Health care expenses in retirement are the proverbial elephant in the room. Most employees don’t know how big the elephant is. As Medicare solvency and retiree health care issues receive increasing attention, it is time to rethink overall benefit approaches and assess what is appropriate and affordable for an organization to help achieve workforce renewal goals and solve delayed retirement challenges. Just as Medicare was never designed to cover all of the post-65 retiree health care costs, neither is a workplace retirement plan designed to cover 100% of preretiree income. Now employers can consider strategies that may better equip retirees to meet both income needs and health care expenses in the most tax-efficient way. By combining defined contribution retirement and health care plans, employers have the power to increase benefits for employees while maintaining total benefits cost.

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Health Care Benefits in Retirement: Why They Matter

In a well-balanced, meaningful benefits program, organizational commitment to provide retirement security for employees has long been accepted as the norm. Employees expect support for accumulating retirement plan assets in their active working years to help fortify income security in retirement.

But what about health care security in retirement? During active service, employees expect to have access to and employer support for health insurance. Many take it for granted that health insurance will continue in retirement and that employer support for the cost of insurance will continue right through their retirement years. Traditional defined benefit retiree health plans, which provide access to health insurance, with or without a premium subsidy from the employer, did just that.

Consider this: When employees start thinking about retirement, it is often the first time they actually learn about the retiree health care policies of their employers and the hard facts about Medicare (how it works, what it does and doesn’t cover) and other supplemental coverage and health care needs. Among other factors, if an individual finds out that he or she will no longer have access to employer-sponsored health insurance or any support for such coverage, retirement may be delayed.
The impact of delayed retirement is hard to ignore for employers seeking to manage workforce demographics and control high end-of-career compensation costs and related benefits.

Supplemental health insurance coverage has always been needed to protect retirees from catastrophic expenses. Likewise, Medicare cost sharing is likely to increase over time, as policymakers interested in cutting the federal budget deficit and managing health care costs will zero in on Medicare and other entitlement programs. There are many potential ways of reforming Medicare in the future, including raising the eligibility age, cutting benefits, increasing cost sharing, raising payroll taxes and reducing payment to providers. For average retirees, this means the responsibility for health care security likely will increasingly fall on their shoulders. Changes to Medicare costs and benefits as well as the cost of supplemental coverage will be more critical than ever to factor into overall retirement planning.

**Key Milestones:**

**Accounting Standards**

Changes in accounting standards have triggered changes in retiree health benefits. Fewer employers offer retiree health benefits and, when they do, retirees pay more. Employees shoulder more of the burden through spending caps, access-only plans or more stringent eligibility rules, such as age and service requirements.

**What Do FAS 106 and GASB 43 and 45 Mean to You?**

Under Financial Accounting Standards (FAS) Statement 106, employers are required to replace pay-as-you-go accounting with accrual accounting. This means the balance sheet must show the expected cost of providing retiree health and group benefits for all employees and retirees who are or may become eligible to receive these benefits in the future.

Under Government Accounting Standards Board (GASB) Statements 43 and 45, in addition to reporting annual account expenses, public sector employers are required to report long-term future liabilities for other postemployment benefits (OPEBs), including retiree health care. Employers that have to report long-term future liabilities also must provide a plan for funding these liabilities over the long term. Moreover, although it is not mandated, GASB also encourages prefunding OPEB liabilities. New guidance for public employers makes reporting unfunded liabilities even more transparent.

**Key Milestones: Affordable Care Act**

The implications of the Affordable Care Act (ACA) are particularly important for employers that provide health care coverage to both employees and retirees. In certain cases, the law may spur greater changes in the workforce as early retirees gain access to individual health insurance coverage.

ACA requires U.S. citizens and legal residents to carry health insurance or pay a tax penalty. The law also creates a new means by which individuals can purchase health insurance—through state- or federally run health care insurance marketplaces—and some individuals may qualify for significant subsidies for this coverage based on their income. Finally, it removes the risk that an individual would be denied health insurance coverage because of a preexisting condition and significantly limits age-rated pricing for older Americans.

Employers have begun migrating away from a traditional defined benefit retiree health care plan to a new model in which the employer sets aside funds for employees, who then purchase a health insurance plan that meets their needs. Some employers have begun setting up retiree health reimbursement arrangements (HRAs) and offering retirees aged 65 and over access to Medicare supplement or Medicare Advantage plans through a private exchange.

These plans allow an employer to predict its annual expense for retirees.
Even so, these arrangements still create accounting liabilities that must be reflected on an employer’s balance sheet. This can pose long-term financial problems for those choosing this alternative.

Some employers have gone even further by offering to set aside funds in a trust during the working career of the employee. The employee maintains a retirement health account during the working years; in retirement, the account may be used to pay for health insurance or other out-of-pocket medical expenses. Employers typically stop making contributions once an employee retires, so there is no accrued liability on the employer’s balance sheet.

**Helping Employees Become Retirement Ready**

Saving for retirement isn’t as simple as stashing away money in a 401(k) plan. For many employees, saving for retirement is the easy part. More complicated is “planning for” retirement. In particular, planning for health care expenses in retirement can be one of the more complex challenges, and it’s why many employees and employers are not sure where to begin.

According to the Employee Benefit Research Institute, employer-provided (and -subsidized) retiree medical benefits have been on the decline since the mid-1990s. While there are several factors behind this trend, the rising cost of health care, accounting law changes and the early wave of baby boomers entering retirement have created a “perfect storm” forcing many plan sponsors to reconsider how and if their retiree medical plans are achieving their intended purpose. The employer exodus of subsidized retiree health plans means that employees will have to assume more cost-sharing and purchasing responsibility.

From a planning perspective, income security + health care security = retirement readiness. The concept of retirement readiness has become more important, especially since defined contribution retirement plans have effectively replaced traditional pension plans. Workers accumulating retirement savings in a defined contribution plan must now manage how their assets will be drawn down in retirement. Failing to properly account for routine health care expenses and custodial care in retirement can leave an enormous gap in any financial plan. Routine health care costs such as Medicare Part B premiums, medigap insurance plan premiums, Medicare Part D premiums, copays, deductibles and other out-of-pocket expenses average between $4,500 and $9,000 per year.¹ Not included in these costs are custodial services, such as nursing home care and home health care services, which could cost as much as $70,000 or more per year.² Retirees trying to allocate their retirement savings income should consider how and if they can manage these expenses for the rest of their lives. Exacerbating the challenge is that medical inflation historically has outpaced regular inflation by two to one; therefore, proper drawdown planning must account for higher-than-average inflation when it comes to health care needs throughout retirement.

It’s also important to understand that out-of-pocket costs for routine health care services increase with income. Medicare Part B premiums are means-tested. In other words, the higher a person’s taxable income in retirement, the more he or she ends up paying for Medicare. Beginning in 2018, retirees with less than $133,500 in modified adjusted gross income (MAGI) will not see an increase in percent of Medicare Part B premium paid as a result of the Medicare sustainable growth rate provision known as doc fix. However, retirees with MAGI between $133,501 and $214,000 will see a 15% increase in the percent of Medicare Part B premium paid. The percent of Medicare Part B premiums paid for by retirees with MAGI from $133,501 to $160,000 will increase from 50% to 65% of the cost of coverage, while the percent of premium paid by those with MAGI of $160,001 or more will increase from 65% to 80%.³ This suggests that workers today need to employ more effective tax strategies and utilize vehicles such as Roth 401(k)s, Roth IRAs, health savings accounts or other tax-advantaged savings vehicles specifically designed to meet health care expenses in retirement. These options will help reduce taxable income in retirement, minimizing the impact of means testing related to Medicare premiums.

**Reevaluating Defined Benefit Retiree Health Care**

Facing an aging workforce, unfunded benefit obligations and complex accounting requirements, many plan sponsors are reevaluating their defined benefit retiree health care plans. The challenge is finding a solution that helps employees achieve health care security in retirement while strengthening
health care strategies

fiscal control over the total compensation budget.

**The Rise of the Defined Contribution Retiree Health Plan**

Defined contribution retiree health plans are becoming more popular because of the unsustainable nature of unfunded subsidized medical plans for both pre-65- and post-65-year-old retirees.

Traditional pay-as-you-go benefits and access-only plans generate significant expense for an employer. This expense will be exacerbated by the wave of baby boomers entering retirement over the next ten to 15 years. The combined impact of FAS 106 as well as GASB Statements 43 and 45 liabilities and boomers living longer can have significant consequences on an employer’s bottom line and, subsequently, the organization’s overall mission.

Employers are reviewing their total compensation packages and evaluating the overall cost of providing pensions as well as health benefits to retirees. It’s a valuable analysis to undertake.

Cost savings can be achieved when reviewing the entire benefits package and allocating resources efficiently. A defined contribution retiree health plan may be a great solution for the employer and provide retirees with the means necessary to realize financial security as well as health care security in retirement.

**Defined Contribution Retiree Health Plan Design**

A defined contribution retiree health plan is a unique type of health and welfare benefit plan. Traditional retiree health plans are defined benefit arrangements. A defined contribution approach is more akin to a 401(k) plan where an employer sets aside a specific dollar amount in a tax-advantaged account during employment. Upon retirement, the individual may use the retiree health account to pay for health insurance premiums, copays, deductibles and other out-of-pocket medical expenses on a tax-free basis. The employer no longer contributes pay-as-you-go premium subsidies, and it may even consider eliminating access-only plans now that individual health plans are guaranteed issue and less expensive as a result of ACA.

Employers realize significant savings by eliminating the FAS 106 as well as GASB Statements 43 and 45 liabilities, the pay-as-you-go premium subsidies and the morbidity risk of carrying an aging population on an active employee health plan. The savings from these changes alone will outweigh the cost of contributions to a new defined contribution retiree health plan. However, employers are also evaluating that their 401(k) retirement plans in the same context as they evaluate their retiree health plans. In some instances, employers are considering a reallocation of a percentage of the employer contributions from a 401(k) plan toward a completely tax-free retiree health account.

**Flexibility and Control**

A defined contribution retiree health plan can be designed to reward long-service employees and serve as a workforce management tool for recruiting, retaining and retiring employees in a timely fashion. Plan rules such as eligibility, contributions, vesting and entitlement to benefits are entirely up to the plan sponsor. The plan sponsor has the flexibility to:

- Define who is eligible and when contributions begin (or end), such as at the age of 40
- Determine what the contribution schedule will be (and if employees will be permitted to make after-tax contributions)
- Determine if contributions are subject to vesting; the employer specifies when a retiree is “entitled” to benefits.

**Benefits of a Defined Contribution Solution**

Institutions increasingly are shifting to a defined contribution approach to retiree health care in much the same way they implemented defined contribution retirement plans many years ago. Through a retirement plan, employers help employees address the issue of income security, which is one part of the retirement readiness equation. By adding a defined contribution retiree health care plan, employers can help employees address the second part—health care security—while managing the organization’s total compensation budget and addressing looming workforce management issues. Employees who feel more confident about their financial futures may retire at normal retirement age rather than delay retirement to maintain coverage under their employers’ group health plans. A gradual transition from a defined benefit to a defined contribution approach could reduce and potentially eliminate FAS and GASB liabilities.
Financial services firm TIAA-CREF has designed its retirement program to meet employees’ need for wealth accumulation along with providing the security of lifetime income in retirement.

TIAA-CREF provides a number of defined contribution plans intended to address both income security and health care security. Plan offerings include a:

- TIAA-CREF retirement plan
- TIAA-CREF 401(k) plan
- Retirement health savings plan
- Health savings account.

**TIAA-CREF Retirement Plan**

The TIAA-CREF retirement plan is a money purchase plan with graded company-paid contributions of 5% to 12.5% of base pay. The plan features automatic enrollment, default election into a lifecycle investment fund and the flexibility to choose from a wide array of fixed and variable annuities and index and actively managed mutual funds. Participants have access to a variety of tools, both online and directly with wealth advisors, to assist them in selecting investments appropriate for their age and risk tolerance. Significantly, payment options are in the form of an annuity (several annuity options are offered), which is designed to provide a steady stream of lifetime income to plan participants in retirement.

**TIAA-CREF 401(k) Plan**

The 401(k) plan features automatic enrollment and offers dollar-for-dollar company matching contributions on the first 3% of pay contributed to the plan. Default contributions start at 3% of pay. Investment default is into a lifecycle fund, and the investment lineup mirrors that in the TIAA-CREF retirement plan. The plan has an autoescalation feature that raises employee deferrals by 1% each year (to a maximum of 10%). Distribution options include both annuity and lump-sum choices.

At a savings rate of 3% (to maximize employer matching contributions), the core retirement program provides annual savings of 11.0% to 18.5% of pay during an employee’s career—amounts that promote a solid foundation for a secure retirement. The company also focuses on the health care security side of the retirement readiness equation.

In addition to the core retirement programs described above, TIAA-CREF also promotes saving specifically to provide funding for postemployment health care-related expenses.

**Retirement Health Savings Plan (RHSP)**

This plan was introduced in 2010 and offers employees the ability to save for future health care-related costs through a trust (a voluntary employees’ beneficiary association (VEBA)). Here is an overview of the features:

- Employees are eligible on their first day of work and have no restrictions on the amount they can contribute.
- Contributions are made on an after-tax basis but grow tax-free in an account that can be used to pay for eligible health care expenses (both premiums and cost of health care services) postemployment.
- TIAA-CREF pays a dollar-for-dollar match of employee contributions, up to $750 annually.
TIAA-CREF Case Study Continued

- Employee contributions and TIAA-CREF’s match are automatically invested in a TIAA-CREF lifecycle fund at a target retirement age closest to the employee’s 65th birthday.
- Employees can also choose to invest their RHSP account in one or more of the plan’s investment fund options.

While employee contributions cannot be made with pretax money (like a health savings account), there is no limit on the amount an employee can contribute to the plan each year. This permits participants to accumulate substantial assets in the plan, and more than 30% of eligible employees are participating in the program. At retirement (or separation from service with TIAA-CREF), a former employee “activates” his or her account in order to submit claims and be reimbursed for medical expenses. A third party handles administration of the program, which reimburses for any eligible health-related expenses.

Health Savings Account

TIAA-CREF offers employees an account-based health plan as one option for medical benefits. The plan is offered with access to a health savings account. Employees can contribute their own funds on a tax-advantaged basis, and TIAA-CREF “seeds” the accounts with an annual contribution of $500 to $1,000 (depending on whether an employee elects individual or family coverage in the health plan). The company communicates to employees that a health savings plan is not only a vehicle to fund for current, nonreimbursed medical expenses but also serves as a tax-efficient way to accumulate assets to pay for health care-related costs postemployment.

New Approach to Retiree Health Care

TIAA-CREF has long provided financial subsidies and access to corporate-sponsored health benefits for employees who retired from the firm and met certain age and service-level requirements. The plans were expensive, for the firm and retirees, and the relatively small population covered under the plan resulted in rate volatility and difficulty managing long-term trend. Because of accounting rules, these benefits created a large balance sheet liability and ever-upward expense numbers. In the short term, this added pressure to effectively manage costs by affecting the benefits offered to active employees. In the long term, these challenges made the viability of continuing to provide these benefits unsustainable.

After extensive analysis, TIAA-CREF decided to transition away from corporate sponsorship of the program and instead will provide retirees and their eligible dependents the ability to secure coverage through a private exchange. Through the exchange, retirees have access to several different plan options (Medicare Advantage, medigap and Medicare Part D plans) and can select a package of benefits that best fits their needs, based on their health status and lifestyle. The cost of insurance through the exchange is substantially lower than the corporate-sponsored program, and long-term trend rates for these individual insurance products have been low (in the 3-4% range annually) over the past decade. TIAA-CREF is offering continued financial support through a health reimbursement arrangement (HRA) it credits each year. Credits are based on age and service with the firm and have been set at an amount equal to the subsidy the company provided under its defined benefit, corporate-sponsored coverage approach.

Retirees can stretch the company subsidy to purchase insurance that is a better fit for them and use any excess funds in their HRA to reimburse the cost of Medicare Part B premiums, dental insurance, eyeglasses and other eligible health-related expenses. In addition, TIAA-CREF has experienced a substantial reduction in its other postemployment benefits (OPEB) liability and annual Financial Accounting Standards 106 expense.

TIAA-CREF also offers a robust wellness program in addition to its health and retirement benefits.

A healthy workforce is a more productive workforce. Absenteeism goes down, long-term health care cost trends are trimmed and employees take an active role in their health and financial well-being—the pillars of promoting retirement readiness.
Summary: Reevaluating the Benefits Package

While employers appear ready to exit the business of traditional subsidized retiree health care benefits, alternative strategies are emerging. Many employers are reviewing their entire retirement benefits package from a holistic perspective rather than arbitrarily eliminating retiree medical benefits. Plan sponsors can and should consider if their pension or 401(k) match contribution is effectively helping workers achieve retirement readiness. The savings brought on by the elimination of traditional defined benefit retiree health plans might be well-spent in the form of a defined contribution retiree health care plan. Retiree health care savings plans can provide a triple tax-free benefit for retirees. Employers that set aside funds in a specialized trust such as a voluntary employees’ beneficiary association (VEBA) for retirees will enhance their employees’ ability to retire. Employer contributions, investment gains and distributions for qualified medical expenses are all tax-free. These programs can be customized to meet any employer’s goals and objectives while at the same time providing employees with an extraordinary tax-advantaged savings vehicle. Even employers that no longer offer traditional retiree health benefits are considering how much employer funding they direct to a 401(k) plan and determining if a portion of that savings might be more beneficial to a defined contribution retiree health care plan.

Endnotes
2. See www.LongTermCare.gov.

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