

## Options for Managing the Cost and Risk Associated with Retiree Health Coverage, Including Remarks on the Current Interest in VEBAs

Voluntary Employees' Beneficiary Associations (VEBAs), which have existed for years, are suddenly in the media spotlight in the wake of recent agreements between General Motors, Chrysler and Ford Motor Company and the UAW to establish and manage a VEBA to fund retiree health care. Those actions are intended to eliminate the companies' substantial retiree health liabilities that must be reported under Financial Accounting Standard No. 106 (FAS 106). Employers that are interested in adopting that strategy should note its limited applicability. The [text box on the next page](#), which summarizes the news from the automobile industry, describes what a VEBA is, and explains why not all employers will be good candidates for VEBAs. This *Spotlight* presents an overview of strategies for addressing retiree health liabilities, including advantages and disadvantages. It also briefly notes factors employers should consider before selecting a strategy.

### WHAT ARE THE AVAILABLE ALTERNATIVES TO VEBAS?

Changing retiree plan design — such as increasing retiree contribution requirements, deductibles, copayments, coinsurance and/or out-of-pocket maximums, more restrictive eligibility requirements (e.g., requiring more years of service), and revised coordination of benefits with Medicare — has been the traditional method employers have used to control costs. There are, however, other options for addressing the cost and risk associated with offering retiree health coverage, including two proven approaches and an emerging strategy, all of which are described below:

- **Coverage Caps** Coverage caps are generally defined as the maximum amount an employer will pay toward the cost of coverage (e.g., \$7,000/year for retirees under age 65 and \$2,000/year for Medicare-eligible retirees). When the cost of coverage exceeds the coverage cap, individual retiree contributions increase to make up the difference. The main financial advantage of coverage caps is that they eliminate medical trend from the FAS 106 liability, at least with respect to the point in time that the cap is reached. (In the early 1990s, when FAS 106 reporting began, many employers adopted coverage caps in an attempt to control the liability and expense.) The disadvantage of coverage caps is that retirees will experience substantial cost sharing, which can make the caps difficult to sustain over time.
- **Defined-Dollar Design** Under this defined contribution (DC) approach, an employee receives a specific dollar amount to apply towards the cost of retiree medical benefits upon retirement — and do so on a tax-free basis, provided certain administrative rules are followed. In some designs, the amount is defined as an annuity (e.g., the employee receives \$100/year for each year of service). In other designs, employees are “credited” a lump sum (e.g., \$1,000 for each year of service) that they draw down over their lifetimes to pay for benefits. As with the coverage-cap approach, the DC approach eliminates medical trend from the FAS 106 liability. The structure is easily tailored to encourage specific retirement behavior and makes clear to employees the value of the coverage. Depending on the design, retirees may face substantial out-of-pocket outlays as medical costs rise because the defined-dollar amount will not.
- **Medicare Advantage (MA) Plans** The Medicare Modernization Act's expansion of private Medicare options gives most Medicare-eligible retirees a fairly broad array of coverage options, all of which can be offered by an employer on a group basis.

Medicare Advantage (MA) plans provide medical coverage for a monthly premium through health maintenance organizations, preferred provider organizations or other entities, and may include prescription drugs. Also available are Medicare Part D Prescription Drug Plans (PDPs) that, when combined with traditional fee-for-service Medicare and perhaps even an individual Medigap plan, provide comprehensive coverage. While many of these MA plans provide rich benefits and are priced attractively today, there is considerable variation in what is offered throughout the country and some uncertainty as to whether these plans will be as attractive in years to come. Nevertheless, for an employer with substantial numbers of Medicare-eligible retirees in certain geographic markets, MA plans will likely be cost effective in the short term.

**WHAT STRATEGY  
MAKES THE MOST  
SENSE FOR MY  
ORGANIZATION?**

Employers considering retiree health obligations can review a wide range of options in addition to and including implementing a VEBA. The right answer depends on what the organization's staffing and reward objectives are and will likely involve a combination of these different strategies. Many employers may be able to achieve cost savings through the emerging government-financed MA market by adopting one or more MA options. Careful selection and implementation of a MA plan can minimize or even eliminate disruption in medical services to retirees. Some may wish to combine a DC approach with a VEBA that allows employee pre-funding to help offset the impact of future medical cost increases. Others may want to maintain a more traditional design but introduce cost sharing that encourages employees to stay in the workforce longer. Those employers with retiree obligations that are collectively bargained, or employers that are in bankruptcy, may wish to consider exploring options presented with a VEBA.



*To discuss strategies for addressing retiree health liabilities, contact your Sibson consultant, Noel Boyland (212.251.5372 or [nboyland@sibson.com](mailto:nboyland@sibson.com)) or the nearest Sibson office.*

**VEBAS: THE NEWS IN BRIEF AND THEIR LIMITED APPLICABILITY**

In October and November, members of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) ratified three landmark contracts with General Motors, Chrysler and Ford Motor Company, which will result in the establishment of a trust to protect retiree medical benefits at current benefits levels.

The trust, a VEBA, is not administered by the union, as widely reported, but by an independent board of trustees. It is unclear whether there will be a trust for each company's retirees, or whether the trust will be a multiemployer fund. These details will be worked out in the coming months.

A VEBA, a trust fund vehicle governed by Section 501(c)(9) of the Internal Revenue Code, permits an employer to set aside funds for specific purposes only (e.g., life, sickness, accident or other benefits) for its participants. VEBA contributions can include employer contributions, active employee contributions (after-tax), and other assets. Retiree health benefits paid from the VEBA are tax-free. Liabilities under FAS 106 can be offset through use of a VEBA.

While creating and funding a VEBA in exchange for the "liability" associated with providing coverage can manage the financial risk associated with such promises, such an approach only has application in limited situations, as described below:

- > As a result of collective bargaining, where there is a large retiree health obligation and both current and future retirees, and
- > As part of a bankruptcy settlement.

(To return to the discussion of alternatives to VEBAs, click [here](#).)

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