undertaken some of these actions in the last three or four years.

Under a flexible program, the employer can strive for cost control in another way. The company can offer choices to employees, providing an opportunity to those who desire it to keep the high coverage if they are willing to pay the high price tag involved. Other employees can drop back to less expensive coverage that may be fully paid for by company money. The employer contributions to the program can be pegged to a different strategy and can be permitted to escalate at a rate which is slower than the escalation rate with overall benefit costs.

Or put in another way, we separated the cost of compensation from the form of compensation. This is sometimes used as the new definition of flexibility--a method of compensating employees which separates decisions on the forms of compensation which the employee decides from decisions on the cost of compensation which is an employer decision.

Here's an example of how this can work in a program. Assume that a company gives employees a choice of two medical insurance plans with differing levels of coverage, one priced at $1,200 per year the other priced at $1,600 per year. If during the first year the experience under Plan A would require a premium increase of only $100 dollars and Plan B requires

$200 more, the prices in the second year of the program can reflect the amount needed to support the specific coverages--creating a $500 difference in the two plans in year two in contrast with only a $400 difference in year one. As the gap between the two plans grows, so does the incentive for the employee to choose the lower cost plan.

The employer's commitment to support the medical benefit can be completely independent of the prices charged for the coverage. For example, in the first year if the company were to make available $1,400, the employee choosing Plan A would have $200 left over to spend on other coverages, while the employee choosing Plan B would basically have to dig into his pocket to come up with $200 to afford the coverage. In this illustration, the employer decides going from year one to year two that they will increase the contribution by $100 per employee, perhaps related to the increase in average payroll expense or perhaps pegged to the cost of the increase in the lower medical plan. The employee choosing Plan B now finds that he is $300 short, and has to dig even deeper. Over time, as the difference in the cost of the medical plans becomes larger, more and more employees will be encouraged to choose the lower cost plan. This clearly indicates some cost shifting as a possibility from the company to the employee, but it also should have a positive impact on the overall utilization of medical expenses - some real cost reduction because research has confirmed basically the conventional wisdom that says the utilization of medical services decreases as the employee share of the cost increases.

The most straightforward application of this conclusion is simply for a company to replace its current basic medical plan (with some first dollar coverage) with a comprehensive plan having front end deductibles and copayments, and take the savings and create a flexible reimbursement account (or a flexible spending account or a benefit bank - it goes under a number of names). Considerable interest has been expressed in the last year or two in this basic very simple approach to flexibility in an attempt to quickly convert employees into more cost-conscious consumers of health care services. Companies like Quaker Oats, Xerox, Alcoa, Motorola, S.C. Johnson and others have moved basically in this very specific direction.

Obviously, there is some limit to the cost savings under a flexible program beyond which positive employee reaction is difficult if not impossible to maintain. However, a well designed flexible system can secure employee satisfaction at a lower cost than a program that does not include employee choice making. Now let me consider the tax-effectiveness objective for a moment.

I'm sure you are all familiar with Section 401(k) plans and the use of salary reduction as a mechanism for funding these cash or deferred profit sharing plans. Maybe you might be somewhat less familiar with Section 125 and the use of salary reduction for providing employee benefits on a pretax basis.

Flexible compensation programs, when used in conjunction with Section 125 salary reduction, can allow employers to help satisfy this third objective of providing benefits in the most tax effective manner. Through salary reduction, the employees of many companies are now able to pay benefit

premiums (primarily for health services but also for group life and LTD benefits) and other eligible expenses through contributions to one of these reimbursement accounts on a pre-tax basis. The end result of going through that process is increased take home pay for the employees without really impacting on the employer's cost. Obviously, something which accomplishes that leads to increased employee satisfaction.

The use of salary reduction under Section 125 is clearly a subject raising a great deal of controversy these days. We will get into some of those details a little bit later. Although Section 125 has been a part of the Internal Revenue Code for almost six years, since 1978, there are not yet any regulations, even on a proposed basis, from the Treasury Department. Therefore, salary reduction as a source of funds has not been specifically blessed by Washington as it has in Section 401(k) under proposed regulations. The obvious concern by the Treasury Department and the IRS is the potential of substantial tax revenue loss if salary reduction becomes as widespread under Section 125 as it has under Section 401(k).

We acknowledge that the spending accounts have recently come under some significant attack by the IRS (IR 84-22), primarily as a result of some fairly aggressive approaches to salary reduction funded reimbursement accounts, sometimes referred to as ZEBRA's or zero balance reimbursement accounts. Under these plans, the IRS has taken the position that employers are merely recharacterizing a portion of the employees' salary into nontaxable dollars. So what is viewed as tax effectiveness as employers isn't always viewed with such great favor by the people in Washington. As I mentioned, I am anticipating there may be a question or two from the floor related to that specifically.

We and many others are clearly working hard in Washington to try and make sure that key Congressmen and their staffs are aware of some of the advantages and positive uses of Section 125 rather than over-reacting to some of the abuses, and have offered suggestions as to some alternative ways to limit the tax revenue loss while still maintaining the positive effects.

As noted earlier, there is a great deal of diversity among the currently implemented flexible compensation programs. A very basic program would typically include a reimbursement account or some choice in at least one benefit area, usually the medical area. Quaker Oats, Xerox, Alcoa, Simpson Industries, Toro are among the companies who have introduced programs with limited flexibility of this type. As plans become broader, they provide options in an increasing number of benefit areas such as group life, long term disability, medical, dental, buying and selling vacations, capital accumulation, reimbursement accounts and salary reduction. The broader flexible programs in effect today have choices in the majority of these areas--companies like American Can, Northern States Power, PepsiCo, The St. Paul Companies, and Mellon Bank. Some companies, like PepsiCo, have started with a limited program and have introduced broader flexibility on a phased-in basis.

Let's take a look at a couple of specific examples of programs.

One company, BFGoodrich, was among the many companies who was specifically trying to find a way to deal with the problem of soaring health care

costs. At Goodrich, over the last decade the medical payments by the company had more than tripled. As Goodrich announced to their employees in their communication: "It's clear that health care costs for the Company have reached staggering proportions. Good common sense ... and sound business practice ... demand that something be done."

The new approach that Goodrich took involved the elimination of first dollar medical coverage. Instead, as of May 1, 1983, salaried employees were given choices among comprehensive plans with low, intermediate, and large deductibles in addition to an HMO and varying stop-loss provisions. In addition, the company created a flexible reimbursement account with $300 for each employee which can be used to pay for the premium cost for the low or medium deductible options. The full amount of $300 will buy full family coverage under the richest of the options, although the richest of the options is a substantial reduction from the preflexible plan. To the extent money isn't used for premiums it is available to cover all other health care expenses that are incurred during the year. Under their program unused amounts at the end of the year at least have been promised to the employees to be paid in cash.

Goodrich expected to accomplish a number of objectives through that restructuring. First, in their minds a change represents a return to the original intent of medical benefits--catastrophic protection. The shift away from first dollar coverage at Goodrich (even when combined with the $300 reimbursement account) was projected to save them over $3 million dollars in the first year. Second, by involving employees in the cost of health care, they hope to encourage smarter health care utilization. Finally, through the choice-making mechanism, they expect to make medical benefits more responsive to employees who find themselves in differing situations.

The flexible program at PepsiCo, entitled "Benefits Plus" was one of the earlier programs, and is maybe the best example of the phased-in implementation. At its inception in 1980, employees were given options in the medical, dental, hearing and vision areas. In 1982, they added options in the death and disability areas. In 1983, the program was expanded to include a savings plan and salary reduction and earlier this year they added a flexible reimbursement account.

At the same time that they were expanding the program in terms of the benefits covered, the covered groups of employees was continually expanding to include more of PepsiCo's divisions such as Taco Bell, North American Van Lines, Frito-Lay and Wilson Sporting Goods.

Effective January 1, 1984, Armco, the diversified steelmaker in Middletown, Ohio, introduced a flexible program that offered employees a range of benefit options also in exchange for the elimination of first dollar medical coverage. Their objectives were basically: first, to immediately reduce health care costs and second, to produce a program with greater future cost containment potential. The specific program there offered employees a choice between four medical plans with varying deductible and stop-loss limits, a choice between two dental options, an optional vision plan, and the ability to sell up to one week of vacation and a flexible reimbursement account.

Armco basically provides enough information to allow the employee to buy the standard coverages which would include the $200 deductible medical plan, the $25 deductible dental plan, and the vision plan. The employees can opt for higher or lower coverages in those areas. In addition, Armco contributes $200 to the reimbursement account which the employee can supplement through optional salary reduction or through dollars freed-up by selecting less than the standard benefit coverages. The reimbursement account can be used to pay for a variety of health care expenses as well as dependent care or personal legal services. Any unspent funds at the end of the year are payable in cash or rolled over into a 401(k) savings plan.

The program was tested with employees before it was introduced at Armco showing that choicemaking or salary reduction (although they used the term salary reduction as most people do, a little better name for it might be choice pay, benefit pay, conversion pay) really had very strong appeal. In addition, 81% of the employees said that they believed that sharing in the cost of health care really would encourage more effective cost utilization.

Although it may seem intuitively obvious that employees would like to have a hand in designing their own benefit programs, there is now some statistical data to help support employee enthusiasm. As actuaries, most of us like to have some statistical data to support the intuitively obvious. Consider the results of a couple of recent surveys of companies that have had programs in effect for a number of years:

1. Recently American Can hired Yankelovich, Skelly, and White, the pollsters and market researchers, to take a reading of attitudes among more than 4,000 salaried employees covered under their flexible program. They found that 74% of the employees rated American Can as having very good or excellent benefit programs (in comparision with a norm of about 56% for other companies that Yankelovich had surveyed), 89% liked the ability to annually re-evaluate and select their benefits, and 51% felt that the flexible program was clearly better than the benefits provided by other companies, and most of the remainder felt that it was comparable.

2. Another company, TRW, also tested employee's attitudes concerning flexible compensation. Among 1,200 current and former employees they found that 87% of current long-term employees who had been around since the inception of the program, 91% of new employees and even 82% of former employees who are now working for competitors believe that TRW benefits are better than those provided by other companies. This is substantially higher than for TRW employees that were tested in nonflexible divisions. About 90% of the employees indicated that they are moderately or very satisfied with the flexible program, and about three-quarters of the employees feel that the program has a positive impact on retention and recruitment.

Another important question is, "will a flexible program really bring about cost containment?" There is clearly just beginning to be data emerging in this area, but in a recent study of companies that participate in our annual compensation forum, we surveyed some companies that have choice-making in the medical area. Eight of those were specifically pulled out

to be studied in greater detail. On average among those eight, 37% of the covered employees selected a plan that was lower in coverage (i.e. a higher deductible or greater coinsurance) than the preflexible medical plans. The data shows that employees can be influenced away from rich medical benefits, although the results do vary significantly from company to company - no two programs are really alike. The amount of credits available to employees, the price tags on the options, the attractiveness of the options in other areas, all of those things differ and can have a significant impact on this. The range was 11% moving away from the current preflexible plan up to 94%; very vast differences.

In two of the major flexible plans in effect for a number of years, this movement away from first dollar coverage has had a significant impact on slowing the rate of increase of employer medical costs. At PepsiCo, over a two year period, employer-paid medical costs had risen at an average rate of 18% per year for their major divisions that had not yet adopted the flexible program and only 11% per year in the flexible divisions. It varied from division to division, but all the nonflex divisions were higher than all the flex divisions - really a very substantial differential. At American Can, the rate of medical inflation slowed by about one quarter relative to the hourly employees who are not in the flexible program.

Employers have long struggled with what was thought to be a basic irreconcilable conflict between the goals of controlling employer costs on the one hand and appealing to the workforce on the other hand. Certainly if one of those two objectives is pushed to an extreme, the other just can't be achieved. But it is symptomatic of the environment of companies of the 1980's that companies really do want to achieve both goals to some extent. They want some control on the upward spiral of noncash compensation, but not at a price of alienating employees.

Many of these companies are seeing flexibility as a workable approach to get some cost control while continuing employee perception at a high or even at an enhanced level. And the third goal, increasing tax effectiveness, becomes a way to more palatably increase employee participation in funding for those benefits and savings.

So flexibility has evolved to the point where it is no longer justified only because it is something nice that a company does for its employees. The key to its evolution over the last two to three years and to the expected evolution in the future is the development of a strategic role that holds high promise for delivering cost containment and incorporating tax effectiveness.

MR. DAVID G. ADAMS: Dale has given us an excellent overview of the evolution and a look at the future of flexible benefit plans. And, while there is curently some uncertainty as to the future of laws and regulations affecting flexible benefit plans, I think we are all optimistic that flexible benefits will continue to play an increasingly important role in total compensation programs for employees.

My presentation relates to the plan design process. I will comment briefly on the history of optional benefits and discuss how modern flexible benefits differ from the more traditional approaches. Then, I

will talk about the plan design process as it took place in one particular company, focussing not so much on the individual plan design features but rather on the program objectives and some of the specific issues that had to be dealt with and resolved. Finally, I will comment briefly on the importance of effective communication in building a successful program.

Originally, employers offered employees little choice in the areas of pay or benefits. Pay was fixed and benefit plans were often contributory. An employee's only choice was to decline coverage and thereby save the amount of the employee contribution. Paternalism was widely accepted and employees' needs were much more homogeneous than today.

Gradually, companies began to offer contributory extensions of these basic benefit coverages. Examples of voluntary extras included additional group life insurance, a voluntary accident coverage, employee-pay-all LTD plans and so on. These voluntary extras are relatively easy to design, communicate and administer and result in little or no cost to the employer. The primary disadvantage of these types of benefits is the inevitable pressure to make them non-contributory. Additional employee-paid coverage fits very well into flexible benefits plans. In some cases, we can improve on the tax effectiveness by making the contribution arrangements on a pre-tax basis. But, in other cases, the traditional after-tax payroll deduction is still the best way to handle them.

In more recent years, programs have offered additional flexibility and choice. For example, some organizations offer a choice between a high benefit medical plan and a low benefit medical plan or a choice between a company sponsored medical plan and an HMO. Other organizations permit employees to choose between the conventional group life insurance and a survivor income program. These "conventional options" have generally been offered to satisfy the increasingly diverse needs of the employee group. And, in general employee reactions to these plans have been favorable. However, these arrangements tend to be more complex and to increase the employer's exposure to additional cost due to adverse selection. But at this point, we are really very close to the modern definition of flexible benefits.

Flexible benefits, however, go one to two steps further in that they offer a wider range of benefit choices generally. And as with conventional options, each option has an assigned price tag but with flexible benefits, the price tag is usually much more prominent.

Now let's turn to the process of designing a flexible benefits program. As I mentioned, I want to focus on the process involved and some of the issues that have to be dealt with. Although not a case study in the classic sense, my comments and observations are drawn from a specific project with a medium-sized life insurance company. Perhaps some of the issues we dealt with will have a familiar ring to them.

At the outset of the project, we spent a considerable amount of time talking about benefit objectives. What does the organization want to achieve and how can these objectives be accomplished through flexible benefits? Based on these discussions, we established five objectives. The first, and probably most important objective, was to help employees provide financial security through a program that is both flexible and

tax-effective. The key words here are not so much "flexible" and "tax-effective" but rather the word "help" - help employees provide for financial security. The company wanted to provide the means for employees to achieve security but strongly resisted the notion that this is the employer's unilateral responsibility. In their view, it is the employees' responsibility with the employer assuming an obligation to help.

Second, this company needed a strategy to manage its benefit costs more effectively. For pay-related benefits, the objective was to maintain costs as a stable percentage of payroll. For non-pay related benefits such as medical, however, management felt that a more reasonable objective was to hold cost increases to the rate of medical inflation. Even this was considered to be an ambitious goal since it meant controlling the cost in medical plan utilization. As part of the cost management strategy, the company wanted to develop a more rational and consistent approach to determining employee contributions from year to year so that both the company and the employees would share in any future cost increases.

Third, the company wanted to remove certain inequities that they perceived to exist in the current program. Fourth, the company wanted to promote a more positive attitude toward the benefit program and the company. And finally, the company wanted to maintain a competitive benefit program.

With these objectives in mind, we set out to review the design of the current program, testing each plan against the objectives and recommending changes that would help the company better meet its goals. For each plan we asked:

° Does it offer sufficient flexibility to meet employee's varying needs?

° Is it tax effective?

° What design changes are needed to keep the plan within the established cost boundaries?

° Is the plan equitable?

° Does it foster positive employee attitudes?

° Is the plan competitive?

The process went very smoothly at first. Both the life and LTD, as they were directly related to pay, required little change. We decided not to use pre-tax contributions for these plans since the immediate tax advantage of pre-tax contributions would be partially offset by higher imputed income for life insurance under Section 79 or by taxable benefits in the case of LTD.

In the area of deferred income, we made no changes in the pension plan. We did add a 401(k) feature to the profit sharing plan in order to add flexibility and stimulate voluntary employee saving. If we hadn't noticed it before, it became clear that there were some inconsistencies in our objectives. For example, the addition of a 401(k) savings feature, while

adding flexibility and improving tax-effectiveness, meant more administration and therefore more (not less) cost.

These conflicts came into sharper focus as we began looking at the medical plan. We felt that it was essential to introduce significant cost containment measures such as an incentive second surgical opinion program and outpatient surgery. Both of these features involved "penalties" for employees who did not follow the rules. We also felt it necessary to reduce first dollar coverage and to increase some employee contributions. We were confident that these changes would achieve better cost management but by this time we felt that we were sacrificing any hope of fostering more positive employee attitudes.

Perhaps the most difficult issue in the medical area was determining how the plan should treat employees who don't need coverage. Under the old program, employees paid $7 a month for employee medical coverage. Consequently, employees with working spouses often obtained coverage under their spouse's plan at a lower cost. To some in our study group, this seemed inequitable since these employees were realizing no value at all from the company's medical program. Others looked at the situation and saw it as a "free ride" for the company. Why give up a good thing? Initially, those who favored equity gained the upper hand and proposed that all employees be given a credit of $40 per month, the average company cost of single medical coverage. The idea was that employees who needed the coverage would add $7 of their own money while those who did not need the coverage would apply the $40 a month to other benefits. This seemed like a great idea until we found that about 100 employees (nearly one tenth of the work force) would now be gaining a benefit credit that they did not have before and that the total cost was about $50,000 in the first year. At that point, the more cost conscious members of the group gained the upper hand and the credit idea was scrapped. Eventually, a compromise emerged whereby all employees would be covered for a core medical plan providing a $500 deductible with 80% coinsurance and a $3,000 annual limit on out-of-pocket expenses. Those favoring equity were satisfied since all employees would have a minimal level of coverage while the more cost conscious members of the group were satisfied since the cost of this arrangement would be far less than the $40 a month credit. This decision also led us to abandon the idea of allocating credits to all employees. Since we were, in effect, forcing all employees to take some medical coverage, we preferred to provide the core coverage automatically with an option to upgrade to a better plan rather than offer a credit and be forced to turn down requests for a cash option.

Next we turned to the question of how the plan should charge for dependent medical coverage. As in most companies, this employer was paying a high percentage of the cost of dependent coverage. Not only were we concerned about the issue of equity, but we also raised the question of a potential legal challenge since many states prohibit discrimination in employment on the basis of marital status. To achieve full equity, without reducing benefits for any group of employees, would have required the company to provide a uniform benefit credit for all employees equal to the average dependent subsidy. The additional cost to provide these credits would have been almost $1,000,000 in the first year. No compromise was reached, and the idea of equity with regard to this dependent issue was postponed indefinitely.

A further complication was that the company's existing medical options - a high benefit option and a low benefit option - were not consistently priced. The high benefit plan was subsidized more heavily than the low benefit plan. To correct this situation, we could charge more for the high plan and avoid an increase in the company's cost. But this would be perceived as a "take away" by employees in that plan. Alternatively, we could charge less for the low plan, but this would have the effect of increasing the company's cost. This situation was complicated enough, but we now had to include the new core plan and we had to recognize that the company also offers two HMOs. Finally, we had to anticipate the effect of selection. This may sound like a very complicated situation but we were able to reduce this down to a single equation with only ten unknowns which we were able to solve without undue difficulty. If we had a little more time I could tell you how we were able to do that. Seriously, Dick will be offering some thoughts on this issue that I think you will find quite informative.

Having completed our design work, we began thinking about communicating the new program to employees and we asked ourselves the question, "How do employees view their current benefits?" Now it may seem a little late to start asking this question, but our purpose here was to prepare for communicating the program.

We needed to explore employees' perceptions and identify the most effective channels of benefit communication. We also wanted to send a message to employees that the company values their thoughts and opinions. Overall, we found that the company was doing an above average job of communicating and that employees had generally positive attitudes toward their benefits. However, we found that most of the communication was in the form of telephone calls to the personnel department, masking the fact that the printed communication materials were not doing the job that they were meant to do. More importantly, we found that employees, even in an insurance company that is active in the group market, were only vaguely aware of the sky-rocketing cost of medical care. This observation obviously had very important implications for a company that was about to communicate some cost containment changes. Finally, we found that employees were not aware of their personal responsibility to save for retirement. Not only would this make it more difficult to "sell" a 401(k) savings plan but it was putting unnecessary pressure on the company's pension plan.

Based on these findings, the company decided to first of all develop a series of articles for its employee newsletter articulating the company's benefit philosophy that employees have ultimate responsibility for their own well-being and educating employees about the soaring cost of medical care. With these messages delivered, the company was then in a much better position to introduce its new flexible benefits plan.

MR. RICHARD BILISOLY: By now you have seen that there are factors of concern with the development of these flexible benefit plans that are really closely intertwined. It is hard to figure out what is happening in any one of them without looking closely at what you are doing to others. David, I wish that you had promised that we would solve 10 equations and one unknown rather than one equation and 10 unknowns - that would be

easier. But I would like to touch on these four aspects of design of cafeteria plans: the cost of the benefit option, the price tag that is going to be set for those options, the allocation of employee credit - the number of ways that have been developed for such allocation to enable employees to buy back at least some of the options that they want, the measurement of experience meaning more or less the same kind of thing that we do with traditional group plans - most important perhaps being ascertaining monthly benefit costs per employee for each option, and finally to talk at a little greater length on adverse selection and means that have been devised so far to try and take into account the amount of selection that you are likely to get.

The basic problem is one of determining option price tags and having done that, a system for allocation of credits. On the surface it seems to be a pretty simple problem, but there are many objectives and many criteria that have to be taken into account in doing these things.

First of all, let's talk about some of these sources of employee credits even though we have previously gone into that. The main source perhaps in most plans is contributions from the plan sponsor. Another source consists of employee salary reduction or salary redirection, whatever euphemism we wish to place on that. And Dale pointed out those are ordinarily channeled through the medium of pre-tax dollars to pay for the extra benefits that are desired. Finally, there are the benefit give-ups. Some examples given before were the giving up of one week of vacation in order to obtain more medical, dental, life insurance benefit, things of that sort.

Imagine yourself just for the moment to be faced with the necessity of computing these option price tags and then devising a means whereby the employees can buy back some or all of these benefits. Here are some of the obvious constraints which come to mind (as you will see, it is seldom possible to meet these constraints in other than an approximate or ad hoc manner):

° The prices in aggregate should be enough to pay for the benefit costs. You are designing a plan for a client and you are hoping that the price tags that you give him will upon being paid suffice to pay for the benefits in aggregate. If they do not, most probably the employer will have to pay for the difference.

° Prices should, at least to some extent, reflect option costs. As you have heard before, they do not in all instances. Dave just made mention of a plan in which the price tag for the high medical plan was not enough to carry plan costs. You see the contrary thing once in a while; the situation where the price tag for the high medical option might be higher than is thought necessary to carry the plan costs for that plan. That can be counterproductive after a while, because you'll get the so-called dreaded assessment spiral we have all heard of in our training. The one theme that emerges again and again from consideration of these objectives is that they are all intertwined and you have to think carefully what you are doing to the others when you change your practice on only one of them.

- The prices themselves should not be too onerous to employees. As I have just mentioned, the price itself can strongly affect the proportions of employees electing different benefits. That in turn can contribute to the detriment of the option costs themselves.

- Prices may be caused to reflect adverse selection. That depends upon election levels and upon prices set. Sometimes we even try to affect the election of options by setting prices in one way or another.

- Employer provided credits should be limited in some way. This goes back to the idea that many times the reason for the institution of a flexible benefit program is that the employer wants to contain costs. So the portion of credit that emanates from his contribution should be set to produce that level.

- I think this is a very vexing problem and Dave touched upon it very well and that is what about reflecting the desired equity. We meet with the client before hand and try and determine what these objectives are. Often times these objectives shift as they see what the implications of choosing these objectives are. One employer mentioned that he wanted to try and continue to subsidize employees with families. Those employees had before gotten more credits just by virtue of that employer having paid their dependent cost (this employer paid all medical costs). The employer wanted that to continue. In other instances you could justas well see that the employer wants to create a greater climate of equity by giving every employee the same number of credits that he can allocate to medical plan regardless of the dependency status of that employee.

A few other things - the sex of the employee - should that affect the credits that are given? Should the service of the employee or the numbers of dependents impact the credits that are given?

Let's talk about determining the credits and price allocations themselves. How do you start? It occured to me as these other panelists were talking, that one way you can start is to simply assume that all the option prices should be what they really will be. Look at the age difference of these employees, look at the experience that has resulted in the plan for the last several years, look at tables that are published with respect to individual health insurance so you can ascertain how costs increase by age and sex. Try to set option prices which you think at first would hold, if there were no other considerations. Then set the credits applicable to each employee equal to that which would be necessary to buy back the plans that are in force right now. That would be a simple way to start. It's straightforward and somewhat logical. Then look at the various constraints that you are trying to satisfy and move these credit allocations around a little bit to satisfy those criteria. Then you are in a position to begin some of the testing.

Just one brief diversion; I was in a meeting this morning that dealt with option prices and futures and I was glad to see that at least one other class of actuaries has to be plagued with the same uncertainity that we are here in doing these things. But here is how we try to deal with some of this uncertainity; simply by testing.

Ordinarily, we have been taking the whole workforce of a particular employer and performing certain tests. Having picked a certain set of option prices and a certain set of credits allocable to the various employees, we perform certain tests. The first being a frequency distribution of the amount of out of pocket expense, or the amount of salary deduction, maybe even the amount of money that is going to be required after salary reduction for employees. Then forming a frequency distribution, we determine how many will have to pay zero to ten dollars per month after the plan is implemented, how many will have to pay ten to twenty dollars per month, and so forth. You can get some sort of idea of how much dissatisfaction might emanate out of this group after the institution of these new prices and credits.

Another thing to be considered is the effect on overall costs of a particular set of prices and credit allocations. Here you have to remember that these things are correlated to a high degree. The option prices themselves will strongly affect the proportion electing certain options. But you can form a grid of probable overall cost results, depending upon these two variables: the percentage electing various options and the amount of anti-selection that you expect with that particular degree of election. It sounds like you are just playing games, but actually we feel that by doing these kinds of calculations, determining the actual overall costs that will result from these rather tentative assumptions does provide a great deal of insight into what is actually going to happen with this plan. After performing these various tests, there are other kinds of tests too. You can adjust your option prices and you can adjust you credit allocations and do the tests all over again.

Let's talk just for a moment about the measurement of experience. The most important thing is to try to gauge net plan costs that are going to come out of a particular set of option prices. This shows you in the future which option could profitably be added, which items to drop, which options to stay away from, and what percentages tend to elect the high and low option. There are so many variables that affect these plans that what you see in one plan is not at all neccessarily going to carry over into another.

Two other things that are important to consider are first, the proportion of total costs that is paid by the employer - that's important in affecting the outcome of these plans. The second one is the existence of a flexible spending account. If there is a flexible spending account, perhaps some of the statistics that came out of the Rand study might be thrown awry a little bit. It looks as though these low plans do in fact result in a lot less utilization than is ordinarily anticipated. But, if the flexible spending account is standing there to absorb some of the costs that otherwise would have to be paid out of pocket, and if that flexible spending account is funded to any great extent by the employer, perhaps those plans will be more nearly alike in the frequency of plans that are generated. This information might be helpful in the design of new plans and yet you have to be aware of these differences that exist.

Now let's investigate some of the means that have been used to try to tell how much anti-selection might be present in these different medical plans. The medical plans and the dental plans usually present the greatest opportunity for anti-selection, (maybe short term disability and long term disability too, but everybody worries most about medical and dental).

Let's suppose for a moment that there are but two plans, let's say A is the high plan that pays virtually everything, and B is a low plan that has a very large deductible. One thing you can do after a year or so of experience has gone by, assuming that that experience is anywhere near creditable, is simulate repayment of all these claims under A alone. Then you can turn around and simulate repayment of all the claims under B alone. You do this as though A first and B second, were the only plans in existence.

The extent to which actual A claim costs exceed simulated claim costs (and to which actual B claim costs are less than simulated B costs) is a measure of adverse and pro-selection. You can look at plans that already existed for several years, and then attempt to apply that data to the new plan that you are designing.

All in all you can see that quite a blend of intuition, guesswork and subjective judgment is necessary. But if you can put together all the statistics, it is possible to get on these plans these days, I think you can learn a great deal about what is going on and about what will go on when you implement that plan.

MR. GROSH: Any questions from the floor or of any of our panelists based on their presentations?

MR. MARTIN HICKMAN: Are there any standard patterns as to how often the employee is allowed to make the selection? Is it just assumed to be annual or does it flip-flop back and forth?

MR. GIFFORD: Almost without exception, the plans that we have seen have had an annual enrollment cycle where about two months before the beginning of the plan year the employer goes out with election forms and the employees makes their new elections. There are some exceptions, in at least a couple of the programs that have been in effect for a long period of time, the employee is given an opportunity to re-enroll each year, but is only asked to resubmit their form if they want to make changes. It is presumed they are going to stick with what they have unless they specifically indicate they want to make changes. Another exception which I mentioned, Armco, wanted to have a stand-alone vision option. I guess most actuaries would anticipate that this might be subject to a touch of adverse selection potential. In Armco's case they wanted to have a stand alone vision program because their current program had vision and we, working with their carrier, Equitable, came up with a three year election period for vision care specifically. Often dental had a two year election cycle just to try to reduce the potential of adverse selection.

MR. GROSH: Typically with the programs we have worked with, that is also the case - annual enrollment. An exception to that would be a change in status; marriage, a death in the family, addition of dependents. That would almost be a pre-empt to the annual election process where employees could freely make choices given changes of that nature.

MR. PAUL W. ORMROD: I wonder if Dale could tell us of those companies that he had going the cafeteria route, how many were self-funded? Secondly, if there is adverse selection involved, and it seems obviously there is, how do you get around the assesments spiral problem?

MR. GIFFORD: With most of the companies that have flexible programs, I'd say that a majority of them that have optional medical plans are in fact self-insured and maybe using an insurance company only for claims payment. The issue of pricing is really something that comes back at the company and isn't an insurance pricing issue. Most of the smaller organizations have tended thusfar to go with programs that have a single medical plan with a reimbursement account and may have choices in some of the other areas. I think over the last year or so some of that has been changing as more of the insurance companies have become more agreeable to underwriting choice-making plans and I think it would be fair to say that some of them have gone somewhat aggressively after that market. I would expect that smaller companies that are in a more insured situation will tend to seek insured medical options in the future - there are some that are in that category now.

MR. BILISOLY: Some of the experience coming out of the plans we have seen seems to indicate that some of the selection on medical plans is engendered more by what coverage an employee's spouse might have than by a desire to pick the plan that will do him the most good medically. Most of these employees look at their spouse's plan to see what is available. So cursory statistical information shows that the adverse selection isn't as much a problem as had been thought to be the case, and so the assessment spiral doesn't seem to be unfolding as yet.

MR. ADAMS: In a couple of cases with medium size employers, the insurance arrangement for the medical benefits has not been fully insured, but some modified form of self-insurance. The carriers have expressed concern, but they have shown a willingness to try to approach these situations looking at it as the employer would look at it. What is the nature of the risk here, what kind of overall cap on liability makes sense? The carrier will then try to structure the contract so as to provide protection to himself; but also to provide a meaningful arrangement to the employer. Another technique that can be employed here is to try to look at the program in the aggregate, to try and estimate what the total claim costs will be from both a high plan and a low plan. Make different assumptions as to what percentage of employees will elect one plan versus the other and make different assumptions as to the degree of adverse selection. For each of these different assumptions you can actually calculate what those expected claim costs will be. You can create a grid of different possibilities and get some feeling for what the range of expectations is. In other words, you can look at the costs under a bad news scenario and the cost under a good news scenario and make some judgments as to what level of premiums, if you are an insurance company, you would need to charge in that kind of situation.

MR. MARTIN HOFFMAN: Where an employee initially does not opt for a dental benefit and opts for it at a later point, do you generally find that the plans would have limited benefits such as providing "preventative only" reimbursement for a one or two year period, or would they be allowed to participate fully in the plan?

MR. GIFFORD: Occasionally I have seen restrictions, but it has been much more the exception than the rule. I think most companies have elected to be fairly liberal until they see if there really is a problem emerging, and at that point they deal with it. In the dental area, I'd say many of the plans have heavily subsidized options in order to encourage pretty

broad participation. So many so the plans that do have an "opt in" or "opt out" alternative are sitting in the area of 75, 80 or 85% participation. So there is a pretty broad spreading of risk.

MR. GROSH: On the plans that we have been working with we've had some general plan design features that would be a little different. Typically, in these plans there is some type of open enrollment period and from that point if an employee is electing up, (and that includes the case where he has elected zero to start out with and is electing a benefit for the first time), there would be some sort of restriction. In some cases we have even seen plans that have gone as far as keeping the employee out of that coverage for a period of two years if in fact he hasn't elected that at the initial onset. The fear, the driving force in doing that, again, is the old thing called anti-selection - that is companies fear that if they freely allow employees to elect up, then what are we really getting into here?

MR. GIFFORD: I think it is important to realize that with most of these plans that have choice making in the medical area, the highest option may be the pre-flexible plan. The other options that are available are the ones of a more comprehensive, bigger deductible nature. So, from an insured point of view, the flexible program will have lower claims in total than the pre-flexible plan, because all of the options are equal to or lower than the pre-flexible plan. Where the adverse selection comes in is really in terms of whether the employer over-rewards people who opt down to the lower coverages. I think that is important to keep in mind because there are relatively few flexible programs around that really offer the employee a choice of plans which includes options higher than their pre-flexible plan.

MS. LINDA GORDON: I wanted to ask you a question about your interpretation of the IRS news release on February 10 as to whether or not they are going to tax reimbursements for deductibles and coinsurance levels. If the employee chooses the richer plan initially and doesn't have that $200 or whatever is going to the benefit bank, then he is going to pay for that premium with pre-tax dollars and yet be taxed on reimbursements. Also if there is anything left in the benefit bank at the end of the year, it seems that he can, as usual let it go into the 401(k) plan without any tax consequences.

MR. GIFFORD: We have clearly been tracking this quite significantly. This Information Release 84-22, issued February 10, basically was attacking the zero balance reimbursement accounts where the IRS said that basically employees taxable pay was being characterized as nontaxable benefits. There clearly were some plans, a small minority, where flexible reimbursement accounts were operating that way. The information release also happened to suggest that any reimbursement account that gave unused funds at the end of the year to the employee in any way, shape or form - cash, roll into a 401 plan, anything like that - would be an invalid plan. The amounts payable under those plans would, therefore, be subject to taxation and not be nontaxable. It also suggested that employers and employees who were operating under those plans would likely be subject to retroactive taxes, interest and, in some cases, retroactive penalities.

This certainly came as a shock to many employers who had had these plans. I suspect that all of us on this panel helped some companies get into that situation where they had those types of plans - particularly in an area where the Treasury Department was officially silent for almost six years, and even when specifically asked by employers for guidance, they refused to give any guidance. This obviously created an uproar among companies that had those plans in effect, particularly if they were in effect for 1983, what should we do with W-2s? Do we revise them? On what basis? Additional clarification was needed. We went through a couple of weeks where there were an awful lot of letters and telegrams and visits to congressmen and irate quotations in newspaper articles trying to get the IRS to back off. After a couple of weeks the attention really moved to Congress. The House Ways and Means Committee started having some hearings on a number of tax issues and they started going after a tax bill. The Senate Finance Committee started working on their version of a tax bill. Both of those looked like there might be some significant likelihood of Section 125 amendments. So the IRS backed off on their issuing Q's and A's or proposed regulations, waiting to see if Congress was going to change Section 125 so that they wouldn't look so foolish by issuing proposed regulations that would be immediately preempted by legislation.

There was a lot of attention directed, particularly at the Senate Finance Committee where the staff put together a fairly extensive amendment package to Section 125, which in some respects would have been a lot better than the Q's and A's, and in some respects would have been disastrous. Fortunately, or unfortunately, depending on how you look at it, the Senate Finance Committee had bigger fish to fry and the hundred and fifty million dollars that was assigned to the Section 125 amendments was small potatoes. So they basically reported out their tax bill without any Section 125 amendment. Most people, and I put myself in that camp, expected the long-awaited and already drafted and approved Q's and A's to be released at any second, once it was determined that the Senate Finance Committee wasn't going to put anything in their tax bill. The little glitch there was that the Q's and A's were in Red China at that moment with the Assistant Secretary of the Treasury for tax policy and apparently they couldn't be released while he was in Red China. He came back from Red China and they still aren't released.

One speculation is that there are still a couple of points at which the tax bill could be amended to include Section 125 amendments, either an amendment from the floor of the Senate, which is unlikely but a possibility, or modifications once the Senate and the House individually pass their bills and it comes to a joint committee. If nothing happens along the route of the tax bill, I think there is still a significant possibility that we may see the Q's and A's, probably in a proposed and temporary regulation basis coming out shortly after that.

There is one other little initiative that is occuring, that I will just mention to you in case you have any clients that you would like to suggest get involved with this. Senator Packwood and at least three other senators on the Senate Finance Committee have jointly signed a letter to Roscoe Eggers of the Internal Revenue Service suggesting reconsideration of a couple of features of IR 84-22. Specifically, the penalities on the pre-funded or non-zebra accounts and the threat of retroactive penalities assigned to companies operating in an area in which the IRS hasn't been

willing to issue any regulation. If any of you have clients in the states where the senators are on the Senate Finance Committee, you might want to suggest that they try to quickly encourage those senators to jump on that bandwagon. It isn't the most powerful letter. It isn't likely to solve all the problems. But it seems to be the only game in town right now. It is really up in the air. Something could happen through legislation, and if it happens through legislation there is at least some willingness to back off, I believe, from the "use it or lose it" requirement, as long as reasonable constraints can be put in through dollar limits, non-discrimination, utilization tests and other features of legislation.

MR. GROSH: The Internal Revenue Service news release, at least to the fairly intelligent reader really dealt primarily with just the spending account issue and certainly didn't place in jeopardy comprehensive flexible programs which fall under the purview of Section 125. The major issue of that news release was that if you put money into one of these spending accounts and it was left at the end of the year, you forfeit it if you didn't use it. That really seems to be the main issue. Some sort of irrevocable election by the employee at the beginning of the year as to the level of salary reduction to build up an account to pay for things that aren't paid for under the regular medical plan, such as employee contributions, deductible, coinsurance, and I suppose you can go much further into Section 213 of the Internal Revenue Code to include all of the types of expenses that you can claim as a deduction for income tax purposes. On the other hand, even though those things might be in jeopardy because of the news release, at least to the extent of employees having to forfeit unused dollars at the end of the year, there are still expenses such as dependent care and day care which I think are easily budgetible - people know generally what their day care expenses are going to be and can program for those - that I think really aren't in jeopardy. Those plans we are still recommending and still designing as part of comprehensive flexible benefit programs. The interesting thing about the news release is that the IRS talks about the "use it or lose it" rule, with the unused balance at the end of the year being forfeited. They don't really tell you what you can do or what will pass in terms of an acceptable plan. So, we didn't want to leave the impression that this news release in any way jeopardizes comprehensive flexible benefit programs; it simply jeopardizes, to some extent, what's going to happen with these spending accounts, which typically are part of the comprehensive flexible benefit programs. Of course, who can speculate what the Q's and A's might contain when finally issued.

MR. GIFFORD: That's a very good point. Even the worst case scenario off of the information release would not destroy all reimbursement accounts. It would require modification of all but one or two that are in effect today that I'm aware of. It clearly does not go into issues of broader choice-making under Section 125 which is most of what we have been talking about here today.

MR. GROSH: I'd like to ask Dave if he would just take a few moments to tell us how one measures whether a flexible benefit program is effective. How do you measure it from an employer's perspective? From an employee's perspective? How do you go about doing those types of things?

MR. ADAMS: I don't think there is really a single answer to that question. I think when you start talking about measuring the effectiveness or measuring the success of a program, you really have to start by asking what that particular program is intended to achieve. I think you can sense from the comments of the panelists here, plans are designed to achieve a variety of objectives. Some are directed primarily at cost control, and this seems to be more and more the focus of plans, as Dale was pointing out. Others have quite different objectives. There may be plans out there that are intended primarily to support varying employee needs, there may be plans out there that are designed primarily to discourage unionization. There can be just a wide variety of objectives. I think you have to identify those before you can answer the question "Is the program effective, and how do you go about measuring its effectiveness?"

If the plan is designed primarily to better meet employee needs, some of the techniques that Dale alluded to can be used. Surveys of one type of another can be used to access employee's attitudes. You can look at the pattern of choices and get some feel for whether the plan is meeting those employee needs. If all of the employees, or a high proportion of the employees, elect the pre-flex option, you may think that the program really hasn't achieved what it was set out to do.

From the standpoint of plans that have high on their lists of objectives controlling benefit costs, I think you have to measure the success of the program in terms of dollar results. Do the total benefits paid out less the employee contributions, fall within the parameters that have been set as objectives for the plan? Dick has talked about some of the difficulty in trying to anticipate costs. I think we are finding that employees, where they are given a choice of benefit A or benefit B, clearly are going to elect the choice that will optimize their total compensation. I think we are finding certainly that as years go by and employees get into the second and third round of choices, they become better and better selectors of choices. The role of the actuary, the consultant in this case, is to do the best job possible in trying to anticipate what that cost will be. It is almost to the game of trying to stay one step ahead of the employee, if a plan is to achieve its cost objectives.

MR. HOBSON CARROLL: I think that cost savings versus cost control is an important distinction when talking about flexible benefits. In the absence of changing the medical plan to control utilization and costs that way, it is my impression that all the employer is going to be doing is saving her or him money, but not decrease the amount of benefits that are going to be paid out. In fact, it is not very hard for any of us to imagine a scenario where an existing benefit package in existence for everyone is cut back. Everyone gets a core and then x dollars to go buy either life insurance or LTD insurance or dental or medical. The overall benefits that are going to be paid out under that plan are going to exceed what would have been paid under the other one. But, I'm not against employers trying to control their costs, it's just that we don't operate in a vacuum. The cost is being shifted to employees and to taxpayers because of the use of the 401. So I think that ultimately society is going to have to look at this thing and say "Do we want to do it that way?" I also mention this type because that is the kind that we have worked with at my company. There is no money reimbursement situation; they have to take it in benefits.

MR. GROSH: There is no question that when you give an employee choices that is exactly what is going to happen; plan costs are going to go up. On the other hand, I think we have heard some interesting comments by both Dale and Dick about utilization. When you offer employees the option of lower type plans, you actually experience a lowering of utilization rates. Now the nice thing about flexible benefit programs is that you offer employees lower medical plans or lower dental plans for example, and you combine those with a flexible benefit spending account, the employee really takes a risk. He says "I will pay less on an insurance basis on a lower plan because I don't think I am going to have the claims, but I can really hedge the bet because I have the spending account to pick those up at least on a pre-tax basis, if, in fact I haven't had them covered under the indemnity plan." I think that is really where the cost containment comes in. It is a combination between the lower plan with the lower utilization and the spending account which essentially the employee is paying for with his own money but he is saving taxes. So I think you are right, there is a diffence between health care cost containment and cost shifting and I think there is a certain amount of cost shifting taking place in flexible benefit programs. But the statistics at least seem to indicate that there is some change in utilization as well.

MR. GIFFORD: One other aspect of cost shifting that you didn't mention. When you talk about cost shifting to the employee and cost shifting to the government through tax subsidies. There is another element which is significant in any company and that is cost shifting to other employers. You can say what you would like about what the social merits are in that but there is, even in nonflexible programs, a great deal of cost shifting existing between contributory plans and noncontributory medical plans. Auto companies and steel companies have traditionally been heavy recipients of cost shifting from insurance companies and banks and retailing organizations that have tended to have very heavily contributory medical plans. Some elements of this can work for companies like that in encouraging companies through small rewards to elect coverage under the spouse's employer plan. That is at least as hard to quantify in some of the preliminary stages as some of the other things we have talked about here. But it is a real factor that is very important for many of those companies.

MR. BILISOLY: We have some clients who have opted not to go to flexible benefit programs but have instead decided to really go whole hog toward cost containment. I am amazed initially by some of the results that have been obtained. I think the cost increases have really been held down to a great degree just by cost containment methods that you have all heard of.

MS. BETSY UZZELL: It seems to me that the impact of more coinsurance or a higher front end deductible would be impacted quite a bit by what is happening to the money that the employee is not contributing to the cost of insurance. For example, if it is put into an account which he will lose if he doesn't use it, then that would tend to make the high deductible plan behave at least as badly, maybe worse, than some medium type deductible plans. So be careful that you know what you are opting to or from with that money he is not putting into that insurance.

MR. ROBERT RYAN: Salary reduction has been one of the contributors to the source of credit. Have the salary reductions been applied on a uniform schedule, for example uniform percentage of premium, or to a variable scale or optional scale?

MR. GROSH: First of all employees are allowed to use salary reductions to pay their employee contributions, either directly or indirectly under any type of flexible benefit program. In the medical area that might be a uniform flat dollar amount for employees. But in other areas, such as a savings plan, employees are typically allowed to contribute in these plans anywhere from one to fifteen percent of pay. Long term disability, if it is pre-tax dollars, it is typically a uniform percentage, but in some plans it is age related. Life insurance is age related, typically in these plans, so it is very hard to say that salary reductions follow any sort of pattern.

MR. GIFFORD: Any contribution to a cafeteria plan generally has to satisfy the nondiscrimination requirements under Section 125. Basically benefits are allocated into two types. One is indemnification benefits covering things that are not pay related. Medical is the most obvious example of that. Additional amounts like those Allan referred to for group life insurance, disability beneifts, vacations, those type of things would typically be pay related. So often what you see as a maximum amount of salary reduction that might be X dollars plus Y percent of pay with the employee having the ability to elect anything between zero and that maximum amount of salary reduction.

MR. GEORGE CALAT: It appears that in order to go to a flexible benefit program and to meet the objective of controlling costs, you really need to start with fairly rich program so that you can cut back and put some of those dollars you are saving into a flexible savings account or a flexible spending account of some sort. It also appears that because of the selection spiral from which I think most of the panelists will agree will take place over time, some of the savings you do effect by going to a flexible program with lower benefit levels eventually reduce or evaporate. How much of the initial cost savings are lost because of the administrative costs of this type of program since it must inevitably be more expensive to administer?

MR. ADAMS: Let me just comment on one point you made concerning the inevitability of higher cost. I guess I don't share that as being inevitable. We've talked about a number of forces that are taking place and I think that most of us on the panel would agree that as you open up more choices, you create the potential for higher benefit costs. But there are a number of factors at work and one that we haven't talked too much about is the employee contribution side. I think clearly one way to make up for that extra cost to the extent that it exists is by asking employees to contribute more. Most of us would tend to go fairly lightly on that initially, thinking there would be great resistance to it. But we have been surprised on some cases to find that employees are not as resistant to paying more for what they perceive to being a better overall program. Despite the fact that there may be higher benefits paid out in total, an employer can achieve meaningful cost management.

MR. GIFFORD: I share Dave's reaction that it is not inevitable, partially because the spiraling cost of the highest medical option may often be passed on to the employee in the prices of the options as David said, which will result in a smaller and smaller percentage of employees taking the highest option. Many companies have set up a strategy that says "Once we get to a small enough percentage in that highest option, that will no longer be an option in our plan; we will cancel that." Therefore, through a number of years and an interactive process, they effectively eliminate the highest option, rather than doing what some companies have done in terms of immediately eliminating the current rich medical plan and going directly to a comprehensive plan. So you can get to the same conclusion either in one fell swoop, which has some attractiveness from a cost containment point of view, but some "disincentives" in terms of employee relations. Or you can get there over a number of years through the natural pricing and choice making mechanism.

MR. GROSH: Let me address the first question I think you asked and that was you had to have a pretty rich program to start out with to be able to convert it to a flexible benefits program. That's not necessarily the case either because there are several ways you can structure a flexible benefits program. For example, in the high technology areas where companies are typically not spending a lot of money on benefits, at least when they are small and growing, what is very attractive to these companies is to start very slow. Then they are able to expand either by putting more money into the program at some point in the future or by adding benefit options to the program. One of the approaches to flexible benefits is what we call the "add-ons" or the "supplements" where you take an existing program which is clearly not adequate and you add a benefit option to it. Maybe perhaps you add some money in terms of credits where employees can spend the credits to buy at least a part of that option. So you really do not have to start with a rich program. One of the approaches to flexible benefits programs is to take an existing program, cut it back to a core, and release funds for the employee to spend on other programs or on options. But that's only one of the many programs. There are other approaches which start with much lesser programs and build them up over a period of time.

One of the things we have been able to accomplish in the flexible benefit area is really an involvement of some expertise in the administrative area. We have all heard the stories about the first few major plans that went into effect and the price tags that went along with them in terms of getting them up and running - some said a half a million dollars, some said one million dollars, and we're not really exaggerating those costs. I think the first few major programs that went up did cost those kind of dollars. Where we are today in the administration of flexible benefits programs is light years ahead, because many companies are able to administer these plans in-house. I think the benefit consulting and the insurance industry has gained years of experience where the attitude now is to sit down with employers and show them how to do it, and they are able to do it. I think the cost of administering one of these programs has probably come down by a factor of four or five. I think there is no question that when you project the cost of a program out for four or five years for a management team, for example, you are going to find that first year costs, including the set up cost and communication cost, are probably going to be at the same level that they would have been had you not had

the flexible benefits program, or maybe slightly higher. I think the payoff in a flexible benefits program really comes in the second and ensuing years and that is when the costs really start to drop.

MR. BILISOLY: Going back to the first part of your question, the same question has been leveled at cost containment measures. Maybe after they begin to take hold the medical costs will resume their climb because the nation is ageing and there is a continuance of new discoveries on the medical front. I'm not disagreeing with the panelist. I still think the flexible benefits are a good thing, but maybe there is some transitoriness to the savings.