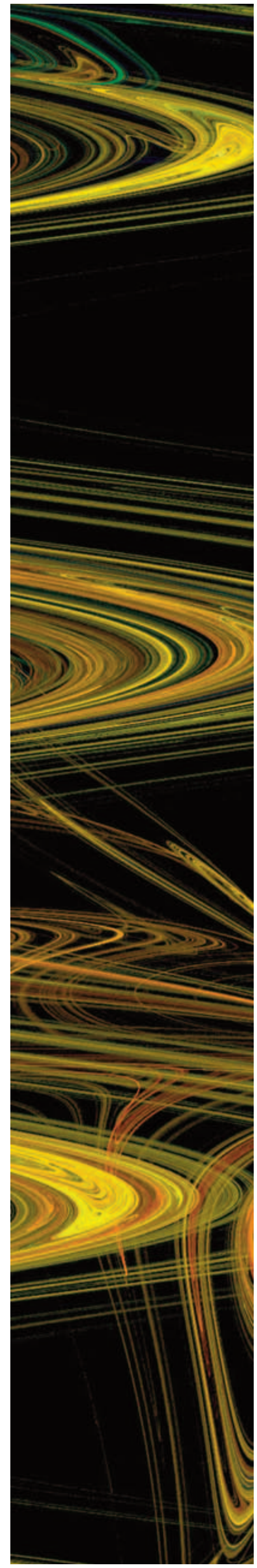
# EMPLOYEE BENEFITS

## ANYTHING IS POSSIBLE

**With few signs that the world economic situation will improve before 2010, many companies are struggling to find ways to lower the costs of their overall benefits programs while still serving the needs of their workforces. No easy task. When they look at the marketplace, employers may find their benefits providers have also been changed by the economic tumult. They will find, too, the legal and regulatory environment changed by the government's recent efforts to spark economic recovery. And if they look ahead, they will see the coming of a major push for broad health care reform by the new U.S. administration.**



### ECONOMIC CONDITIONS AND THEIR IMPACT ON THE WORKFORCE

Layoffs are a standard response by employers to bad economic conditions, as well as a standard measure by which economists determine how bad things really are. True to form, reductions in force (RIF) are up nearly 5%, year over year, although specific numbers in the U.S. vary by region and industry. One factor (of many) that distinguishes this economic storm is the number of cost-cutting measures and often novel alternatives broadly being considered in regard to costs of compensation and benefits. Employers are considering voluntary and compulsory furloughs, rolling furloughs, incentivized furloughs, extended leaves, days off without pay, reduced hours and more. (Congress has already responded to some of these employer actions by implementing a COBRA subsidy, discussed below.) Salary freezes at all compensation levels are also increasingly common.

As for benefits, a variety of cost-cutting schemes are in the mix as well. Employer initiatives include broad cutbacks of all employee benefits programs as well as adjustments in benefits funding. The full spectrum of benefits is potentially on the block – ranging from simple employee fringe benefits to the employer's core group medical, dental, vision and other health and welfare plans. This includes qualified retirement benefits, such as traditional pension plans (to the extent that there are still employers that offer such programs) and Section 401(k) and other defined contribution plans.

Some employers are beginning to apply surcharges in order to maintain spousal eligibility (even student eligibility), while others are eliminating eligibility altogether for dependents that have access to other group health coverage. A growing number of employers are replacing traditional benefit offerings with employee-pay-all voluntary benefit products. Voluntary benefit programs do more than help slash costs; the associated compliance duties are often significantly less burdensome. Although employers historically defer plan cost changes until open enrollment season, the current environment has forced many organizations to institute mid-year adjustments. Because of IRS restrictions on participant plan election adjustments, some plan changes could impose hardships on plan participants.

Retirement plans are often taking the most severe hits. Automatic enrollment and company matches have plateaued. Plan sponsor suspension of Section 401(k) contributions is increasingly common. Defined benefits plans are being frozen across the nation. Defined benefits programs have been especially hard hit because of severe legislative and regulatory actions that impose expensive funding duties. Congress's handling of problems in this area is often regarded as having worsened the situation, pushing many employers away from sponsorship of such programs.

Some employers are now taking a drastic step that many would have previously regarded as unthinkable: the total elimination of employee benefits programs. While certainly a draconian move, the appeal of eliminating huge compliance and financial burdens in one fell swoop is undeniable.

## INSURANCE CARRIERS

While mostly fortunate to avoid the damage faced by other organizations in the broad category of financial services provider, insurance carriers are certainly not immune to the economic turmoil. Global economic decline has depressed demand for insurance products, which, after years of soft market conditions, sets the stage for a highly challenging environment for the U.S. insurance industry in 2009.

Many employee benefits carriers have suffered. United Health Care, Humana, Aetna and others have endured record drops in stock price, which is now translating into lowered financial ratings. The likelihood of an imminent turnaround seems remote, as medical carriers are forecasting a drop in insured lives of 2% or more. Increasing costs and decreasing revenues are expected to lead to further industry consolidation and redistribution of assets. These factors will force insurance providers to adopt new skills and business discipline in order to survive the economic turmoil.

## INSURANCE/STOP LOSS

Insurance carriers are tightening up where they can. We anticipate more denials by insurers and stop-loss providers. Insurance plans are employing more care-management techniques, such as prior authorizations for specific services (magnetic resonance imaging, specialty pharmaceuticals and many surgical procedures). More claims for experimental care through alternative "cancer centers" and other alternative providers can be expected as the providers expand promotion of services, but most plans will exclude such coverage.

## CONSUMER-DIRECTED HEALTH PLANS

Employers are beginning to gravitate to consumer-based strategies, where employees take on more responsibility for costs, lifestyle choices and treatment decisions. Some employers have expressed high expectations for immediate financial relief, but the move to the consumer-directed approach will, in all likelihood, prove most effective over the long haul. The long-term advantages predicted for consumer-directed plans are also questioned by some who contend that carrier competition for covered lives under these plans has driven down costs too far, setting the stage for a market correction similar to that which took place in the years following the introduction of managed care.

## LEGISLATIVE LANDSCAPE

The insurance industry is also concerned about the shape of future health care reform initiatives. A recent *Wall Street Journal* article notes that by leaning toward acceptance of the idea of community rating, the industry is helping pave the way for a major industry shift. ("Insurers Offer to End Prices Tied to Illness," March 25, 2009.)

National and state legislators, meanwhile, are not waiting for the big promised overhaul. Many key employee benefits issues – expansion of health coverage, Medicare, using state resources to subsidize private sector health coverage – remain popular topics in Congress and in statehouses.

In February, Congress enacted a landmark economic stimulus package, which included a temporary COBRA subsidy provision that employers must address immediately, as its requirements went into effect for most plans on March 1, 2009. Under the new rules, group health plans must accept 35% of the required COBRA premium as full payment for the coverage for certain involuntarily terminated employees and their dependents. After receiving the 35% payment, the employer may recover the remainder of the COBRA premium through offsets to payroll tax deposits or direct payment from the government, but the employer must provide certain information in order to receive reimbursement. Also, in the case of certain employees involuntarily terminated on or after September 1, 2008, group health plans must allow a "second chance" COBRA election. The COBRA subsidy is temporary, but some believe that if the economic climate does not improve Congress may be tempted to extend it. Moreover, Congress may also seek to expand the subsidy by making employers pay some or all of the remaining 35%. (For additional information about the COBRA subsidy, please see *Willis HRH's Employee Benefits Alert*, Vol. 2, No. 4.)

A less discussed but equally important development was passage of the Children's Health Insurance Program Reauthorization Act of 2009 (CHIPRA). This law extends the State Children's Health Insurance Program (CHIP) established under the Social Security Act. CHIPRA is likely to draw attention once it goes into effect, as it gives states the authority to directly subsidize premiums for employer-provided group health coverage for eligible children and families. The law encourages states to provide premium assistance to low-income employees who want to change their single coverage to family coverage in order to include a CHIP- or Medicaid-eligible dependent.

The economic stimulus bill also heralded many significant changes to HIPAA privacy and security regulations. Health plans subject to those requirements will need to reevaluate their compliance duties. With these changes already underway, what else can employers sponsoring benefits plans anticipate?

# TAXATION OF HEALTH INSURANCE

One of the most controversial proposals on the legislative table relates to the possible taxation of health insurance benefits. Right now, the Obama administration is aggressively exploring ways to increase revenue without opening themselves up to attack as tax-and-spend liberals. A tax on health coverage could represent one of the largest tax hikes in U.S. history – without directly touching tax rates.

Federal income tax law addresses two aspects of a worker's health insurance plan: the premiums and the benefits. Although many variables impact the tax treatment, employer-paid premiums are excluded from income. Also, a worker can exclude from taxable income any health insurance premiums paid by the employer for covering the employee, employee's spouse and tax dependents.

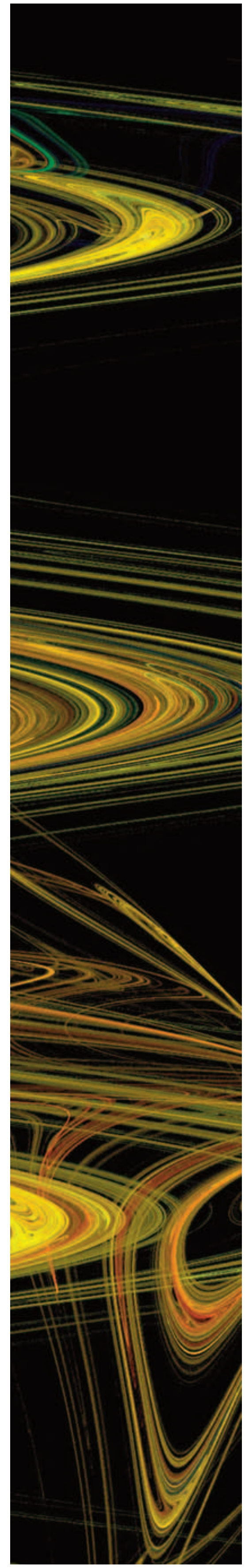
The Obama administration is signaling to Congress that, despite the president's stance during the campaign that the exclusion for employer-provided medical benefits was sacrosanct, he might now reverse himself and support taxing some employee health benefits to help pay for overhauling the health care system. Observers note that the proposal is virtually identical to the idea proposed by Senator John McCain during the presidential campaign a few months ago. At the time, the Obama campaign loudly denounced McCain's proposal as "the largest middle-class tax increase in history." ("Administration Is Open to Taxing Health Benefits," *The New York Times*, March 14, 2009. )

# MEDICARE SECONDARY PAYER

We anticipate that aggressive Medicare secondary payer (MSP) enforcement will be another way government can shift costs to employers. The Centers for Medicare and Medicaid (CMS) is using the IRS and collection agencies to bill employers for claims (plus interest and penalties) related to violations of the MSP rules. CMS is expected to increase funding for enforcement initiatives as those outlays are historically revenue positive. TRICARE (the Defense Department's health care program) has recently adopted rules that closely parallel MSP rules. Rigorous TRICARE enforcement is similarly anticipated.

# STATE ACTIVITY

As health care reform initiatives at the federal level stalled in the previous two administrations, a growing number of state legislatures began tackling problems with the health care system. State proposals include mandates on employers to provide Internal Revenue Code Section 125 programs (also referred to as cafeteria plans) for all workers. These plans allow employees to pay for their own insurance coverage on a pre-tax basis. Such a cafeteria plan mandate was a key component of the widely watched Massachusetts health care reform effort. We anticipate this trend to continue.



# MARKETPLACE PERSPECTIVES – MANAGED CARE TRENDS

*The following are highlights from a recent public conference call hosted by Matt Borsch of Goldman Sachs with Steve Lewis of Willis HRH. They offer an overview of managed care marketplace trends.*

**BORSCH:** We are particularly interested in contrasting the intensity of price and other competitive pressures that you are seeing now versus what you were seeing a year ago.

**LEWIS:** The key trend we've seen this year is a shift in carrier underwriting focus towards client retention and away from the aggressive new business underwriting...

**BORSCH:** Could you give us a sense of how the rate negotiation process proceeds and how it might have been different a year ago?

**LEWIS:** This year we've seen the incumbent carriers take a more aggressive approach to the initial underwriting quote, so that has been less of a factor in driving us out to the market as compared to prior years.

**BORSCH:** What do you observe in terms of an average level of renewal increase for 2009...?

**LEWIS:** All-in negotiated, those settled into a range of -10% to +22%. On average, I would say we were seeing price increases in the mid-teens on initial renewal action down to a negotiated level of high single digits by completion...

**BORSCH:** ...is the high single digits as the end point on average about the same a year ago?

**LEWIS:** That is about the same.

**BORSCH:** Has that [benefit buy-downs] increased in light of the twin pressures from the economy and continued health care affordability? (...“benefit buy-downs” refers to the increased co-pays and deductibles as well as sometimes reductions in benefit levels...)

**LEWIS:** We've actually seen the level of “benefit buy-downs” slow significantly this year relative to last year, which might come as a surprise when you think about the pressures of the current economic conditions. And our feedback has generally centered around the fact that employers have been cutting employee costs in so many other areas: pay cuts, salary freezes, lay-offs, elimination, or serious reduction in bonus levels, frozen 401K matches. In that light, employers are holding the line on making additional cuts into their employee benefit programs. That said, most January 1 decisions were made by mid-November and I think it still remains to be seen how the continued economic deteriorations since then will impact our upcoming spring and summer renewal cycles.

**BORSCH:** What about the employee premium contribution levels versus a year ago? Are employers also keeping those stable?

**LEWIS:** We've seen a shift towards trying to increase the family proportion of the employee contribution while trying to hold the line on the individual. But in general I'd say that – consistent with what we talked about on the benefit buy-downs – employers are looking to hold the line across the board...

## UNCERTAIN PROGNOSIS

Health care reform and coverage for the uninsured have been debated for years. Many observers have noted the similarities between the proposals set forth in the inaugural addresses of President Barrack Obama and his Democratic predecessor Bill Clinton on the topic of health reform. The speeches contain obvious parallels that lead one to wonder whether President Obama's plan will suffer a similar fate to Clinton's.

Underlying the debate is the question of money.  No universal health care solution is free. Given the federal government's recent commitment to infuse financial markets with cash, money to support health care reform may not be immediately available – except perhaps by way of a tax on employer-provided health care coverage.

Some health care experts are concerned that with all the attention centered on health coverage access, presidential candidates and legislators may miss another fundamental issue – the cost of health care itself. Although millions do not have health insurance, a majority of voters do, and numerous surveys reveal that voters with health insurance are most concerned about curbing skyrocketing medical costs.

Regardless of what the government does, employers must respond now to the economic conditions at hand. As daunting as they may be, the current challenges can be met and overcome with innovation and creativity, along with the help of skilled professional advisers. Many companies have already made difficult plan design changes. With changes under their belt, employers can focus attention on managing program operations so that, despite budgetary constraints, they remain well positioned to deliver benefits programs so highly valued by their employees.

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