



Other Post-Employment Benefit Liabilities

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Today's Material

- OPEBs: a brief history
- Current pressures
- GASB and FASB changes
- Reduce or eliminate OPEBs?
- Redesign opportunities
- Funding possibilities
- Policy shifts?
- Conclusion

OPEBs: A Brief History

- OPEBs (nonpension post-retirement benefits such as retiree medical, dental, long-term care and life insurance) took off during WWII
 - An exchange for forgoing wage increases
- Boosted significantly by the employer deduction for medical expenses and tax-free nature of medical benefits to employees or retirees
- Initially a low-cost item ($\frac{1}{2}$ of 1% of total compensation costs in 1950—while retirement was then 3% of total compensation costs)

OPEBs: A Brief History

- ERISA does not require funding or vesting of OPEBs or extend PBGC coverage
- Case law developments in 1980s clarified employer's right to reduce or eliminate OPEBs
 - Genesis of "reservation of rights" language in today's plan documents and SPDs
- FAS 106 required employers to account for OPEBs in early 1990s and many capped benefits

Current Pressures

- Healthcare costs jumped from ½ of 1% to 8% of total compensation costs by 2004 (barely exceeded by retirement at 9%)
- Assets of OPEBs of S&P 500 in 2004 were \$82.2b versus liabilities of \$379b, leading to an underfunded balance 95.1% higher than underfunded pensions among same companies
 - Only three S&P 500 companies have overfunded OPEBs

Current Pressures (cont'd)

- 2005 SEC study called for more transparency in OPEB accounting
 - Recommended reconsideration of FAS 106
- International accounting rules moving toward UK standards, which do not permit smoothing of prior service costs and gains or losses

GASB and FASB Changes

- Both groups governed by Financial Accounting Foundation
- GASB Statements 43 and 45 establish OPEB accounting, reporting, and disclosure standards starting NOW
 - Shift reporting from pay-as-you-go to full cost of earned OPEBs
 - Annual OPEB cost estimated to be from five to 20 times current annual pay-as-you-go

GASB and FASB Changes (cont'd)

- FASB will move current FAS 106 footnote disclosing funded status for OPEBs to balance sheet of financial statements
 - Issue Exposure Draft in late March with 60-day comment period
 - Final rule applicable for years ending after December 15, 2006/retrospectively applied
 - Expected to reduce shareholders' equity of Fortune 1000 by \$126 billion based on 2004 data
 - Largest impact on durable manufacturing industry
- Second phase of FASB study to examine smoothing mechanisms that mask gains and losses and obscure long-term liabilities
 - Expected to be highly controversial

Reduce or Eliminate OPEBs?

- Unlike retirement benefits, OPEBs are not subject to ERISA vesting or funding
- Collective bargaining or past statements may constrain some employers
 - Many employers have retained right to modify, reduce or eliminate OPEBs since 1980s (if not earlier)
 - Critical to examine all prior statements, communication material, exit interviews, etc. to determine risk associated with OPEB modification

Reduce or Eliminate OPEBs?

- Medicare Part D represents opportunity to eliminate prescription drug coverage for retirees age 65 or older
 - Total elimination of prescription drug coverage greatest cost saver for employers
- Resurgence of Medicare Advantage plans
- The dilemma: Good financial planning for employers may be terrible social policy

Redesign Opportunities

- Many opportunities to redesign OPEBs that are less crude than termination
 - Some may argue that “defined benefit” style OPEBs do not match a “defined contribution” workforce anyway and need to be modified to reflect changing employment patterns and employer workforce needs
- Key tool: variations of HRAs
 - Introduce asset-accumulation vehicle
 - May tie to HDHP
 - Caps ER liability at fixed amount/shifts medical inflation risk to retiree

Redesign Opportunities

- HSAs paired with HDHPs: the new kid on the block
 - Accomplish same “DC” shift
 - Permit employee funding of the accumulation
 - Address security issue of HRAs
- Old standbys:
 - 401(h)/420 transfer
 - VEBAAs
 - COLI

Funding Possibilities

- VEBAAs have always worked in union, government, tax-exempt environment
 - Requires special investments for for-profit world to defeat UBIT
 - TOLI
 - TOHI
 - Limits on deductible contributions
 - Recent cross-fertilization between VEBA and HRA to secure HRA promise (subject to typical VEBA problems)

Funding Possibilities

- HSAs represent dedicated assets, but will not count for FAS 106 purposes
- 401(k) plans with welfare side-funds finally seem DOA
- 401(h) requires ongoing employer DB contributions/420 transfer requires an overfunded DB plan (subject to possible relaxation in House/Senate Conference)

Policy Shifts?

- ERISA vesting/funding obligations?
- Tighter case law on reductions in or terminations of OPEBs?
- Enhanced Code rules (perhaps relaxation of VEBA funding and UBIT restrictions)?
- Reduction in tax advantage for employer-provided medical benefits?
- Increased access to HSAs?

Conclusion

- One or more of these policy shifts have to occur before employers can effectively prefund current levels of OPEBs
- Short-term forecast: heating up financial disclosures, a reduction in benefit levels, a movement towards “DC” OPEBs, and an expansion of HRA/HSA tools

Thanks for Attending!



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