BENEFITS & COMPENSATION INTERNATIONAL

TOTAL REMUNERATION AND PENSION INVESTMENT

Can the Retiree Health Benefits Situation in Canada be Saved?

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In 1984, the Canadian federal government introduced the Canada Health Act (CHA). While each Canadian province has constitutional authority over its healthcare system, the CHA effectively helped create equality among provincially-sponsored public healthcare plans by tying federal transfer payments to a list of conditions, such as universality, comprehensiveness and portability of coverage. This led the provinces to cover physician visits, all diagnostic tests and hospital procedures and services. In addition, while the CHA does not expressly focus on healthcare coverage for seniors (those over age 65), by the mid-1980s all provinces had established drug coverage programs specifically targeted to seniors.

In addition to public healthcare, the majority of Canadians enjoy private healthcare coverage. While employers are not required to provide healthcare coverage for employees, most organizations operating in the country choose to do so to attract and retain talent. Most employer-sponsored plans cover most, or all, supplementary healthcare costs, such as prescription drugs, vision, hearing, out-of-country coverage, dental and paramedical costs, that are not paid for by the provinces. This coverage is generally extended to employees' immediate family members – and coverage, in many cases, extends into retirement years. Up until recently, plan sponsors expected the cost burden of these retiree healthcare benefits to be relatively modest, and reasoned that this was an appropriate benefit to provide for employees who had given significant years of service to the company.

With this coverage safety net having been in place for more than a generation, Canadians have come to expect that their healthcare expenses will be reimbursed at levels close to 100% by governments and/or employer plans. However, the country's healthcare resources have been strained in recent years by a number of factors – including slow economic growth, escalating healthcare costs and the associated liabilities, an aging workforce, a growing number of retirees and increasing life expectancy.

Faced with the realization that these trends aren't likely to ease any time soon, governments and employers across Canada are looking for ways to control their share of retiree healthcare costs. One needs only to look to Ontario – Canada's most populous province – for a significant recent example of how the winds of change are blowing. In February 2014, the government of Ontario announced that public-sector employees who retire on or after January 1, 2017 will pay 50% of the cost of their premiums in a cost-sharing arrangement. Currently, the government pays 100% of retiree benefits for its public-sector employees.

In the private sector, many plan changes have been made over the past decade to reduce or end retiree coverage. This shift has serious implications for the future of retiree benefits. Canadians, long conditioned to pay little attention to the cost of their healthcare consumption, are ill-prepared for a world in which more of these costs may need to come out of their own retirement incomes.

If Canada hopes to avoid pushing its retirees into financial crisis, now is the time to explore how retiree healthcare coverage can be saved.

THE CURRENT SITUATION

According to a recent study by the Conference Board of Canada, a non-profit think tank, almost all Canadians employed full-time by mid-sized to large organizations have benefit coverage funded by their employer.[1] With roughly 70% of Canadians' healthcare spending covered by government-sponsored programs, the financial safety net that the supplementary employer-sponsored programs offer is invaluable to those having to juggle escalating housing, childcare, transportation and other living costs, not to mention needing to save for emergencies and retirement.

The same study indicates that the number of retired Canadians with healthcare coverage sponsored by their employer is significantly lower than for Canadians who are working, at just over 50%. Of employers that sponsor retiree plans, half indicated they have closed their plans to new retirees.

Given rising costs and shifting demographics, it is little surprise this is happening. Our analysis of plan sponsors' data on paid claims and out-of-pocket expenses shows that supplementary healthcare claims average from

C$1,000* to C$1,500 per person, per year for working-age employees. These costs jump to between C$2,000 and C$3,000 for seniors – including not only a broad spectrum of services like private duty nursing, but also long term care facilities – and much higher for those living with chronic conditions and severe illness.

Assuming that the average senior's annual supplementary healthcare costs total C$3,000, and that these costs increase by an average trend rate of 7% annually, the present value of future supplementary healthcare costs after age 60 for someone who is age 40 today is around C$200,000. Let's assume that, by the time our 40-year-old is set to retire, governments have shifted just 10% of their program costs on to the individual over 20 years. This additional shift would increase the present value of this person's retiree healthcare costs to more than C$300,000. This means that the individual would need to have an additional C$300,000 set aside to fund these costs if his or her employer has eliminated retiree benefits coverage.

As significant as these numbers are today, evidence suggests they'll grow exponentially in the coming decades. With newer medicines and technologies emerging and people living longer, supplementary healthcare costs in retirement are moving well past the modest amount plan sponsors once believed they would reach. Today, Canadians aged 65 and over make up 14% of the population and consume 45% of total public healthcare dollars. Projections indicate that the over 65 demographic will account for 18.5% of the population within 10 years, and up to 25% by 2041[2]. If seniors' consumption of healthcare services grows at the same rate, this will mean Canadians over age 65 will consume about 80% of total healthcare costs by 2041.

Given the significant accounting liabilities that retiree benefit plan costs place on an organization's bottom line, the number of employer-sponsored retiree plans is likely to continue dropping. As governments look for opportunities to manage their coverage costs, they'll need to be cognizant of the social risk of passing a significant financial burden on to retirees with no private coverage. If uncovered healthcare costs push retirees to bankruptcy, governments – and other taxpayers – will still end up paying.

It's not unreasonable to assume that Canadians, not trained to think about these costs, or advised to plan for them, will fight back if forced into survival mode where their retirement is concerned.

WHAT CAN GOVERNMENTS DO?

Governments, which fund the majority of healthcare costs for Canadians of all ages, are facing the same cost pressures as private-sector plan sponsors. Consequently, elected leaders across Canada are focused on finding ways to reduce their cost burden, lower the percentage of total healthcare spending they fund, or both. The easiest solutions – increase taxes or cut services – are the least palatable from a political standpoint, since both force Canadians to pay more.

Instead, the provinces have been working – individually and together – to find creative ways to maintain coverage while lowering costs. Over the past decade, all governments have put in place price caps on generic drugs, reducing prices from an average of 70% of the branded equivalent to as low as 18%. Approximately 16% of Canadians' total healthcare spending is comprised of drug costs administered outside of hospitals[3] – the potential savings of these caps to government plans is significant. Canadian generic pricing is still high relative to other countries, so there may be further opportunities for savings.

Canada's provincial premiers have also been working together, forming the Health Care Innovation Working Group in 2012 to find ways to save on healthcare spending. The group's first significant win came in early 2013, when it reached a bulk purchasing deal for six commonly used generic drugs.

There are other ways Canada's governments could supplement this work and help empower Canadians to take responsibility for their own healthcare costs. The federal government, for one, could reconsider contribution maximums for Registered Retirement Savings Plans – accounts available to all Canadians for tax-deferred saving and investing – to allow individuals to save more money for retirement in order to cover additional healthcare costs. Alternatively, tax-effective individual savings accounts could be introduced, targeted specifically at saving for future healthcare needs. Governments have already introduced funding vehicles for plan sponsors. However, if they improved the tax deductibility of these, more plan sponsors would use them. These types of arrangements are useful for helping Canadians improve their financial planning. They can also limit the risk of an intergenerational transfer of costs from the elderly who consume the extra healthcare to the younger taxpayers who might otherwise be on the hook.

WHAT CAN PLAN SPONSORS DO?

As mentioned earlier, a growing number of employer plan sponsors have moved to restrict or end their retiree benefit coverage. However, as most of these plan sponsors have learned the hard way, it is difficult to take coverage away once it has been offered. This is especially true for retiree benefit plans, where members may have made retirement planning decisions during their working years based on the understanding they would have access to group coverage in retirement. Employers who choose to close their retiree benefit plans face unpredictability in their workforce planning as more employees delay retirement to continue their healthcare coverage. They may lose a competitive advantage to other employers who maintain retiree coverage as part of their total rewards offering. Further, they risk facing legal action from retirees threatened by an uncertain financial future.

Some plan sponsors may look to the methods being used by the provincial governments to keep their plan costs in check. Those with significant claim volume and

* £1 = C$1.79; €1 = C$1.41; US$1 = C$1.12
as at 10 October 2014

clout have already started exploring and implementing bulk drug pricing agreements similar to those described above. Another solution may be to limit the number of drugs covered on the plan formulary. A report by the Canadian Health Policy Institute shows that, from 2004 to 2011, Health Canada approved 373 new drugs for sale in the country[4]. On average, the provincial plans added just over 20% of these new drugs to their formularies for coverage. In contrast, 81% of these drugs were covered by at least one private insurer. This raises the question of whether employer-sponsored plans are picking up these drug costs consciously as part of their design, or by default because they don't understand that they have a choice in how they restrict their formularies.

Of course, if the plan didn't cover these costs, then the individual would need to. In discussions with plan sponsors focused on the future of retiree plans, my firm has found that a number of organizations are aware of the burden their retirees would face if they ended their coverage. They recognize the strain this puts on their former employees and also that society as a whole suffers – financially and socially – if our seniors are living in impoverished conditions. Many organizations, such as financial institutions and not-for-profits, want to continue providing some financial support for their retired employees – they just don't want to do it the way it has been done in the past. They would prefer a solution that allows them to provide some form of facilitated coverage, but to limit the liability this coverage adds to their bottom line.

There is no magic bullet for plan sponsors. To date, the range of retiree benefit plans offered covers a wide spectrum of designs, structures and costs. There are traditional plans, reduced traditional plans with lower coverage maximums and reimbursement rates, catastrophic plans that provide coverage of limited services only after large deductibles have been reached, healthcare spending account-only plans and defined dollar plans. Real defined contribution plans have not yet been fully explored in Canada, but may provide the best hope for the future of retiree health plans.

Canada's Income Tax Act (§144.1) was amended in 2009 to allow for Employee Life and Health Trusts (ELHTs). An ELHT is a taxable trust established for employees of one or more participating employers in order to provide benefits for employees and their dependents. The key benefit to an employer is that ELHTs can be set up in a number of different ways (see BOX 1), allowing the employer to prefund retiree benefits and to reduce or no longer assume the future accounting liability. They can be most effectively used to support a true defined contribution arrangement where funds are paid into the trust while the employee is working. The contributed funds grow until the plan member retires, and the sponsor can decide beforehand, with or without the member's input, what the accumulated pool of funds will be used for. The balance could be used to subsidize premiums in a group or individual plan, potentially turned into an annuity-like spending account, or just used to pay specific claims, until the funds are exhausted. For plan sponsors, this arrangement has the benefit of not creating an accounting liability on their balance sheet if the funds are contributed when earned – just like a defined contribution pension plan.

BOX 1 **Are ELHTs Part of the Answer?**

The following are three strategic ways ELHTs could be used to help maintain retiree benefits:

Annual funding. Group sponsors can add funds above the annual cash costs of the plan to build up dedicated assets in the trust. If the plan is for a single employer, a tax deduction for part of the contribution may be deferred whereas, for a multi-employer plan, the full contribution would be deductible. This structure would improve the financial position of the plan; however, it may be more attractive for non-taxable or multi-employer plan sponsors. The take-up of this type of arrangement is likely to be low, as many plan sponsors are not looking to keep traditional plans and fund them now that their pension plans are running deficits, and they might instead put available cash into the business.

Exit strategy. As General Motors Canada did, plan sponsors could contribute the full amount of their benefit liability, or another agreed-upon amount, to an ELHT and pass along responsibility for plan design and administration to the trust. This strategy would most likely be of interest to plan sponsors who have cash or a need to relieve their balance sheet and settle the liabilities.

True DC plan. In a similar way as with a defined contribution pension plan, plan sponsors can contribute funds based on a formula (for example, 2% of pay or C$1 per hour worked) during the plan member's working years, which build up to a balance that can subsidize the employee's healthcare costs in retirement. This arrangement could be of interest to any plan sponsor or employee group that wants to enhance, or even create, a retiree benefit plan for future retirees that does not create an accounting liability.

CHANGING PERCEPTIONS

An ELHT with a defined contribution structure would give plan sponsors and plan members the opportunity to contribute a portion of salary, or unused flex plan credits, into the trust to help build up the balance available at retirement. This combines the defined contribution philosophy of current pension arrangements and retiree healthcare needs. This might be a more appropriate model for the future of retiree healthcare plans, as it ensures that funds are available at retirement, whether they're set aside by the plan sponsor, the plan member, or both. This type of structure offers labour groups the opportunity to be involved and to take over responsibility for management of the plan. This structure does not generate an accounting liability from the plan sponsor's perspective, and it can help with workforce planning by allowing employees to set aside a portion

of income while they're working for their future healthcare needs.

Of course, for this solution to be viable, it requires the plan member's support and participation. This raises a key point: one of the most important things a plan sponsor – and governments – can do now to help control plan costs and ensure that Canadians are prepared for the healthcare costs they could face in retirement is to start educating them.

Since Canadians have come to expect their healthcare costs – during their working years, and also often in retirement – to be mostly or fully covered, any shift away from the traditional delivery of this coverage will require changing Canadians' way of thinking.

Plan sponsors need to do a better job of focusing member communication on the dollar value of their benefits coverage, and what that looks like as a percentage of their total compensation. Members need help understanding how escalating plan costs impact the organization's ability to stay financially healthy and to grow – and, to do this, they need to be given the right tools, so they can help keep their healthcare costs down today and in retirement.

As we've learned from the ongoing shift from defined benefit pension plans to defined contribution schemes, plan members will generally accept change – and their role in it – if the reasons for it are clearly explained to them well in advance.

Successful organizations tend to think of their employees as their best ambassadors. They take care of them financially, continue their professional growth and development, and make sure they and their dependents are secure. Retired employees who leave an employer feeling cared for and respected have the potential to become that organization's best customers and to help advance the organization's mission and values further than any marketing strategy might. While the financial case for cutting retiree benefits may be plain today, organizations should aim to consider all future implications in any decision they choose to make. Ω

References

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2 'National Health Expenditure Trends, 1975 to 2013', Canadian Institute for Health Information, October 2013.
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Reproduced from Benefits & Compensation International, Volume 44, Number 4, November 2014.
Published by Pension Publications Limited, London, England.
Tel: + 44 20 7222 0288. Fax: + 44 20 7799 2163. Website: www.benecompintl.com
Produced by The PrintZone (www.theprintzone.co.uk).