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POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

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MR. SEAN T. MONAGHAN: Leslie and I first became acquainted when we were retained by different sides in a buy-sell to estimate retiree medical liabilities to be included in the purchase. It was interesting to see how widely the opinion of two actuaries can vary on this topic. In the course of our discussions of assumptions we, at various times, questioned each other's planet of origin, the marital status and species of each other's planet, and so on.

The fact that opinions can vary so widely on this issue, that data to support these opinions are so thin, and the magnitude of the dollar swing is so large points out the fact that a great deal of fundamental research, data collection, and model-building and testing needs to be done in the next few years. I hope that some of you can become involved in this process because those of us who practice in this field can use both the help and new ideas.

I recall the first time I heard the notion of prefunding retiree medical. It was over six years ago, and a client called and explained that they had some money that they would like to place somewhere and asked about prefunding their retiree medical plan, which struck me as a novel idea. I made some calls and was referred to an actuary in our Cleveland office who had been active in this area, who advised "try running it entry-age normal, with a plus 2%, minus 2% corridor." I thanked him and

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hung up, thinking that here was a start. I needed to find out only two things: what entry-age normal is, and what a plus 2%, minus 2% corridor is.

That same actuary later provided a good perspective on what working in the field of retiree medical valuations is like. I had called him with a question on a certain assumption, and he explained how he had handled it. I wasn't entirely convinced so I asked him if he was comfortable with that approach. He paused a moment and replied, "You very well know that anyone who feels comfortable with retiree medical doesn't know what they're doing!" By that definition I must be an expert, because doing this work scares me to death.

What do FASB, OPEB, and SFAS 106 mean? Briefly, FASB is the Financial Accounting Standards Board, which sets standards used in Generally Accepted Accounting Principles (GAAP) accounting. OPEB is Other Postemployment Benefits (that is, other than pensions) and SFAS 106 is the Statement of Financial Accounting Standards No. 106, which is the FASB's standards for OPEB.

In my presentation I will discuss a brief history of SFAS 106, in a very simple fashion, the calculation of liabilities and expenses under SFAS 106, and will finish with what several major employers have done in redesigning their plans.

A question that many clients have raised is, why is this issue coming up now? We find ourselves at an unfortunate confluence of increasing medical costs in general, compounded by an aging workforce, with employees retiring earlier, living longer, with greater health expectations. At this same time, attempts to terminate these benefits have highlighted both the value of these benefits as well as the difficulty employers have in changing them. All of this has increased the awareness of the significance of these benefits to the point that no one can argue over their materiality.

This topic did not just pop up. FASB recognized as long ago as the late 1970s that the promise to provide medical benefits during retirement was a material item. It was included in the early 1980s in the project to revise pension accounting, but was spun off from the pension project, which was released as SFAS 87. SFAS 81, which requires footnote disclosure of the presence of a retiree medical plan as well as the number of participants and estimated annual cost, was issued as a stopgap in 1984. Following release of SFAS 87, FASB focused its attention on the OPEB issue, which led to release of an exposure draft on Valentine's Day in 1989, and the final adoption of the statement in December 1990.

The basic objectives of SFAS 106 arise from the notion that OPEB plans are a form of deferred compensation and, as such, are incurred as employees render service. The key objective of the statement is to enhance the usefulness of financial statements and that inclusion of estimates of these liabilities, even if done on today's less-than-ideal basis, would be superior to ignoring them entirely. The effective date for the new statement is, for most employers, their first fiscal year beginning after December 15, 1992. This will be 1993 for most companies.

There are also some requirements related to SFAS 106. Financial Accounting Standards Statement No. 96 (SFAS 96), which is the FASB standard for accounting for income taxes, may or may not limit assumed deductibility for SFAS 106 expenses

and liabilities in future periods. Also, Standards Accounting Bulletin 74 (SAB 74), which is the SEC Staff Announcement Bulletin, requires disclosure of the future impact of accounting changes when they are known and can be estimated.

Let me define a few important acronyms and terms for you which will be used later. Expected Postretirement Benefit Obligation (EPBO) represents the present value of the entire retiree liability. Accumulated Postretirement Benefit Obligation (APBO) represents the portion of the EPBO attributed to elapsed years of service. The service cost is the portion of the EPBO attributed to the current year's service. Finally, the attribution method is the method of assigning the EPBO to an employee's working lifetime.

In Financial Accounting Standard 106, if absent a specified accumulation period, these benefits are to be attributed evenly over years of service from date of hire to the date of earliest eligibility for the full benefits. For example, if you reach age 55 years and have 10 years of service, then you are eligible for the entire benefit under the Financial Accounting Standard under the earliest benefit eligibility attribution method. The liabilities for such a person would be spread evenly over his or her entire service career from date of hire until 55 and 10, even though retirement might not occur until age 62 or 65. This provision resulted in a fair amount of controversy during the exposure draft period, and, in fact, FASB itself bounced back and forth on this several times before the final release using this particular method.

To illustrate this attribution method, we take our employee that hired at age 25, is currently 45, and will be eligible to retire at 55. The EPBO is spread evenly over his or her years of service from date of hire to age 55. The portion of the EPBO for years which have already elapsed for that individual is called the APBO. There is a gap from age 55 up to date of actual retirement. By the time the person is eligible for benefits, the entire amount should have been accrued on the books regardless of whether the person is going to retire at 55 or at 62 or at 65. Using this methodology, the net periodic cost or accrual cost for the individual and for the group of individuals in total is the sum of the following: this year's service cost plus the amortization of the accrued liability (which can be spread over the longer of 20 years or the average remaining service for employees expected to retire), and interest on the APBO. (The reason there is an interest component is because this is a present value method. Since for each elapsed year you're losing one year of discount, the APBO has to grow by that amount each year.) We then subtract the return on assets if funded and add the actuarial gain or loss from year to year.

Let's go very briefly through an example starting with the required data. It's very similar to what's required for pension valuation. We need an employee identifier, date of birth, sex, location code, plan code, and date of hire. If there is a retiree life plan that's pay related, you need the pay amount. For retirees you need most of the same items, but you also need additional data on spouses and dependents who are actually enrolled in the medical plan. Also, if there's life insurance involved which is not a flat amount, then you need the individual retiree life amounts. Since most of us are geared to doing pension accounting, most of this information is already available. In addition, however, we need the plan and cost data.

For the plan data I like to summarize what I need to know as follows: who, where, gets what, when, and how much do they pay for it? We also get copies of the certificates and summary plan descriptions in collective bargaining agreements, handouts, and anything else that bears upon describing the plan. For cost data there are two types of data you need: claims experience and medical enrollment data. If we're working for insurance companies, I think that we need to make sure that we have adequate experience reporting capabilities for our clients. Those of us in the consulting business should meet early with our clients and with their claims administrators or their insurance companies to make sure that the proper data are going to be available. Data vary from being very good to terrible to nonexistent. Some firms or some insurers are able to provide good data. Others at least will give you tapes, and sometimes you have to make do with a couple of numbers on the back of an envelope.

If you asked two actuaries to set assumptions you're going to get wildly different results. Many of the assumptions are common with pension valuations in that we need to concern ourselves with withdrawal, disability, mortality assumptions, and discount rates. Retirement documents often used on pension valuations are fairly simplistic compared with the greater precision that's required for retiree medical since it is much more sensitive to the early retirement assumptions than pension valuations. Unique to retiree medical are obviously medical inflation and some type of a gross claims model where you break down claims experience and project it separately by component.

If you try to come up with an adequately parameterized model, you soon get up to 40 or 50 parameters, none of which is adequately known. On net claims models you're usually working with two or three assumptions which aren't adequately known. I'm not sure which is really superior at this point. That's an area that really requires some additional thinking and hard work, especially from insurance carriers that have large databases. Those of us practicing in the field would love to see some decent demographic data, age, sex, utilization morbidity curves, and so on. Often we have to interpolate from smaller populations. In addition, you do need to make assumptions about the portion of retirees or active employees who do actually elect coverage once they retire. I'll give you an example. If the employer is paying for the entire cost, then chances are most of the employees will elect coverage. If there's a substantial contribution requirement, a lot of them will drop out. So you need to pay particular attention to that.

Let's go very quickly through an example for an average employee who is currently 45, hired at 25, and eligible at 55. Let's also assume that 60% of the active employees will actually end up retiring at an average retirement age of 63. Furthermore, assume that 75% of the employees will have a covered spouse and that wives are three years younger than husbands.

While in practice for these valuations we fire up our computers and apply all of the factors year by year, for illustrative purposes, we can make an enormous leap and assume that over the next 50 years medical inflation will, on average, equal our discount assumption. As it turns out, this assumption really isn't too bad, and if you make that assumption, then you can do a calculation using just life expectancies for an individual. For the male employee, he'd have two years of coverage under 65 at

let's assume $3,000 per year. He also has $1,000 per year for 17 years on average over 65 based on our mortality assumption. This results in the present value of that male employee's liability at $23,000. Following a similar approach for the spouse, recognizing the three-year age offset will result in more years under 65 as well as over 65 since the wives are probably going to live longer. This produces a liability per spouse of $36,000. Since we assume that 75% are married, on average the liability will be $27,000. The sum of the retiree's and spouse's liabilities will be an average present value for an employee of $50,000. Since we assume that 60% retire, the average present value liability per employee is $30,000.

You can turn that $30,000 into an expense for that individual by first calculating his APBO based on 20 years of service out of 30 years being that he has eligibility at 55 and 10. This results in an APBO of $20,000, that is, 20/30 of the $30,000. Since we're going to amortize that over 20 years, the annual amortization expense is $1,000. This year's service cost is the $30,000 liability divided by 30 years' service or $1,000. An interest cost of 8% on the APBO and the service cost, since it is a beginning of the year value, results in an interest cost of $1,680. The final result is a net periodic cost for this active employee of $3,680 per year.

It's important to recognize that right now there's no expense that's being recognized on the books for this particular employee. Once SFAS 106 is effective, you're going to have to recognize close to $3,700 a year for each employee. Extending that to an average company with 5,000 actives and 500 retirees with a payroll of $129 million, and current medical expenses of $12 million of which $1 million is for retirees, under SFAS 106 the retiree medical expense is going to be $11 million. Comparing personnel costs on a current basis and on a SFAS 106 basis, you'll see that there's a net increase of $7 million assuming a SFAS 96 tax offset.

For design considerations, Dan and Tom are going to talk about these particular items in more detail. I just want to mention that when we're working with an employer in redesigning their plans, the goal is to strike a balance between expense and benefits provided. The first question to ask the employer is what can you afford to provide. To illustrate, one employer I'm working with is going to see his retiree medical expenses go from $1.5-9 million on a FAS basis. Their reaction was that the benefit was worthwhile providing to employees at $1.5 million, but not at $9 million. They made the statement that if they had an extra $7.5 million, they sure wouldn't spend it on retiree medical. So the other part of the consideration is whether under this new accrual approach and the higher expenses you are getting an adequate "bang for the buck." Tom will talk later about different funding alternatives.

I'd like to go ahead to the range in possibilities for redesigning these benefits. One that's been around for a couple of years is TRW, which switched from a provider-paid plan to what's called a defined-dollar plan. What they've done is to change their promise from "we'll pay for whatever the cost is" to "we'll give you credits based on your years of service." The credits of $8 per year of service will be for you and separately for your spouse toward the cost of monthly benefits. Once either you or your spouse reaches age 65, those credits are reduced to $3.25. As an example, let's take an individual who retires with 20 years of service. TRW will pay up to $160 toward the cost for that employee's coverage under age 65. They've gone one step further and committed to increasing those credits every year based on a

maximum of 4% per year or up to half medical CPI. Many defined dollar plans do fix the contributions and don't have an explicit increase from year to year.

Another interesting illustration is IBM. They announced that they're going to cap their reimbursement for new retirees only at the point at which the cost has doubled. After that point they weren't entirely committed on what they were going to do. I like to call that a "2 X" plan. They immediately get the impact of reducing the medical inflation assumption so that they get the benefits of reduced liabilities and expenses. No one really gets affected for another five or six or seven years until the cost has doubled and, at that point, who knows what delivery of medical benefits is going to look like.

Another interesting example is American Airlines. In 1990 American Airlines announced to its employees that if you want to continue to be eligible for retiree medical benefits, you need to start contributing $10 per month after tax into a Voluntary Employees' Beneficiary Association (VEBA). Participation was very good, around 98%. Employees who leave the plan or die prior to retirement can withdraw their contributions plus interest. This illustrates the trend among employers who are setting up funding vehicles to allow employees to contribute while they're active and have an income to provide for their retiree medical benefits.

AT&T and GE plans are notable because both of these companies reached agreements with their unions to cap the future costs. It's similar to the approach that IBM took with some minor variations. For instance, GE has agreed to cover the cost for the duration of the contract; however, at the expiration of this contract, costs are capped.

The last illustration that I'd like to discuss is Westinghouse. It's almost a "2 X" plan with again an interesting variation. If employees as of the current date contribute $15 per month to a VEBA, then once they retire their benefits won't be capped. So what we've seen is a tendency of employers to make some sort of alternative funding available in addition to cutting back benefits. I think that some of the more interesting ones are where you make it possible for employees to save for their own retirements. Dan McCarthy is going to discuss benefit alternatives and design issues and Tom Laubenthal will talk about funding issues.

MR. DANIEL J. MCCARTHY: As Sean said, I've been asked to talk about this subject primarily from the aspect of insurers as employers, and presumably that's an interest since approximately half of the members of the SOA work for insurance organizations. I suppose it's worth beginning by asking what makes insurers different from other employers. I would suggest that there are four things that are worth talking about which are elements of difference to varying degrees. The first is that for many insurers -- mutuals, Blue Cross/Blue Shield organizations, and other entities who do not do public GAAP reporting -- statutory accounting is much more relevant than GAAP accounting and the issues, although in the long run they may be the same, are in the short run different.

Second, for many insurers and a sizeable number of the larger mutuals, special issues relating to commission-compensated career sales forces are of particular interest and pose particular cost allocation problems. Third, because many insurers are, after all, in

the business of either selling health insurance or providing administrative services or health benefits or both, it's not unreasonable to think that there might be some special insights arising out of that activity of insurers. Finally, although this is not really a difference but simply a reflection that insurers participate in a trend, a significant number of insurers, including mutuals, have had sizeable early retirement window programs in recent years accepted by many of their employees. I think that poses some particular issues as to what is and what is not on their balance sheets. Let's take those up one at a time.

Turn first to the question of statutory accounting. Recently I participated in a panel with Professor Joseph Belth who has had a good deal to say about insurance companies and statutory accounting. His starting position was that different insurers do not apply statutory accounting principles consistently, and that in fact some of them take advantage of those principles. My starting position was that in many areas there aren't any statutory accounting principles. In fact an interesting development in that regard has emerged in the laws of many states which are now requiring that insurers obtain opinions from accounting firms, not on their GAAP books but on their statutory books. The required opinion is that the books of this insurer have been maintained and its statements have been prepared in accordance with statutory accounting principles.

The accounting firms not unreasonably have turned to the NAIC and have said, "You don't have a statement of what statutory accounting principles are. Therefore, it will be very difficult to render such an opinion." I think it likely that over the next few years that kind of tension and the requirement for audited statutory financial statements consistent with statutory accounting principles will bring us closer to a comprehensive statement of what those principles are. Even if you try to glean it out of the laws of any state, you will find that some parts are spelled out in great detail and some parts are simply not discussed at all. Although it may not be a written down principle, nobody to the best of my knowledge is holding on their statutory books an obligation for postretirement benefits other than pensions.

In the course of preparing for this session, I did encounter one insurance organization that does not report on GAAP; however, they said, in effect, that wherever we can't find a statutory accounting principle, we fall back to GAAP. I would say that they are the exception rather than the rule in this regard. Some people have suggested to me that for statutory purposes insurers carry their pension obligation in a very different way than would be required by FASB and that is potentially an offset. That's true in some cases but not in all. I don't know what we would find if we could add it up over the whole industry. But I had recent information from four large insurers concerning the overfunding of their pension plan that was in fact being carried as a statutory liability and the corresponding absence of any statutory liability for postretirement benefits other than pensions.

For one of those large insurers the two numbers were large and approximately the same order of magnitude: a very substantial pension overfunding and a very substantial retiree medical cost not reflected and approximately equal in size. For another the pension overfunding was far larger than the retiree medical liability would have been, and for the other two it went quite in the other direction. So it may be true that if you could add it up over the whole industry you'd find some offset. However, it

bounces around very differently from company to company depending on their past funding practices and depending in particular on what they've done with their pension plans over the last several years. There is no current initiative that I am aware of to impose a specific statutory requirement concerning the funding of retiree medical benefits. I suspect, however, as I suggested before, that it will be a subject of increasing visibility over the next several years.

Second, I want to talk about career sales forces. There are large insurers whose retired sales force populations are considerably larger than their active sales force populations. That is often a result of their stepping up productivity requirements for continued participation in active sales forces in recent years. Nevertheless, people who had been in those sales forces for long numbers of years had been promised a retirement medical benefit from the insurer. Large numbers of people are being covered by that benefit, and it is not reflected again on the balance sheets of the company. It's also a competitive issue since those companies are essentially funding that entire current cost, pricing that into their products as best they can. It's an obligation they have which they're trying to deal with in current expenses. That is frankly making a noncompetitive situation in contrast either to companies whose sales forces have different demographics or to companies who operate on a basis in which they are not providing those benefits to sales forces. The companies who have the large obligations for retired sales forces are carrying a competitive cost that is difficult for them to deal with.

Third, I suggested that insurers might be different because, after all, they're in the business. If you look at the actual practices for postretirement medical planning for these insurers who are in the business, I would say you see two things. Number one, you've heard the old axiom "knowledge is power." Some of these companies have recognized the problem by virtue of being in the business, and they are probably more concerned about it and are trying to do more with it than firms for whom the providing of these benefits is not part of the business they are in.

On the other hand, I would say that a considerably larger number would fall into the old axiom about the shoemaker's children wearing the poorest set of shoes. I'd have to say that issues are simply not being dealt with in a way that I would view as reflecting the real financial issues involved. I'll illustrate that when talk about early retirement windows.

To give you a sense of numbers, we did a calculation recently where we were focusing on the point of retirement. We found that approximately half of the retirees of a particular employer had retired before age 65. The average retirement age of those people was about 60. The other half retired at 65 or later, the average retirement age being just slightly over 66. At the point of retirement, the expected cost of the postretirement benefit was eight times higher for the first group as for the second.

Now you know, of course, that in pension plans where there is frequently not a full actuarial reduction, it costs you a little bit more for early retirees. However, you will not see multiples like eight to one. The one trend that I do see that people are beginning to react to is this focus on the fact that early retirees cost so much more than retirees at age 65. There is a trend beginning to emerge in companies which are

imposing very different cost sharing during the period from retirement to age 65 than for the post-age 65 period. Frankly, I've seen more companies not doing anything about it yet. However, there are several who have done it and have dealt explicitly with the fact that the large piece of the cost occurs between retirement age that averages out to be late 1950s or early 1960s for your pre-65 retirees and the attainment of age 65.

One insurer that I'm aware of has been looking at managed care options and has essentially created a very strong pressure for its retirees to join HMOs with which that insurer has made negotiations. The cost sharing was set at a very different level, far more than the current cost difference, for people who would join the HMOs versus those who would not.

I want to emphasize a couple of things about what Sean said concerning the assumptions that are used for pricing these benefits. We've had occasion in the last couple of years to work in situations where there was a company bankruptcy and a group of retirees who were creditors in the bankruptcy. The question was, "What is the value of their claim?" Since these people are already either retirees or retirement eligible, there's no question about turnover assumptions or retirement age. You take a lot of those very difficult assumptions and just put them on the side. Typically the first calculations done would differ by 50% or more in terms of present value. Even what I'll call a negotiated set of assumptions based on intensive discussions and experience studies will frequently still leave gaps of 20-25%. So there is a lot to be done here simply in terms of, as Sean said, obtaining better experience information.

I'd like to make one final point on benefit design questions. Sean indicated that some of the case examples he gave provide essentially nothing in terms of current cost relief to the companies but do relieve the long-term FASB liability. That is a theme which seems to be emerging with greater frequency. We've worked recently with an insurer who does not report on GAAP but who will soon have to, and their focus was very simple. They said we're satisfied with our current cost, but we've got to get the liability down. Essentially if you want to get the liability down, you've got to deal with the trend assumption and be willing, in effect, to neutralize all or part of the trend. That means you've got to adopt a contribution structure or a benefit structure that will be self-adjusting and, furthermore, the self-adjustment mechanism in it must continue not just up to the point of retirement but beyond retirement.

A number of insurers have felt somehow that they are locked in for the current retirees with the promises they've made even though the documents don't say that. But the question of whether current retirees are locked in to some particular structural promise is an issue that insurers are having to face and deal with.

Let's take a look at how our panel's firms deal with this question of postretirement medical benefits. Two of us work for accounting firms and two of us work for consulting and actuarial firms. The two accounting firms deal with the issue by not providing postretiree medical; that certainly keeps the liability down. The two consulting firms deal with it in each case by providing it but by reflecting it rather differently. Wyatt's position, as I understand it, is essentially an employer-funded benefit for postretirement. Milliman & Robertson's position is that retirees are offered the opportunity and encouraged to join the company's postretirement medical plan,

which is an extension of the preretirement plan. However, we use an actuarially adjusted cost which passes on to the employees the full cost of that benefit. The idea is to neutralize questions of individual health but not to take on an employer obligation. People must join at the point of retirement or they can't come back in later. We thought you might be interested in the four different organizations and different ways of approaching it.

MR. THOMAS J. LAUBENTHAL: As with Sean and Dan I've been working in providing retiree medical benefit consulting services to many of our clients and companies in terms of plan design and funding issues primarily. I've been doing this well before the FASB came out with its exposure draft approximately three years ago on SFAS 106. What's been most interesting to me in following this whole area closely since the FASB came out with 106 in exposure draft form is to see how employers have dealt with this issue and how they've reacted to it, which has been fairly consistent across the board.

About three years ago when the FASB first came out with the exposure draft, a lot of employers commissioned actuarial studies to see what the number was. Since they wanted to get a handle on the extent and size of the liability under the exposure draft, these actuarial studies were commissioned. The actuarial assumptions and methodologies used were perhaps more similar to pension plans than to retiree medical programs. However, these studies were done and the first reaction that I observed is that when the actuary brought in the report with the number on it, the employer had a very emotional response that was not deserving.

The second reaction was to get the attorneys involved. I'm an attorney and I got involved with quite a few of my clients since the question was how can we terminate these plans unilaterally? Can we terminate these plans unilaterally? Have we reserved all the rights to modify and amend, etc., existing retiree medical programs? Certainly we can do that for the active participants under these programs. So a lot of work was done early on to try to determine what the extent of the legal liability was for these planned benefits and how locked in place everybody was. That work is still going on. Many employers are paying attention not only to the written plan document but also to how these benefits are communicated to employees. You don't want the people in Human Resources conducting an exit interview with the employee who's retiring and saying to him something like, "Don't worry, these retiree medical benefits are yours for life" when the plan clearly provides that the employer can unilaterally terminate the plan at any time. There have been a number of court cases in which the employer has come up on the short end when the communication hasn't dovetailed to the written plan.

Today the employer reactions and focus are really threefold. One is to step back from this whole process a little bit and look at SFAS 106 as an accounting issue first. Let's look at it closely and determine what impact it's going to have on our financial statements before we start touching the plan and amending it and communicating things to employees that we're really not prepared or willing to do right now. Let's look at the actuarial assumptions we're employing very closely and make sure that they're our assumptions. Let's make sure that it's our medical trend rate, not some national medical trend rate, and that we're comfortable with the discount rate. So the focus is to get a clear grip on SFAS 106 and what impact it's going to have on

the financial statements. At the point when you've come up with a number which is your number, you can then start looking at plan design changes that will have a minimal impact on the plan benefits such as shortening the attribution period for accounting for this liability or perhaps putting a premium cap in place that you may reserve the right to move up at some point in the future.

Second, they're looking at how these medical benefits are being delivered from an administration standpoint and from a medical benefits standpoint. Are we or should we be looking at managed care, for example, for our retirees? How are these programs being administered by the life insurance company or the third-party administrator? Let's look closely at our contract with them and how they're processing claims to make sure that we're being as efficient as possible in administering the program and delivering the benefits under the program. Finally, they're looking at manners and ways of prefunding this obligation, putting aside monies to offset the liability in the future. The first question that everybody asks is why should companies prefund.

The normal profile that you're going to find on a company that you prefund is one that makes economic or regulatory sense to prefund. The clear examples would be utilities that would be able to bake this into their rate or defense contractors that are seeking to get reimbursed for these types of liabilities. Under the federal acquisition regulations and cost-accounting standards that defense contractors have to comply with, you don't get reimbursed for these expenses unless you pay them. So in order to match the expense and the obligation here, companies that are defense contractors are looking to prefund these obligations.

Other companies that are interested in prefunding these obligations are ones that are looking for a tax deduction perhaps or who have excess cash that they're trying to shield from a potential takeover by depositing it irrevocably in some sort of a fund. Perhaps they just have excess cash for which they'll get a greater return on their investment by setting it aside in some sort of fund for the SFAS 106 liability. Obviously another reason why a company might prefund is that they could create a SFAS 106 asset which might be used on the financial statements to partially or completely offset the SFAS 106 liability.

Finally, there are some reasons for providing some benefit security to employees and retirees by prefunding this obligation much like you provide benefit security in the sense of retirement income programs, especially qualified retirement income programs. Of course, ERISA requires that you maintain some minimum funding standards for retirement income programs. At this time, ERISA does not have any minimum funding requirements in it relative to welfare benefit plans such as retiree medical. There really aren't any minimum participation or coverage requirements as well. However, that may change if Congress is moving in a direction in this area.

Next I'd like to look at the funding objectives that most employers will be considering in terms of deciding on the funding vehicle. There are really four funding objectives that most employers are looking to achieve in selecting a funding vehicle for SFAS 106 liabilities. The first one is to make sure that the contribution when made to the funding vehicle is tax deductible. The second is that any income that's generated within the fund also accumulates on a tax-free basis. The third objective is to make

sure that when benefits are ultimately paid out of the vehicle to the participant in the form of a medical benefit that such benefit is tax free. The final objective is to create this SFAS 106 asset that can sit on our financial statements and offset the SFAS 106 liability.

There are essentially two major sets of funding vehicles that are available, as well as annuities. I'd like to cover qualified plans first, and then go to welfare benefit funds to look at some life insurance products that are being used in that regard. Let's first focus on qualified retirement programs. There are essentially a lot of things that can be done in this area. The biggest limitation in this area is the size and amounts of monies that you can set aside for retiree medical. If we look at defined-benefit pension plans, for example, you can establish a 401(h) account which is a retiree medical account within this plan. You can set aside up to 25% of your annual contributions each year into this account.

What that normally does is to create an employee communication issue because you're taking away existing dollars from the retirement income basket and you're pushing them into a retiree medical account that can be used only for retiree medical. Another approach that provides more flexibility to the employees is to allow them to make a one-time irrevocable election as to whether they want a portion of contributions that are being made by the employer allocated to this retiree health account. I think that has more popularity, especially when the employer is not expanding the amount of contributions.

The final area in the qualified plan that I wanted to talk about was relative to leveraged Employee Stock Ownership Plans (ESOPs). Many of you probably have heard of this as the Proctor and Gamble animal where they established something called a HSOP, which is a 401(h) employee stock ownership plan. They also did it on a leveraged basis. They were able to get a favorable determination letter from the IRS that the written plan would qualify. Since that time, however, the IRS has backed off from issuing any further favorable determination letters on this type of plan. We believe that the law is such that this type of plan should and will be available, but the IRS claims it needs additional time to focus in on some ESOP policy issues associated with this type of program. The Proctor and Gamble HSOP is essentially a combination stock bonus and money purchase pension plan. The stock bonus piece of the plan essentially provides the retirement income to the employee group, whereas the money purchase portion of the plan houses the 401(h) account.

The interesting thing about the Proctor and Gamble HSOP was that it was a leveraged HSOP. Many of you probably have looked at leveraged ESOPs relative to 401(k) plans where the employer has purchased a huge block of its securities on the open market to prefund its matching contribution obligation under the 401(k) plan. The reason why a lot of companies have looked at this other than from a cash-flow perspective is that any appreciation on those securities within the ESOP prior to allocation to participants is really going to their benefit in offsetting the matching contribution obligation in the future. This same thinking holds true relative to retiree medical. When the transaction is first completed, the shares are allocated to a suspense account within the ESOP. As loan payments are made, interest and principal are made on the ESOP loan and shares are released from the suspense account. The way the Proctor and Gamble ESOP worked is that 75% of those

shares were released to the stock bonus portion of the plan, the retirement income portion of the plan, and 25% of those shares were released through the 401(h) account, the money purchase pension plan side of the plan. The interesting thing is that it looks like it worked very nicely. There's a tax deduction for contributions. There's tax-free accumulation of income within a qualified plan to the extent these benefits are paid out of the 401(h) account. The monies are tax free or the benefits are tax free to the recipient, and we should have created a SFAS 106 asset here equal to the amount at least which is funded in the 401(h) account. Now the question that needs to be addressed by FASB is whether the shares that are sitting in that suspense account that have not yet been allocated to the 401(h) account will qualify as a SFAS 106 asset. At least 25% of those shares will qualify as a SFAS 106 asset. But if that's true, it creates a very nice potential for offsetting your SFAS 106 liability in this manner.

I'd like now to move to welfare benefit funds and to focus on VEBAs and non-VEBAs or nonexempt trusts. The Internal Revenue Code sets forth deduction rules applicable to welfare benefit funds.

One of these welfare benefit funds is a VEBA, a 501(c)9 organization with which many of you are familiar. However, that isn't the only welfare benefit fund that's out there. You can have another irrevocable trust that looks and smells and acts just like a VEBA except it doesn't have fancy language at the start of the document that says, "we intend this plan or trust to be a 501(c)9 entity." Those are nonexempt trusts and essentially are taxed under the grantor trust rules of the Internal Revenue Code. Both of these are welfare benefit funds and the tax deduction rules apply equally to both of them. As far as establishing deductible reserves on a tax-deductible basis, the rule under Section 419(a) of the Code is that you're allowed to establish these reserves and fund for them over the working lives of covered employees using actuarial assumptions that are determined on a level basis and are reasonable in the aggregate. Essentially what that means is you're allowed to prefund this obligation over the remaining working lives of covered employees.

An issue comes up as to existing retirees since they have no remaining working life. There is some thinking that you should be able to prefund the entire retiree obligation on a terminal funding basis. The IRS is not really, as far as I know, too excitable about that avenue. The other one is to use a blended approach where you assign a zero working life for existing retirees, and then you compute the average remaining working lives for your covered employees and fund over that level basis. Essentially, the problem with funding for welfare benefits whether in a VEBA or in an nonexempt grantor trust is that the earnings are going to be taxable. Even though the VEBA is a tax-exempt entity, its tax-exempt status falls to the wayside when you get into the rules for unrelated business income associated with tax-exempt entities. Those rules indicate that to the extent you're funding for postretirement medical benefits, even though an allowable reserve may be created under the deduction sections of the Code, there is no allowable reserve under the unrelated business income tax sections of the Code. So to the extent you fund for postretirement medical benefits with a VEBA, you create exposure for unrelated business income tax. That tax, if it has to be paid, is equal to 31% at this time. I've been talking with a number of clients about using a nonexempt trust or grantor trust for postretirement medical funding instead of using a VEBA. The reason is that the income there is treated as deemed

unrelated business income and is taxable to the employer. The tax rate that an employer must pay is 34%. However, the same Code sections that force this income onto the employer's tax return allow the employer to obtain a tax deduction equal to the amount of tax that's paid on the deemed income. So if the example were that the trust had $100 worth of income which showed up on the employer's return and he paid $34 of tax, he would get a tax deduction for $34 as well. It's not too hard to see that the effective tax rate is not 34%. Instead, it's really 22.44%. So you've created a little bit of an arbitrage here between a VEBA with a 31% rate and a nonexempt trust with a 22.44% rate or an 8.5% differential. To avoid those problems entirely though, some employers have been looking at the types of investments that a VEBA would hold or that a nonexempt trust would hold. Those types of investments might be focusing in on investments that do not pay any current dividends or interest like growth stocks or maybe tax-exempt bonds or perhaps life insurance.

A lot of companies are looking at life insurance right now as an investment within a VEBA or other welfare benefit fund to provide some tax advantages that normally you see outside of the VEBA. Why life insurance first of all? Why would we look at it at all, whether it's in a welfare benefit fund or not? Why is life insurance interesting? Well, life insurance is interesting basically because it tracks the retiree medical liability fairly nicely. The reason why it tracks it in terms of its payout is that if you look at statistics or surveys that are out there relative to retiree medical, you're going to find that approximately 80-90% of the retiree medical costs that the company is actually going to pay out relative to any particular retired individual is all going to occur relative to the final illness of that individual.

So in the last one or two years of this individual's life, the majority of the company's cost associated with retiree medical is going to be focused. Certainly when the death benefit is paid, that coincides quite nicely then with the large portion of this cost. From a tax standpoint, although premiums are not deductible, you are allowed to accumulate the cash surrender value on a tax-free basis. There are alternative minimum tax considerations which I'm not going to get into, but generally you can accumulate the cash surrender value on a tax-free basis. The death benefits are going to be tax free to the employer as well. Certainly you can borrow against the cash surrender value.

Since the 1986 Act there's been some significant curtailment of that opportunity. The biggest one obviously is that you cannot borrow more than $50,000 per insured employee. So there's a limitation on the magnitude of the borrowing in order to get deductible interest under the policy that an employer can have. Now a lot of companies have been looking to put this life insurance product within the VEBA itself and to have the VEBA own the policy. This has been known as TOLI, trust-owned life insurance, instead of COLI, corporate-owned life insurance. Essentially the product that we find most employers are looking to right now is a group variable life product within the VEBA. They're looking at this group variable life product from the standpoint which allows the employer the opportunity to self-direct the investment allocation within the contract itself.

There are some insurance companies that are allowing employers to self-direct up to 100% of this amount. But the ability to self-direct this account mirrors much what

qualified plan trust assets would look like and you hire an investment manager to self-direct those assets.

For the group variable life policy within the VEBA, you'll be able to get a tax deduction for your contributions to the VEBA. The cash will then be used to pay the premiums which would have been nondeductible outside of the VEBA. Also, the income that's generated on that policy in the form of buildup of cash surrender value is not taxable currently.

If the product is set up correctly you can borrow from this cash surrender value. The deduction of the interest expense is somewhat meaningless within the VEBA since it really doesn't have any taxable income that it needs to offset. However, you can still borrow on those proceeds and obviously the death benefit when paid within the trust is going to be tax free as well. It's an investment vehicle that many employers are looking at in terms of utilizing the assets within the VEBA for postretirement medical benefits. One other use of life insurance is to use it outside of the VEBA. I have a client in Cleveland who has purchased a large amount of corporate-owned life insurance. This particular client is borrowing from the cash surrender value and using that as cash flow to make contributions to its welfare benefit fund, its VEBA. In that sense it's taking a nondeductible contribution or premium payment, and by borrowing the proceeds and using that cash flow it's generating a tax deduction on making its contribution to the VEBA or welfare benefit fund. Therefore, it can be used inside or outside of the vehicle and has some potential application and use there as well.

MR. EVERETT D. WONG: I have a question on the VEBA borrowing money from the corporate-owned life insurance or the trust-owned life insurance. How would the VEBA then utilize the tax deduction up to $50,000?

MR. LAUBENTHAL: As I indicated, the tax deduction in most cases will have really no use to the VEBA unless it can perhaps offset that deduction against unrelated business income. Perhaps it might be able to utilize it in that sense, but the deduction associated with interest is really of no value.

MR. WONG: On the VEBA where there is unrelated business income, do you find that it's necessary to change the discount rate?

MR. LAUBENTHAL: I believe that you'll have to do that. For the discount rate, in terms of SFAS 106 actuarial assumptions, the after tax rate would be used.

MR. ROBERT J. DOLAN: I have a question for Mr. Monaghan. I'm interested in knowing what sort of medical inflation factors you see in plans that do not have the "2 X" limitations or some other limitation out there. What medical inflation factors are we using?

MR. MONAGHAN: Well, surprisingly low. We've been tracking experience on a number of fairly large plans, very credible Fortune 500 companies, for four and five and six years. Looking at it on an age-adjusted basis and a demographically adjusted basis, it's not unusual for us to see for these base plus major medical plans by and large a medical inflation rate of 10.5, 11, 12, 13 over a 5-6 year period of time. I know you all see in the literature average rates of increase of 16, 18, or 20. But at

least in the large plans where we've been able to track good data over a number of years, I haven't seen it for the starting inflation.

MR. BRUCE J. NICHOLSON: I have a question for Mr. Laubenthal. You referred in your last comments on the trust-owned life insurance primarily to VEBAs. Grantor trusts presumably can also use the trust-owned life insurance vehicle. Is there any advantage to using a grantor trust rather than a VEBA in terms of potentially borrowing money and re-lending it to an employer in a cash flow crunch situation?

MR. LAUBENTHAL: Borrowing money out of the fund and lending it to the employer?

MR. NICHOLSON: Yes. Assume that the employer has set up a grantor trust or VEBA and the trust has purchased life insurance contracts to get the advantages that you describe of not having current taxable unrelated income. If we then posit that the employer has a cash-flow crunch situation himself, in a grantor trust is there any potential opportunity not in a VEBA for the trust itself to borrow money from the life insurance policies and then lend or otherwise assist the employer's cash-flow situation, consistent obviously with protection of beneficiaries?

MR. LAUBENTHAL: Well, there are going to be two major problems with that. First, let me make sure that the comment is understood that I used the word grantor trust. That word does not signify that the trust is a revocable trust, only that the relationship is a custodial relationship. This is an irrevocable trust. There are two problems. One problem is under Title One of ERISA in that I view a prohibited transaction involved with borrowing and extension of credit between a party-in-interest to the plan and the plan itself. You know there are penalties associated with doing that which can range from 5-100%. But the real problem here is that it's a welfare benefit fund. I believe the Code section is 4976. Under that Code Section to the extent that you access any monies out of that welfare benefit fund after they have been deposited there, the employer is going to be subject to 100% income excise tax plus a 34% income tax and then the 100% prohibited transaction excise tax. It looks like you could be paying about 234 cents on the dollar for trying to get at this money. These are irrevocable trusts. Once the money goes in you could pretty much say it's going to stay there.

Now the answer perhaps to your question would be to make sure that the trust document, whether it's the VEBA or the nonexempt grantor trust, allows the employer to pay out benefits other than postretirement medical benefits (to pay perhaps current active medical benefits or severance or disability benefits). These are benefits that are allowed to be funded under these types of welfare benefit funds. You can therefore gain advantage by going after the cash within the trust to offset these other current liabilities. My perspective is that's the best that could be done. I think that was a no in response to you question. I guess one more point needs to be reflected here. To the extent that you reserve the right to use the cash for these other purposes, you've just eliminated the ability of this asset or this fund to be viewed as a SFAS 106 asset available to offset the SFAS 106 liability.

MR. NICHOLSON: The answer was, I think, clearly a no. The more specific part of the question to which I think I also got this answer was, other than the different tax

on unrelated business income that you referred to, are there any other material advantages to what you would call a grantor trust rather than a VEBA?

MR. LAUBENTHAL: No, there are not. In fact the Code Section that allows for contributions to welfare benefit funds for postretirement medical benefits requires that the fund follow the nondiscrimination requirements outlined in Section 505 of the Code relative to VEBAs. You still have to comply with those nondiscrimination requirements as you would with the VEBA. So there really isn't any other advantage other than the tax arbitrage that I was talking about.

MR. HOWARD YOUNG: I have a question for Sean Monaghan. I understood you to say that in the sample employee illustration you used you were assuming that the medical care inflation would equal the discount rate which was 8%. My question is if everything happened according to the assumptions as I understand your illustration, the next year the overall net cost would be 8% higher. Is that correct?

MR. MONAGHAN: Yes.

MR. LANCE MALKIND: What is the timetable for implementation of SFAS 106? What is the outlook for any further changes in that?

MS. O'BRIEN: Let me tackle that question by saying that SFAS 106 was published by the FASB in December 1990. It requires that GAAP financial statement companies adopt a SFAS 106 treatment no later than the first fiscal year subsequent to December 15, 1992, except in certain instances. Those exceptions have to do with basically nonpublic companies that have fewer than 500 employees who are expected to receive benefits under the postretirement plans of that employer. So, for the most part, major U.S. corporations will be adopting in 1993, but the FASB also has encouraged companies to adopt sooner if they choose to do so. We've seen a fair amount of activity in that area, most notably IBM and GE. But it would not be a big surprise if we hear toward the end of the year of other companies that adopt sooner than the latest permissible adoption date.

MR. LAUBENTHAL: In that respect, companies that have had a lot of publicity as of late relative to layoffs and other restructurings and have had a fairly poor year on record right now are indicating that we might as well get the transition liability under SFAS 106 behind us. The second part of that question though was whether any changes were viewed to be likely under SFAS 106. I think perhaps that question was generated from the experience that people have had relative to SFAS 96. From our analysis and perspective, we view that it is highly unlikely that anything will impede SFAS 106 from becoming fully operable in 1993 or 1995 if you've got a small company. So I don't believe that we're going to see anything holding it up.

FROM THE FLOOR: There's a little glimmer of hope on that though. I don't realistically think anything is going to come of it, but I thought it was rather interesting that FASB itself provides retiree medical coverage to its own employees and SFAS 106, if applied today, would basically put them in the tank.

FROM THE FLOOR: I was wondering if I could get a comment from Mr. Laubenthal on the tax implications for not-for-profit employers if they were to set up a VEBA.

Regarding the investment earnings on those VEBAs, how would the tax implications for them work out?

MR. LAUBENTHAL: The VEBA is still going to be taxed under the unrelated business taxable income (UBTI) rules. Just because the employer is a tax-exempt organization, the VEBA itself is still a tax-exempt entity even in itself and those rules associated with related business income are going to apply to that organization just like it would to the tax-exempt organization itself, the hospital for example.

FROM THE FLOOR: I thought there were specific exemptions that if substantially all the contributions come from companies that were not for profit in the five preceding years, then their VEBA is exempted from UBTI rules.

MR. LAUBENTHAL: Yes, but is it five years or is it more than that?

FROM THE FLOOR: I think it's five. The rule of thumb is 90% usually.

MR. LAUBENTHAL: I guess then the tax-exempt entity would avoid the UBTI tax there. The other thing is to the extent that doesn't occur (and you're going to find that to be the case in many hospitals that have for-profit subsidiaries and for-profit liabilities), a combination funding approach might make sense to have the VEBA be used for those entities that could comply with that rule and to have the nonexempt grantor trust be used by those entities within the control group that couldn't comply with that rule.

FROM THE FLOOR: If they're not for profit, what's the advantage of the 501(c)9 trust since they don't care about the deductions anyhow?

MR. LAUBENTHAL: That's right.

FROM THE FLOOR: Essentially they want to set up a funding mechanism for these liabilities.

FROM THE FLOOR: Couldn't you do that right on your balance sheet? It seems to me in your company's situation that you wouldn't need to go to the trouble.

MR. LAUBENTHAL: You could use a grantor trust. One advantage of using a trust is to get it at arms length. You want to get these assets at arms length from the corporation so if anything ever occurred, at least these funds are guaranteed for the corporation and a creditor can't get at them.

MR. WILLIAM CARROLL: Dan mentioned statutory accounting for these things. I work in that area in government relations, and I have responsibility for the financial accounting and statutory areas. First Dan mentioned lack of statutory accounting principles for these benefits. That's absolutely correct. Second he mentioned that he speculates that will change and that's correct.

Work is in progress, and I'd like to tell you about it. Dan referred to the fact that there are audit requirements that statutory audits based on statutory financial statements be prepared. That's correct. There are 14-20 states that currently have

requirements in their laws or regulations, but an important event occurred last December. The NAIC adopted as part of its instructions for the annual statement a requirement that the audited financial statement based on statutory accounting be incorporated into the annual statement. That has the impact of requiring for December 31, this year's statements, that all statutory statements be audited essentially.

These current statements typically say that the statement is fairly presented according to principles or practices permitted by the domiciled state. Underline the word permitted. The NAIC regulators would like to change this. They would like it to say that the statements have been done in accordance with NAIC rules. Then the auditing community or the accounting community came back and said there are no NAIC principles and practices. It's true the NAIC has an accounting manual, and that this accounting manual is indirectly looped into state law. But it's too general. It provides for multiple practices in many areas, and in these areas, including the one we're talking about, it provides no advice. So the NAIC has undertaken a project to revise its accounting manual to make it more specific to the goal of the state financial examiners which is, wherever possible, to provide for only one preferred statutory accounting treatment and to bring in those items not included which include these benefits. Work has already begun. It's going to take two years at least. This postretirement benefit other than pensions is on the list of things to be treated. The NAIC Emerging Issues Task Force has also placed this on their agenda. It is possible that they might try to jump the gun on the accounting manual and come up with a faster solution.

MR. WONG: I don't quite get the importance of trying to qualify some sort of fund as plan assets under SFAS 106. Anything that is considered not a plan asset will simply be considered as an asset of the company and you'll get the same effect one way or the other. Under SFAS 106 there is no minimum balance sheet liability, not like SFAS 87. So there's not a clear advantage of building up plan assets which avoid that minimum liability. Can you comment on that?

MS. O'BRIEN: Let me see if I can take care of that one. The question was what advantage is there to having an asset qualify as a SFAS 106 asset when it could qualify as any other company asset and have the same net impact on the company's financial statement? That is a correct observation. There is no financial benefit as a result of having that asset qualify as a SFAS 106 asset except that to the extent that you can potentially lower your annual accruals by having a transition obligation that would be lower than it ordinarily might be. Hence, you have lower amortization charges in the future and lower net interest charges. The difference between interest charges and interest credits obviously flow through as an annual cost to the plan.

But the other side of the coin is that to the extent that your corporate assets are diminished by that amount, then your corporate earnings are diminished by the same amount. And really in effect it becomes more of a window dressing matter than a matter of financial substance to the company. Does anyone disagree with those comments, by the way?

MR. LAUBENTHAL: I think you're right. In the final analysis it's more appearance. You accurately reflected the two sides of it from a corporate earnings perspective to an adjustment of the SFAS 106 amortization in current cost.