Developments

RECENT DEVELOPMENTS IN EMPLOYEE BENEFITS

The Uncertain Future of the Cadillac Tax

by Edward B. Scott, FSA, FCA, MAAA

By now you have likely heard of the Cadillac Tax. It is the excise tax portion of the Affordable Care Act (ACA) that is scheduled to begin in 2018. A common misconception is that the Cadillac Tax is designed to serve the same purpose as a sports luxury tax, a term with which baseball and hockey fans should be familiar. This is the surcharge put on the payroll of a team that has a payroll above a certain threshold. The purpose is to prevent teams in major markets with high incomes from signing almost all of the star players and damaging the competitive balance. Does that stop the New York Yankees from signing most of the big time free agents? No, but it does produce an additional revenue stream for Major League Baseball.

The Cadillac Tax is similar in that if all employees produced identical claims the employers offering the richest plan designs would pay the tax. Technically, it could be argued the revenues received from the excise tax would help provide coverage for others. But why should there even be an effort to level the benefits playing field? After all, since the wage freezes implemented during World War II, employers have used benefits as a means of attracting and retaining skilled employees. Offering better benefits than the competition has often guaranteed a better work force.

How the tax works

In a sense, the excise tax diminishes this competitive strategy. The main fallacy, however, in comparing a sports luxury tax to the Cadillac Tax is that a richer plan design isn't the only determining factor in causing average claims to exceed the threshold. A plan could simply have a sicker population than average causing a modest plan design to produce costs that are higher than average. Did you catch that? Employers will actually be punished for covering the sickest of the sick. Shouldn't such behaviors be rewarded?

If average claims exceed the thresholds set by the government, the tax is assessed on the amount in excess. The threshold is set so that in 2018, health benefit coverage costs that exceed $10,200 for an individual employee or $27,500 for dependent coverage will be subject to a 40 percent excise tax. Plans covering workers in high-risk professions and retirees will have their thresholds increased by $1,650 for single plans and $3,450 for family plans; however, for purposes of this article, we will just look at the base threshold.

Example 1: In 2018, ABC Company has a total of 1,000 employees. 500 employees cover themselves only and average $10,500 in costs, while the other 500 also cover dependents and average $28,000 in costs. The total excise tax amount is $160,000.

- $60,000 for individual coverage:
  ($10,500 - $10,200) x 40% x 500 EEs
- $100,000 for dependent coverage:
  ($28,000 - $27,500) x 40% x 500 EEs

This doesn't seem like much of a penalty. This is only 0.8% of the total spend for ABC Company of $19.25 million (($10,500 x 500 EEs) + ($28,000 x 500 EEs));

Also in this issue:

however, one of the more worrisome aspects of the threshold is the rate at which it will grow. Any employer that offers health benefits is aware that the medical cost trend has historically been in the double digits even if it is only now expected to be around 8% going forward. Common sense dictates that a threshold tied to medical benefits would be linked to the increased costs of medical goods and services, right?

Wrong; the bar will increase with the Consumer Price Index (CPI) plus 1% in both 2019 and 2020 and then CPI alone beginning in 2021. CPI measures the general rate of inflation, which has been about 3% on average over the last 20 years. Because benefit values are expected to rise much faster than the CPI, the question becomes not if a plan will pay the Cadillac Tax, but when.

Example 2: It is now 2022, and ABC Company still has a total of 1,000 employees that have seen health-related costs increase at a rate of 8% per year. Again, 500 employees cover themselves only and average $14,285 in costs, while the other 500 also cover dependents and average $38,094 in costs. In this example, the total excise tax amount is $1,824,000.

- $516,200 for individual coverage:
  ($14,285 - $11,704) x 40% x 500 EEs
- $1,307,800 for dependent coverage:
  ($38,094 - $31,555) x 40% x 500 EEs

Now this is a bit more significant! This is 7% of the total spend for ABC Company of $26.2 million (($14,285 x 500 EEs) + ($38,094 x 500 EEs)). This type of growth ensures that employers will need to manage plans very aggressively to avoid this tax, reducing plan option values and increasing the employee cost share. A plan sponsor can be well under the threshold in 2018 only to find itself paying substantial amounts of tax a decade later.

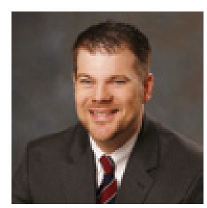
There are several important things to note about the Cadillac Tax that will make it a particularly effective method of raising tax revenues. First, unlike most taxes, the Cadillac Tax will not be deductible. The tax is based on the gross value of the plan, regardless of whether the employer or employee is paying the cost, and while the tax doesn't include the value of dental and vision benefits, it does include the value of FSAs, HRAs, and employer-funded HSAs.

The uncertain future

At this point you are likely wondering why the title references an uncertain future for the Cadillac Tax. The simple answer is organized labor. Union collective bargaining negotiations have historically produced very rich benefit plans at the expense of wages. One of the primary reasons for pushing the implementation of the tax out to 2018, eight years after ACA's birth, was to allow enough time for the unions to shift compensation from health benefits to pay as their current collective bargaining agreements expired. Unfortunately, it appears the idea of rich benefit plans is ingrained to such an extent that change has been minimal (at best) for many organized labor plans.

As the magic year approaches, plan sponsors of all types are becoming keenly aware of how likely passing the threshold is in the relatively near future. But no one is more aware of the impending cost impact that is heading their way than union plan sponsors. And there are few plan sponsors that have the political pull of the unions. Don't be surprised if the unions are able to negotiate some sort of exemption from the Cadillac Tax for themselves. And if they do, will nonunion health plans be alone in facing the tax? Perhaps, but that may not play very well politically either.

There is little doubt that ACA will be a hot button issue in the 2016 election cycle. By this point many plan sponsors will be up in arms about the impending Cadillac Tax. Plans covering a sicker or older population will demand relief. Unions will push for exemption. The threat of this excise tax dying before it ever takes off is legitimate; however, a prudent plan sponsor must prepare for what is currently the law. This includes projecting future costs against the threshold levels and planning for ways to reduce the liability through health management strategies. For more information about the Cadillac Tax, please contact your BPS&M consultant.



Edward B. Scott, FSA, FCA, MAAA, *Ed has worked in the health and welfare actuarial field since 1999, displaying a diverse work experience with both public and private medical plans. His knowledge and experience on public and private sector accounting disclosure valuations make him a valuable client resource. Wells Fargo routinely turns to Ed for internal education on hot topics in the health field, such as the Health Care Reform and wellness program design. He also has a background in design and funding of medical plans, including Medicare Part D attestation work and setting annual, self- insured premium rates for clients. Ed is a consulting actuary in our Nashville, TN office.*

Defined Benefit Pension Plan De-risking Initiatives

by Brian Hartman, FSA, EA

Defined benefit pension plans have grown increasingly complex and pose a myriad of risks to plan sponsors. Minimum required funding costs and balance sheet liability on financial statements are just two challenges facing plan sponsors. These challenges are especially significant when investment markets are volatile and interest rates are low, as we have seen during the past several years.

Pension de-risking techniques can help sponsors mitigate or eliminate these challenges. De-risking techniques can take two approaches:

- Transfer the liability and risk to a third party, which could be the individual plan participant or an insurance company.
- Retain the liability as part of the pension plan and apply de-risking techniques to manage overall risk.

The optimal de-risking strategy will likely include a combination of both liability transfer and liability retention strategies over time.

With either or both approaches, pension plan de-risking strategies must align with the plan sponsor's long-term objectives, such as helping their plan participants prepare for a financially secure retirement. Most employers, however, manage toward a series of short-term objectives. Goals such as minimizing the volatility of annual funding cost and accounting expense may be short-term goals that allow the plan sponsor to achieve its long-term objectives.

Transfer liability strategies

Transferring the liability of a pension plan to a third party also transfers the risk associated with that liability to a third party. That third party could be the individual plan participant or an insurance company. The following table summarizes how the prominent de-risking techniques immunize against several key risks and how they help address the plan sponsor's de-risking goals.

Liability Transfer Strategies

Issue	Plan Design	Lump Sum	Annuity Purchase	Buy-In Annuity	Plan Termination
Cost of Economic Implementation	Least Costly	Cost varies with interest rate basis	Costly, generally more so than lump sum	Costly, generally more so than lump sum	Most Costly
Plan sponsor interest rate risk immunization	Not addressed	Full, for participants that elect lump sum	Full, for participants for whom annuities are purchased	Full, for participants for whom annuities are purchased	Full
Plan sponsor investment risk immunization	Not addressed	Full, for participants that elect lump sum	Full, for participants for whom annuities are purchased	Full, for participants for whom annuities are purchased	Full
Plan sponsor demographic risk immunization	Some future demographic risks may be eliminated	Full, for participants that elect lump sum	Full, for participants for whom annuities are purchased	Full, for participants for whom annuities are purchased	Full
Overall size of pension plan	Existing obligation unchanged, future accruals may be reduced	Reduced by obligation related to lump sums paid out	Reduced by obligation related to annuities purchased	Unchanged	Plan is completely liquidated

Retain liability strategies

De-risking techniques that involve retaining the liability primarily consist of liability driven investing (LDI) strategies. LDI strategies attempt to reduce the mismatch between the interest rate sensitivity of a pension plan's assets and liabilities. If the interest rate sensitivities are aligned, a plan's funded status will remain level even if there are movements in interest rates.

The graph below shows various LDI strategies and where they fit on a de-risking spectrum. The vertical axis represents risk, while the horizontal axis represents the progression of de-risking the pension plan to the sponsor. No risk is represented by the bottom of the vertical axis, so, a fully de-risked pension plan is at the far right on the horizontal axis.

In perspective

Many plan sponsors took steps to de-risk their plans in 2012 and 2013, and more are expected to do so in 2014. In an employer survey conducted in late 2012, 60% of surveyed plan sponsors indicated they intended to adjust their plan's investments to better match its liabilities, while 39% were likely to add or liberalize a lump sum option for their terminated, vested employees.[1]

A plan sponsor may be unable to implement a de-risking strategy currently because of cost, market conditions, or resource availability. Even if implementing a de-risking technique is not feasible at the present time, plan sponsors may wish to develop a plan and begin their preparation for eventual implementation. Interest rates and economic conditions may only be favorable for a brief period. If appropriate triggers are met, it is important to be able to act quickly to take advantage of the conditions.

Further, many of the techniques require complete and accurate participant data. Data completion projects are often time-consuming exercises and may involve a significant research effort into old personnel files, address searches, and death searches. Finishing these projects well before implementing a de-risking strategy can save valuable time and help ensure a successful outcome.

Please contact a BPS&M consultant to learn more about analyzing, designing, and implementing de-risking strategies. We can assist plan sponsors by designing an individualized plan, developing appropriate triggers for implementing a technique and monitoring economic conditions to determine when the triggers are met.

[1] *2013 Hot Topics in Retirement, AON Hewitt.*

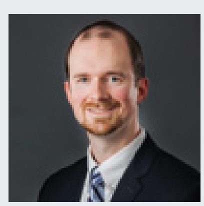
Brian A. Hartman

Brian is a consulting actuary with more than eight years of experience related to the design, funding, administration, and regulatory compliance of both qualified and nonqualified retirement plans. He has provided a variety of actuarial services to clients for corporate, nonprofit, and supplemental executive retirement plans. Brian earned a B.A. in Economics and Mathematics from the University of Virginia. He is an Enrolled Actuary and a Fellow of the Society of Actuaries. Brian is a pension consultant in our Richmond, Virginia office.

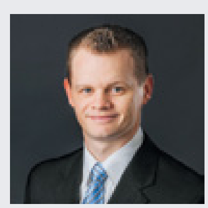
CONSULTANTS *in the* LIMELIGHT

Daniel Duggin and **Joshua Pace** have earned the Associate of the Society of Actuaries designation. Both Daniel and Joshua are based in our Louisville, KY office.

For more information about our consultants, please visit www.bpsm.com.



Daniel Duggin



Joshua Pace

Introducing the Wells Fargo Pension Discount Curves

by Megan A. McGee, FSA, EA, MAAA

The Wells Fargo Pension Discount Curves are proprietary discount curves developed by BPS&M to determine the discount rate used for accounting disclosures for pension and other post-employment benefit plans. Before the Wells Fargo Pension Discount Curves were available for use, many BPS&M clients relied solely on the Citigroup Pension Discount Curves in setting discount rates for their accounting liabilities. The Wells Fargo Pension Discount Curves give plan sponsors an alternative approach to determining the discount rates used in the accounting disclosures for their plans.

The Wells Fargo Pension Discount Curves provide another method to determine discount rates in accordance with the Financial Accounting Standards Board and Securities and Exchange Commission (SEC) guidance. An acceptable method to estimate the discount rate is to look at current rates of return on high-quality fixed-income investments. The SEC clarifies "high-quality" to be one of the two highest ratings given by one of the credit rating agencies, such as AA-rated or higher corporate bonds from Standard & Poor's. The Financial Accounting Standards Board further requires that the high-quality, fixed income investments used to define the yield curve should be noncallable investments and should be zero coupon bonds.

The Wells Fargo Pension Discount Curves are spot rate yield curves that meet all of these requirements. In development of these curves, BPS&M uses bond data that satisfy the following additional criteria:

- Have maturities between 0.5 and 30 years;
- Are noncallable, nonputable, and do not have a sinking fund provision;
- Have fixed coupon payments with a single payment at maturity;
- Have more than $250 million par outstanding;
- Are U.S. dollar-denominated bonds;
- Have an average rating of AA- (S&P/Fitch) or Aa3 (Moody's) and higher.

To produce the Wells Fargo Pension Discount Curves as of a given date, BPS&M obtains bond data meeting the accounting standard requirements and our additional criteria. Then, outliers from the bond data are removed using statistical modeling techniques. From the resulting data, BPS&M produces an AA-Only Discount Curve and an AA-Above Median Discount Curve.

The Wells Fargo Pension Discount Curves are produced as of the last business day of each calendar month; however, BPS&M receives daily data from Barclays and, therefore, has the ability to update the curves at interim dates. For example, if a plan sponsor's accounting disclosure date is December 31st, BPS&M has the ability to produce a discount curve as of December 15th, which could be used to estimate disclosure results before the December 31 data are available.

While the industry-standard Citigroup Pension Discount Curve still remains an appropriate choice for plan sponsors, the alternative Wells Fargo Pension Discount Curves offer advantages that make them easy for plan sponsors and their auditors to adopt. The table on the following page highlights the major differences between the Wells Fargo Pension Discount Curve and the Citigroup Pension Discount Curve for AA-bonds and provides comments describing the advantages offered to plan sponsors through the use of the Wells Fargo Pension Discount Curve.

For further information on the Wells Fargo Pension Discount Curves, to receive a copy of the disclosure document for your auditor, or to inquire about the availability of interim discount curves, please contact your BPS&M consultant or Megan McGee at megan.a.mcgee@bpsm.com.

Comparison to Citigroup Curve

	Wells Fargo Pension Yield Curve	Citigroup Pension Discount Curve	Comment
Bond Credit Ratings	Include bonds with an average rating of AA across Moody's, S&P, and Fitch	Include bonds with an AA rating by Moody's and/or S&P	Use of the average rating of bonds from multiple rating agencies may produce more consistency in the includable set of bonds between each measurement date.
Bonds with Options	Exclude	Include certain types of call features with an adjustment	Excluding callable bonds provides more certainty in pricing of the bonds, and more certainty in determining yield to maturity for individual bonds. This approach can offer more stability, period-to-period, in the determination of the yield curve.
Type of Yield Curve Model	Minimizes difference between actual price and model price using a smooth and continuous discount function	Treasury yield curve plus an option adjusted spread (OAS) curve that measures the AA-bond spread. The OAS curve is fit to bond data in 5 maturity buckets (1-3, 3-7, 7-15, 15-25, and 25+)	The Wells Fargo Pension Discount Curve is developed as one continuous yield curve, minimizing statistical error in its development. Using corporate bond yields is the most consistent with Financial Accounting Standards Board requirements, and can enable the plan sponsor to construct a fixed income portfolio that closely matches the yield curve.
Outlier Methodology	Remove bonds that have pricing errors greater than two standard deviations from the model price	Eliminate those bonds with spreads more than two standard deviations above the market-weighted average within each maturity bucket.[1]	Development of a single curve without maturity buckets has greater potential for consistency in the yield curve from period-to-period.
Availability of Yield Curve	Published monthly, but available daily upon request	Published monthly	Wells Fargo can provide mid-month updates to the yield curves when approaching fiscal year-end, providing a better estimate of month-end discount rates.

[1] *Source: "Citigroup Pension Liability Index – Revised Methodology" December 31, 2010*
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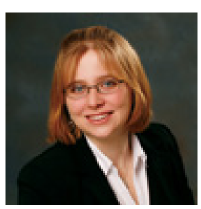
Megan A. McGee, FSA, EA, MAAA



Megan has been supporting our clients' administration and compliance for both traditional and cash balance defined benefit plans, preparing actuarial valuations for funding and accounting disclosure, and conducting asset/liability forecasting and risk management projects since 2007. She has been a project manager and transition consultant for Wells Fargo's growing defined benefit pension plan administration outsourcing service, known as Total Retirement Management. She has gained in-depth experience in the administration of plans with multiple benefit structures, minimums, and transition benefits, and has helped clients gain greater automation and efficiency through streamlining plan provisions and processes. She has worked on a wide variety of pension plan designs, which include both qualified and nonqualified plans. Megan is also a thought leader in the actuarial profession. She has been a member of the Pension Finance Task Force, which is a joint SOA/AAA task force, since 2011. She is also a member of the SOA's Enterprise Risk Management (ERM) exam committee since 2012 and began serving as co-chair of the committee in 2014. Megan is based in our Nashville office.

The BPS&M Pension Liability Index

Updated as of January 31, 2014

by Jeffrey Thornton, ASA, EA, MAAA

Interest rates are arguably the primary driver of the volatility in pension plan liabilities. BPS&M has established a set of liabilities and applied the yield curves to those liabilities in order to create the indices used to demonstrate the effect of interest rates on plan liabilities. The BPS&M Pension Liability Index tracks the percentage change in liabilities for a typical defined benefit plan under the following four interest rate standards, which are in general use:

1. The Full Yield Curve published by the IRS for minimum funding purposes under IRS Code §430.
2. The 24-month Averaged Yield Curve published by the IRS for minimum funding purposes under IRS Code §430.
3. The Adjusted Average Yield Curve reflects the impact of the Moving Ahead for Progress in the 21st Century Act (MAP-21), which provides an expected short-term decrease in the minimum funding requirements for pension plans beginning with the 2012 plan year.
4. A Corporate Financial Yield Curve used for financial statement pension liability determinations. Prior to January 1, 2014, this was measured using the Citigroup Pension Discount Curve. Beginning January 1, 2014, this will be measured using the Wells Fargo Pension Discount Curve (AA-rated or higher). For more information about the Wells Fargo Pension Discount Curve, please read the article titled "Introducing the Wells Fargo Pension Discount Curves" in this issue of Developments.

The BPS&M Pension Liability Index uses a hypothetical plan for benchmarking purposes based on "typical" pension plan features. The duration of the liabilities under this hypothetical plan is 15 years. The benchmark period for the Index starts with the effective date of the Pension Protection Act (January 2008), and the graph shows the rise and fall in liabilities due to changes in interest rates relative to that date. All other factors remain constant throughout the benchmarking period; ergo, the change in liabilities is due solely to the interest rate environment.

The trends demonstrated in the graph will generally hold true for most pension plans, but the magnitude of the percentage changes will vary depending on a given plan's demographics and benefit accrual patterns.

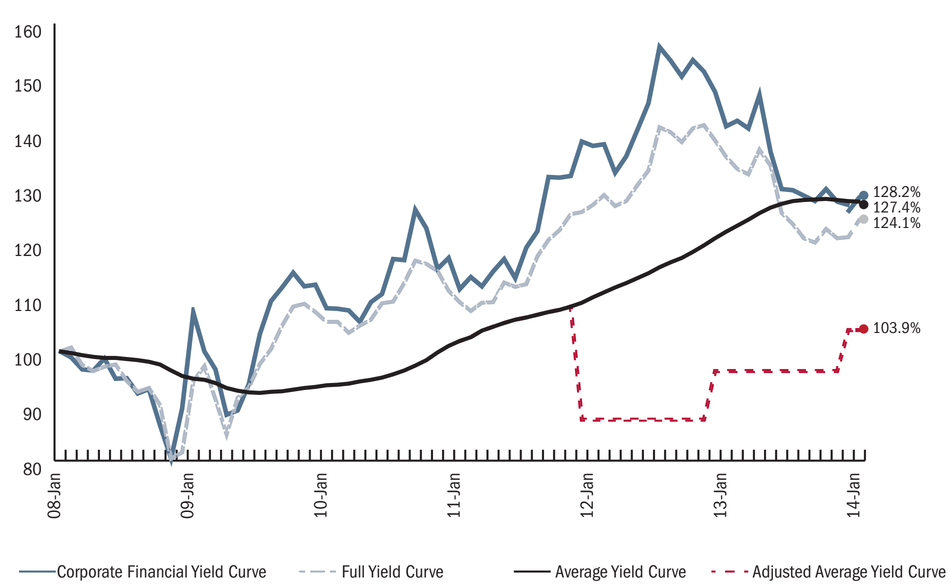
The following table shows the percentage changes in the indices over various periods.

Indices Changes

Indices	*Since Inception (1/1/08)*	*2014 Year to Date*	*Last 12 months*
Full Yield Curve	+24.1%	+2.6%	-8.5%
Averaged Yield Curve	+27.4%	-0.1%	+4.5%
Adjusted Average Yield Curve	-3.9%	0.0%	+7.8%
Citigroup Pension Discount Curve	+28.2%	+2.1%	-9.2 %

The BPS&M Pension Liability Index is updated regularly. If you have questions or comments concerning the BPS&M Pension Liability Index, please contact your BPS&M consultant or jeffrey.p.thornton@bpsm.com.

BPS&M Pension Liability Index since inception



BPS&M

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Betsy Hammond to Lead BPS&M

Betsy Hammond has been named Managing Principal of BPS&M. She succeeds Phil Trella, who retired at the end of 2013. Betsy, who is based in our Nashville, TN office, will report to Joe Ready, director of Wells Fargo Institutional Retirement and Trust.

"Over the years, clients have benefited from the expertise and knowledge that Betsy Hammond and her team deliver consistently day in and day out," said Joe Ready. "In her new role as Managing Principal, she will continue her rich tradition of excellence and track record of outstanding performance as she leads this team."

Betsy joined BPS&M in 1992, and moved into a variety of leadership roles. Since 2004, she has been Director of Actuarial Services, managing a team of professionals who deliver actuarial and benefits consulting expertise to clients.

Betsy is an Enrolled Actuary, a Fellow of the Society of Actuaries, and a Fellow of the Conference of Consulting Actuaries.

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RECENT DEVELOPMENTS IN EMPLOYEE BENEFITS

About BPS&M

Bryan, Pendleton, Swats & McAllister, LLC has been providing actuarial and benefit consulting services to clients since 1971.

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