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DESIGN AND FUNDING POSTRETIREMENT MEDICAL BENEFITS

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- o Potential liability
- o Design techniques for controlling liability
- o Effect of inflation
- o Effect of medicare change
- o Financial accounting requirements
- o Funding vehicles and methods

MR. DALE H. YAMAMOTO: Liabilities of retiree welfare plans are becoming more visible to the public. This awareness has largely been due to the size of the liabilities and the prevalence of these plans. Liabilities can approach the same level as those under company-sponsored pension plans, but with no assets to back them up.

Late in 1984, Towers, Perrin, Forster & Crosby (TPF&C) studied the retiree welfare plans offered by 250 large and medium-sized companies. This study revealed that 94 percent of the companies offered lifetime medical coverage and 76 percent offered a retiree life insurance program.

The current financial situation of retiree welfare plans is similar to the position of pension plans prior to the passage of ERISA in 1974. The situation could be worse than that, since unlike pre-ERISA pension plans, virtually no one funds retiree welfare plans. One of the events that prompted the passage of ERISA was the failure of the Studebaker Corporation to provide for pension benefits after bankruptcy. A corporate failure with large unfunded retiree welfare liabilities may prompt similar legislation. Congress, employers, accountants, and benefit specialists should recognize these potential liabilities before it's too late.

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MR. WILLIAM R. GLASCO: The subject of liabilities for retiree medical benefits is largely unexplored. Our experience and measurement techniques are immature. The increase in attention being given to these liabilities presents us with immediate challenge and excitement. The obligations for postretirement medical coverage constitute a surprise package for the sponsoring employers. As with any surprise package, an appropriate question to ask is: Is it bigger than a breadbox?

Depending on plan design, the retiree medical benefits my firm has valued generated an accrued liability ranging from 25 percent to 100 percent of the accrued liability for the company's pension plan. Also, a plan covering one thousand lives can easily have an accrued liability of five to ten million dollars, all of which is probably unfunded. Typical advance funding costs may be four to six times greater than current pay-as-you-go financing.

Another significant item is that retiree medical programs are widespread. Department of Labor statistics from 1983 indicated 63 percent of employers were extending employer-sponsored medical coverage to their retirees. The percentage was much higher (about 80 percent) for employers with 2,500 or more covered lives. Usually lifetime coverage is provided.

These programs have historically been low priority for employers. The introduction of Medicare in 1967 fostered the growth of retiree coverages at what appeared to be a very acceptable cost. Since the postretirement program was usually tied to the plan for active employees, retirees benefited from plan improvements that occurred over the years. Since it seemed appropriate and consistent with treatment under the active life plan, pay-as-you-go financing became firmly entrenched.

Loose administration and management practices also developed. When retirees shared in the cost, their share was typically based on aggregate premium or contribution rates, including active lives. Frequently, plan changes were made without any analysis of the effect in terms of either advance-funding costs or present values. Loosely worded employee communications on the terms of coverage became the norm.

With medical care cost inflation, accounting proposals, Medicare's financing problems, and court decisions, employers are becoming sensitized to their liabilities for retiree programs and will be giving these coverages more management attention.

Four possible steps plan sponsors might take are:

1. Increased use of stand-alone retiree programs.
2. Greater emphasis on preretirement service in the operation of retiree plans.
3. Greater use of nontraditional approaches for providing the coverage.
4. Tighter management controls.

Stand-Alone Plans

A stand-alone plan is a program distinct from the active life plan as to benefits and the monitoring and managing of plan costs. Rather than extending the preretirement plan to retirees with a carveout approach to coordinate with Medicare for retirees over age sixty-five, we might see distinct, and probably less generous, benefits for retirees, including a supplemental plan to coordinate with Medicare in a less direct manner. Stand-alone plans would also facilitate a better awareness and understanding of claims patterns.

Emphasis on Preretirement Service

Employers that provide postretirement medical benefits are currently quite liberal with respect to the preretirement service required to obtain this coverage. For example, a majority require no more than ten years of service for coverage upon early retirement. Service requirements are even more liberal for retirement at age sixty-five. The benefits seldom vary by length of preretirement service.

These practices will change, and preretirement service will probably be given more weight in the areas of:

1. eligibility for coverage;

2. the share of the cost borne by the retiree;

3. the benefit provisions themselves, including the possibility of several distinct plans for retirees with assignment to a particular plan being based on the length of preretirement service.

Nontraditional Approaches

We will probably see alternative health care delivery systems applied to retirees to a greater extent than we have in the past. For example, health maintenance organizations (HMOs) can be expected to become increasingly active in this area. HMOs for retirees are relatively new, but their early experience has been favorable.

Assuming a defined contribution financing scheme could be done on a tax-favored basis, employers could provide for the accumulation of funds prior to retirement, from which postretirement coverage could be purchased. As with defined contribution plans in the retirement area, this arrangement could effectively define and limit employer obligations.

Tighter Management Controls

Tighter management controls will be implemented by many employers. These controls include:

1. Actuarial studies of current program obligations and the cost implications of possible changes in the plan or medicare.

2. Improvements in management information on claims experience for retirees and their dependents.

3. Increased emphasis on cost containment features such as utilization review mechanisms.

4. An audit of communication materials describing the terms of coverage to ensure that limitations are appropriately addressed.

These efforts are simply good management practices already overdue.

We have a great opportunity to provide valuable actuarial and consulting assistance to employers. An interesting combination of skills will be required to do this effectively.

MR. YAMAMOTO: Actuarial valuations of retiree welfare plans blend the two actuarial disciplines of group underwriting and pension mathematics into one consolidated result.

Several actuarial funding methods and assumptions used with pension plans may be used for retiree welfare plans. The common actuarial methods include: (1) Entry Age Normal, (2) Projected Unit Credit, (3) Aggregate, (4) Frozen Initial Liability, and (5) Level Percent of Pay.

Actuarial assumptions typically used in pension plan valuations are also used, including mortality, turnover, disability, retirement, and salary increases. Retiree welfare valuations need to consider both actuarial methods and assumptions.

The appropriateness of a particular actuarial method should be considered. Is a method designed to produce costs as a level percent of pay appropriate for retiree medical plans, since the benefit has no relation to pay? Or, over what period should benefits be assumed to accrue under the Projected United Credit Method - to the eligibility date of benefits or to the expected retirement age?

Three different types of "inflation" assumptions need to be developed. These may be grouped as follows:

Gross medical trend - This is the customary group underwriting trend assumption applied to retiree-only coverage. It includes the typical components of that trend, such as inflation, utilization, modern technology, and so on. This is a long-range assumption and not just a one-year estimate. It needs to represent the same period as the valuation interest rate being used to discount the future benefits.

Medicare trend - This assumption should consider the same elements as the gross medical trend with an overriding consideration - the government's ability to control medicare costs by its reimbursement procedures.

Retiree contributions - This assumption may be independent of actual medical costs and can remain level or change at the same rate as salaries.

Other assumptions used in retiree welfare valuations include the probability of coverage at retirement. In plans that are retiree contributory, not all eligible participants will sign up for coverage. The valuation should reflect this. Another assumption would be claim cost estimates for the current year which could vary by age, sex, and dependent coverage.

External factors have a great impact on the valuation of retiree welfare plans. A few of these are:

1. Changes in reimbursement procedures under medicare (e.g. diagnostic related groups (DRG))

2. Medical inflation trends greater than assumed

3. Changes in required accounting (e.g., DEFRA restrictions on funding retiree welfare plans)

4. Plan design changes (e.g., changes in cost sharing)

5. Shifts in retiree choices among insured versus HMO plans.

While the last two items are difficult to quantify without more specifics, we can analyze the impact of the first three in general terms. The first graph, labeled "Base," is a forecast based on some standard assumptions commonly used. The basic assumptions are a flat 8 percent for both interest and medical inflation. The plan's prefunding expense decreases to 3.9 percent of pay in 2005 from 6.1 percent of pay in 1985. The pay-as-you-go costs increase from 2.0 percent of pay to 3.0 percent of pay over the same time period.

The changes in medicare reimbursement procedures have been estimated by assuming the medicare inflation rate will be less than the total medical inflation rate in the future. If this pattern were recognized beginning with the current year, the 1985 medical plan expense would be 12.5 percent of pay instead of 6.1 percent of pay. The graph "Alternative 1" shows the plan expense based on a medicare inflation trend of 6 percent (versus 8 percent for the gross medical trend). The projection exhibits the same pattern as the "Base" graph except at a higher level. The 1985 plan expense is twice the amount developed under the assumptions used in the "Base" graph. This deviation gets larger over time, increasing to a 2005 plan expense that is 2.5 times the "Base" assumption plan costs.

If medical inflation should be greater than assumed, the actuarial cost method would handle it through the gain and loss mechanism by amortizing any impact into the future. "Alternative 2" presents the impact of greater-than-expected medical and medicare inflation using "Alternative 1" actuarial assumptions. We assumed that the real inflation rate for both was initially 10 percent higher and then graded down to the expected level after ten years. The plan expense increases in the future due to the recognition of actuarial losses in the cost method. The plan expense is 13.3 percent of pay in 1995 under this scenario compared to 10.0 percent of pay under "Alternative 1."

Another likelihood is that medicare will be the secondary payor under all benefit programs. You can see this coming when you look at medicare's current secondary status for active employees, and according to the latest Medicare Trustee's report, the program will be running into financial problems in the late 1990s.

The graph "Alternative 3" illustrates the impact on plan expense if medicare were made secondary payor in the year 2000. This graph utilizes the same assumptions before the year 2000 as does "Alternative 2." After the year 2000, the plan cost jumps to the high level of about 30 percent of pay.

By imposing the DEFRA funding restrictions (i.e., zero medical trend and an after-tax interest assumption), costs are initially about half of the "Base" assumption costs. These costs will increase as a percent of pay as they continue to reflect the experience losses due to nonrecognition of medical inflation.

The plan expense can vary widely, depending on the future economic experience and the actuary's expectations.

MS. MARILYN M. OLIVER: The only guidelines for funding a postretirement medical plan through a pension plan are located in Section 401(h) of the Internal Revenue Code and in Regulation 1.401-14. There are two major restrictions in addition to putting the appropriate language in the plan document.

1. Your benefits must be subordinate. Contributions for medical benefits plus certain life benefits may not exceed 25 percent of the total normal cost contribution for the plan as a whole. The test must be met on a cumulative basis from the time postretirement medical benefits are included in the plan. This is very important because of the fluctuations in cost.

2. You are required to separately account for contributions to the medical portion of the plan. This means creating an actual book account where you can track contributions and allocate investment results appropriately. Forfeitures apply to reduce future medical contributions only. No funds accumulated to provide medical benefits may be used to provide other plan benefits. If the plan is terminated, excess assets left after satisfaction of medical liabilities must revert to the employer.

3. The plan must also be nondiscriminatory towards the medical portion of the benefits of the plan such as coverage, benefits, and contributions.

Under a voluntary employee's beneficiary association (VEBA), the deduction is limited by the funded welfare plan limitations of DEFRA. You must cover actives and retirees, and excess assets must be allocated to retirees and employees.

Under an insurance continuance fund you are also limited by the funded welfare plan limitations of DEFRA. Guidelines for this are in Revenue Ruling 69-382.

The "funded welfare plan" limitations of DEFRA do not apply to coverage provided through the pension plan but do apply to both the VEBA and the life insurance continuation fund. The plan must prefund over the future working lifetimes of covered employees. You may not include an assumption about future medical inflation, but you may include an increase in claims for aging. It is controversial whether you can recognize future increases in utilization or declines in reimbursement from medicare. The IRS may specify assumptions in regulations, but not soon.

The trust income is taxable. If the plan is in a 501(c)(9) trust, income is taxable to the trust. If in a retired life reserve, income is taxable to the corporation at the rate at which it would have been taxed if held in a 501(c)(9) trust. Finally, the plan must not discriminate as to coverage and benefits.

This constrains your funding of these plans. There is argument for moving over to the pension plan environment, but you then have the problem of subordination of benefits.

MR. LORIN S. CHEVALIER: More controversial issues are being referred to by acronyms. Now there's OPEB. OPEB stands for other postemployment benefits - that is, postemployment benefits other than pensions, primarily including health care and life insurance benefits provided to retirees.

The Financial Accounting Standards Board (FASB) is the private sector organization responsible for setting financial accounting and reporting standards for publicly held companies. The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards. Throughout the SEC's history, however, the policy has been to rely on the FASB as long as it fulfills that responsibility in the public's interest. Since 1973, the FASB has been the designated organization in the private sector for establishing standards of financial accounting and reporting - the rules governing the preparation of financial statements.

OPEB are currently accounted for by most employers on a pay-as-you-go basis, i.e., the cash disbursement in any year for the retiree benefits equals the expense provision for the benefits.

Because of the significant magnitude of employers' liabilities for OPEB which are usually unrecorded and often unfunded, the FASB has been studying employers' accounting for other postemployment benefits to determine whether the current accounting practice is appropriate.

The OPEB issues were originally considered as part of the project on Employers' Accounting for Pensions and Other Postemployment Benefits. In 1979, an exposure draft of a proposed FASB Statement entitled "Disclosure of Pension and Other Postemployment Benefits Information" was issued.

Response to the exposure draft reflected an overwhelming concern that the proposed OPEB footnote disclosures would be immaterial, that very little was known about the subject, that the FASB was on a "fishing expedition" for data, but that the OPEB should be considered within the scope of the pensions project.

As it turned out, FASB Statement No. 36, Disclosure of Pension Information, was issued in 1980. However, that statement did not include the exposure draft's provisions requiring that descriptions of OPEB be disclosed in the footnotes to financial statements because the FASB decided that additional research into the nature of these benefits was necessary.

Subsequently, a 1981 Discussion Memorandum, the 1982 Preliminary Views document, and a 1983 Discussion Memorandum analyzed pension plans and OPEB plans for similarities and dissimilarities and explored whether accounting for other postemployment benefits should be the same as, or different from employers' accounting for pension benefits. Additionally, OPEB measurement issues and an appropriate transition from current accounting were discussed.

Many respondents to the Preliminary Views and the 1983 Discussion Memorandum expressed concern that the OPEB issues had been overshadowed by the pension issues, and therefore urged the FASB to separate OPEB from the pensions project. Accordingly, to ensure that the OPEB issues would be clearly identified and fully considered by the FASB and its constituents, employer's accounting for postemployment benefits other than pensions was made a separate agenda project in February 1984.

Thus, in a period of only five years, three significant steps were taken with regard to other postemployment benefits. First, we succeeded in getting OPEB added to the scope of the pensions project. Second, we succeeded in publishing several documents on the subject. And third, we succeeded in having OPEB taken out of the scope of the pensions project.

The FASB decided two things:

1. OPEB measurement and recognition issues were going to take substantial time to resolve, and

2. Some information about these benefits ought to be provided to financial statement users without further delay.

As a result, an exposure draft of a proposed Statement of Financial Accounting Standards was issued on July 3, 1984. The exposure draft dealt with disclosures that could be provided practically and that would present meaningful information now. Such disclosures would constitute an interim step pending completion of the recognition and measurement of the other postemployment benefits project. The FASB issued the Statement of Financial Accounting Standards No. 81, Disclosure of Postretirement Health Care and Life Insurance Benefits on November 8, 1984.

The specific disclosures required by Statement 81 are as follows:

1. A description of the benefits provided and the employee groups covered;

2. A description of the accounting and funding policies followed for those benefits;

3. The cost of those benefits recognized for the period; and

4. The effect of significant matters affecting the comparability of the costs recognized for all periods presented.

Currently, the FASB is working on a proposal to accrue a liability for amounts payable through OPEB plans. This proposal's origins are from the 1982 Preliminary Views document which proposed that the cost of postretirement health care and life insurance benefits should be accrued over the periods in which employees render service. The FASB believes that retiree benefits offered to employees are a form of deferred compensation. The benefits have been earned by employees providing past and current service. However, the employer has incurred a current obligation to provide future benefits to retirees.

Because retiree health care and life insurance benefits are similar to pension benefits, the FASB will consider accounting for pensions as potentially applying to OPEB as well. Since pensions and OPEB are both forms of deferred compensation, the final decision on the pensions project may impact any prospective decision regarding OPEB.

To quantify the portion of the liability attributable to periods in which employees provide service, certain actuarial measurement techniques must be employed. The FASB is now examining the differences between various actuarial methods and assumptions and the different results that can be obtained through their use. The FASB must assess the validity of alternative actuarial attribution methods, and the validity of different actuarial assumptions.

The employee benefits environment is another factor that will influence the FASB's consideration of OPEB issues. It is currently studying tax laws, legislation, and judicial decisions concerning employee and retiree benefits. The sections of the Deficit Reduction Act limiting employers' ability to fund postretirement health and welfare benefits are being considered. Likewise, attention is being given to the bill now in Congress that proposes to extend Section 208 of ERISA, which

currently prevents cutbacks in pension benefits upon a merger, consolidation of plans, or transfer of plan assets, to retiree health and welfare plans. Recent court cases such as the Bethlehem Steel and the White Farm Equipment cases are also being analyzed for their potential implications in accounting for OPEB.

MR. JOHN M. BERTKO: Mr. Yamamoto, could you address the question of explicit versus implicit assumptions? In your alternatives, you give two or three explicit alternatives, but there are a whole range of assumptions. Which do you think is preferred? If you used a common set of assumptions for all the projections that you do, what is the justification in using different assumptions for different studies?

MR. YAMAMOTO: As in pension valuations, I use more explicit assumptions in valuing any type of benefit. I use something like an 8 percent medical trend assumption and the 6 percent or 7 percent medicare trend assumption because that gives the employer a more realistic view. If you use 9 percent medical inflation and 8 percent interest, you probably end up with the same result. The main reason for using explicit assumptions is to get the employer to be comfortable with the assumptions; implicit assumptions are just too hard to understand.

I do not use the same set of economic assumptions for all of my valuations. My valuations have been for pension clients, and I try to make the assumptions consistent with the pension plan assumptions.

MR. JACK E. BRUNER: Is there any leaning toward one specific actuarial cost method for funding these plans? Is FASB really likely to arrive at a definite set of rules for accruing these expenses? Is it going to lead to mandatory prefunding of these expenses?

MR. CHEVALIER: FASB Board is still in the process of trying to gather additional information about what the effects of the various attribution methods may be, but we are leaning towards a cost approach because of the difficulty in associating these benefits with an actual period in which the benefits are earned. There are very few situations in which postretirement medical benefits are vested along the same lines as a pension plan. For those situations in which cost methods are being used, the entry age normal and the aggregate methods are common. With pensions the FASB has stated it's going along the lines of the benefits approach and using a projected unit credit method. We are not in a position to require prefunding. The FASB is regulating the actual accounting treatment that will be applied to whatever funding or accruals take place.

MR. BRUNER: Would you expect legislation to follow up your recommendations for accruals to require funding?

MR. CHEVALIER: In the Studebaker case, the company was unable to make payments to retirees which prompted ERISA. Chances are that if a situation arises again in relation to postretirement health care benefits, Congress may act similarly.

MR. TOM BOLIN: VEBA limits are the welfare funding limits imposed by DEFRA. Some prefunding of postretirement medical benefits has been in some of the multiemployer welfare funds. They traditionally use VEBA trusts as their medium. Now of course, there is a very conflicting legal and case environment here. DEFRA has limited the ability to fund these benefits.

The problem with taxability of interest on the accumulation of funds exerts pressure away from pre-funding. On the other hand, we have cases such as the Bethlehem Steel and the current FASB activity that applies pressure toward funding the benefits.

MR. YAMAMOTO: There is discouragement for funding based on DEFRA. Employers have to determine whether to fund in this current environment depending on how investment income is going to be taxed within the fund. The tax status of the company and the internal rate of return the company earns may dictate whether funding is worth it. The interest investment is going to be taxed, but you'll have the ability to deduct these contributions on the front end.

MR. THOMAS M. DANT: Suppose one wanted to adopt a pension plan approach. Would it be sufficient merely to incorporate in the promise to pay the monthly premium on an insured approach to a postretirement medical plan under a separate section in an existing plan? Or do the benefits have to be spelled out specifically in the pension plan?

MS. OLIVER: The benefits must be spelled out specifically in the plan document. The plan must contain a description of the benefits and also the amount that will be reimbursed.

MR. DANT: If someone were to go ahead and fund one of these plans before FASB comes out with any definitive roles on measurement, and then rules do come out, will there be any recognition of the funding that has already taken place within plans? Will these plans be exempt in any way, or would they still be required to put something in the financial statements?

MR. CHEVALIER: They would be required to put something on the financial statements. However, the FASB will ensure an appropriate transition from current accounting to future accounting. If some companies start prefunding now, they will probably want to put this asset on their books anyway. Then when FASB comes around and requires a recognition of a liability the asset will exist.

MR. DANT: Of course if the funding is through the pension plan, there would not be currently either a liability or an asset.

MR. CHEVALIER: If it is being funded through the pension plan, then today's pension accounting documents apply.

MR. DANT: In a VEBA, an existing retired life group must also be funded or costed as part of the arrangement. Is that true of the pension plan, or could a pension plan only provide the cost of postretirement funding for the active employees as opposed to the current retirees?

MS. OLIVER: Your VEBA is considered to be a deferred compensation plan. You have to cover active employees for their preretirement coverage as well and pass your premiums through the VEBA, if you wish to go through a VEBA. If that happens, then it is legal to do this whole thing through the VEBA.

MR. DANT: You could exclude the retired lives if for some reason you didn't want to prefund that liability. Do you do that in your plans? Do you actually value liabilities for the existing retired life group as well as the active life group?

MR. YAMAMOTO: Under a VEBA or 501(c) trust we'll value both the retiree and active groups.

MR. DANT: How about under the pension plan approach?

MR. YAMAMOTO: I don't have any clients that are funding the retiree medical plan through their pension plan.

MR. WILLIAM LANE: Your 8 percent interest rate was an after-tax interest rate or no tax was applicable to it. Have you done your projections based upon the current situation with VEBAs where the interest rate would be taxable and your rate might be 4.5 percent after taxes? What happens to the percentage of payroll costs on your entry age normal cost method?

MR. YAMAMOTO: We did take a look at that for one client. Their tax rate was effectively 35 percent, so I used 65 percent of my after-tax rate of 8 percent which was 5 percent. I lowered the interest rate to 5 percent, assumed no medical inflation, assumed no salary inflation, and still used entry age normal, i.e., a level dollar entry age normal cost method.

MR. LANE: Current DEFRA law with respect to VEBAs doesn't allow you to project cost using inflation assumptions. Did you try to run the projection with inflation to see what a realistic number would have been, not what the tax deduction would allow?

MR. YAMAMOTO: We showed the client basically two runs, the valuation results based on what we felt were the best estimate long range assumptions and then the DEFRA limitations. You have to make the client's potential liabilities clear because we include a range of contributions in the pension valuation and also some kind of documentation of what the deductible contribution is. If retiree welfare valuations become more common, the realistic long range liability, plus any kind of deductible limitations imposed by legislation ought to be included in the report.

MR. DANT: Is it true that under a pension approach earnings accumulate tax free?

MS. OLIVER: As I read it, yes. DEFRA limitations would not apply to pension plans.

MR. DANT: I saw that the Treasury plan for proposed tax reform was heavily weighted in favor of the pension plan and indicated that the prohibitions of DEFRA would not be applicable to pension plans. Can't an inflation assumption be used under the pension approach as opposed to under a VEBA?

MS. OLIVER: Yes.

MR. DALE F. ETHINGTON: If you use the pension plan, are any of the benefits taxable, or do they generate taxable income?

MR. YAMAMOTO: They will be a nontaxable benefit. It will be just like the employer-provided medical plan while you were active.

Our clients are taking a close look at their retiree medical plans. Especially after we come in and do a valuation and show them how big the numbers are. They start asking questions about what can be done for the future. We recommend especially making the retiree medical program more of a service-related benefit. Why should you reward the ten-year employee with the same type of retiree medical insurance as you reward your long-service thirty-year employee? We encourage a close look at their program to control their costs.

MR. GLASCO: The problem is trying to get employers to take a closer look. They still aren't aware of the potential problems they might have.

MR. CHEVALIER: There have been several cases in which employers have tried to back out of these plans. The Bethlehem Steel and White Farm Equipment cases were both instances in which employers who had been providing benefits to nonunion employees, scaled back or tried to completely cut back benefits. In both cases, the courts overruled this type of reduction in benefits. There have been several cases regarding union employees, in which some of the court disputes arose regarding whether or not, upon the expiration of a collective bargaining agreement, the employer could terminate benefits if, for example, a division of a corporation was discontinued or divested.

MR. STANLEY GOLDFARB: On 401(h) plans how do you support your tax deduction? In other words, if you're prefunding and there is no Section 404 of the Code, is there any sort of actuarial certification required now or can you put in whatever you want?

MS. OLIVER: There doesn't appear to be any explicit statement that anything in the way of pension funding at all applies to these plans. There was an old regulation back in the 1960s governing maximum deductibility which clearly no longer applies. It indicates methodologies which are different than what you would use for a pension plan.

MR. YAMAMOTO: There is the subordination rule where the contributions going into the pension trust fund cannot be greater than 25 percent of the current year's pension costs.

MR. GOLDFARB: Is that total pension costs or normal costs?

MR. YAMAMOTO: It says current year's pension costs, but I would translate it into normal cost. Basically the costs cannot be greater than a third of the normal cost.

MR. GOLDFARB: Is there any relationship between 401 (h) plans and Section 415 of the Code? Are there any sort of limitations of either defined benefit or defined contribution plan types?

MS. OLIVER: For purposes of your ninety thousand dollar limit, you're not affected. Five percent owners have to be separately accounted for just as in DEFRA - the separate account for medical benefits. You have to have it for 5 percent owners if you utilize the pension plan, and that does count for Section 415 just like it would for a key employee under a DEFRA arrangement.

MR. GOLDFARB: Mr. Yamamoto, why didn't your graphs cross? How far into the future do you have to go before they cross? If they are never going to cross, there's certainly not a very strong argument to prefund.

MR. YAMAMOTO: A lot of people don't think it is going to cross. It's got to cross eventually when the plan starts dying out.

I'm showing an open group forecast. It has new entrants going in so the assumption was that your employee population stayed the same. You had new hires in the future to replace the people that left. It will be a growing retiree force.

The example that I showed deals more or less with a typical group. It had about twenty thousand active employees and there was about six to eight thousand retirees.

MR. GOLDFARB: If it hadn't crossed for them for twenty years, that seems like a pretty long-term view of it then. What would be the point in prefunding a plan of that sort?

MR. YAMAMOTO: The prefunding or preexpensing, has to do with a company's view of accounting for the benefit. It more properly allocates your cost of these benefits to the time it should be attributed to: when these employees are working. It goes back to the companies that want to take a look at a valuation of this sort, which are companies that either (1) feel from the accounting sense, they should have some kind of prefunding, preexpensing of the liabilities or (2) are utility or government contractors who want to get these things into their cost basis. It's more of an accounting principle to account for these benefits in the proper accounting period rather than a funding issue or some other philosophical issue.

MR. CHARLES SHERFEY: The laws and regulations conflict about using reasonable actuarial assumptions and not using an assumption as the future medical care inflation. I was wondering if you had considered zero or negative interest rates, if you have actually used them, or what your comments are on this subject?

MR. YAMAMOTO: I personally haven't used them because I couldn't come up with any justification to make that reasonable. I can't come up with a justification on why I shouldn't use any inflation rates either.

MR. JEFFREY PETERTIL: Implicit in what has been said is that no one really knows of a 401(h) funding. There is no case now of anyone using a 401(h) to fund postretirement, medical, or other benefits.

MR. YAMAMOTO: The only thing that I have ever heard of is that some union plans have a cents per dollar type of arrangement to fund retiree medical plans. That's the only case that could possibly be using 401(h).

FROM THE FLOOR: I've seen illustrations that have been prepared to justify contributions to VEBA that were level amounts over future working lifetimes, based on very high medical care inflation factors which gave current deductions which were disproportionate to the person's income. It was just the abuse of using medical care inflation rates that the IRS was trying to eliminate. There was an abusive situation where there were very large deductions in VEBAs.

MR. WAYNE DYDO: If a company was funding postretirement health benefits through a pension plan, any statement that finally comes out about pension plan reporting would automatically apply to the whole pension plan, including the postretirement benefits. Might you consider segregating this into a final statement on a pension plan?

MR. CHEVALIER: Would we consider looking at the postretirement health care benefit as being accounted for unlike the pension benefit that it is tied to? I would think not, depending upon how closely tied they are. I'm not sure how the workings of a 401(h) plan would tie these two together if the funding and the accrual is somehow related, it would probably be cost inefficient to try to separate the two and have different accounting methodologies for each different use of the funds.

MR. YAMAMOTO: When using a projected unit credit cost method for retiree medical plans, we use a projection based on service to date divided by service to early retirement age. The justification is similar to restrictions on pension plan valuations that if you use projected unit credit, it has to be prorated over the benefit period. It is similar to a pension plan that accrues the maximum benefit after twenty-five years. You don't accrue anything after that, so you accrue your benefits over the first twenty-five years of a working lifetime. Another alternative would be using the prorate up to whatever the expected retirement age of the employer is rather than earliest retirement age or eligibility for the benefit. Does anybody have any theoretical thoughts on what is more proper? The shorter your prorate period the larger the cost is going to be.

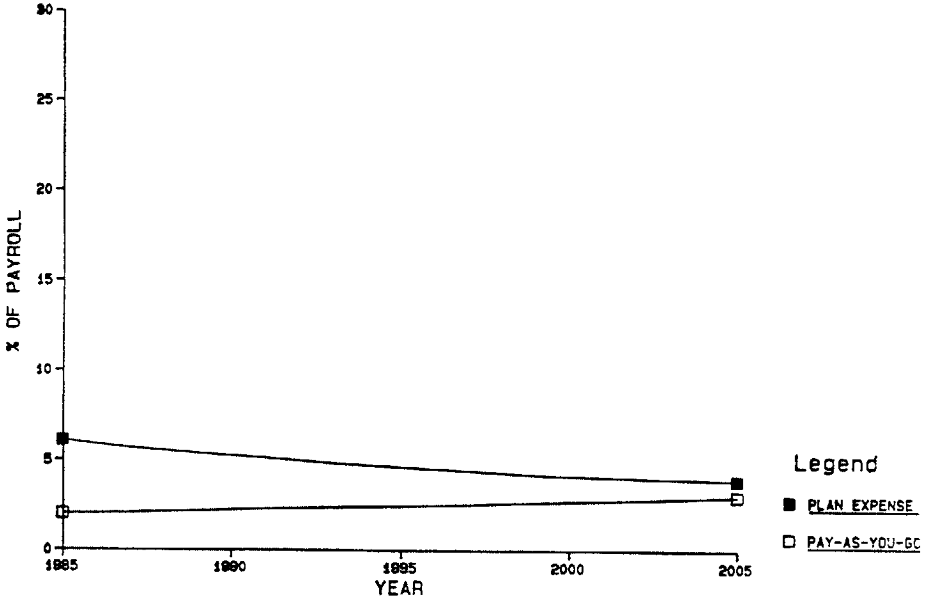
MR. BRUNER: Since we are not under any type of legislative or funding constraints imposed by the IRS, why not use what you feel is a proper accrual method? Go out to age sixty-three if that is what you feel is expected retirement age rather than just going up to the benefit eligibility date.

MR. YAMAMOTO: In the Academy guidelines, Interpretation Number 2 for pension plans says you should go up to the earliest eligibility date for accrual. For a lump sum death benefit, you prorate up to the eligibility date to come up with the present accrued benefits.

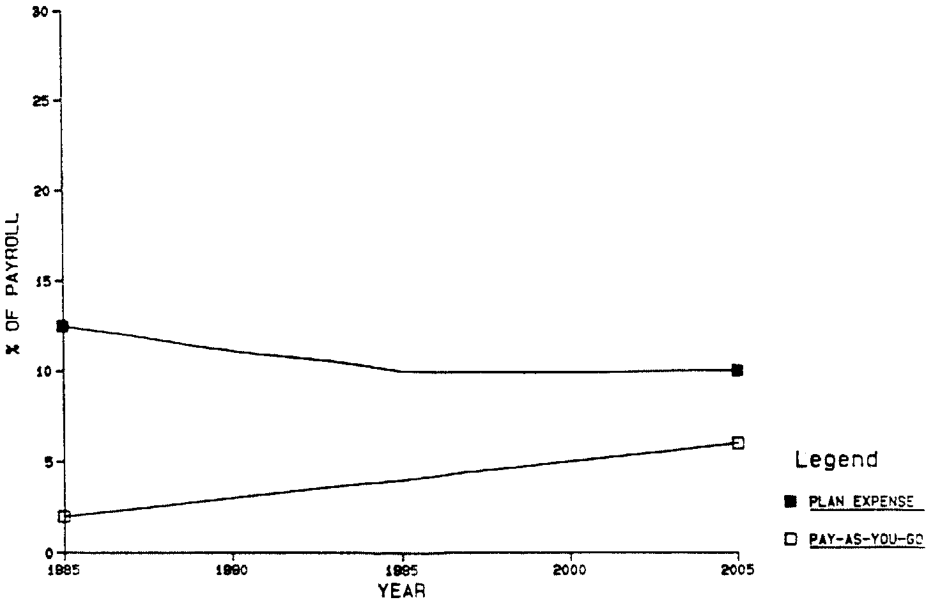
MR. JAMES GINGRICH: Are you doing anything with a more realistic medical inflation factor than 8 percent, especially since 15 percent may be more appropriate; and what the effect on that liability might be?

MR. YAMAMOTO: When I have done it, I have softened the impact because I had the interest rate go up, marching along at the same pace. Our programs are capable of doing that but I made a general assumption that for medical valuation you have two factors that offset each other. You have the medical inflation rate and the expected investment return. The investment return over the last three years has been large especially the last five years. If you did include something that was, for example, 15 percent graded down to 8 percent ultimate after ten years, it does make a difference. You still are projecting quite a ways down there using that 8 percent inflation assumption. One of the primary reasons for doing or using the calendar year medical inflation assumption is to get a good feel of what the benefit disbursements are going to be from the fund.

BASE



ALTERNATIVE 1



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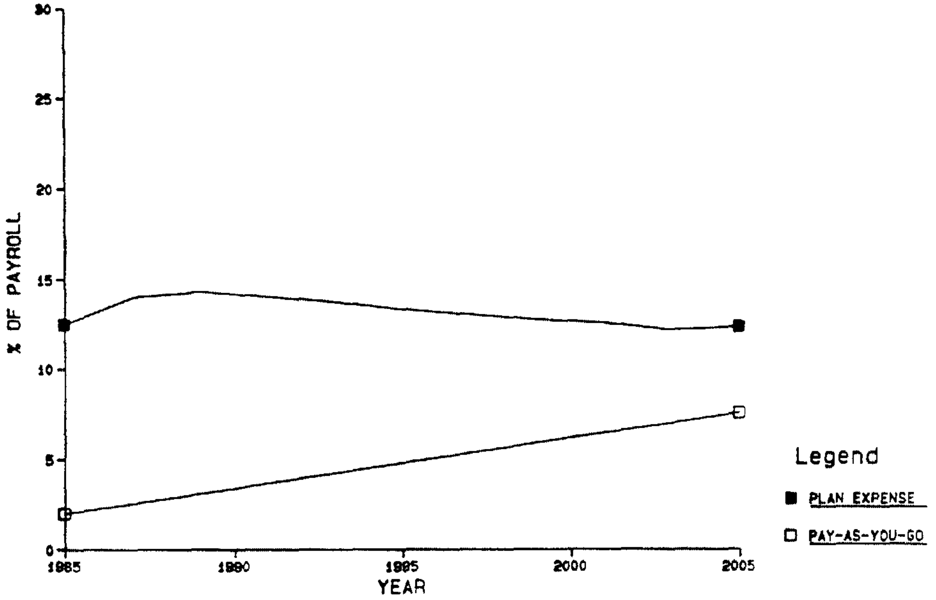

ALTERNATIVE 3