

## September 2006

The following news summaries were developed by Gabriel, Roeder, Smith & Company to inform clients and other benefit professionals of news in the benefits industry. Our thanks to Mary Ann Vitale for her diligent work on this issue. To receive this publication electronically, send an email to [web.admin@gabrielroeder.com](mailto:web.admin@gabrielroeder.com) with the message "SUBSCRIBE NEWS SCAN" in the subject line. To stop receiving this publication electronically, send the message "UNSUBSCRIBE NEWS SCAN" in the same manner. Copies of this and other benefit-related publications are available on the GRS web site at [www.gabrielroeder.com](http://www.gabrielroeder.com).

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### **GRS in the News: GRS Participates in Public Health Care Symposium**

On September 15, 2006, a panel of industry experts gathered in Chicago at the Public Health Care Symposium & Exhibition to focus on the health care challenges facing state and local governments and to examine various solutions. Sheldon L. Freilich, director of health care consulting at Gabriel, Roeder, Smith & Company, participated in the symposium and discussed the underlying causes of health care inflation. The September 26<sup>th</sup> issue of BNA's *Pension & Benefits Reporter* quotes him as saying: "Double-digit increases for health care benefits will continue for myriad reasons. These include an aging population, lifestyle choices, technology, state and federal mandates, cost shifting to Medicare and Medicaid, consumer insulation, direct-to-consumer drug advertising, vendor consolidation, drug using and pricing, and managed care backlash."

The panelists also discussed the potential impact of the new accounting and reporting requirements for retiree health care and other post-employment benefits (OPEB) applicable to state and local governments. In 2004, the Governmental Accounting Standards Board (GASB) issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, to be implemented in stages beginning in 2007. GASB No. 45 requires governments to disclose information in their annual financial reports regarding OPEB benefit provisions, funding, and costs on an accrual basis. Parry Young, a director of Standard & Poor's Rating Services, is quoted as saying, "the resulting actuarial valuations and new reporting will provide for greater transparency, and disclosure will lead to an examination of the current viability and long-term deliverability of the current benefit levels." He added that the required information "provides a framework to better understand the components of these liabilities and manage them more effectively."

Source: BNA *Pension & Benefits Reporter*, September 26, 2006.

### **NASRA/NCTR Release Public Fund Survey**

In September 2006, the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR) released the Public Fund Survey *Summary of Findings for FY 2005*. The survey presents key data from 102 public retirement systems with 125 plans, covering 12.8 million active members, 6.0 million retirees and other annuitants, and holding \$2.26 trillion in assets as of FY 05. The data

pertain to defined benefit plans, including several hybrid plans. Overall, the systems surveyed represent approximately 88% of public retirement plan membership and assets.

The survey results are available on-line individually for each system and plan, including: plan membership, actuarial assumptions and methods, plan assets and liabilities, contribution rates, and system asset allocations, among other information. Selected data can also be viewed through comparative tables that allow sorting on selected items and provide graphs of selected data (e.g., inflation and investment return assumptions).

The *Summary of Findings* presents statistical analysis regarding plan funding, membership, benefits, contribution rates, cash flows, and actuarial assumptions. The key findings include:

- The average actuarial funded ratio for the surveyed plans was 86.6% in FY 05, down slightly from 87.6% in FY 04, with two-thirds of the plans having funded ratios above 80.0%.
- The aggregate funding level declined for the fourth consecutive fiscal year, but is projected to rise in FY 06 due to growth in assets that is expected to outpace growth in liabilities.
- Since FY 01, the number of annuitants has grown by a cumulative 17.7% compared with an increase in actives of only 2.1%. The ratio of active members to annuitants fell from 2.18 in FY 04 to 2.13 in FY 05.
- The median actuarial assumption for investment return was 8.0% in both FY 04 and FY 05. The median assumption for the real rate of return increased from 4.0% in FY 02 to 4.5% in FY 05.

The survey is available at: <http://www.publicfundsurvey.org>. Although registration is required to access the data, once the user is registered the data are available at no charge.

### **GASB Adds Project to Enhance Disclosure Requirements for Governmental Plans**

On August 31, 2006, the Governmental Accounting Standards Board (GASB) added a short-term technical project to its agenda. The project will reexamine the requirements for state and local government financial report disclosures and supplementary information related to pension plans. This project is in addition to the GASB's recent research initiative to determine the effectiveness of the existing governmental accounting standards for public plans (as reported in the *GRS News Scan* for March 2006).

The GASB expects the new technical project to change certain pension accounting requirements to correspond with similar requirements for other postemployment benefits (OPEB). As reported in the GASB's related news release, some of the OPEB disclosure requirements that potentially may be required for pensions include:

- Disclosure of the plan's current funding status based on the most recent actuarial valuation in the notes to the financial statements of pension plans and certain employers.
- Disclosure of the plan's funded status and multi-year schedule of funding progress using the entry age actuarial cost method when the aggregate cost method has been used to determine annual required contributions.
- Additional disclosures about actuarial methods and assumptions used for the annual required contributions and funded status of the plan.
- Disclosure by employers in cost-sharing plans of how the contractually required contribution rate is determined.
- Disclosure by employers in cost-sharing plans of the plan's required supplementary information, if the plan does not issue a financial report that complies with generally accepted accounting principles (including required supplementary information) or the plan is not included in the financial report of another entity.

The formal exposure draft is expected before December 31, 2007. More information is available in the GASB's news release posted at: <http://www.gasb.org>

### **District Court Rules Vested Health Care Benefits Not Precluded by Plan's Reservation of Rights Clause**

On August 7, 2006, the U.S. District Court for the Eastern District of New York held that an employer's promise of lifetime health care benefits was not precluded by a reservation of rights clause in the health care plan documents. (*Aleo v. KeySpan Corp.*, E.D.N.Y., No. 05-CV-4490 (JFB)(ARL), 8/7/06).

The KeySpan Corporation maintains a health care plan for certain employees and retirees, subject to a reservation of rights clause in the plan documents that allows the company to "terminate, amend, or modify" the plan. In 1998, the company initiated an early retirement program and distributed materials intended to encourage employee participation in the program. As described by the court, the materials explained that the company was considering changes to its retiree health care plan but that employees who elected the early retirement program would not be subject to those changes. A related chart also suggested that participants in the early retirement program would not be subject to future medical plan changes.

In 2004, the company reduced its health insurance benefits to participants in the early retirement program, who then sued to recover benefits. The company moved for dismissal, arguing that the materials describing the early retirement program constituted informal communication that was superseded by the reservation of rights clause in the health plan documents. In examining the case, the district court noted that, under the Employee Retirement Income Security Act (ERISA), an employer generally has the right to modify or terminate its health care benefits. However, the court went on to say that an employer may agree to vest such benefits and, if vested, the vested benefits should be enforced. Moreover, to support a claim of vested benefits, the plaintiff would need to show "specific written language that is reasonably susceptible to interpretation as a promise to vest the benefits." Finding that the early retirement program materials provided such language, the district court denied the company's motion for dismissal and called on the parties to proceed to the discovery phase of the case.

Source: *Aleo v. KeySpan Corp.*, E.D.N.Y., No. 05-CV-4490 (JFB)(ARL), 8/7/06.

### **Teacher Retirement System of Texas Studies Impact of Retirement Benefits on State's Economy**

In July 2006, the Teacher Retirement System of Texas released "Beyond the Classroom: The Impact of Pension Benefits Paid by the Teacher Retirement System of Texas (TRS) on Business Activity in Texas, Its Regions, Metropolitan Areas, and Counties." The study was done by the Perryman Group, a firm specializing in economic analysis, using a well-established economic impact model. It found that the \$5.39 billion in annual benefits paid by TRS in 2005 to approximately 250,000 retirees and beneficiaries generated substantial additional economic activity in Texas, including:

- \$9.87 billion in Total Expenditures;
- \$4.74 billion in Gross State Product;
- \$2.93 billion in Personal Income;
- \$2.66 billion in Retail Sales; and
- 72,014 permanent jobs.

Moreover, as a result of TRS's strong investment performance, the economic return on State contributions is significant. According to the report, every \$1 of State funds contributed to TRS leads to \$7.85 in total spending in the Texas economy.

The report is available at: [http://www.trs.state.tx.us/About TRS/beyond\\_the\\_classroom.pdf](http://www.trs.state.tx.us/About_TRS/beyond_the_classroom.pdf)

## **Study Finds DB Plan Returns Outperform 401(k) Plans by an Average of One Percentage Point Annually**

In September 2006, the Center for Retirement Research (CRR) at Boston College released an issue brief titled "Investment Returns: Defined Benefit vs. 401(k) Plans." The study found that over the period from 1988-2004, defined benefit (DB) plan returns outperformed 401(k) plans by an average of one percentage point (100 basis points) per year. The lower 401(k) returns were due in part to investment management fees which tend to be significantly higher in 401(k) plans than in DB plans. The lead author and CRR director, Alicia H. Munnell, noted that the reduced returns would result in a 401(k) participant having 20% less at retirement over a 40-year worklife than would otherwise be the case. However, the one percentage point shortfall understates the problem since nearly 50% of 401(k) participants fail to diversify their retirement accounts.

The brief also reported that Individual Retirement Accounts (IRAs) earn even lower returns than 401(k) plans. Based on the Investment Company Institute's data, the authors estimated the aggregate average rate of return for IRAs over the period from 1998-2003 to be 3.8% compared with 6.6% for DB plans and 5.6% for 401(k)s. According to the study, IRAs account for 43% of total private-sector retirement assets, defined benefit plans account for 23%, and 401(k)s and similar defined contribution plans account for 34%. Since IRAs account for a larger share of private-sector retirement savings than either DB or DC plans, their relatively poor performance will likely have a significant impact on retirement security in the future.

The Issue Brief is available at: [http://www.bc.edu/centers/crr/issues/ib\\_52.pdf](http://www.bc.edu/centers/crr/issues/ib_52.pdf)

## **CMS Announces Medicare Physician Payments to Drop 5.1% in 2007**

On August 8, 2006, the Centers for Medicare and Medicaid Services (CMS) released a proposed rule that would revise payment rates and policies under the Medicare Physician Fee Schedule. As a result, overall physician payments under the Medicare program would decrease by 5.1% in 2007. CMS estimates that during 2006 Medicare will pay approximately \$61.5 billion to 875,000 physicians and other health care professionals for more than 42 million Medicare participants.

The Medicare Physician Fee Schedule specifies payments for thousands of health care services and procedures, ranging from office visits to surgery. CMS reported that expenditures for physicians' services in 2005 increased by 10% over 2004. This increase was primarily due to the greater volume and complexity of services for Medicare beneficiaries, including more frequent office visits as well as growth in laboratories services, imaging techniques, and physician-administered drugs. Under Social Security Act § 1848, CMS is required to annually adjust the fee schedule depending on the actual expenditures of the last completed fiscal year compared with a target rate, known as the sustainable growth rate (SGR). The SGR is based on such factors as medical inflation, projected growth in the domestic economy, and changes in laws or regulations. When actual spending exceeds the SGR, CMS must reduce the fee schedule and most reimbursement levels.

Since spending on physician services and other Medicare Part B services has grown faster than the target spending rate, CMS has indicated that a reduction in 2007 is required. Additionally, CMS Administrator Mark McClellan has stated that if Congress intervenes to block the proposed cuts (as it has in past years since 2002), the estimated cost for the federal government of a one-year increase in 2007 would be \$13 billion over five years. Separately, he also announced that Medicare Part B premiums will increase by 11% to \$98.40 in 2007.

The proposed rule for the physician fee schedule was published in the *Federal Register* on August 22, 2006. Comments on the proposed changes are due October 10, 2006. CMS is expected to respond to the comments and issue the final rule by early November. The new payment rates and policies under the final rule will be effective January 1, 2007.

The CMS press release is available at:

<http://www.cms.hhs.gov/apps/media/press/release.asp?Counter=1939>

The proposed rule is available at:

<http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-6843.pdf>

### **Study Links U.S. Medical Spending to Increase in Life Expectancy**

On August 31, 2006, the *New England Journal of Medicine* (NEJM) published the findings of a recent study titled “The Value of Medical Spending in the United States, 1960-2000.” The study was conducted by researchers from Harvard University and the University of Michigan to measure the value of medical spending by comparing gains in life expectancy with the increased costs of medical care. The authors estimated life expectancy at the beginning of each decade from 1960 to 2000 for four age groups in comparison with lifetime medical spending for the same periods. Lifetime medical spending was calculated as the present value of annual medical spending over an individual’s lifetime, adjusted for inflation, and discounted at a rate of 3%. To control the influence of non-medical factors on life expectancy (such as not smoking), the researchers assumed that 50% of the improvements in longevity were due to medical care.

According to the study, lifetime medical spending per person increased \$69,000 over the period, from \$14,000 in 1960 to \$83,000 in 2000, with a significant portion of the increase attributable to more care rather than higher costs for existing care. Over the same period, average life expectancy for newborns increased 6.97 years, from 69.90 years in 1960 to 76.87 years in 2000. Assuming 50% of the increased life expectancy was due to medical care, the authors calculated an average cost per year of life gained over the period of \$19,900. About 70% of the increased life expectancy resulted from a reduced rate of death from cardiovascular disease, 19% resulted from reduced infant death rates, and 5% resulted from reduced death rates from external causes, such as accidents (most commonly involving motor vehicles). Other results include:

- On average, the average cost per year of life gained increased from \$7,400 in the 1970s to \$36,300 in the 1990s.
- Between 1960 and 2000, the average cost per year of life gained was about \$31,600 at age 15, \$53,700 at age 45 and \$84,700 at age 65.
- At age 65, medical costs rose more rapidly than life expectancy, with the cost per year of life gained averaging \$121,000 between 1980 and 1990 and \$145,000 between 1990 and 2000.

The authors concluded, “On average, the increases in medical spending since 1960 have provided reasonable value. However, the spending increases in medical care for the elderly since 1980 are associated with a high cost per year of life gained. The national focus on the rise in medical spending should be balanced by attention to the health benefits of this increased spending.” The authors concluded by recommending that efforts to allocate health resources should focus on specific diseases.

The NEJM abstract is available at: <http://content.nejm.org/cgi/content/short/355/9/920>

### **Union Groups Examine New Models for Retirement Plans**

The September 4, 2006, issue of *Pensions & Investments* magazine featured an article regarding two union groups, AFL-CIO and the Service Employees International Union (SEIU), who are developing separate hybrid retirement plan models. Both union groups have similar principles for hybrid plan concepts, albeit the SEIU (representing 1.8 million health care workers in the U.S., Canada, and Puerto Rico) was formerly associated with the AFL-CIO.

In August, the Washington office of the AFL-CIO issued their retirement income policy principles, which would:

- 1) Allocate financing and risk equitably among government, employers and workers;
- 2) Provide opportunity for workers to retire at age 65 with at least 70% of pre-retirement income;
- 3) Allow portability of retirement benefits;
- 4) Structure defined contribution plans to serve the interest of workers; and
- 5) Represent participants in the governance of their plans.

Additionally, the article indicates the SEIU has proposed a hybrid pension plan model that would:

- 1) Cover the 50% of workers who are not currently covered by traditional plans;
- 2) Offer portable accounts;
- 3) Pool investment risk;
- 4) Pay benefits primarily in annuity form;
- 5) Require employer contributions;
- 6) Minimize costs; and
- 7) Be easily communicated.

The article quotes Dallas Salisbury, president and chief executive officer of the Employee Benefit Research Institute as saying: "A next logical step would be a universal DB(k) where you could put aside a portion of retirement income." A DB(k) is a combined defined benefit/401(k) plan with an employer-paid guaranteed lifetime retirement benefit that can be supplemented by tax-deferred voluntary employee contributions. Under the Pension Protection Act of 2006, employers with fewer than 500 employees may establish DB(k) plans beginning in 2010 and later. Under the Act, the minimum DB benefit payable for employees who work three or more years would be the greater of 1% of average pay during the last three years of work multiplied by years of service, up to 20 years or 20% of final average pay. The 401(k) provision requires the employer to match at least 50% of an employee's contributions up to 4% of salary.

Source: *Pensions & Investments*, September 4, 2006.