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An Approach to Retiree Benefits Risk

The old joke is that if I had known I was going to live so long I would have taken better care of myself. That's the state of retirement health care and pensions today – if the government had known we were going to live so long it would have made different rules. When the Social Security Act was passed in 1935 the average life expectancy was about 62 years, so risking retirement benefits at 65 wasn't a bad bet. The only problem was not having an escalator clause that by now would have pushed retirement age to 75 or 80. We would have fewer golfers and more experienced employees.

Now, of course, the major risk management problem facing Corporate America is providing retirement benefits. Unfunded liabilities for pensions and retiree health care now number in the hundreds of *billions* of dollars.

For SIIA members this problem may serve as your advance homework before attending the national conference in Phoenix next October. The keynote speaker will be Roger Lowenstein, author of (take a deep breath before you read this) *While America Aged – How Pension Debts Ruined General Motors, Stopped the NYC Subway, Bankrupted San Diego, and Loom as the Next Financial Crisis.* A big subject apparently requires a long title.

I don't want to steal any of Roger's thunder, but I'll offer an approach to solving the retiree support crisis right now in one word: "captives."

Companies are already establishing captive insurance companies as the funding mechanism for retiree costs on a tax-deductible basis. While tax-deductibility doesn't occur for self-funded health plans until claims are paid, pretax money can be invested in a captive to hopefully grow in some reasonable approximation of future liabilities.

Self-insured organizations from the largest down to the middle market may now consider establishing captives to insure retirees' benefits even before addressing the funding of ERISA plans covering their current employees and dependents. Alert TPAs and other professional service providers may think of this combination as a strategic risk management package.

Establishing captives to cover employee benefits began slowly in the U.S. The Department of Labor, which has approval over ERISA plans, seemed suspicious of captives for a time but warmed up to the concept as more U.S. states became captive domiciles.

Now the DOL operates its fast-track application process known as EXPRO to provide exemptions from prohibited transactions in about three months. The catch is that applying companies must demonstrate that at least two similar companies must already have been approved.

Largely, the DOL relies on approval and oversight of the captive's licensing authority, the state captive insurance regulator. So a captive's funding arrangements must meet the requirements of both its state of domicile regulator and the DOL.

Methods of setting up benefits captives have grown more complex in recent years, stemming from their increasing reliance on employee contributions. With ever-spiraling health care costs, plans have migrated from being totally supported by employers to including a mix of employee contributions in various proportions.

There is a widespread perception among some consultants and employers that a Voluntary Employees' Beneficiary Association (VEBA) trust must be established as the vessel that holds both employer and employee contributions. This is not true but perception in many cases has become the reality. Not only does the method become far more complicated than necessary, it also penalizes employers drastically.

Once employer money is comingled with employee contributions and locked up in a VEBA trust it is gone for good, not available to the employer at any time in the future. Rather a captive may follow a strategy of identification and segregation: *Identify* whose money is being held in trust and *segregate* employee contributions from employer contributions for greater corporate flexibility in managing cash flow.

The important concept is that without tying up its money in a VEBA trust, the employer's money will accrue to the employer's benefit. I believe that some major benefits captives have cost their employer-owners millions of dollars in money that has been unnecessarily locked up within a VEBA trust and lost to their use. This would imply that many more companies would be setting up employee benefits captives if they realize they can still retain the use of their cash.

Setting up captives whose assets will accrue value through future years will help any organizations support its retiree benefits obligations, and also help solve a national problem.

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