

## Vive VEBAs?

# Buyouts for Retiree Medical Liability: Who? What? How? And, Most Important, Why?

By Steve Ferruggia, Robin Simon, Bob Walter

*Many employers have shouldered annual increases in costs for their retiree health care programs for years. That weight has become crippling for some employers. They include employers in distressed industries with a significant percentage of unionized and older employees who are covered by very generous postretirement health benefits. These characteristics typify employers in the auto, steel, mining, airline, and communications industries.*

The confluence of global competition, hyperinflation on health care costs, and an aging workforce threatens major U.S. manufacturers and, in fact, entire industries. For many of these employers, bankruptcy is not out of the question. In an effort to improve financial health, they have been searching for creative ways to reduce their ongoing burden of retiree medical costs. The search has brought some to the bargaining table where they and the unions have used a certain type of Voluntary Employee Beneficiary Association (VEBA) to relieve this severe economic and demographic pressure.

In exchange for the employer's promise to set aside funds for these heretofore-unfunded health care liabilities now, the union agrees to limits on the liabilities the employer will be required to fund in the future. Thus, the union gets some security for its members' health care benefits in exchange for releasing the employer from its ongoing obligations.

This InsightOut focuses on the use of VEBAs to settle postretirement medical obligations. Specifically, it:

- Defines the type of VEBA we are examining.
- Looks at the nature of some of the contingencies accepted by employers and unions in their agreements.
- Poses questions that employers considering this type of VEBA should ask themselves.

- Describes new communication challenges:
  - For employers to shareholders and analysts
  - For unions to active members (who must ratify the deal), current retirees, and possibly, regulators

### VEBAS DEFINED

VEBAs themselves are not news. In fact, Buck Consultants received a private letter ruling for the use of a VEBA trust in 1969 to fund its own employee benefit programs on a tax-favored basis. This financial arrangement proved so advantageous that Buck went on to recommend it to several clients.

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What is news is the sheer magnitude of some recent transactions that use VEBA's to transfer liabilities from the corporate balance sheet. In these multi-billion dollar transactions, the employers' open-ended defined benefit promises were converted to fixed dollar schedules of contributions.

For instance, the General Motors (GM)/United Auto Workers (UAW) agreement reached in September 2007 calls for GM to contribute \$24.1 billion to the VEBA by January 1, 2008, and to make additional payments as listed in Table One.

**Table One: The GM/UAW VEBA Price Tag**

In addition to its \$24.1 billion contribution to the VEBA by 1/1/08, GM and the UAW agreed to:

- An estimated \$5.4 billion payout from GM to cover retirees' health benefits until 12/31/09.
- Up to \$165 million/year contingent payments by GM for 20 years.
- A \$4.4 billion debenture from GM for the benefit of the VEBA.
- An increase of \$66.70/month in GM's pension payouts to its unionized pension plan participants, to allow those participants in turn to contribute an additional \$51.67/month toward the cost of their medical coverage.
- Automatic cost-sharing increases of three percent annually until 2015; four percent annually thereafter, passing along some additional costs to the GM unionized retirees.
- Unionized employees' forgone COLA and raises redirected to the VEBA.

As large as these contributions to the GM/UAW VEBA will be, these amounts represent only a fraction of the full balance sheet obligation for postretirement medical benefits that was reported by the company for accounting purposes under FAS 106. Typically, a VEBA settlement requires contributions of only 50 to 70 percent of the employer's reported obligation. Several factors determine the size of this "discount," including:

- *Interest rate arbitrage.* The difference between the discount rate the employer must use in valuing the liability for FAS 106 purposes and the rate of investment return that the union assumes will be earned by the VEBA in evaluating its agreement.

FAS 106 requires that employers measure and record liabilities using a conservative discount rate based on "high quality fixed income instruments," generally AA or AAA long-term bonds. These rates are currently about six percent.

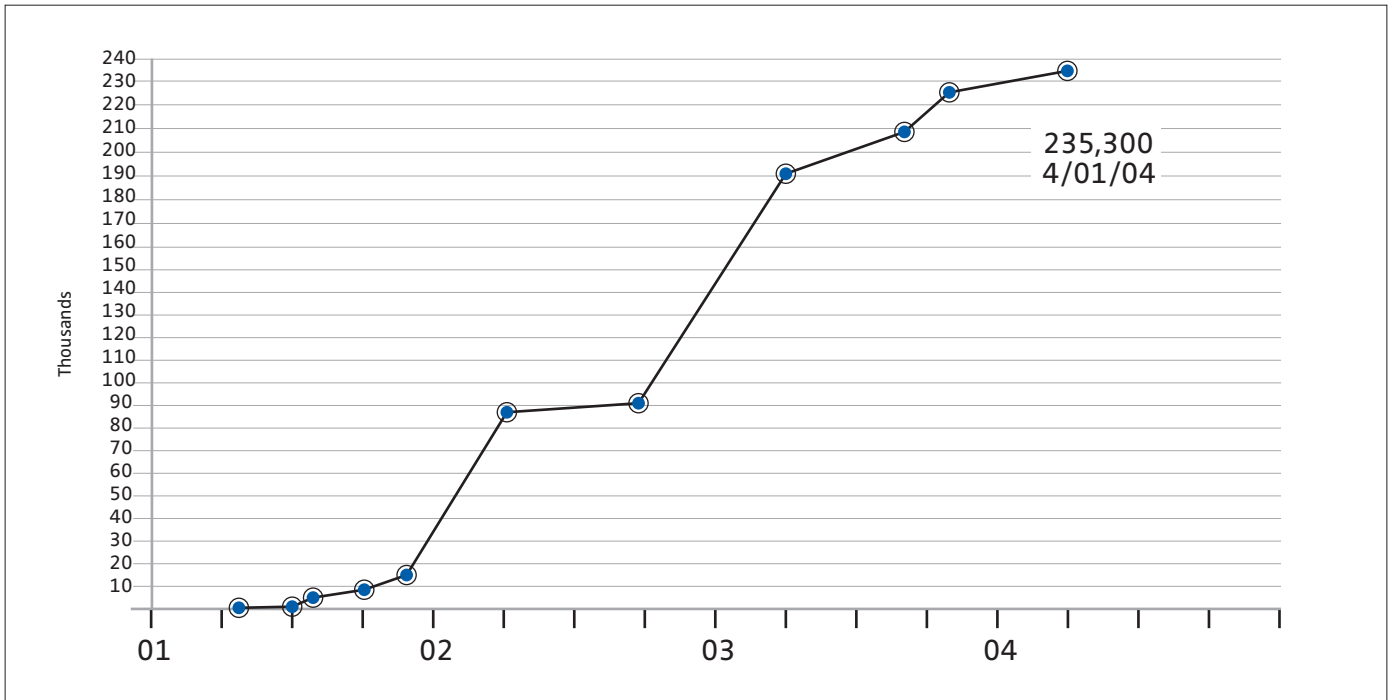
By contrast, a union can choose to evaluate a proposed bargaining agreement by measuring the future obligations that will be transferred to the VEBA using the much higher rate that it expects to earn on invested plan assets. In the GM case, the union used nine percent for this purpose.

All else being equal, this interest rate arbitrage alone can reduce the values assigned to benefit liabilities by 30 percent or more.

- *Future Health Benefit Changes.* FAS 106 prohibits a company from taking account of the possibility of future health plan changes or federal legislation affecting health care costs. Some believe this restriction leads to an overstated measure of the ultimate real obligation. However, an agreement for transferring liabilities to a VEBA can reflect the possibility of future changes —

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**Chart One: Steelworker Retirees Who Lost Health Care Coverage 2001-2004**



Note: Estimated hourly retirees and dependents. Source: United Steelworkers of America.

implicitly or explicitly — thereby further reducing the employer’s contribution required for the VEBA tradeoff.

- *Company’s Possible Bankruptcy.* In distressed industries, the possibility of bankruptcy and the potential for losing all benefits are very real to union members and retirees. Chart One shows the number of retirees from bankrupt and liquidated steel companies who have lost their health care coverage.

Given the likelihood of bankruptcy in some industries, unions representing workers in those industries are willing to trade in rich benefits that are completely unfunded for more modest benefits that are protected with a large infusion of cash.

*“Your bargaining team believes the risk of a future VEBA shortfall is clearly preferable to the risk of relying on GM to continue to provide retiree benefits indefinitely.”*

An excerpt from the statement by the UAW’s leadership to its GM members about the proposed VEBA

### **PARTIES TO THE DEAL**

One requirement for an effective transfer of liabilities to a VEBA is that every faction gets and gives something. The factions include the employer, the union’s leadership, its active members, and current retirees. Union-negotiated agreements generally cannot bind retirees because they are no longer members of the collective bargaining unit. For that reason, litigation may be necessary to bring current retirees under the new arrangement.

In the case of GM, there had previously been a class action lawsuit by union retirees challenging earlier cutbacks. A new class action has been filed, as a step toward the implementation of the recent GM/UAW agreement.

In other situations, the union has collaborated with a group of retirees to file a class action suit. In one recent case, the employer initiated the litigation by requesting a declaratory judgment against the class of retirees. In these kinds of cases, an agreement among the parties to settle the litigation in a way that is consistent with the agreement between the

employer and the union for the VEBA transfer would then be the subject of a hearing. The retirees are given a chance to present their own claims. The litigation is “settled” in a manner that binds the retiree class, only if the court finds that the negotiated deal is fair to the retirees as well as to the employer, the union, and its current membership.

Although it is possible, at least in theory, to implement a buyout VEBA arrangement with current retirees only, without any union involvement, such a deal would not succeed without the protection offered by a litigation settlement.

## FUTURE PAYOUTS

VEBA buyouts can be structured as simple, single lump-sum transfers, but they also can be complex financial transactions, with future payment streams contingent on variables such as:

- Employer’s stock price
- Price of employer’s product and/or amount of product delivered
- Employer’s earnings level
- Actual return on the VEBA’s assets
- Health care inflation
- Potential federal legislation

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## FOR EMPLOYERS CONSIDERING VEBAs: POINTS TO PONDER

VEBAs are not the answer to every employer’s rising retiree health care costs. As mentioned, they could be a viable option for employers in a distressed industry, with an aging, largely unionized workforce entitled to relatively rich, employer-funded retiree medical benefits.

But even employers who fit that profile should consider several important questions before approaching the bargaining table to discuss VEBAs. For instance:

- Does the employer acknowledge that it has an ongoing obligation for retiree benefits, or does the employer contend that it has the right to modify or terminate benefits unilaterally? If the employer believes it can terminate benefits at any time, why pay for the right to eliminate the obligation?
- Is the organization perceived as facing a real possibility of bankruptcy?
- What is the current status of union/management relations? Specifically, is it likely that, under current circumstances, the company can propose this modification to the union during the bargaining process?
- What is the company’s credit rating? How expensive would it be for the company to raise the necessary money to fund the VEBA?
- Are current and future retirees likely to accept modest plan design changes, such as premium cost sharing and increased co-payments, in exchange for the benefit security that the union says the VEBA will provide? Are employees and retirees likely to accept the union’s loss of its right to bargain for such changes with the employer, in exchange for that benefit security?

- What are the perceived prospects for some kind of national health insurance?
- If the employer's retiree population might be too small to eliminate the risk of adverse fluctuations, has the union negotiated similar deals with other employers? If so, it might be possible to work out a deal that would use a VEBA that would cover retirees of more than one employer.

## COMMUNICATION CHALLENGES

Any change that requires the buy-in and support of many different stakeholders, often with different — and conflicting — interests, also requires a good deal of communication to generate that support. This type of VEBA transaction is such a change. It presents communication challenges for employers and unions alike.

An employer must persuade shareholders and analysts that the exchange of open-ended liabilities for the large upfront contribution to the VEBA (and possibly subsequent contributions) will provide a basis for an eventual increase in the stock price. The rationale for this conclusion includes the prospect that the company's health care cost savings and increase in cash flow will be substantial when it stops paying for retirees' health care. It also includes the likelihood that total

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employment costs for new hires (including benefit costs) will decrease. For instance, Ford recently announced that its newly negotiated VEBA buyout is expected to result in a net cash flow benefit of \$1 billion annually when fully operational.

The union's communication challenge is, in essence, to persuade current and future retirees that "a bird in hand is worth two in the bush." The "bird in hand" is the security offered by the new VEBA program; the "two in the bush" is the assumption, however problematic, that the employer will continue to fund retiree health benefits at current levels.

In one respect, current retirees are a hard sell for the union because the union does not legally represent them and they are not parties to its collective bargaining with the employer about the VEBA. In fact, as noted previously, the only way in practice to ensure that current retirees are bound by the negotiated arrangement is through litigation.

In another respect, convincing future retirees to ratify the proposed VEBA can be an even harder sell. Over time, they stand to lose the most if the VEBA turns out to be not as secure as the union advertised. While unions retain actuaries and other experts to look at the projected returns on trust assets, the assumptions that they rely on are typically a few points higher than FAS 106/158 would have allowed any publicly held employer to use in its own projections. Over the years, that difference in projected returns could add up.

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But the investment risk is dwarfed by the risk posed by the relentless increases in health care costs. FAS 106 obligations are generally measured using an assumption that health care cost trend rates will moderate over time and ultimately increase not much faster than inflation. But such expectations may be more optimistic than reality warrants. VEBAs set up in the past have run out of assets before they were able to pay all promised benefits, because of the onslaught of unanticipated increases in health care costs.

Experience suggests that these VEBAs will only be able to work in the long term if those who are appointed by the unions to manage the programs are willing to make hard choices and cut benefits when necessary. Absent that willingness, maintaining current benefit levels will require luck, or more pragmatically, a continuing stream of payments into the VEBA, via some profit-sharing arrangement with the employer. In any event, it's possible that, even if a VEBA appears amply funded, without a hint of "doomsday projections" about benefit levels, some unions may have to make — and communicate — tough decisions regarding future benefit levels.

This brings us to disclosure. Presumably, disclosures to all VEBA participants (and regulators) about projected obligations and the VEBA's ability to meet them will be the responsibility of the union-appointed administrators, just as similar disclosure had been the employer's responsibility. Year after year, these VEBAs will have to disclose enough information to assure interested parties that the trust remains financially viable.

## CONCLUSION

If the government does expand federal health care programs, that coverage will most likely raise current coverage for pre-65 retirees to Medicare levels but no higher. As a result, the desire for employer-based supplemental medical benefits is real and can be expected to continue in the future. This InsightOut raises the question: How should certain employers consider providing it?

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