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FUTURE OF FLEXIBLE BENEFITS PROGRAMS

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Many factors are affecting the design of flexible benefits programs. Some of these include:

- o Desire for greater choice in benefits in order to meet employee needs
- o Desire to make benefits more cost effective or to contain costs
- o Desire to make benefits more tax effective

Not all these desires and needs are compatible. But to successfully implement a flexible benefits program, compensating factors must be balanced. To do so involves examining these factors from different perspectives.

This section will examine four perspectives for flexible benefits:

- o What is the current regulatory environment in the United States relating to flexible benefits programs and how is this affecting the design of such programs?
- o How have the design and cost of flexible benefits evolved from the employer's perspective? This will be examined from the perspective of one employer, Educational Testing Service, which has had a flexible benefits program for ten years.
- o How does an insurance company approach the risk aspects of flexible benefits with regard to insured coverages? What type of selection costs have evolved in flexible benefits programs and who is paying these costs? What is being done to measure the cost of selection?
- o What is the flexible benefits environment in Canada?

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OPEN FORUM

MR. THOMAS J. KUHLMAN: This afternoon we plan to cover the subject of flexible benefits from a number of different perspectives. First, how does an insurance company view flexible benefits in terms of the products and services that it offers, the type of market that it has, and what is really happening in terms of adverse selection in choice programs. Covering that subject will be Mr. Mark Golden.

We will also cover the subject of flexible benefits from the employer's perspective. For this, we are very fortunate to have Ms. Mary Jane Klansky from Educational Testing Services (ETS). ETS has the oldest flexible benefits program in force--in existence over 11 years. ETS has adapted to a number of different changes in tax laws and changes in employee reactions over the life of its program.

Finally, although flexible benefits is not a new subject in Canada, relatively few companies have adopted such programs. The reasons for adopting flexible benefit programs in Canada can be different than in the U.S. Covering the Canadian perspective is Mr. Donald McGrath.

I have a couple of background comments before we get started. First, why have companies adopted flexible benefits? Initially they did it to offer employees a choice. The first programs offered a lot of choice. Flexible benefits, though, have changed over time.

After 401(k) plans began in 1981, many U.S. firms suddenly realized that the idea of "pretax" could be extended to flexible benefit programs, giving employees a pretax choice on benefits. Many programs were established where choices were based primarily on tax considerations. While other employer motivations included cost shifting, cost containment and influencing the way employees use benefits, particularly health care benefits, a major reason was to offer more pretax benefits. Therefore the pending changes in tax laws in both the U.S. and Canada have made these programs a topic of great current interest.

First of all, choices in a flexible benefit program, one that complies with Section 125 of the U.S. Internal Revenue Code are limited to cash and statutory nontaxable benefits including group life, health care benefits covered under Sections 105 or 106, dependent care assistance as covered under Section 129, group legal plans covered under Section 120, cash and cash/deferred profit sharing plans. There are some questions as to whether accidental death and dismemberment (AD&D), dependent group life and vacation pay are covered, but a proposed Technical Corrections Act will address these miscellaneous benefits. Finally, certain benefits are excluded from flexible benefit programs--van pools and scholarships.

The idea of salary reduction is to substitute benefits on a pretax basis as long as there is an election prior to the benefit commencement period. The election must be irrevocable in the period of coverage for the plan year. The only exceptions to the irrevocable requirement occur when there is a change in family status. Some questions remain as to what that really means. Also, there are "use-it-or-lose-it" rules. The employee is at risk if he elects the pretax arrangement of an expense account paying pretax dollars for health care, dependent care or legal

benefits, forfeiting any amounts that aren't used at the end of the year.

A major discrimination made in Section 125 is on key employees; they are subject to taxes on their benefits if the share of nontaxable benefits for this high-paid group exceeds 25 percent. President Reagan has introduced a tax simplification bill which affects flexible benefits and, in particular, taxation of benefits in general. The primary change is the introduction of new uniform nondiscrimination rules that cover a wide variety of welfare benefit programs--group life, health benefits, group legal, dependent care assistance programs, educational assistance plans, welfare benefit plans funded through 501(c)(9) trusts or Voluntary Employee's Beneficiary Accounts (VEBAs) and so forth. First, there can be no discrimination regarding eligibility to the programs. Second, there can be no discrimination regarding the benefits or contributions that are provided. The definition of discrimination is structured around the concept of "prohibited group." A prohibited group is defined as one of these categories:

- employees who own at least 1 percent of the company,
- employees earning $50,000 or more per year,
- employees receiving the top ten percent of salaries paid.

If an employee belongs to a prohibited group he cannot be provided with eligibility, benefits, or contributions that are more favorable to this prohibited group than to other employees. If so, the benefits to those in the prohibited group become taxable to them.

There is an additional requirement that if the average rate of participation of the prohibited group in welfare plan options is more than 125 percent of the average rate of participation of the nonprohibited group, the prohibited group will have taxable benefits. This is a particular onerous requirement since it is tested for such welfare plan option in the program.

Finally, there is a proposal wherein the first $10 per month of health care benefits would be taxable for single coverage, the first $25 per month for family coverage.

What is the likelihood of these changes passing? As time goes on, I think the chances improve, some version of it is very likely to pass in 1985. It's been promised that there would be something on the President's desk to sign by Christmas. Three months of debates are scheduled. During three months of hearings (June, July, August), over 500 witnesses will be called in to testify for or against the tax proposals. The real question is whether momentum can be sustained over this three month period. Regulations will go to the conference committee, probably, in November. If we go into 1986 without major tax changes, the likelihood of passage (or of major revision in the tax code) decreases.

MR. MARK C. GOLDEN: I'm pleased to have been asked to address an actuarial forum regarding an issue many of you here today have spent

your careers analyzing, debating, anticipating and controlling. I'm referring to our old nemesis, adverse selection. Many benefit managers would like to see that term changed to "intelligent" selection. Certainly, from the consumers' perspective, the selection or choice of a benefit will be as economically and intelligently sound as he or she can make it. However, for our discussion here today, let's use the term adverse selection, since we in the insurance industry are normally on the receiving end of it.

Before delving into the more detailed aspects of adverse selection, let me spend a few moments on where we at Aetna as a carrier, see the flex compensation market moving. Incidentally, I use the term compensation, not benefits--and I will use that throughout this talk. There are three major forces moving the market right now:

1. The ever-changing demographics of the work force--encompassed in this is the necessity to address the varying needs of the two-income family, the issue of the single versus married employee, the large employer subsidy traditionally enjoyed by the married employee and, the insurance requirements of the ever-growing number of women in the workforce.

2. Cost escalation--flexible compensation plans allow employers an opportunity to introduce optional medical plans which may provide for greater cost sharing on the employees' part. Through pricing and communications strategies, the employer can influence employee choices, which may ultimately lead to an overall lower level of medical claims. In addition, the process of budgeting a cap of dollars per employee, rather than benefits per employee, is often viewed as a major opportunity for employers to gain better control over the overall cost of benefits. In fact, I often think that you can logically view the move in pension products from defined benefits to defined contributions as being extended to insurances. Employers are moving away from the highly paternalistic attitudes of the last few decades, and they are drawing a much more distinct line between compensation and benefits. Employees are being given a choice on how those dollars will be spent.

3. Tax law changes--to 1978 changes U.S. Internal Revenue Code Section 125 for insurance benefits and Section 401(k) for pension benefits have piqued interest in flexible compensation. These two sections provide a safe harbor from the doctrine of constructive receipt, permitting employees to choose between benefits and cash without suffering adverse tax consequences. Looking to the future, if tax reform is passed and levied on benefits, it's probable that current interest in flexible compensation will increase even more. Employees will want more control over the form of their compensation if it's going to be taxable.

While we at Aetna are very optimistic and positive about the outlook for flexible compensation, I'd be remiss if I didn't touch upon some areas of concern. Clearly, administration and recordkeeping are extensive under a flex comp plan and employers must assess this burden very carefully. However, as flexible compensation plans have become more

prevalent, the benefits community (employers, consultants and insurance companies), have responded to this concern with software developed specifically for flex plan recordkeeping. Administration can be simplified with some of the software available in the market place today. Much of it is microcomputer based, but with the increasing power of the micros, significantly large numbers of employee accounts can be handled.

In addition to the administration issue, employers must be prepared to conduct extensive employee communication programs, to be sure that employees are given the proper information upon which to base their benefit elections. Many employers view this as a significant opportunity to advise employees of the excellence of the fringe benefit program that they offer.

Another major item which employers must be cognizant of, and which I'll discuss in a little more detail, is the issue of adverse selection. I'll start with a definition of adverse selection, and a concept that highlights the fact that increased flexibility leads to an employee choice which produces adverse selection, which ultimately results in a cost. It's important to understand up front that adverse selection must be reckoned with as a cost to the plan. My nonactuarial definition views adverse selection as an opportunity for an employee to choose a benefit he perceives will provide him with benefits that are greater in value than the additional cost of the option.

This results in less than 100 percent participation in any one particular plan of benefits, a nonrandom distribution of claim costs and an opportunity to select against the plan.

I'll briefly describe two methods of measuring adverse selection. The first measures selection on an individual option basis. Under this approach, selection is defined as the average paid claim of an option divided by the actuarial value of that option. Alternatively, adverse selection can be measured in the aggregate. Here, adverse selection is defined as the average paid claim of all options, divided by the average of the actuarial value of all options. While we at Aetna feel that selection on an aggregate basis is manageable, I'm very careful to caution plan sponsors to also assess selection on an individual option basis.

I'd like to spend some time on how we, as a carrier, deal with the issue of adverse selection, broken down in two major functions: anticipation and control.

Some of the tools we make use of in anticipating adverse selection and its effects are census analyses, employee surveys and focus groups, claim level analyses and experience (the extent to which we've encountered similar situations before).

Let's briefly look at some of the components of census analysis. To the extent that we make some general assumptions about the demographics of a group, we look at some of the following objective criteria:

- o Age--older employees have a tendency to pick higher-valued medical plans. Younger, single employees tend to choose lower-valued medical plans, and may use additional credits for vacation time.

- o Number of dependents--employees with dependents tend to choose higher levels of life and disability insurance and more comprehensive medical benefits. To the extent that we know the number of secondary wage earners, we may find that we may be able to analyze the extent of coordination of benefits (COB) savings.

Again, these are very generalized assumptions. We are beginning to learn more about the lifestyles and attitudes underlying employee choices. However, some objective demographic analysis is still in order. Incidently, one of Aetna's employer-clients terminated his Flex Plan D (which was a rich basic and major medical plan) after the third year and subsequently moved to a much more sound cost containment plan.

In addition to the census analysis, we find employee surveys, or focus groups, to be particularly helpful in predicting participation levels for given options. To the extent that we know more about the employees' attitudes, and willingness to pay for the plan, the more comfortable we feel with rate and participation levels. As a result of this feedback, in many cases, we may redesign the plans to reflect what the employees have told the employer.

The claim level analysis shows the total cost and component cost to the employee for each option at various claim levels. This indicates which option is the best buy for the employee, assuming a certain level of claims. Additionally, we can determine the cross-over point where one plan is no longer the best buy. Finally, we can determine the claim level at which a plan will max out--a point where additional claim dollars no longer generate employee cost. The real benefit of the claim level analysis is to determine the best buy/worst buy scenario at various claim levels.

One critical element in anticipating the effects of adverse selection is knowledge of the employer's objectives for the plan. Does the employer want to maintain the existing program and its options, or is the goal to drive employees into the lower option, eventually eliminating the higher option? If, in fact, the employer wants to maintain the existing program and its options, for how long will it be maintained? What is the employer's attitude toward health maintenance organizations (HMOs)? In fact, HMOs may promote one of the most difficult of all adverse selection issues. Many are community rated, and if younger, healthier lives migrate into the HOMs, the employer's experience may worsen. Under a flex plan, even though younger, healthier lives migrate to the less costly option, the employer still avails himself the beneficial effects of those lives. Under a federally qualified HMO, those healthier lives benefit from a community rate, not the employer's experience rate.

I've spoken about anticipating the effects of adverse selection. Now I'll spend a few minutes on the subject of controlling it. The most important element in controlling adverse selection are sound plan design

and underwriting rules. If a plan offers employees the choice of prescription drug, dental or vision care coverage on a stand-alone basis, the plan will enroll heavy utilizers of those services, with few employees over which to spread the claims cost. That just doesn't make sound financial sense. Under these circumstances, an employer might be wise to package such ancillary coverages under one option, or subsidize the dental rate to make it particularly attractive and increase participation. A little bit later I'll talk about some of the trends we are seeing in the marketplace, but one rule I feel is very important is that life insurance increases only with satisfactory evidence of insurability. Coverages such as life insurance and long-term disability (LTD), which have low incidence levels but high liability of claim dollars, are difficult to price for adverse selection. Therefore we look to sound underwriting rules such as evidence of insurability to protect against that risk.

In addition to underwriting rules and plan design, pricing should take adverse selection into account. The concept is, very simply, to give credit to the low option or less rich plan, assuming that the healthier lives will enroll in these plans, and to adjust the rates for the less healthy lives which will remain in the high options. It is critical, at each renewal, to carefully assess what these adverse selection adjustments have produced. One must very very careful that a spiral does not precipitate where we are never able to price the rich plan properly, due to the high percentage of unhealthy lives. When this phenomenon begins, the employer needs to address whether continuation of that rich plan is feasible. Again, it's critical to know up front what the employer's objectives are.

Assuming rates are set using the tools and data we have just described, let's talk a little bit about the experience rating process. Timing and guarantees on an ongoing basis become very important. For example, the experience accounting year may operate from July to July, while the flexible compensation plan operates on a calendar year basis, due to deductibles and coinsurance. You may very well say: "So what's the big deal? All of our plans operate on that basis." However, take into consideration the extensive communications which must be conducted with employees, and the opportunity during the open enrollment period (typically October) to change various selections, and you see how this starts to become complicated. For example, I may not have a good handle on what my experience base is under a flex plan until the October or November open enrollment period occurs. However, the employer must communicate contribution levels, or new flexible credit allocations, in September. Therefore, the insurance company has to tell the employer, in June or July, what the rate level will be for individual options for the coming calendar year--six or seven months away. The rate level will be based on a very limited five or six month immature claim base. I think you can appreciate that it starts to become a little bit unwieldy, requiring extensive experience analysis and an increasingly frequent "gut reaction" about what various participation levels will be. In essence, we are shooting at a moving target --the employee population.

Let me touch upon some of the trends we are seeing in the marketplace today and some of the ways we are attempting to deal with them. Within the past twelve months, there seems to have been an increase in the number of requests to waive evidence on life insurance increases. It may simply stem from a desire to provide greater flexibility. However, I have concerns about the trend, and I personally don't believe it's wise. A potential back-off position might be to allow 50 or a 100 percent increase to a maximum $50,000 or $100,000. However, in this situation it is very important to carefully assess volume and total premiums so there is a reasonable relationship between the maximum amount at risk and the total volume.

Another trend paralleling the above is waiving evidence of insurability on increases under an LTD plan. Though this may not be as bad as it initially sounds if there is at least a noncontributory core of coverage, I personally would not recommend this kind of arrangement but do think it is reasonable if that good experience base is in the core plan. As I mentioned earlier, with coverages such as life insurance or LTD, where there is that low incidence of claims but the high cost once the claim comes in, it's more reasonable to protect oneself through plan design and underwriting rules rather than through pricing.

I will wrap up by saying that we in the insurance industry, at least at Aetna, are very optimistic about the future of flexible compensation. Over the long haul, the primary motivator for flexible compensation will probably be the changing demographics of the workforce. Flexible compensation plans have really proven to be of value in allocating employers' very scarce resources. Clearly, other issues are moving the flex market, but we think the demographic one is the most important.

My charge today was to give you a perspective on a carriers' view of flexible compensation and, more specifically, adverse selection. We feel confident we've developed enough tools and experience to anticipate and control that selection. However, I would like to leave you with the thought that adverse selection should not be taken lightly. Any time we introduce choice, selection will occur. That is an issue that the flex compensation plan sponsor, the insurance carrier and the consultant must deal with. However, it is generally not of such magnitude that it should deter sponsors from moving to a flex plan if flex fits in with the employer's overall objectives. The keys to dealing with adverse selection are anticipation and control.

MS. MARY JANE KLANSKY: My charge today is to tell you about how Education Testing Service (ETS) came into the flexible benefits business and, until I spoke to Mr. McGrath a few minutes ago, I was very comfortable and pleased with myself that we at ETS were the first in the world to have a flexible benefit program. Now I'm told that our Canadian neighbors have been doing exactly the same thing for many, many years--just not calling it that. So I must back off from saying we were the first--that I know of.

In 1971, we took a look at our benefits program and realized that we were about 5 percent below what the Chamber of Commerce was

recommending for fringe benefits in terms of payroll. We knew we had to do something, and in our business that something had to be a benefit that would touch every employee. ETS has no unions--everybody has the same coverage from the groundskeeper all the way up through the cafeteria workers, the PhDs and the President.

How were we in management going to provide a benefit that would give everybody his or her own ability to structure a program suited to personal needs. It was very, very difficult, so we went out to the market and looked around. We found that back in 1960 someone--and I don't know who--thought of the cafeteria style program. But nobody was willing to take a chance on it. It was a matter of "Let's wait until John does it and we'll see how he makes out, and then we'll try it."

ETS, creative and innovative as it is, decided to be "John". We sold the idea to management; they said: "looks great--now go out and sell it to the troops." At ETS, every employee has to have a part in such decisions, so we formed task forces, we formed committees, we did analysis upon analysis and finally we came up with thirteen benefits. Those were put on a ballot that was given to each employee (once a year) to make his choices. All of the items on the ballot were over and above what the organization was giving in the core program. That core of benefits included life insurance, single medical coverage, income replacement, temporary and total disability, vacations, holidays, personal days and a 6 percent noncontributory, qualified retirement plan. Within the 13 percent flexible benefit options were extensions of the core benefits. For example, one could purchase additional insurance coverage up to one times annual salary. One could buy dependent medical coverage. And to make it fair for everybody, the organization gave the employees a percentage of their salary to pay for these options. For zero to three years of service, that was 3 percent; from four to six years of service, 4 percent; from seven to nine years, 5 percent; ten years and over, 6 percent.

That benefit program not only touched everybody in the organization and gave everybody the opportunity to create a benefit program to suit his or her own individual needs, but by taking the employees into the process of designing it, we automatically removed all dissatisfactors. And beyond that, we gave them the money to do it. So it has become not only a very workable program in our organization, it has also created more employee interest and appreciation than any benefit program that I have every worked with before.

The program continues to be successful. The "flexible" part of it is that we can change it as the organization's philosophy changes and we can change it as the laws change (we have done that). We did not offer cash in the beginning, because the Internal Revenue Service (IRS) said that if we did, we would be inconstructive receipt. So we didn't. But then, back in 1979 that 1978 IRS rule was amended, and we could offer cash. We just put it on the ballot. It was as simple as that. We didn't increase the benefit. We didn't increase the parameters that we had set. It still had to be within the three to six percent of credited salary, but we allowed employees to now take it in cash. Of course, it was taxable to them. When President Reagan came

along and said that tax-free dependent care could be offered, we put that on the ballot. So we've had absolutely no problem creating options in our system as the laws have mandated that we should, or that the philosophy of the organization has said that we should.

One area I am often asked about when I speak is adverse selection. Mr. Golden spoke about that earlier, but there's one word I did not hear him use. He used the words "controlling" and "anticipating," he did not use the word "eliminating." What we did at ETS, when we put our benefit program together, was to establish a dental program. We designed and wrote this dental program with incentives to continue enrollment. It has a $50 deductible the first year, and 60 percent of bills are paid up to $400. If an employee has an examination in January, that deductible is removed and the second year, the percentage goes up to 70 percent, the benefits go up to $600. If he or she continues that into the third year, again there is no deductible, the payment coverage goes up to 90 percent and the benefits to $800. In the fourth year, the figures are 100 percent and $1,000 respectively. But if at any point in that four the employee drops out, or does not have that examination, he goes back to the year one schedule. So we have eliminated a great deal of the adverse selection.

Of course, you have to realize that dental care is not like medical. Everybody buys medical insurance, but only the people with bad teeth buy dental insurance--it's a demonstrated fact. Years from now we may see a change in that, but right now I believe that's the way we have been able to control the adverse selection. The same think is true with additional life insurance. If an employee does not buy that one times salary additional life insurance under the flexible program the first time it's offered, he or she cannot get it the second year without a medical examination. So we've eliminated adverse selection there. The other part of it, as Mr. Golden said, is not to allow people to change their selections until the annual open enrollment time--unless there is a change in status. At our company, an eligible change in status is clearly defined: an employee gets married, gets divorced, a spouse dies, a child is born. If spouse loses a job and, therefore, the ETS employee has no other benefits, we will allow him or her to come into the program. That has really worked well for us.

We have now increased the number of options offered to sixteen. We've added three mutual funds as additional investment choices. In the thirteen original options, we had four for retirement savings, one of the most popular being a matched savings plan (that matched plan is 3 percent). If an employee opted for that matched plan; he put in 3 percent of the flex money (which is organization money) and that was matched by another 3 percent of the company's in addition to the 6 percent in the core program. He or she has 12 percent of annual salary going into a retirement plan without any out-of-pocket contribution. Again, our program has worked extremely well for us. I'm not quite sure what President Reagan's proposed rules and regulations are going to do to us though. I can't tell you that I was pleased to see the proposal removing the ten-year average forwarding under 401(k), but I can tell you that we're not under 401(k). We operate under the 403(b) counterpart for non-profit organizations.

The most important element in this kind of program--the most important thing you have to do to implement it--is communication. Make sure you take everybody into consideration because the ability of a benefit manager to walk down a hall and have someone say, "Hey, are you going to put an IRA into the flexible benefits next year?" is communication that you can't buy. Most employees know where to go to get a hospital form or where to go to get a doctor's form and that's all they know about their benefits. Today, you have them communicating with you on a weekly basis, on a daily basis. You meet them and get memos, you get telephone calls. And some of their ideas are pretty darned good.

We've set the parameters on contributions to be between 3 and 6 percent and we have seen cost increases only from salary increases. Anything that's salary driven will increase once you give a merit increase, and we give a merit increase every July. Any premium increases are passed on to the employee to pay for out of that 3 to 6 percent. So there is a very good cost-containment feature. And it doesn't hurt the employees. How can they get angry when it's the company's money that their spending? Our turnover is less than 4 percent. I won't insult your intelligence by telling you that that's mainly due to the flexible benefit program. But I'd like to think that the flexible benefits had something to do with it.

Another thing that Mr. Golden mentioned was that he was not talking about benefits but compensation. That's what everyone is talking about because down the road (if the government leaves it alone) the employee will have the ability to say "I do not want a $5,000 salary increase. I want that put into my retirement plan." Total packages of direct and indirect compensation will be offered in a very short period of time.

Some companies already have it--I believe American Can does. That's where I'm headed and that's what I want done. I think that we are all going to see that in a very short period of time.

MR. DONALD A. MCGRATH: It's my task to attempt to bridge the Canadian and U.S. experiences with flexible benefits. It reminds me of Winston Churchill's remark that the British and the Americans are divided by a common language. I think that perhaps we North Americans are somewhere in between that with the interesting addition of French.

I'm going to examine the driving forces in Canada, and also consider the constraints which are social, demographic and to some extent, legislative. The basic approach we use here in Canada includes objectives to contain costs and to shift loses as well as certain human resource goals involving individual needs. Generally speaking, we observe the same objectives in this country as in the U.S. However, we have had a considerably slower rush to flex benefits in response to them.

Taking a moment to consider some of the characteristics of the Canadian environment, it's clear that the alarm bells have been very slow to ring here. One of the reasons for that, which I'll talk about in more detail in a moment, is our system of Medicare. The opportunities are, in

fact, fewer and we have not had the same kind of tax encouragement that has been enjoyed in the U.S. Also, there has been a long history of flexible options or flexible benefits in Canada. We have had, for years, programs which provide optional group life, dependent group life, voluntary group accident, variable entry ages into pension plans, voluntary pension or RRSP contributions, mechanisms for excluding the working spouse, the ability to transfer the cost of Medicare to a spouse working elsewhere, and voluntary savings and thrift plans. At the present time, we are seeing the emergence of some new options--spousal life insurance, spousal LTD and group auto and homeowners. Coming are fitness programs and child care services.

Given the number of options that are typically found in Canadian programs, it's difficult to come to any conclusion except that Canadian programs, while somewhat traditional in concept, offer a great deal of employee choice and are already highly flexible. Even a monolithic type of program can be enhanced by the addition of a few options. It also should be noted that, in Canada, many of the executive perquisite programs contain flexible accounts. We are not concerned with top-heavy rules in this country, so there is a lot of flexibility in perquisite accounts for executive employees.

I'll turn now to what is probably the major element in the Canadian environment severely curtailing the development of flexible benefits in the U.S. style. I refer to Medicare. Every Canadian resident enjoys state-provided hospital, medical and surgical coverage. Canadian Medicare covers about 75 percent of potential health-care costs. The financing varies by province. Three provinces charge a direct premium. Two impose a payroll tax. The others fund programs out of general provincial tax revenues. The 25 percent of health-care costs not covered by Medicare is in the purview of the employer-sponsored plan--a major medical supplement over the basic Medicare program. It's largely made up of out of hospital drugs, paramedical services, therapeutic devices and appliances and so on. Direct premiums do not come close to covering the cost of the program. In Ontario, where the monthly family premium is now about $60, only 19 percent of the 1984 cost was covered. When Ontario initiated Medicare, the then Premier said the cost sharing was going to be one-third from direct premiums, one-third from provincial revenues and one-third from federal revenues. It is obvious that the direct premium portion has fallen far behind the target. That shortfall must be met from diminishing government revenues.

The overall cost of Medicare in Canada increased at an alarming rate, for reasons that people in the U.S. would recognize. Government budgetary deficits will force some cost shifting to the private sector, even though Medicare is seen to be an almost inviolate right of Canadians. Some evidence of cost shifting is seen again in Ontario in the rates of semiprivate hospital accommodation. "Semiprivate" is not a Medicare-covered expense. At one time the semiprivate revenues of the hospitals were used to reduce the burden of funding from the government sectors. Ontario, a couple of years ago, said: "No, you may now charge what you want to for semiprivate rooms and you may keep all of that money. It will not serve to reduce the government transfer

payments." So there is evidence of some cost shifting in the major medical programs.

What's important to understand is that a major portion of the health care benefit package lies totally outside of the employer's control, both with regard to scope of benefits and to the cost. The method of financing is a political decision, as are the rates of taxation or the direct premiums assessed. And as part of a political process, they seem to bear very little direct relationship to the costs.

We have to look also at the tax considerations in Canada. In a sense, our system is somewhat simpler and less complex than the U.S. However, when we look at the Income Tax Act as it is presently constituted, we don't find any explicit recognition of flex benefits--the ability to use before tax dollars to buy employee benefits. Section 61A essentially taxes all benefits from employment with specific exemptions, and flex does not fit as a specific exemption. Salary reduction schemes are not sanctioned. There is no equivalent to the 401(k). However, there have been some attempts in the nonprofit sector to pass salary reductions through what is called an employee benefit plan, which is a creation of the Income Tax Act and does not mean employee benefit plan in the usual sense. For those nonprofit organizations who did this, it was tantamount to providing an annual registered retirement savings plan (RRSP) contribution without any limits at all. People at my firm were somewhat surprised that the recent federal budget did not close that door, although they are still looking at it. Despite the uncertainty about the tax treatment, in that it is not specifically covered by the act, we have received a legal opinion which states that the tax should follow the nature of the benefit elected. That is, the flex credit should not be taxed solely because cash may be an option. It follows, therefore, that flex credits should first be used to buy benefits which would not be taxable if paid directly by the employer--such things as major medical, dental premiums or a tax-sheltered vehicle such as the registered pension plan or an RRSP.

Some other Canadian characteristics which affect the development of flexible benefits--I think it's fair to say that Canadians generally are viewed to be somewhat more security conscious and somewhat less resentful of paternalism. Canadian companies are generally of smaller size, which increases the risk of antiselection with the attendant underwriting concerns we heard about earlier. The smaller size may also reduce opportunities for self-insured and administrative services only (ASO) arrangements; although I personally believe that the risks attendant on major medical and dental can be assumed by all but the smallest employer.

As a result of the recent, and in some business sectors continuing, recession with 11 percent unemployment, employee concerns are more focused on job security, severance payments through supplementary unemployment benefit schemes and so on.

In spite of the smaller size of the Canadian employer, the financial aspects of the benefit delivery systems are generally very efficient. Insurers accept a high degree of risk, due to expensive experience

rating, which reduces underwriting profit opportunities and increases the chances of deficit termination. Cash flow opportunities are minimal, due to the granting of explicit interest on reserves and net cash flow. It's difficult for the carriers to establish adequate expense margins. This all results from a very competitive group insurance market driven to some degree by the extensive use of consultants and brokers by Canadian employers. The trend toward self-insurance continues and it is likely that Quebec's "imaginative" extension of the sales tax act to insurance premiums will hasten the trend toward self-insurance in this province.

Let's now look at a typical Canadian benefit program. This is meant to represent the employer-paid benefits in a typical program. You can see group life of one times to two times earnings; AD&D in like amount; long term disability being 66-2/3 after an elimination period of six months with the benefit going through to age 65; semiprivate hospital reimbursement, probably 100 percent; major medical with a $25 calendar year deductible, $50 married, 80 percent coinsurance; dental not having a deductible, basic and routine reparative reimbursement at 80 percent with prosthodontia and orthodontia at 50 percent; and for purposes that we will see later, I have assumed a salary of $30,000.

This would then show the typical cost of the program to the employer. I think you can see that there is little room for downsizing. If we exclude Medicare, the health/dental benefits amount to $288 per year for the employee, or $768 per year for the family. It's very difficult to see how the program could be shrunk sufficiently to generate meaningful flex credits without incurring substantial employee resistance. In those provinces where a direct Medicare premium exists, there is an opportunity to generate credits for married employees who are able to transfer coverage to an employed spouse. However, this creates problems of equity for those who do not have employed spouses and in the situation of a couple working for the same employer. Nevertheless, cost containment is becoming so important here, as it is in the U.S., we cannot conclude that nothing can or should be done. Let's see what would happen to our typical program at the end of five years if we don't do anything.

It's with some trepidation that I stand before this audience and present a projection. The assumptions I'm using are that the plan design remains unchanged, we have salary escalation of 5 percent per annum, no unusual experience trends, major medical escalating at 10 percent, dental at 6 percent and Medicare premiums at 10 percent. I think those are fairly reasonable assumptions. If we use them and apply them to the family premium for simplicity, we can see what happens if we don't do anything to the design. Payroll has increased by 22 percent over the period, yet our benefit costs have increased by 47 percent, from 6.4 to 7.7 percent of payroll. Now the cost of the salary-related benefits will, generally speaking, increase in step with payroll. The dental and Medicare costs increase directly with the assumed rate of utilization and the assumed premium increases, respectively. The major offender, as you can see, is the major medical benefit because of the leverage effect of a fixed deductible. The major medical represents 12.5 percent of our package today, increasing to 20 percent of the cost

after five years. The major medical premium, which is now $20, was probably about $10 or $11 five years ago and no one was terribly concerned about it. It can no longer be ignored. The phenomenon of the fixed deductible causes the amount reimbursed under the plan to increase at a greater rate than the actual rate of utilization or inflation, producing a corresponding impact on premiums. In order for the premium to increase at the same rate as the actual cost, it is necessary to index the deductible and any internal maximum to the plan utilization rate.

It also makes sense to have all supplementary health and dental coverages subject to a common and escalating deductible of greater magnitude than currently exists in this country today. I believe that we have to re-educate employees to assume the minor and repetitive budgetable expenses and to rely upon the external plans to provide coverage for the larger less frequent occurrences. That is to say, we must revert to the principles of insurance, regardless of the method of funding or financing selected by the employer. It's not unusual in Canada to find plans that provide for drug expenses after a thirty-five cent deductible and not provide any coverage for the one truly catastropic event that can occur--out-of-country emergency medical expense.

The principles underlying flexible benefits can be used to structure a program permitting cost for budgetable items to be passed back to the employee. Initially, one would try to structure the dollar trade-offs to be equivalent. In time, the employee may assume a greater responsibility for his own welfare. The pricing of options and the determination of credits remain under employer control. If, to be considered flexible, a program has to contain a credit account of some fashion, our experience suggests that, at least initially, the employer may experience an increase in cost as he seeds the program. Whether there is any explicit increase in cost, there will be some implicit cost in absorbing antiselection, start up costs and administration. But an increase in cost is not necessarily a negative. If a program is now felt to be uncompetitive, there would be additional costs incurred to bring it to the desired level. It may be preferable in the longer term, to improve the plan by using a flex approach than by the traditional method of improving specific benefits for all employees. The growth potential of the employer may also be a consideration. It may be worth taking an additional cost now to fund flex benefits in order to save future cost relative to work force not yet hired. It is worth noting that most flex programs seem to concentrate on the health and welfare benefits. I feel that this is unnecessarily confining. The concept should be expanded to include total compensation. For example, many long service employees find that they are unable to take their full vacation entitlement, particularly after staff downsizing has occurred. The trading of excess vacation over a mandatory minimum for other benefits of equivalent value could be allowed. Note, though, that if you do that, additional cost will definitely be incurred if the employee would not have been able to take a vacation anyhow.

A banking system in lieu of cash or credits could be structured. A concept which appeals to me is to accumulate the unused vacation to be translated into a mandatory preretirement regimen of decreasing the

work week. You might decrease it to four days, then to three, then to two in the period prior to retirement. This would help the employee to cope with the psychological transition from work to retirement, and at the same time ensure that the replacement comes on stream in an orderly fashion.

Pension reform we are struggling with in Canada may change our approach to company retirement plans. The traditional contributory defined benefit plan may be replaced by a noncontributory defined benefit of lower amount, coupled with voluntary employee contributions, perhaps supplemented by employer contributions (like a savings plan, being channeled into a defined contribution vehicle).

The coming into effect of Section 15 of the Canadian Charter of Rights and Freedoms leads us into very swampy ground with regard to what will, in the future, be considered to be discrimination in employment. If, as is almost certain, employers are not permitted to exercise mandatory retirement at a predetermined age, great care will have to be taken with plan design. The benefit plan should not be so attractive as to encourage persons, particularly those in marginal health, to remain in employment, yet they must be sufficiently adequate to serve the needs of the total workforce.

Projections suggest that in fifteen years, 20 percent of the employed population in Canada will be part timers. What type of programs will have to be developed to serve the different needs of this segment of the workforce?

Some will be sole income earners and will require extensive income security. Others will not require nor want to contribute to such programs. It's my conclusion that the trends to greater employee choice and the provision of benefits or products through payroll deductions will continue to accelerate in Canada. But a relatively small number of companies will implement programs which involve extensive flex credits. In some situations the modular approach, which involves selecting from alternative packages, each having equivalency of cost when employee contributions are taken into account, will make more sense. As part of a growing perception of the need for personal financial planning, employees will want to review their options annually and make appropriate adjustments to their coverages. I think it's fair to say that we are entering a period of experimentation. We must strive to see the total picture and not be sidetracked by details. Underwriting and administration concerns must be recognized, but not used as a shield to hide behind. Some mistakes will be made, as they have been made in the past, but this is, I believe, the price of progress. Flexibility in benefits reflects a changing world.

FROM THE FLOOR: The ETS program sounds very interesting. Do you have any problems finding inexpensive implementation assistance?

MS. KLANSKY: Let me say that any program you start will have expensive initial costs. This program was expensive when we put it in because there was no one out there to help us. There was no software

and consultants weren't available, so everything that was done, we did in-house. We designed our own ballots, we designed our software, we've copywrited most of what we have. In the beginning, there was a tremendous amount of staff involvement. I had the records department, I had part of the compensation department, I had the systems people and part of the payroll people involved. But now I have a staff of five people and they do everything, not just flexible benefits. They do the salary administration work connected with flex, they do the vacations, the ill time program and any of the flex that comes along. What you're going to find to be a lot easier is that there are people like myself, people like Mr. Bob Felder from American Can, Ms. Shirley Curry from TRW out there who will help you and be only too happy to help you. All you have to do is give us a call. It's going to be cheaper for you.

FROM THE FLOOR: I have a question about processing the claims under your insured dental programs. Do you have problems placing that business with a carrier? Is it expensive compared with typical dental claims administrative processing?

MS. KLANSKY: No to both questions. We did not have a problem placing it with a carrier. That carrier has our life insurance, our medical insurance and our dental insurance. And it's the only benefit ETS gives its employees that they do not contribute to in some way. Yes, it is part of the flex, so therefore you could say that the company is giving them money, but ETS subsidizes the single employees' medical coverage and pays for the employees' life insurance. The dental program has survived over the years and is almost a stand-alone program. You find the same people enrolling year after year. The percentage of enrollment is low, but so is the experience, because we are now at a maintenance point. So, no, we haven't had any problem with it at all. Because we've built in the adverse selection elimination, or control, we haven't had a problem with it.

FROM THE FLOOR: You mentioned that the employees get between 3 and 6 percent of their pay toward benefits. You also indicated that the cost of benefits has gone up and, at times, the employees have received less. How has that gone over with them?

MS. KLANSKY: Well, I'll be perfectly frank with you. They do see that they are not getting as much "bang for their buck," if you will, out of the fact that when premiums go up the amount of benefits goes down. Dependent medical, for example, subsidizes some of that cost through either flexible credits or payroll deduction and it is something that we're looking at. We may increase the flexible percentages. I have a problem that when we put this in, we were behind where we should have seen as far as the Chamber of Commerce was concerned. If we don't do something now though, we're going to find ourselves in another catch-up position and will have to increase those flexible credits more than we would have to if we act now. We are also looking at other cost saving measures such as using a third-party administrator. I envision that we are going to save more than half a million dollars the first year, and the trust fund for the employer's contribution (as well as the employees' contribution) will be earmarked to improve benefits.

Those will either be enriched or the cost reduced. We are looking for ways of controlling that and helping the lower-paid employee.

FROM THE FLOOR: Yes, I see that as a continuing problem over time. If you keep fixing the percentage of pay, sooner or later you're going to transfer costs over to the employee and then you have to revisit that problem.

MS. KLANSKY: That's very true. It's not a problem-free system. I don't think there is such a thing or we probably wouldn't all be here. I find a lesser problem with what we're doing because there are so many things that can be done. As an example, if I ever had this program to do over again, I would certainly not go up with thirteen options. I would have taken two medical levels--a higher premium, a lower deductible; a higher deductible, a lower premium--that type of thing. And I would have done that in dental also. And that's the only thing I would have done the first year. The second year I might have added retirement, and in the third year I might have added the vacation (we allow them to take 75 hours, which is two weeks of our time of vacation). It's much easier to do it as you go along, year after year, than it is to hit them with it all at once. Also, it's very hard to take away a benefit once you've given it. I see those things as ways that we have taken up some of the slack, but again, if I were to do it today and if I were to counsel you on what you should do, I would say don't go up with thirteen options. Start with two.

FROM THE FLOOR: In regard to optional benefits in Canada, my feeling is that there have been substantial optional benefits available, but the key difference between optional benefits and flexible benefits is that, in Canada, the employer isn't dealing with annual re-enrollment and promoting. I see that as a very major difference between flexible benefits and optional benefits. I see the ETS plan perhaps being the mother of flexible benefits.

MR. MCGRATH: I think you make a very good point. They have been available. They are in effect and there is not an annual re-enrollment. However, I do find that, in the plans we are involved with, the eligibility is usually based upon change of status as in the ETS program. This permits the benefit to be increased or elected without evidence of insurability. But I think your point is well taken. The program is not communicated or promoted as well or as frequently as a true flex program would be.

FROM THE FLOOR: I have two questions: First, how many employees are there in ETS?

MS. KLANSKY: We have 2,500 people in eight different locations.

FROM THE FLOOR: Of the various classes of benefits where you have less than 100 percent enrollment--I'm not thinking of medical where there may be several choices and where presumably you have 100 percent over all of the choices--what would those benefits be and what would be the typical participation?

MS. KLANSKY: As I said earlier, the most popular benefit has been the matching plan. I think that's because the employee realizes he is getting more money--for his 3 percent he is getting 6 percent. The next most popular benefit is the vacation. The next is cash. The next is the dependent medical insurance. The next is dental and then comes the additional life insurance. Beyond that are additional choices, and I really can't give you the bulk of them, but there are additional choices in retirement and mutual funds. The cost has remained almost predictable over the years. You'd be surprised because you'd think that as the pendulum swings and older people drop off from retirement or attrition, that younger people coming in would cause your costs to go down or up as the case may be. If they had children, you would assume it would be up. But it has stayed almost at a predictable ratio. You will see an increase of 2 to 3 percent and then a decrease the next year of 2 to 3 percent, so it's really a predictable program.

MR. KUHLMAN: I have a question I'd like to pose to anyone who wants to respond. In choice plans, but particularly in flexible benefit plans, there is a lot of pressure to eliminate or at least drop minimum participation standards for optional life plans. Given the competitiveness of the group term market these days, I've seen a lot of carriers willing to do that. I'd like to pose the question: Do those of you working for insurance companies see a change in optional life and disability programs to meet competitive standards? For example, dropping the participation levels for fully-pooled optional life plans? Certainly I think employers going into flexible benefits would be looking for that because of the difficulty of guaranteeing different levels of participation.

MR. GOLDEN: I think the Canadian situation over the past few years has seen a considerable reduction in the participation requirement at the level of which evidence is required. And if evidence is to be required, then virtually any level of participation is attainable. I think one of the controls that might be used in this case is for the standard of underwriting to be somehow related to the actual degree of participation achieved. I think there has been a trend, certainly in the U.S., to liberalize our participation requirements on the supplemental plans. Many times, though, it's been a change from experience rating. A lot of employers will do it on an experience-rating basis.

MR. KUHLMAN: Ms. Klansky, has anyone talked abut reflecting lifestyle changes in the contributions? The simplest example is a smoker, nonsmoker. But even beyond that is the idea of wellness within the flexible benefit program. Maybe not as an additional benefit, but at least a reflection in the value?

MS. KLANSKY: We have had quite a few such questions, but not necessarily regarding smoking. We do conduct stop-smoking programs. I have four nurses reporting to me. The put on programs such as that, and we are going to put in a wellness program. We've just chosen a new corporate site close to the Princeton location. We are moving a great number of our people over there. Some are in our programs. The new facility has a huge gym for us to pilot a program on wellness. But, should we do a full blown wellness program, have a doctor, do stress tests, do EKGs, or should we just use the equipment

that's there, supervised by someone doing aerobics? Whether or not we're going to put that program on the ballot, I really don't know. Our ballot is so full now, I think we're going to have to redesign it and make it two-pages. We are looking at wellness programs and also at auto and home owner's insurance through payroll deductions.

FROM THE FLOOR: Ms. Klansky mentioned that ETS had only a 4 percent employee turnover. I don't know much about ETS, but it appears to employ a rather well educated group of people. That's probably not as true of American Can or TRW, particularly American Can. I'm wondering if you can comment on two things: one, how the low employee turnover rate might have affected the low level of changes in your cost levels and two, whether you would expect the same pattern in a less well-educated type of employer situation.

MS. KLANSKY: Let me say first that my greatest problems are in educating people from the MBA on up. The PhDs will throw their ballots in drawers. We get no response from three quarters of them. But you have a valid question.

Maybe I ought to give you some statistics--70 percent of the ETS staff are women. Of that 70 percent, I would say about 22 percent have Bachelors/Masters degrees. Of that 22 percent, 12 percent are in managerial positions. We have some secretaries with Masters' degrees because they can't get jobs and they wanted to come to ETS. That's an unfortunate situation, but it exists. Of the top group of PhDs and officers, I would guess there may be 10 percent. So we have a great deal of support staff who need benefits education. And what we do every year before we're ready to start with our flex enrollment is bring in representatives from each carrier, mutual fund, and retirement group, and someone from Social Security, to meet with employees for two weeks. We schedule this only at lunch time, because every cost that we incur at ETS is charged back to a client. By the time we are finished, the support staff knows as much about the program as I do. As for TRW, it does an exemplary job of communicating. And it has a great number of employees. Its pilot program was for 6,000, and now it has gone with another 70,000. A lot of them are overseas, so you know TRW is doing something right. TRS people come down periodically to see if we have anything to share. Ms. Shirley Curry has just retired as President of the Employers Council on Flexible Compensation, and Mr. Marty Ball from Eastman Kodak took over that position. I am Vice President of that organization; Mr. Charley Rogers from Pepsico is Chairman. So there is a lot of educating being done. Education vehicles are available to you if you want to use them.

MR. KUHLMAN: I'd like to make a couple of comments to follow up on what Ms. Klansky said. In my experience designing flexible benefit programs, it's very important to find out what the mind set of employees is. I worked with flexible benefit programs in a few insurance companies where employees were very risk-adverse. Encouraging them to switch to more cost-effective options was a major communication effort. Two tiers of communication were built: one to existing employees and one to new employees. It was much easier to sell to new employees than to existing employees. I think there is a lot to be

learned from demographic characteristics, but there is a lot to be learned within the culture of an organization too. You have to have your ear to that culture in designing a flexible benefit program.

I remember completing a preliminary design study for a hospital. The employees were positive about everything, except for what they felt was the most important aspect of the program: their sick leave. By fine tuning the overall program, it was better accepted and they were much more aware of what the employer was trying to encourage. I think communication is the key. I think you must keep an ear to what the culture of the organization is, and that is dictated by the demographics of the group. But it's also dictated by messages of paternalism that the employer has passed on for many years--"Don't worry, we'll take care of you. We're providing full benefits."--and all of a sudden there is a desire to give choices to employees who have never had them before, so you must be very careful.

I've learned that most employee groups are risk-adverse. And I don't think that varies much by education level, it's a common characteristic. It takes a lot of effort to get them to look at taking on more risk in programs. They also want ease of administration. It's one thing to fill out an enrollment form in the beginning, but complex administration on an ongoing basis, particularly in filing claims and so forth, can be an inducement to pick one option over another. So a lot of things need to be looked at--not just design, not just the number of options, not just how you price them--to gain positive acceptance and the level of enrollment you would like.

MR. GOLDEN: One of the things we are starting to experiment with at Aetna is the interactive video. With the spread of micros and PCs, we may see a day when employees enroll right at their desk through their own PC hooked into the mainframe payroll system. I think the expansion of micros is going to make the communication and enrollment process much easier in the future.

MS. KLANSKY: One other think I would like to say is that you have to build credibility. Don't hesitate to tell people: "No, we're not going to do that. And, here's the reason we're not going to do that." However, once you tell them that you are going to do something, live up to it.

FROM THE FLOOR: How do you deal with administration? ETS was one of the forerunner's; was the program administered manually and later computerized, and does ETS use a mainframe or micros?

MS. KLANSKY: Administration has always been on a computer. We have a mainframe and PCs and I envision, as Mr. Golden was saying, that in the near future everybody will enroll from their own PCs. Right now we have a massive computer system with a personnel system running parallel to the payroll system, because the personnel system has to feed information to payroll about what to deduct and for whom.

FROM THE FLOOR: So you have very sophisticated health resource service administration (HRIS) systems in place to deal with the data.

MS. KLANSKY: Yes we do, but we didn't always have that. What we had in the beginning was a data base that included the normal things, date of hire, date of birth, dependent status and so on.

FROM THE FLOOR: What kind of time period do you allow for re-enrollment?

MS. KLANSKY: We do it all in two months. We start in October and close out by the 10th of December, because that's when our payroll closes out for the year. And most of our work, once we've completed the initial audit tracking, is to make sure that there are no errors. We get computer verification messages that say: "You dropped your dependent medical insurance, did you mean to do that?" If you did, that's fine. But we want you to know during the open enrollment so if you don't choose it, you don't get it. After that's all done, the applications are printed off the computer, so it's a very simple process. We have simplified it over the years, but when I first started, we were doing something like twenty-four cycles. A cycle included printing the ballots, sending them to employees for completion, receiving them back for key entry. We had twenty-four of those. If an employee made a mistake, it went back to him, brand new to start all over again. We're down to five cycles now between October and December. We allow our people to come in as late as November 1, so you can see the short turn-around time we have for people coming on staff November 1. We've polished it and everybody can do the same thing.

FROM THE FLOOR: Do people substantially change their options from time to time, or do they reach a point of stability and choose the same thing year after year?

MS. KLANSKY: We have not seen that many changes. We find that people will experiment in the first couple years, but then they'll get right down to "This is what I want. I want that extra 3 percent in my retirement every year so I will take that year after year."

FROM THE FLOOR: What do you do during the open enrollment if somebody is in the hospital? Can they change their options?

MS. KLANSKY: If they are out on temporary disability, all of their benefits continue and, therefore, we would send their ballot to their home to complete there.

FROM THE FLOOR: So they could change options?

MS. KLANSKY: No. Their coverage is not affected. What they are electing in October through December are benefits to start February 1. But once they've elected options on that ballot, that's cast in iron until there is a change in status.

FROM THE FLOOR: And those benefits commence regardless of whether they are actively at work?

MS. KLANSKY: Yes, as long as they are on temporary disability. If they are on total disability, that's an entirely different program. It's

an insured program and we do not consider those people as active employees. But temporary disability can last for twenty-six weeks, and during those twenty-six weeks they are considered active employees. All of their flexible benefits continue. However, if they don't come back at the end of the twenty-six weeks, they are terminated from the staff, even though they may then receive total disability benefits.