Evaluating options to finance retiree medical commitments

Employers continue to look for ways to address the rising cost of health care while honoring their promises to retirees. Fortunately, the marketplace and the solutions to address retiree medical are evolving, and employers have new and compelling options to manage and fulfill these commitments.

The additional combination of longevity risk, low interest rates, tax changes and overall upward health care cost trend also make employers increasingly concerned about the long-term manageability and financial sustainability of these benefits to their organizations.

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But how far are employers willing to go to solve this problem? Few feel comfortable pursuing a full termination of these plans, particularly for current retirees and those employees close to retirement.

Opportunities to change the nature of retiree medical

Private Medicare exchanges have been available for almost 10 years and can often offer retirees greater value at a lower cost. Compared with traditional retiree medical plans for those who are Medicare-eligible, the individual Medicare marketplace offers greater flexibility for retirees to select the health coverage that best meets their needs, from the lowest-cost carrier in their region, and at a cost less than the current employer-provided plan.

Covering over 40 million retirees, the individual Medicare marketplace has the advantages of large risk pools, carrier competition and enhanced federal subsidies to offer retirees the best price for coverage and lower annual inflation trends.

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Annuity buyouts

A rapidly growing number of employers are already using annuity buyouts to deliver lifetime income for retired employees who had participated in defined benefit pension plans and, in the process, reduce the inherent risks and costs of managing pension plans. The success and acceptance of annuities in this role have given employers the impetus to extend annuity buyouts to retiree medical programs.

Similar to an annuity buyout for pension plan participants, an annuity buyout for retiree medical plans involves the purchase of an annuity for each participant in the program. A recently innovated customized annuity can be utilized to provide retirees with an annual tax-free amount that serves to reimburse those individuals for their postretirement health insurance premiums. These annuities allow employers to meet the benefit commitment they made to retirees while also providing retirees with security and peace of mind that their promised retiree medical benefit will continue, without change, during their retirement for the rest of their lives.

> With health care reform and tax reform as key legislative initiatives, employers have increased interest in alternative financing and annuity buyout strategies.

Employers currently receive a full tax deduction for the cost of each annuity when it is purchased. This accelerated tax deduction reduces the after-tax cost of the annuity purchase and may be more advantageous than other financing options, such as prefunding the benefit through a voluntary employee beneficiary association (VEBA) tax deduction.

From a financial perspective, the annuity purchase eliminates the long-term obligation attributable to retiree medical benefits from the organization's balance sheet. This reduces the potential balance sheet risk retiree medical costs represent to the sponsoring organization. Generally, it also lowers the ongoing cost of these obligations on the profit and loss statement.

> An annuity purchase eliminates the organization's long-term obligations with retiree medical benefits and reduces potential balance sheet risk.

One final benefit of an annuity purchase program is that employers will no longer have to administer these plans on behalf of the retirees who receive the annuity. This would not only eliminate the cost of this administration, including potentially managing a third-party administrator, but also eliminate the employer's responsibility for the plan under the Employee Retirement Income Security Act, including the reporting, disclosure and day-to-day oversight. With HR and benefit staff free from these responsibilities, they will be better able to focus on more strategic priorities and concerns.

Public and private health insurance exchanges

Annuity buyouts and other exit strategies would not be possible if retirees did not have ready access to individual health insurance coverage.

Medicare health insurance exchanges have been in operation for more than 10 years and have established a strong presence in that market. More than 40 million retirees currently utilize the individual markets to obtain supplemental health coverage. While the public exchanges for pre-Medicare health insurance established by state and federal governments under the Affordable Care Act have been operating for several years, they continue to experience volatility and uncertainty.

Annuity buyouts and other exit strategies would not be possible if retirees did not have ready access to individual health insurance coverage.

Even as these exchanges become more established, the marketplace continues to evolve. Medicare exchanges are expanding their offerings and improving communication and education tools for users. This gives retirees the benefit advocacy and support they need to make confident health care decisions.

The result is that the robust individual Medicare plans and exchanges provide a natural marketplace for retiree medical coverage, facilitating a move to a defined contribution approach for financing that coverage. However, a move to a defined contribution approach to retiree medical coverage alone does not eliminate employers' administrative responsibilities or the financial requirements related to this coverage. That is why a natural next step is to combine a defined contribution approach with the securitization of these benefits through the customized annuity buyout described above.

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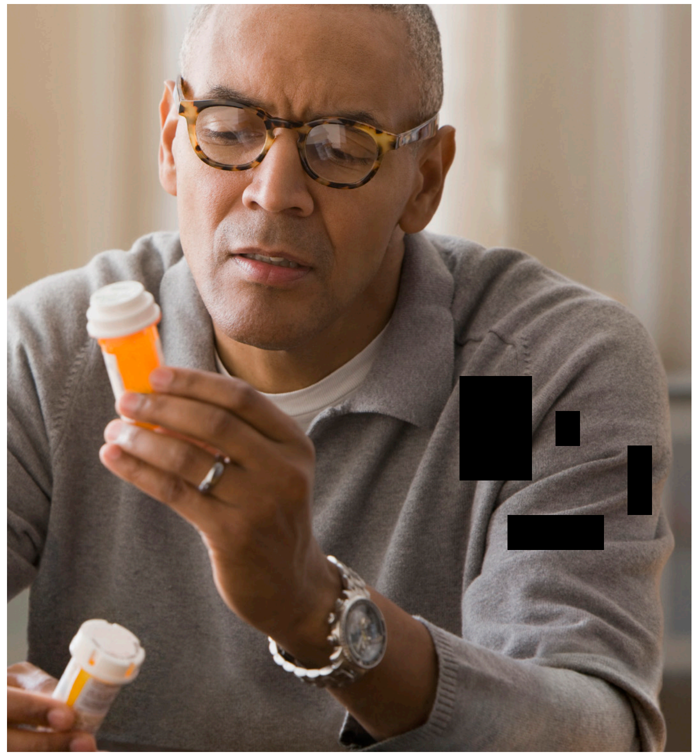
The future path is unique for each organization but requires engagement from HR and finance, and a focused communication strategy

Choosing the right approach to managing retiree medical commitments depends on an organization's specific goals and circumstances. This can include the employer's financial capacity, long-term strategy, and potential impact any financing change will have on current and future retirees as well as the company's own financial situation.

These changes do not have to happen all at once. Employers can take a multiyear approach to solving this problem. This evolution-rather-than-revolution approach can help to make any transition easier on beneficiaries.



No matter the path of change elected by employers, they should commit to strong communication and planning to ensure that retirees are comfortable with the changes. This task has become much easier in recent years as many of the terms and tools involved, such as health insurance exchanges, are becoming much more familiar to current and future retirees.

Employers can take a multiyear approach to solving this problem, which can help to make transitions easier on beneficiaries.

Finally, solving the retiree medical coverage question requires input from both HR and finance. In fact, the situation is a perfect opportunity for HR and finance to team up to solve a lingering problem in a way that allows the organization to meet long-held commitments to both its retirees and its stakeholders.

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WTW-NA-2018-17581

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