RECORD OF SOCIETY OF ACTUARIES
1984 VOL. 10 NO. 4A

FLEXIBLE BENEFITS—DESIGN FROM A PLAN SPONSOR'S VIEWPOINT

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- Adding elements of flexibility to a conventional employee benefits program
- Flexible spending accounts
- Integrating 401 (k) into a flexible benefits program.

MR. ROBERT J. MCKAY: The booklet says we are going to talk about flexible compensation from the plan sponsor's point of view. We are going to do that but we are also going to look at it from the insurance company's point of view as well, that is, from the underwriting or adverse selection perspective.

We've got a very knowledgable, interesting panel. I'd like to thank our two non-society members for joining us today.

Carol Beatty was involved (as an underwriter) in the implementation of a flexible compensation program for St. Paul, moved into the training area and finally into the compensation and benefits area, where she was the flexible compensation project manager. She'll be sharing with us her experiences of how and why St. Paul went into flexible compensation - what results they have seen, what changes they have to make thanks to the IRS and to Congress. Hopefully she'll talk about how their internal actuaries worked on the project and the perspectives they brought.

Cynthia Riley has been with Aetna for 11 years. She spent the first 7 years in employee benefit sales and for the last 4 years has been in their home office involved in marketing flexible compensation. Cindy will be talking about plan design, what flexible plans look like, what controls Aetna likes to see in place when they are insuring a plan to prevent adverse selection, and some results of flexible compensation programs that they are administering or insuring.

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Since I am also acting as a panelist I shall introduce myself. I am Bob McKay with Hewitt Associates in Toronto. I spent about six years in the U.S. in our general offices--during the last two years I was with our flexible compensation unit in Illinois. I now manage our flexible compensation consulting practice here in Toronto.

During the next few minutes I'm going to discuss the future of flexibility as it relates to compensation and benefit programs.

Flexible compensation was first introduced in 1974, a decade ago. Most of us know that TRW Systems Energy Group and Educational Testing Service were the first companies to implement flexible compensation plans. And probably you have heard or read about the experiences of American Can, Northern States Power, PepsiCo, and Cominco in Canada. Beyond that, most of you might be hard pressed to list many companies that have actually implemented programs. Flexible compensation gets a great deal of publicity on a macro level--even Time, Newsweek and the Today program have discovered "flex". We read a lot of information, but much of it is theoretical. My primary goal is to bring you up to date on the current state of flexible compensation programs--prevalence, design, employee reaction, and ability to accomplish management objectives,--and to assess the future of flexible compensation.

Before getting into details, let me tell you that there are well over 100 flexible compensation plans already implemented in North America. It would not be at all surprising to see 200-300 programs by January 1, 1985. There is a wide variation by industry, geographic area and size of organization. As I'll discuss later there is also a great diversity in employer objectives and in program design.

By looking at these charts and graphs, we know there is considerable interest in flexible compensation and that it has moved beyond the exploratory stage. However, we also need to address the question of why there is an increasing interest.

Back in the early days of flexible compensation, management viewed this new approach as a method of improving employee relations by meeting employees' individual needs and preferences, increasing their awareness of benefit values, enhancing its image as an innovative and responsive employer, etc. The thinking was that each employee had different circumstances, and that it didn't make sense for the company to dictate how benefit dollars could be best allocated. The underlying cause of this desire to fit individual needs is the far reaching change in the demographic characteristics of the North American work force which has occurred over the last two decades:

- Almost half of the work force is now female.
- The "traditional" household has given way to the "two-paycheck" household. Today almost two thirds of households with two adults are supported by two incomes, rather than one.
- 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 work force is now in the age group from 25 to 44. And older employees, particularly women whose children have left the home, are reentering the work force in increasing numbers.

It is these changing demographics which initially motivated some employers to introduce greater choicemaking--recognizing the differing needs of individuals and the changing of these needs over time (due to marital and family status changes, compensation changes, increases in age and service).

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

Let's focus on the cost control objective for a few moments.

In the past, employers looking to control benefit costs have had three choices:

- placing a freeze on new benefits,
- taking away or cutting back existing coverages or
- asking employees for greater contributions.

None of these options are particularly palatable to employees, and companies have been reluctant to push too hard in these directions, although a significant number have undertaken these actions in the last two or three years.

Under a flexible approach, the employer can strive for cost control in another way. The company offers choices, providing a chance for those employees who desire to keep high coverage if they are willing to pay the price tag involved. Others can drop back to less expensive benefits which are fully paid for by company money. Employer contributions can be pegged to a different strategy and permitted to escalate more slowly than overall benefit costs.

Perhaps the most far reaching impact of flexible compensation programs is their ability to control future benefit cost increases. In the past, a company's costs for non-flexible benefits would increase automatically with rises in payroll and medical costs. Now, however, the company's commitment to provide flexible credits can be expressed in dollars with no automatic escalation. The potential cost savings come from the ability to escalate company provided credits at a rate slower than the prices necessary to sustain the optional coverages. Put another way, we have separated the cost of compensation from the form of compensation. This is the new definition of flexibility--a method of compensating employees which separates decisions on the <u>forms</u> of compensation

(selected by the employee) from decisions on the <u>cost</u> of compensation (selected by the employer).

Here is an example of the separation of form and cost. Assume that a company gives employees the choice of two medical plans with differing levels of coverage priced at $1,200 and $1,600.

If during the year the experience under plan A requires a premium increase of only $100, and Plan B requires $200 more, the prices in the second year will reflect the amounts needed to support the coverages--a $500 difference between the two plans in contrast to a $400 difference in Year One. As the gap grows, so does the incentive to choose the lower cost plan.

The employer's commitment to support this medical benefit may be <u>independent</u> of the prices charged for coverage. For example, if the company were to make available $1,400 in the first year, the employee choosing Plan A would have $200 available for other uses, while the employee choosing Plan B would have to come up with $200 out of pocket to afford the coverage.

In this illustration, the employer decides to increase his contribution from year one to year two by $100, perhaps related to the increase in average payroll expense or perhaps pegged to the cost increase in the lower medical plan. The employee choosing medical Plan B now finds he is $300 short, and must dig deeper himself.

Over time, as this difference in the cost of medical plans becomes larger, more and more employees will be encouraged to choose the lower cost plan. This will have a very positive effect on health care cost containment, since research has now confirmed the conventional wisdom that utilization decreases as the employees' share of costs increase.

The Rand Corporation published interim results early last year based on a health insurance experiment with nearly 8,000 participants covering an eight-year period. The study emphatically concluded that full medical insurance coverage leads to more people using services and to more services per user. Based on the study, they estimate that there will be about a 20% decrease in overall utilization of health care services by moving from a 100% payment plan to a 75% payment plan (with stop-loss).

The most straightforward application of this conclusion is for a company to replace its current basic plus major medical plan with a comprehensive plan having deductibles and co-payments. Another way in which flexible compensation can lead to cost containment is by helping to break the lock-step between union and non-union groups.

Many organizations have become union driven in their benefits, even for non-union people. Companies are reluctant to take action for salaried people before union negotiations are completed. They are reluctant to establish new benefit patterns for salaried groups for fear of creating targets for the union in the next round.

Adopting a flexible system for non-union employees has the potential for breaking this lock-step, because a program operating on such different

principles will free the company to make decisions on options, amounts of flexible credits, prices of options, and the timing of changes without regard to the bargaining calendar.

Obviously, there is some limit to the cost savings beyond which positive employee reaction can not be maintained. However, a well designed flexible system may secure employee satisfaction at a lower cost than a non-flexible program. Now, let's consider the tax-effectiveness objective for a moment.

I'm sure you're all familiar with Section 401(k) plans and the use of salary reduction as a source of funds for those cash or deferred profit sharing plans. In the past months you probably have become familiar with Section 125 and the use of salary reduction for providing employee benefits on a pre-tax basis.

Flexible compensation programs, when used in conjunction with Section 125 salary reduction, allow employers to meet the third objective of providing benefits in the most tax-effective manner. Through salary reduction, employees of many companies are now able to pay benefit premiums (for health care, group life and LTD benefits) and other eligible expenses (through contributions to a reimbursement account) on a pre-tax basis. The end result is increased take-home pay for employees at no cost to the employer. This, of course, leads to increased employee satisfaction.

As noted earlier, there is a great deal of diversity among currently implemented flexible compensation plans. A basic flexible plan would include a reimbursement account or some choices in at least one benefit area, usually medical. Quaker Oats, Toro Company, and Simpson Industries have plans of this type and Xerox and Alcoa (for their aluminum workers) are currently implementing them.

As plans become broader, they provide options in an increasing number of benefit areas such as group life, long-term disability, medical, dental, vacations, capital accumulation, reimbursement accounts, salary reduction and cash. 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) start with a limited program and introduce broad flexibility on a phased-in basis.

Let's take a look at some specific examples.

The first example is a Canadian one of Cominco, which is a major mining company operating primarily in Western Canada. In March 1984 it introduced a flexible compensation program providing choices in the medical area, dental, death benefits, LTD and vacation.

The very first choice is in provincial health care. In Canada, as most of you know, the province covers most of your medical expenses and in some provinces employees pay a premium for that. Typically that's picked up by the company and frequently there's dual coverage. If your employer picks up the premium and your spouse's employer does it also, you're losing something because you can only pay once. Cominco will

allow the employee to waive that premium payment, if it's picked up by the spouse's employer, and thus get some extra flexible credits.

In medical, there are 2 choices. A $500 catastrophic plan and a $25 deductible plan. The $25 deductible plan -- believe it or not -- is a very typical plan in Canada, because those supplemental plans only cover the excess over provincial coverage.

There are 4 choices in dental: no coverage is an option -- you can get out of dental altogether; a basic preventive plan; an intermediate level plan; and a rich plan, which was the current program before flex.

There are a good number of choices in the group life and A.D.&D area.

In long-term disability, there is one plan. The employee can pay for that using flexible credits, which makes it a company-paid benefit. Flexible credits are, in effect, company dollars. Or you can pay for it as a payroll deduction, in after-tax dollars. The difference is, if you use flexible credits, you get taxed on the benefit you receive if you become disabled. If its paid through payroll deductions, the benefit is tax-free if you ever become disabled.

Finally, employees are allowed to sell up to 1 week of vacation and receive flexible credits which can be spent elsewhere.

In the actual results of elections under Cominco's program, roughly 75% of the employees made a change in the benefit program. Only a quarter of the employees stayed with the program that they had before. And this is a group of employees which is much older than most companies -- probably the average age is 45. So this work-force is more the type that the traditional program is designed for -- the married male with the non-working spouse. Even there, 75% made at least one change.

Now a U.S. example.

Effective January 1, 1984, Armco, the diversified steelmaker in Middletown, Ohio, introduced a flexible program offering employees a range of benefit coverages in exchange for elimination of first dollar medical. The objectives are: first, to reduce health care costs immediately and second, to produce a program with greater future cost containment potential.

The program offers employees a choice between four medical plans with varying deductibles and "stop-loss" limits, a choice between two dental options, an optional vision plan, the ability to sell up to one week of vacation and a flexible reimbursement account.

Armco provides sufficient funds to purchase "standard" coverages in medical, dental and vision care. Employees may opt for higher or lower coverage in several of these areas. In addition, Armco will contribute $200 to the reimbursement account which the employee can supplement through salary reduction and through dollars freed-up by selecting less than the "standard" coverages. The reimbursement account may be used to pay for a variety of health care needs and for dependent care or personal legal expenses. Any unspent funds are payable in cash or

rolled over into a 401(k) savings plan at the end of the year.

Although it may seem intuitively obvious that employees would like a hand in designing their own compensation package, there is now some statistical data to support such employee enthusiasm. Consider the results of two recent employee attitude surveys conducted for companies having programs in effect for a number of years:

a. Last year, American Can hired Yankelovich, Skelly, and White, Polsters 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 employees believe their company has very good to excellent benefits (versus a norm of 56% for other companies), 89% like annual selection of benefits, and 51% feel their flexible program is better than the benefits provided by other companies (most of the remainder feel it is comparable).

b. TRW has also tested attitudes concerning flexible compensation. Among 1,200 current and former employees, they found that 87% of current long-term employees, 91% of new employees, and 82% of former employees now working for competitors believe the TRW benefits are better than those provided by other companies. This is substantially higher than for TRW employees in non-flexible divisions. About 90% of the employees are moderately or very satisfied with the flexible program and about three-quarters feel that the flexible program has a positive impact on retention and recruitment.

Another important question is: "Will a flexible compensation program really bring about cost containment?"

In a recent study of companies participating in Hewitt Associates annual Flexible Compensation Forum, companies that have already implemented flexible compensation programs were surveyed about their medical plan enrollment results. Eight of these with alternate medical plans were then selected to be studied in greater detail. On average, 37% of the covered employees selected a plan with lower coverage (a larger deductible or greater coinsurance) than the pre-flexible medical plan. This data shows that employees can be influenced away from rich medical benefits, although the results do vary substantially from company to company because no two program designs are alike. The amount of credits available to employees, the price tags on options, the attractiveness of the options in other areas all differ.

In two of the major flexible programs that have been 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 the last two years, employer-paid medical costs have risen at an average rate of 18% per year for divisions which have not yet adopted the flexible program and only 11% per year in the flex divisions--a very substantial differential.

At American Can, the rate of medical inflation has slowed by about one quarter relative to the hourly employees who are not in the flex program.

Employers have long struggled with what was thought to be the irreconcilable conflict between the goals of controlling employer cost and appealing to the workforce. Certainly if one of these two objectives is driven to an extreme, the other cannot be achieved. But it is symptomatic of the environment of the 1980's that employers want both goals achieved to some extent. They want some control on the upward spiral of non-cash compensation costs, but not at the price of alienating employees. They see flexibility as a workable approach to getting some cost control while raising employee perceptions of the program. And the third goal, increasing tax-effectiveness, becomes a way to more palatably increase employee participation in funding benefits and savings.

So flexibility has evolved. It is no longer justified only because it is something nice that a company does for its people. The key to its evolution is the development of a strategic role which holds high promise for delivering cost containment and incorporating tax-effectiveness.

Will this cost containment emphasis continue as we move from the recession to economic recovery? The reality of foreign competition presents a long-term need to control costs. Management in many companies will remain firm in this area. Even in prosperous times, we should expect no return to the old days of continually expanding benefit programs paid mostly or entirely by employers.

Monies available for increasing compensation will be used more for direct pay where there is some opportunity to reinforce the concept of pay for performance. In this respect, flexibility fits well into this vision of the future.

MS. CAROL L. BEATTY: Just to give you some background on St. Paul, we started looking into flexible benefits about 1981. In fact, it was towards the end of 1981 we got our first sample of what design for flex could look like. I will tell you where we started from, because I think that every flex program is going to be dependent on what the company's current benefit status is. At the time we were looking into flex we had received an evaluation, and we felt that we were a leader in salaries but only about average in benefits. This is a little before the cost containment push became quite as large as it is now, but it still fits in very well.

This time we were looking at our overall benefit program and rather than adding new benefits, increasing company contributions, etc., to make us competitive, we decided to look at the flex approach which ultimately was really less expensive for the company than the addition of new benefits.

Unlike a lot of companies we have always had fairly significant employee contributions to the benefit package. In other words, our employees were not used to getting first dollar coverage free. They had about a

40% contribution towards their medical cost, whether they took single coverage or family coverage.

In 1980 we introduced a dental plan, which was free for the employees but the employee had to pay 50% of the dependent piece.

The long-term disability plan was paid half by the employer and half by the employee. Any optional amounts of life insurance were paid by the employee.

Because of these significant contributions, we have always given our employees the opportunity to waive any of the benefits they choose to. Our workforce is predominantly female, a lot of second wage earners, second paycheck if you will, and we've never demanded that anyone take anything.

So, in some cases, you might say, employees had some flexibility to begin with. It's just that when they came to the company we asked them what they wanted and they probably never looked at it again. So we felt that our program wasn't bad. We did provide a good pension program, profit-sharing program, but we felt we needed to look into our benefit package, which is what we did with flex.

We thought it was important to offer our employees choice. Our workforce is about 70% female with lots of clerical workers. We thought it was important to be able to offer those people the opportunity to design a program that would really fit their needs.

Again, with the significant employee contributions we've had, the tax advantages are tremendous especially for those people who are buying the medical coverages. Paying 40% of family coverage is quite significant and to get that tax advantage and to pay it tax-free was quite an advantage for employees. We felt that was important to our overall benefit program. Again, like most companies, we had wanted our employees to appreciate the benefit package that they had. This all the more so since we felt that a lot of people thought we should be able to provide the benefits free because we are an insurance company and somehow that was just a product we should be able to give them.

That fits in with what we advance into our total compensation idea, where an employee's salary plus their benefits does equal their total compensation, and we looked at the whole idea of approaching equity in our benefits package. We haven't fully achieved this but we did make a good stab at it with the flexible program. In other words we were paying 60% of medical premiums, whether it was a single premium or a family premium and for those people that were single employees or only needed single coverage they often felt that they were not getting as much as a person taking family coverage and, on a broader scale, those people who chose not to take any benefits were not getting any of the company subsidies. So, we were looking to even this out.

We felt it was important to offer our employees a chance to review their benefits annually, make changes they thought were appropriate and, last but by no means least, look for a way to control the company costs. Just increasing our contribution as medical costs went up seemed to drive up the program costs. So with flex we feel that the dollars we

contribute can be tied to payroll, company profitability, and lots of other things rather than just benefit increases.

As I mentioned we did preliminary studies in late 1981 and early 1982, and by April of 1982 we got the go-ahead to actually study it and develop a final plan for our flex program. I became the project manager of the flex program and stayed in touch with all three pieces.

My goals were to get the program done on time (we were aiming for a July 1983 implementation date) and also to get it done on budget. At that point we were going to implement a 401(K) plan in January and flex the following July. We ended up combining those and doing them all at the same time. We handled it by a three team approach.

We had a design team which actually drove the rest of the party, putting together the design for flex, and we used Hewitt Associates as our consultant. We also used many people from the company. We involved the actuaries from our life company, who had handled the administration of our medical, dental and LTD plans. We involved our lawyers, our tax people, also our benefits people; in fact anyone who could offer something that would keep our program a good viable working program legal, and fulfill as many of our goals as we possibly could.

Along with this design team we had a systems team who started working at that point to develop the systems we would use to implement the program. We have, as I think I have mentioned, 9,000 employees scattered throughout the United States. We also have a few Canadian employees who we didn't bring into the plan at that time.

In addition to that, we had a communications team also working. There's a few corporate people, myself and one or two other people from benefits, who were involved in all three of these teams simultaneously. It seemed like all we did was go to meetings for about a year and a half. It was important for us to keep those teams working on the same type of time schedule. The communications team did a lot of work on understanding the design and how to communicate it. Also, it involved the use of Hewitt Associates for our initial communications and employee listening.

We thought it was very important to involve our employees in this whole idea, for them to have their input. So, we went out in August of 1982 and actually did employee listening. We did it in four different sections of the country so we got a good cross section of our employees. We did the Twin Cities, the East Coast, the West Coast and the South. After we got the results of the employee listening we came back and looked at what employees had said.

We found out that they did understand. They understood the idea of selecting benefits and they understood the tax impact. The only thing they told us in that listening, other than from a design viewpoint, was: "I understand what you're telling me, about paying for my benefits pre-tax, but I want to see how it works for me". That involved devising a take-home pay worksheet that they could use, distributing tax tables and having them actually work through it, once they made their flex selections, to see what that did to their paycheck. That was a really

neat exercise for people, because a lot of people just played around with it and found out that the more they spent pre-tax, the more benefits they could buy with a smaller impact on their paychecks. We found that it was very important to personalise everything we possibly could.

When we came back with the employee listening we balanced the findings with some of the actuarial concerns and with some of the administrative concerns and put together what we felt was a balanced program.

We initially tested four medical plans in addition to the HMO's which we have in the Twin Cities. Our results are a little skewed because we have about one-third of our employees in the Twin Cities, which is a very competitive area for HMO's. Sometimes, that hides the true results of what happens in an indemnity plan.

On the dental plan, we had a really big decision as to whether or not we should free up and offer that dental as a stand-alone. Back in the testing, we did tie it to the medical choice. That did not go over well with employees and we finally did, after a lot of consideration, leave the dental plan stand-alone. In other words, you could waive it which we had never done before. The prediction was made that we'd lose half the people. We didn't lose quite that many but I'll discuss what happened in a minute.

We also offered about three or four choices in long-term disability -- 50, 60 and 70% income replacement; but finally decided that was probably too many and we would be better off to stay with what we have, which is a 60% replacement level. So, we dropped that with some consideration -- both systems and actuarial considerations. So, we did some fine-tuning of the program, took it back to top management in October and got the final go-ahead that "yes" we would implement July 1 of 1983.

The crunch was really on at that time and we had to gear up the systems development, which luckily had been running the whole time, and also the communications. We felt that this drastic a program change was probably one of the most extensive to throw at people all at one time. We didn't phase it in as Pepsico did. We put it all together at the same time which involved a lot of communications. We brought our regional administrative assistants from each of our service centres.

At that time we had 45; we have fewer now. These 45 people came to St. Paul in January, just prior to our initial communications, and spent a week finding out what the program would be and what their role would have to be in it. We then issued 12 weekly newsletters from that time through to the end of March and into April. Then we sent out enrollment kits which involved a pre-posted enrollment form and a workbook - everything necessary for our employees to make their benefit choices.

Just a brief thing on communications since we felt this was very important for the success of the flex program. It is vital to begin as soon as possible. It is important to have a really good knowledge of the company and the employees and I think that from a design standpoint it is very important to know your employee populations.

I think you need to look at actuarial numbers. I think you need to look at your employees. We knew that our employees were risk-adverse. I think that's fairly true of lots of employees. For the most part, employees will go for the most coverage they possibly can unless they have good reason to reduce that coverage from an economic standpoint.

We found that our employees would prefer to go and pay a little more money for the most coverage and that was one of the reasons that we decided to go ahead and offer dental as a stand-alone. We felt that was so important to so many people that probably a super-large group would not be prone to drop that coverage.

The listening exercise was really important because it enabled us to say, when we actually went out with the program, that we did test it with employees -- we had your input, it was important to us.

We did a lot of planning up-front. We felt we had to train the trainers and that really helped. The only thing I would say, if we had to do it again, is rather than bringing them in four months ahead of enrollment, I would have brought them in just a couple of weeks ahead; a little closer to when we actually did the enrollment. We found they forgot a lot in four months. We did have a hot-line to the home office so those people could call us. Instead of having 9000 employees call us, we tried to keep it to just those personnel people in the field.

The newsletters and enrollment materials were really important and really helped us. We sent out the newsletters and that was our flex bible. We gave the employees a folder to keep them in and they were asked to keep that and refer to them during enrollment. The workbook was a summary of their benefits, of the benefits of the flex program, but it did not have the detailed descriptions that the newsletters contained. They were almost a summary plan description of each of their benefits. We also had employee meetings with a slide/tape presentation. They were motivational if nothing else.

Our goal was to get every employee through the program. In other words, we didn't have a "cop-out" type of provision where you could just say "I'll keep what I had before". One of our goals was to stress the value of the benefits. We wanted the employees to see how much their benefits actually cost and make those choices. So, we had to get 100% participation, which we did. It meant chasing down a few people the night before our putting it in the system, but we were able to get everyone enrolled.

I'll give you an idea of what our enrollment form looks like. I don't know how well you can see it. It looks worse than it actually is. Actually we found out it was not that difficult to use. It was all pre-posted for employees.

This year, our second enrollment, we were able to show what employees had chosen the year before. We didn't do that the first year. The system really couldn't quite accommodate it. This year it was much easier. We started, as I said, in July of 1983 with our first year, which meant we enrolled in May and June of 1983. This year we were enrolling in May and June also. But as you know, flex was a little bit

up in the air at that time so what should have been a very easy enrollment this year was a little bit more difficult because we had a hard time telling our employees exactly what was happening.

What we ended up doing was telling them that the IRS had issued some rules and regulations. Congress was going to address them sometime in the summer and we didn't know exactly what was going to come off. So we warned them that it was very likely that their reimbursement accounts would be on a "use-it-or-lose-it" basis. That was probably the most significant thing. We also told them that if they bought additional days of vacation they would not be able to carry over any days. Our employees have always been able to carry over 5 days. Those were the two most significant things. We told them that maybe it would happen and maybe it wouldn't, but that they should be prepared for the worst.

The other thing we decided to do, because of the IRS ruling, was to go to a calendar year plan year. So we had employees enrolled for 18 months this time. The selections they made in May and June were effective July 1 and will run until December 31 of 1985.

Basically, we gave our employees company flex dollars which consisted of enough dollars to buy back single medical, single dental, half of their LTD and their AD&D. We then subsidized the family premiums for medical and dental to the extent that people who have family coverage are still paying 40% of their coverage.

In other words the company is contributing a total of 60%. For those taking single coverage, we are paying 100% now with a $200 deductible, which was our standard deductible. We offer a $500/$1000 family option as well. In the Twin Cities this year we made a change and offered a combination HMO/indemnity plan. So the two deductibles actually apply to our field employees now. So that's why we've seen our results a little bit skewed.

We then show our employees what their actual taxable income would be if they spent all of their flex dollars, and what it would be if they spent none of them. In other words our employees could waive everything and actually take home the company flex dollars in their paycheck as taxable income. Very few people actually do that. There may be a few that decide they need no benefits -- they have a very good program through their spouse. We have choices in the medical, dental and long-term disability areas, and we have higher options for higher-paid executives making over $60,000. We have a variety of optional life choices.

Another area where we had some problems deciding what equity is exactly, is in the life insurance area. Is it the amount of coverage or the amount of premiums provided? So we decided to provide a basic amount of one times salary for all employees, which we always had done. Take it out of the flex program and leave that separate. Employees could then purchase additional amounts through the flex program. Obviously anything over $50,000 becomes taxable income based on IRS tables. That's worked into our payroll system and we could put that right on the W2 forms. So, in other words they can pay for it with flex dollars and just put it back on their paycheck at the end of the year.

Employees can pay for LTD with flex dollars. The benefit would then be taxable if they receive it. If they pay for it through payroll deduction, it would not. They do have that choice to pay for anything they wish with after-tax dollars as well as with pre-tax dollars. Vacation, the reimbursement accounts and the 401(K), which we called voluntary tax-deferred savings, are obviously only to be paid for with flex dollars. It's the only way they make sense. We show employees what their maximums are for each of those. The voluntary tax-deferred savings in the 401(K) has 5% of their income as the maximum. That is shown on everybody's form. Basically, all they needed to do was add up the numbers and if they wished they could use the take-home pay worksheet in order to figure out what their actual take-home pay would be.

I do have some enrollment statistics, which may be of interest. The first year we enrolled a little over 8600 employees in flex. Our employee population has dropped to just a little over 8000 in the last year. We have consolidated some offices so we have a smaller employee base. Our percentage of female vs. male has stayed about the same. We have about 70% female, 30% male. Prior to flex, about 18% of our employees took no medical coverage. That increased 2% the first year and another 1% the second. We now have 21% of our employees not taking medical coverage, so that's fairly insignificant. The people that needed medical still needed it and didn't just walk away from it. I think probably a few people really considered what their spouse coverage did and decided they could apply their flex dollars elsewhere.

The low deductible plan, which was our $200/$600 deductible plan, covered about 60% prior to flex. 22% of our people were in HMOs and that's primarily in the Twin Cities where we have 5 HMO options available. They are very competitive. In the Twin Cities HMOs have, in most cases, become less expensive than indemnity plans. There are two IPAs where most employees can retain their own doctor and belong to an HMO. So, they are very, very attractive.

We had 10% of our employees choose the higher deductible during flex. This year that dropped by 1% -- we were hoping that the percentage would increase obviously, but for a couple of reasons it didn't. Firstly because we forced more of our Twin Cities' employees into the HMOs and most of the people who took the higher deductible option were the higher-paid people who tended to be in the Home Office. The second reason was we had pushed the reimbursement account as a way to cover that higher deductible, but because of what we had to do this year in telling people that it was possibly "use-it-or-lose-it" it negated some of that, which was too bad.

100% of our employees had dental coverage prior to flex. Afterwards, that dropped to 76% the first year and it dropped 4% more the second year. So, we are now down to just 72% of our employees taking dental coverage. It's not an extreme situation. So far our dental plan is in very good financial shape. We told our employees up-front that because dental was free-standing now, if in the future the plan became no longer affordable, we would probably drop it. So they understood that going in. We didn't try to hide it. But we told them, conversely, they could use the reimbursement account, which obviously some people have done.

Long-term disability increased slightly -- most people had taken it but a few more people decided to take it because they had the option to reconsider. Optional life also increased. I think these were solely because a lot of people hadn't thought about it before. They thought about it the day they were hired, but decided to do some looking into what these coverages could do for them now.

A very, very popular benefit was vacation. To the surprise, and maybe chagrin, of some of our management, this has proved to be very popular. 28% of our employees bought vacation the first year; that increased to 33% this year and the average number of days increased slightly as well. Most people who buy vacation buy the maximum available. They can buy from 1 to 5 days at the cost of a day's work. It's a day's salary to buy a day's vacation.

Our medical-dental reserve was used by 33% of the people in the first year for an average of $464. This year it was 18% of the people for an average of $416. So usage did drop by almost half and I think it was because we told people they should be conservative in using it. The general benefit reserve was for day-care and legal but we will be splitting these apart because the IRS says we have to now. It was used by about 9% of the people the first year, with an average of $960. The number of people using it dropped, but the amount going into it increased drastically.

I think those people using it for day-care continued to use it and really understood the value of it and put in as much as they could towards their day-care expenses. It's a really big advantage when you talk to our employees that need day-care. They feel this makes flex worthwhile to them to the point where I know people have had other job offers and they've turned them down because they felt the tax advantages were so great.

Our 401(K) is used by a quarter of the people. That dropped slightly and I'm not really sure why. Maybe because of the confusion over the reimbursement accounts.

Briefly, this is what our employee survey showed us last year. Most people did understand the advantages of flex -- 88% told us they did-- and 90% of our employees felt that it had improved their benefits. 86% said they liked reserve accounts and 401(K). 97% liked salary conversion. We never call it salary reduction. We just said that you can use a piece of your own salary on a pre-tax basis. That was a very positive way of putting it and it was obviously perceived very positively. 89% felt it fitted in well with their own financial planning and only 15% thought they now had too much risk in selecting their benefits. Most of our employees decided that they could handle that very well.

MS. CYNTHIA R. RILEY: My fellow panel members have covered several subjects which I hope will give you a good feeling of the basics about flexible benefits -- the theories and objectives behind them and the reasons for a particular company going with a flexible benefits plan. My presentation is obviously going to be more from the insurance company perspective and I'd like to hit two main areas. One is plan design --

the types of things we are seeing, what we recommend and why. And the other is adverse selection which I know in the past has made actuaries in our own organisation grow old before their time.

On plan design, several types of approaches have emerged over the past five years in particular. It's interesting to look at them. Some offer more flexibility than others. Some are more complex and difficult to administer than others and, of course, some are easier or more difficult to explain to the employees. We'll take a quick look at some of these.

The one that I'm going to talk about for a couple of minutes is the "high-low" because that's very appropriate for a smaller sized group, and we see it often also in larger companies as a first step towards flexible benefits. I'll also discuss "modular" and "cafeteria" which is the ultimate extent of flexible benefits.

A "high-low" design is very appropriate for the smaller employer. Typically they get a choice of: 1. a high value option or 2. a low value option. The reasons that this is very good for a smaller-sized company are twofold. One is that you do not end up with too few people in one option to be able to correctly rate it. Second, administratively it is fairly simple to handle. If you'd take a look at an example, the employee selecting the high option gets a lower deductible ($100) but he gets no dental. If he selects the low option, he takes a $300 deductible but he does get some dental. We'll talk in a few minutes about the reasons for packaging and not packaging benefits in this manner.

The "modular" approach is just really one step up from the "high-low" type of approach. Here the employee might select everything in Module 1 or everything in Module 2 or 3. Very simple to administer. We at Aetna usually require 800 or 900 employees to go into this type of approach. But it would probably work for a smaller sized group than that. You'll want to watch out that you don't end up with too few people in a particular option to make it work. Administratively it's not too difficult.

The tough part about both the "high-low" and this one, and it's one worth bringing up, is that if you have announced to a group of employees that flexible benefits is on the way and they later find out that it's a "high-low" or a "modular", the result is a kind of letdown. You know, "Gee we were going to get flexible benefits and this is it?". So, that's one negative. If it's expressed as being "flexible", this is often perceived as not being such.

The approach that Aetna most typically recommends is something called a "core plus options" approach which you probably have heard of. Generally what the employer does in this case is take the existing plan of benefits and pare it down to a minimum core -- usually, a catastrophic type coverage. That might be a very high deductible medical plan, limited vacation time, limited sick leave and life insurance. Then the money that is saved is put into the form of credits with which the employee can buy other types of options.

You can start as simple as a "high-low" with this type of approach -- it

can be just a very basic approach -- but then go into all sorts of other alternatives. Such alternatives might be different types of insurance and, as I mentioned, this can be done step by step or more extensively than that. It could be taken in the form of cash, extra vacation days, or you can get into all sorts of other types of things such as dependent day-care, legal services and spending accounts. The main thing you have to watch is that you are including only the IRS-allowed types of benefits. For instance, group homeowners and group auto would not be considered acceptable by the IRS under the flexible benefits plan, although of course they could be offered optionally.

In designing a plan, there are several items that should be considered. Many of these have been mentioned already, and this will lead into adverse selection.

The first is taking a look at what the employer's goals are and, as both Bob and Carol have mentioned, this certainly comes into play. One is demographics -- that's probably one of the most common that we run across right now. What's the makeup of the group and is the present plan of benefits meeting their needs? The second is cost shifting -- that I run into most often. Is there a way that we can change the plan design such that the plan will meet some cost-containment goals?

The second step, once we have an idea of what the goals of the employer are and what he's looking for benefit-wise, is to take a look at the systems. Are their existing systems going to be able to handle the new, suggested plan of benefits? Or, are they going to be able to install necessary systems in time?

The third is communications -- is there a budget sufficient to communicate the program to the employees? (I will only briefly mention this one because Carol discussed it well.) We have found that there are many companies which make a quick decision to go into flexible benefits and then don't have the time to adequately describe it to their employees. When that happens, when you don't have a chance to explain what's about to happen, you can end up with more dissatisfaction than you might have started with. You don't necessarily have to get as complex as slide shows, with audio-visuals and that type of thing, but many companies do and they do find it helps their employees to understand. It will depend a lot on the size of the company.

The fourth thing that we begin to discuss with the employers is adverse selection. This, I guess, can be looked at as the additional benefits cost arising out of the employees' choices.

I should note right off the bat that, at this point, (10 or 11 years into flexible benefits at Aetna, with policyholders from TRW onward) we have not found it as tough to control as had been predicted. The relationship of adverse selection deals very much with the plan design. The more flexibility that you offer to the employees in the form of the plan design, the more they're going to choose what is going to be in their best interest (which is obviously adverse to the plan) and that does affect the cost. The opposite situation is equally as true. Less flexibility in a plan means that there's less choice and less impact on the overall cost.

How do you handle the plan design? Well, there are a large number of ways which can help in controlling adverse selection. For instance, election rules can be built into the plan design such as evidence of insurability. If the employee wants to buy significant additional amounts of life insurance, he would have to prove he is in good health prior to doing so. A second typical option is that an employee can only make an election change once a year. More frequently is allowed if he has a major lifestyle change, like he's married or has a new child.

The third way -- one benefit level step each year -- might deal primarily with life insurance. Typically, an employee would not buy up from one times earnings, for instance, to five times earnings of life insurance overnight. Many plans suggest that it just go one step at a time.

And the last one is that there usually is a deferral period of some sort between the election and the actual effective date. The enrollment form might be filled out in October but the plan would probably not go into effect until January 1, so there's a little margin of time built in.

The second item that we look at when we begin to deal with adverse selection has to do with the pricing. How are we going to begin to price it?

The first thing we do is look at what the estimate of enrollments is going to be: are 50% going to go into the high value plan or only 20%? We take a look at the census statistics. We try to get a tape of the particular employee group and find out what percentage are female, what percentage are male, average age, and so forth, and which option are they actually going to select? (We can tell that often from a survey.) Health characteristics of the group -- we have to make some assumptions about that, based on the census statistics. And lastly, what do we think is going to happen with regard to utilization? What has happened in the past in the single plan of benefits for instance that may have had an effect?

Second item is the employee prices. What does the employer intend to do? This gets back to his goals with regard to contribution rates and also with regard to the future annual experience analysis. Is the plan going to be completely self-supporting? In other words, if there are four options and one is the high-value option, and if less healthy people are likely to be in it, will the good experience of the better plans be used to offset it? If not, each choice is self supporting.

If it is so, that's cross-subsidization, and we see a lot of that, especially with employers who intend to have four or five plans of benefits in effect and are willing to play with the rates somewhat to keep them all there.

Take a look at a specific example, highlighted on Chart 1. This is one of our existing policyholders who has been on flexible benefits for four years now. They have 40,000 employees so its a good sized group and a good one to take a look at experience-wise. They have four plans. Plan A has a $500 deductible. Plan B is the core plan for which they don't have to pay anything -- a $200 deductible plan. Plan D is a no-

deductible plan. Plan C is a $100 deductible plan. What we like to do, not only initially but every year, is to take a look at the census analysis and see who has selected what plan. So, just to run through these quickly, you can see what the female employees selected, the younger employees, employees with dependents. This one, I always find interesting -- the younger employees and the ones with dependents you would think would not have a great need for a no-dollar deductible, but actually they're the ones with young children at home who probably make a greater use of the plan than others. So, they tend to like that high-value, no-dollar deductible.

Looking at employees with lower salaries - this one used to surprise me too. A large population who go for the no-deductible again. We found that the employees who do not have large incomes tend to like a situation where they can budget. They'd rather pay a little bit more, but budget it every month, than to have a surprise and have to deal with a $500 deductible all of a sudden.

In this particular case, the employer's goals over time were to get rid of that no-dollar deductible. That concerned him and he was anxious to get rid of it. So, I think we are now in the fourth year and we are down to a very few number of employees, with the intention that that option will go fairly soon.

Take a look at what we do in conjunction with the employer every year. The top line is the actuarial value -- obviously what the rate would be if all 40,000 people were in each of those plans. So, for Plan A, if all 40,000 had chosen the $500 deductible plan, the rate would have been $64. Well, in fact, only 4% actually ended up enrolling in that plan. Now, the census on that group is what we call the explicit information that we have.

The census was young, male, fewer dependents and they were able to get a plus adjustment. The health is what we call implicit information - what could we surmise about the 4% who chose Plan A knowing that there was a $500 deductible? Probably, that they were in pretty good health. So we had to guess that one, but we make some assumptions. At the end of the first year, the result was, not that we needed $64, because that 4% did not make use of the plan as much, but in fact we ended up needing only $28. Compare that to Plan D where we ended up needing $151 vs. the $100 actuarial value. Where this gets to be fun, at least from my perspective, is what do you from here? It is very much a matter of sitting down together -- insurance company, consultant (if there's one involved), and employer -- and figuring out what the goals are.

In this case, as I mentioned, one of the goals was slowly to do away with that high-value plan. Plan A, on the contrary, could not really be maintained at $28 because that is so attractive that you'd have a huge sweep towards it, and if too many went -- let's just say all 100% went -- you're back to needing the $64 again. So, in this particular case, they upped the price of the bottom plan and they also upped the price of the top-value plan.

Communications plays a big role in this too, and I tell this tale because I happen to think it is funny but it's also true. When they

sent the communications to the employees at the end of the first year, they included a little section describing the plans and then they said: "If you've chosen Plan B or C, you've chosen wisely". A little subtle pressure to move down to something a little less elaborate.
Well, their communications worked, and so did their re-enrolment, because a larger number of employees have indeed moved into Plans B and C.

A second step in all of this is something we call a claim level analysis. This is really something that we can provide to an employer or an employer can probably work it out himself. That is, to compare the total cost and component costs to the employee at each option at various claim levels. Now this particular slide (chart 2) shows a claim level of $5,000 and on those four plans that I just showed you, this indicates that Plan B is the best bet, at $5,000-worth of claims. In other words the deductible of Plan B was $200, there was a co-insurance requirement where the employee paid 20% out of his own pocket, which was $500, and there was no employee contribution required because it was the core. So his total cost on that plan would have been $700 had he had $5,000 worth of claims. You can see what the others would have been.

This becomes more meaningful on a graph (chart 3). If the x-axis is the claim level and the y-axis is the cost to the employee, you can see that Plan A is the low-value plan, and Plan D is the high-value plan. Now, if you take a look at this you can see that up to $455 worth of claims, Plan A is the best buy -- the cost to the employee being around $250. Beyond $455, which is the cross-over point with Plan B, then B becomes the best buy. The interesting thing in this example is that C and D are never the best buys. The funny thing, though, is how often that there are plans built into the program which are not valid buys yet people continue to take them because there are not these kinds of analyses performed. Its also interesting to note that where the slope of the line is the steepest, that represents the deductible, so for every dollar of claims incurred the employee pays $1 into the plan. Where the slope of the line is less, that represents where the co-insurance is paid and, finally ,where it evens out, that's where the 100% out-of-pocket feature takes over.

In summary, if an employee believes he or she will be healthy this year, then he is going to choose Plan A. If he thinks he's going to be unhealthy and predicts that he's going to have claims of more than $455, he'll choose Plan B.

Now, the more that we can figure out what the choices are likely to be through analyses such as this and an opportunity to survey the employees, the better we're going to be able to rate such a program.

To conclude, flexible plan design and adverse selection play a really significant part in the insurance company's study of this subject. We ended up spending a lot of time on it and there's a lot more to learn, as more companies come towards flex. As Bob points out, I guess the number is going to grow rapidly in the next two years. Our base of data will offer more revealing information and that is going to enable us to refine the best approaches for flexible benefits.

MR. MCKAY: We're going to look at some results under flexible compensation programs that have been up and running for a few years. I'm just going to concentrate on the medical area because that's the thing that's most different from traditional programs and its also the main motivator for companies putting programs into effect these days. We collected results of elections under flexible compensation programs from a number of sources:

-- From companies that participated in the 1983 and 1984 Hewitt Associates Flexible Compensation Forums.

  The Forum is for practitioners of flexible compensation -- companies that actually have plans in effect. This year, over 130 individuals participated in this two-day information exchange.

-- From companies that administer their flexible programs using Hewitt Associates FlexSystem™ software, and

-- From companies that were testing a proposed program with employees.

In all, over 50 companies supplied data for the study.

In companies that have implemented a flexible compensation program, 44% of employees chose the richest medical indemnity plan available, 38% chose moderate plans, while 10% chose the lowest plan available or no coverage if that was an option. The remaining 8% of the participants enrolled in an HMO.

Of companies that were testing programs, the results were similar with half of the participants electing the richest plan, a quarter taking moderate plans and the remainder taking the lowest plan available or an HMO.

In this analysis, the variation is probably more important than the average number.

For example, while we see that 44% of participants elected the richest indemnity plan on average, at one company only 6% elected rich coverage, whereas at another company 86% elected the richest plan. The company that had the least participation had several rich plans, while the company with the greatest participation, 86%, had only a rich plan and a catastrophic plan; nothing in between.

To see if employees really were electing lower plans, we compared the flexible medical elections with the pre-flex medical plan. We found that 37% -- over 1 in 3 participants -- did elect a lower plan. Again, there is a tremendous variation in these results. One company had only 4% reducing benefit levels, while another company had 78%.

Some companies offer a catastrophic option -- a plan with a deductible of at least $500. These plans aren't for everybody -- they are typically elected by employees who have coverage elsewhere through their spouse's plan. About 1 in 12 employees elect such a plan, with the numbers varying from 2% at one company to 12% at another.

Another option available at some companies is no medical coverage. Typically the companies having such an option did not have mandatory medical plans before flex--hospitals, banks, insurance companies etc. Here the results showed the least variation of all the medical election statistics. One in 8 participants opted out of medical coverage -- this varied from 9% at one company up to 16% at another.

Those are the raw statistics. The major question we had when we were analyzing this information was: "What causes the large variation in these elections?"

The most important factors in determining what plans employees will choose include:

-- How long the plan has been in effect,

-- The design of the plan itself,

-- The pricing schedule used,

-- The type of work-force,

-- Where they're located, and

-- The other options available in the flexible compensation program.

The first reason I mentioned, plan duration, is probably the most interesting and the results are most encouraging. We looked at the results for three companies that have had flexible medical plans for a number of years.

At the initial election, between 64% and 72% of participants chose the richest plan available. At the most recent election, there had been a significant shift in the election patterns at all three companies.

At Company A, the proportion electing the rich plan dropped from 71% to 22% -- half of the people had moved out of it.

At Company B, 64% initially chose the rich plan; now 47% have elected it.

While at Company C, there has been a drop of over 40% in the rich plan participation -- from 72% to 31%.

These particular results, when combined with the results of the Rand report earlier, are encouraging signs that flexible compensation is working.

Design also has a significant impact on election results. It appears that companies offering several choices, not just a high/low option, will have better success in moving employees out of the rich plan.

The pricing strategy is also critical. If there is a significant difference in the price of several options, employees will be more likely to select a lower cost plan. If on the other hand, the price

differences are small, employees will perceive the savings as being trivial and will stick with rich coverage.

A second pricing factor is whether or not employees are given enough credits to purchase the rich plan. If they are, they will tend to spend them on the rich coverage. If they don't have enough they will be reluctant to dig into their pocket to buy a high cost plan.

Demographics of your workforce will also influence the election statistics. Our analysis shows that older employees tend to elect richer indemnity plans. Single employees shy away from HMO's.

The initial statistics indicate there is little difference in election patterns by pay level and by the sex of the employee. Certainly further analysis will be required before we formulate this as an actuarial law.

The location of your work force is another important factor. Companies located in California, Minnesota and those unfortunate enough to be in Hawaii, will probably have relatively low participation in rich indemnity plans. Instead, many of their employees will participate in HMO's. In these areas, an HMO is a viable alternative to indemnity plans.

Finally, the availability of other options or other ways for the employee to spend the flexible credits can have an effect on what medical plan is elected. If other attractive options are available, such as vacation buying, a savings plan, or cash, the employee is going to be less likely to elect rich medical coverage than if the only choices are between different medical plans.

Let's just look at the raw numbers or statistics for a minute. In other medical areas, we found that 85% of participants elected dental coverage when it was optional, and in vision about 39% of the employees do take the vision coverage if it is available.

That concludes the formal remarks. We're now going to spend some time answering your questions.

I have a couple of questions for the panel. One of the reasons that we asked Carol to join us on the panel was that she works for an insurance company as the organization implementing the program. I am wondering what the relationship was between your actuarial staff and the whole process, and where were they in terms of aggressively going head with this or being conservative with respect to adverse selection? Also, do they have different views today?

MS. BEATTY: To answer that question, number one, you should know our flex program had the support of top management from the beginning. So we had a lot of support from the top which is very important. We thought it was important to get as many differnt people involved as we could, including the actuaries from the life company that were administering our plan. Three years ago, flex was much newer and there wasn't a lot of experience and I think it was very natural that those actuaries were more conservative perhaps than those of us who were really gung-ho on the flex idea. I think it was important to get a good

mix of opinions and I believe we did. We went ahead and did some things that we felt were a little more aggressive than the actuaries would have wished, but in other areas, we decided to listen and do what they recommended. So there was a good mix.

As I mentioned in my speech, the dental area became a real bone of contention. That's one place where we just decided to go ahead and say "we're going to do what the employees want", at least initially, with the caveat that they might lose the dental coverage they had asked for. So, we felt that we had protected ourselves. In some other areas, we did not offer as many medical plans as we initially intended and we did not offer as many choices in long-term disability. I think we reached a good compromise.

MR. MCKAY: One other thing. As Cindy was going through her material, she mentioned that it looked like adverse selection was not the problem that it could have been. Have you done any analysis of financial results in your program to try to measure the impact of adverse selection? Have your costs increased or changed as a result of implementing the program?

MS. BEATTY: We look at the funding of our plan on a quarterly and annual basis. Its only been one year's worth of results actually, but we feel that we were successful last year. The dental plan stayed in very good shape financially. It always had been in good shape but it stayed that way. In other words we didn't see a big influx of people using it in order to drop it. We do have, as Cindy mentioned, pretty strict rules on evidence of insurability. If you drop medical or dental you have to show evidence if you want to get back in those plans. Its the same with LTD and increasing life insurance. So, we've put some controls on, and we monitor the situation very closely. Our medical plan had problems because of the HMO impact in the Twin Cities. We were losing the young, healthy people to HMO's and the older people, who wouldn't change doctors, were staying in the plan. That had nothing to do with flex, really; that was just the fact that the HMO's were already there.

MR. MCKAY: One thing that we really didn't touch on, because it has received a lot of publicity already and we don't want to try to cover everything, are the changes in the last six months in this area brought about by the IRS and by Congress passing DEFRA. What changes have you seen in plan design, Cindy, and is there still the enthusiasm in the flexible area that there was before?

MS. RILEY: Well, we found, with regard to flexible spending accounts, that after the DEFRA passage in the summer-time things picked back up again. It had been very slow for a few months. Customers who were considering flexible spending accounts had more or less put them aside until all this was settled. Since then, while business is not as active as it was a year ago this time, we certainly found that there are a lot of companies who are looking at the spending account and going ahead.

Before we decided to proceed too far, we contacted a number of existing large customers who had spending accounts and asked them how their employees perceived the use-it-or-lose-it provision. The basic feeling

is that it's just not that bad. As long as the employee had some control, and most do, over the expenses that they will have in the coming year then they will not elect not to get into the plan.

In other words, if you know that you are going to see the dentist twice this year or you have definite dependent day-care expenses of $100 a month or whatever, there is no reason not to become part of a flexible spending account. Probably for 1985 we'll see a drop in overall participation, but we expect that in 1986 and 1987 that will continue to increase.

MR. MCKAY: I think, from our perspective, talking to our clients, we are seeing a similar reaction. One thing that has happened, with all the publicity, is that many more organizations and their staff are aware of spending accounts and flexibility, so the IRS may have helped flexible compensation.

As I mentioned, there is something in the neighbourhood of 250 programs in effect today. Those companies, such as St. Paul, would much prefer to have the flexible spending accounts that they've got today. So its a bit of a step backwards in going along with the new rules. But there are hundreds of thousands of other companies that don't have these programs yet and, even under the new rules, they can be very attractive. It can be a way of having a more effective total compensation package, especially with dependent care, orthodontic expenses etc. So, certainly, I don't think it has killed spending accounts or flexibility. In the long run it may help. Certainly having the rules clarified after 5 or 6 years is a big plus.

MR. ROBERT C. GREVING: I am here more from a plan administrator standpoint than an actuary. I serve as a trustee on a number of our employee benefit trusts. I'd like to address two questions. One is to Cindy. We have a group of 1000 employees. Is there a group size where this type of benefit approach becomes uneconomical? I noticed that, of the organizations that have flex, more have a large number of employees than a smaller one. I'd like you to approach that question from a system's angle as well as an administrative angle.

MS. RILEY: I'm obviously going to address this from an Aetna perspective but our feeling has been that, down to 200 lives, it's possible to go with a high-low approach and be able to rate it properly and deal with the adverse selection properly. From a system's standpoint, that's also an easy administrative job.

For more complex plans, we usually put the breakpoint at 1000 lives. That has a lot to do with adverse selection again and having a larger number of employees to spread among the various options. Also, a company of that size can probably afford the type of system they need to be able to administer the more complex plan.

MR. GREVING: I'd like to address my second question to Carol. Carol, I noticed in your statistics that you indicate that 90% of the employees felt that they had better benefits after you instituted the program, and also that you had some of your benefits, before the program was instituted, that were elective in nature and some individuals did not

elect those particular coverages and yet you did build into your core benefits some of the basic costs of that. Do you have any feel for the relative start-up costs related to building in this program and providing the initial dollars that these people could work from, as opposed to what you had before the program started?

MS. BEATTY: As I said, we did an analysis of our overall benefit program. The initial recommendation was that we needed to almost double our benefit dollars in order to be competitive within our industry. We were at about $8-10 million range at that point and it was originally suggested that we should put about another $9 million into our program. That was not very palatable to upper management. Taking a look at flex and at the equity issue, which is part and parcel of what you are talking about, it cost us about $2 million dollars to put those additional dollars in. That was ultimately the additional subsidy for those people who had taken only single coverage and for those who hadn't taken benefits both in the medical and long-term disability areas. So, the initial additional amount was $2 million. This has stayed the same or, because our workforce has actually decreased, has probably decreased from there.

MR. K. K. VON SCHILLING: I have a question for Bob Mckay. When you were running down the plan design for Cominco I noticed that the employees have the option to elect an employee-pay-all or an employer-pay-all LTD plan. What effect does that have on the experience-rating process you apply to the LTD plan, and the potential cross-rating between them, with subsequent loss of the tax status?

MR. MCKAY: The way that Revenue Canada is insisting that it be structured is that they are two completely separate plans. So there could conceivably be two different rates. One is the pre-tax plan -- money that is going in is a company-provided benefit. The other is the after-tax plan, the payroll deduction plan. But they are two separate plans and in order for there to be no company money in the after-tax plan, you cannot cross-experience rate.

MR. PAUL A. CRONIN: One of the objectives that you stated for the flex plan is that it introduces cost containment features and basically you are saying that it drives an employee to a lower level of benefits, a high deductible plan, such that utilisation is less. On the other hand, if you introduce, into your flexible program, a flexible spending account in which you allow the employee or employer to allocate credits to the medical-dental line, are you not just doing the opposite? Aren't you encouraging over-utilisation under the use-it-or-lose-it provision?

MR. MCKAY: The rules before the IRS discovered Section 125 did not work that way. Flexible spending accounts worked in tandem with higher deductible plans because you got the money out at the end of the year if you had it left over. So, there was an encouragement not to spend it. That was why companies like Xerox, Alcoa, Toro and many, many companies put in those programs. With what the IRS has done now, it does work in somewhat opposite directions, because if you're going to lose it at the end of the year and you have $50 or $100 left over in the middle of December, you're going to try to spend it. What you'll probably spend it on is Gucci eyeglasses or something. So, it may not affect medical

expenses, but its certainly going to be spent somewhere. It may not offset the improved utilisation.

There are a couple of other areas that the cost savings can come from. One is improved utilisation. Another is, in effect, shifting some of the premium onto the employee by making him or her pay for the rich plan if they still want to keep it. Another is by just offering more types of benefits than you used to be able to afford. A few years ago everyone had to introduce dental because dental was the new thing. Now you can introduce a new benefit and make the employee choose: "Do I want dental or do I want this new benefit?" So that's a long-term way of containing costs.

MR. WILLIAM R. EDENS: This is directed to anyone. I wonder if you would describe the formulas that might be used to credit employees with units or dollars before they get into the spending process? Also, are these formulas dependent on age or length of service and, if so, how do we strike a balance between giving an older employee, who would have expensive life or health insurance, enough credits without overdoing it for your younger employees?

MS. BEATTY: That's a thorny question. We were looking to the total-compensation approach -- an employee is an employee is an employee -- we don't really care about their length of service or family status or age, so we wanted to structure our program to give the same number of flex credits. The only thing we varied in the company credits was in the LTD area, which were salary-related. So the majority of the flex credits are a flat dollar amount that the company generated. That's why we took our basic life insurance out. Originally we were going to release from the basic amount of life insurance just one times salary. We ran into that exact problem -- do we give enough for everyone, especially the older employee, to buy back, or just enough for the younger employee to buy back and make the older people pay more? So there are some areas where its very difficult to do that, which is why we kept life insurance out of the flex program. We give everybody the one times salary. Obviously as you get older, one times salary is worth more than when you are younger, but in the other areas we try to keep as much as possible away from all those external factors. We still do subsidize family medical to some extent, but that's just a factor of where most companies are.

MR. MCKAY: Cindy, have you seen any situations where the credits vary by age or service?

MS. RILEY: Yes, I've seen several. In fact, I believe American Can has credits varying by age and years of service.

MR. GREGORY S. BENESH: I'm going to follow up on that question. Cindy, do you ever, in pricing the benefits, show step rates for any of the benefits, by age?

MS. RILEY: That comes up often, and typically the place where its most likely to seen is in the life insurance area. On the medical, we really have not done that.

MR. BENESH: Have you sold any plans with that kind of format?

MS. RILEY: With the life - yes.

MS. BEATTY: Our optional life is age-stepped.

MR. MCKAY: I've seen a couple of companies that have age-graded rates in long-term disability. Just a handful.

HOWARD L. KANE: A couple of questions. Bob, on the screen you had shown where one of the companies had four choices of dental. I believe it was none, low, moderate and rich. What's to keep someone like myself from one year choosing the rich and loading up on all the bridgework and orthodontic work, and then the next year switching down to the low? Wouldn't that be adverse selction to its fullest?

MR. MCKAY: Not everyone's an actuary, Howard, so we don't think they're going to try to rip the plan off. Actually, that is potentially a real problem and the plan to which I referred uses a couple of the techniques that Cindy talked about. One is, if you opt out of dental, you're out for a couple of years. So you can't opt in every other year, get all the work done and then opt out the following year, get your credits and spend them on whatever you want.

MR. KANE: Can you switch from the rich to the low though?

MR. MCKAY: You can go from rich to low but you are subject to what we call the "staircase". If you're in low for example, and want to get to rich, you've got to elect the preventive plan for a year then the moderate plan, finally the rich plan.

MR. KANE: Secondly, to Cindy, you showed where you had plans A, B, C, and D and I believe where B was always lower than C and D. Do you show this type of graph to your employees and advise them as to what to take?

MS. RILEY: This actually is a fairly new procedure we've begun and we're trying to do it now before the plans are ever brought to the employees. First of all, to find out if the plan design makes a lot of sense, because in that particular case C and D, as I recall, never worked out as being favourable at all. Its a very helpful step though to include in the communications with the employee, in one fashion or another. Maybe not in a graph form, but in some other form to say "let's pick some various scenarios -- let's presume you're going to have $5,000 of expenses or $100 worth of expenses", and give them the options from there to help make a better selection.

MR. KANE: Wouldn't that also suggest that perhaps the premiums for C and D in relationship to B were just out of wack. At some points there should be total equality of the premium vs. the pay-out in the way it was designed. With the premium impact, the cost was always greater.

MS. RILEY: It is a good way of identifying where the rating has been incorrectly done.

MR. MCKAY: In pricing a flexible program, to determine how much employees are going to be charged for the coverage, one approach is to

use actuarial prices where you look at the true differences in value of the plans, and those become the prices. However, you may decide to change some of those prices depending upon your objectives. Do you want to pay anything more for the plan? Do you want anyone to lose, or do you want them to buy back? You frequently have to take those prices and adjust them, and that's where you can run into a problem like that. You need good communication, either with a graph, or I've seen quite a few companies that will have a wheel which you spin around and choose your expected level of coverage, and it tells you how much this will cost. They are helpful.

One issue that doesn't show up there, and I think it is why in some cases Plan C or D may have been better, is if you have coverage through a spouse and there are coordination of benefits issues and you're going to get more from the other plan than you would have otherwise. I think if you look at it all together, there may be some reasons people might choose Plan C or D. You'd need a several dimensional graph to show all of that.

MR. DONALD S. GRUBBS, JR: A question for any of you. Key Congressional leaders have indicated that during 1985 they are going to again consider tax law in this area. Probably substantially reducing the tax advantages of most types of employee benefit programs and perhaps leading either to the desirablity or the compulsion to change such plans by the end of 1985. In light of this, do you expect employers to defer taking any action whatsoever, and should they?

MR. MCKAY: I can take a stab at that, looking at your Congress from across the border. There was a very similar proposal in Canada in 1981. There was a Budget proposed that would tax the value of medical and dental benefits to the employee and our initial reaction was that that would make flexibility a lot less popular because suddenly you're trading off between taxable benefits as opposed to non-taxable. But as we thought it through, we realized that if you have two married employees and they are getting benefits right now, they're both getting something which is non-taxable. With co-ordination of benefits, you can probably get 100% of your expenses covered. But, if suddenly a husband and a wife have a taxable benefit, one of them is going to want to take the medical coverage and one isn't. The one who doesn't is probably going to say "I'm giving up my medical plan -- give me something in exchange for that", and that really is what flexibility is all about. "Give me benefits or give me something else." So, I think, if the taxibility of employee benefits is changed, and many people in Washington think that 1985 is going to be a big year for going after the deficit, it will be a very important impetus towards flexibility.

MR. CRONIN: My question is to Carol. If my memory serves me correctly, you showed on your slide that in the latest plan year, 18% of the employee group were participating in the flexible spending account under the medical/dental. I'm just wondering if at that low level, the expenses to administer something like that outweighs the tax savings you are passing on.

MS. BEATTY: So far our administration has gone very well. The life company that administers our claims just merely added the re-imbursement

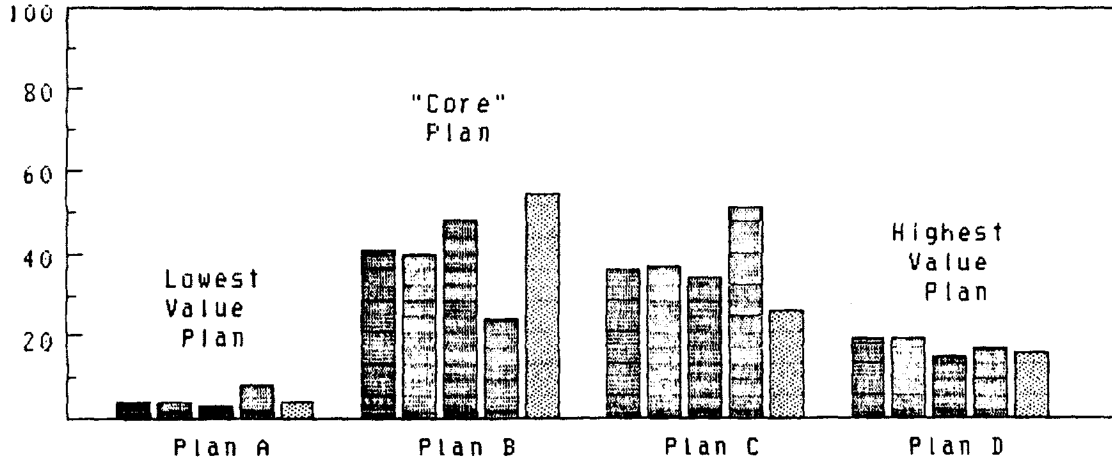
accounts to their claims system and they do little or no checking. In other words, as long as they have proof of the expense they pay it so it doesn't involve a lot of adjusting expenses. Merely syphoning it through the system.

Checks are issued after submitting at least $50, the minimum claim amount. If an employee submits more than he has available in the account, its simply diaried and done once a month. So far its all been automated and there has been little additional expense. I think this year was a tough year for employees. As the rules get settled down and we can help people predict their expenses, that will level off, hopefully in the coming year. It may not rise to the previous level but should go back up to where people realize that they can predict some of their expenses. They were kind of in a quandary this year.

MR. MCKAY: One answer I'd like to follow up on is the size of the companies that was asked earlier. Out of those 250 or so companies that now have programs in effect, roughly a third of them have under 1000 employees. Now their programs are generally not the broad American Can or Cominco-type programs, but many small companies do have some type of flexibility in their programs so its not just something for big companies.

CHART 1

ABC COMPANY
SECOND YEAR STATISTICS



Total Employee Population
Female Employees
Employees Less Than 40 Years Old
Employees With Dependents
Employees With Salary Less Than $15,000

CHART 2

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ABC COMPANY

Claim Level Analysis @ $5,000

Option	Deductible	Coinsurance	Employee Contribution	Total Employee Cost
A	$ 500	$900	($204)	$1,196
B (CORE)	$ 200	$500	$ 0	$ 700
C	$ 100	$500	$ 204	$ 804
D	$ 0	$500	$ 396	$ 896

CHART 3