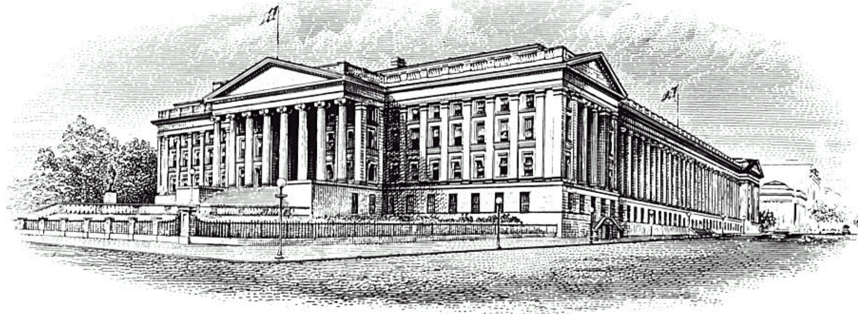

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

For Immediate Release **Contact: Brookly McLaughlin**
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Introduction

With the imminent retirement of the Baby Boom generation and rapidly rising health care costs, our country faces a set of challenges in providing retirement security for the coming generation of retirees. I would like to discuss with you today in some detail the challenges we face, and how the Administration is confronting them.

HSAs

Americans have had very little incentive to plan for, or economize on, health spending, yet health care is the biggest financing challenge we face in the long term. Employer-sponsored health plans often provide extensive health insurance coverage. However, employer-sponsored retiree health coverage has been declining. Plus, the Medicare Hospital Trust Fund is now expected to be insolvent in 2019. Consequently, health care cost growth needs to be moderated, and it is more important than ever that individuals play an active role in their own health care decision-making and purchasing.

To help address this problem, Congress passed, and the President signed, the Medicare Modernization Act of 2003, which makes available Health Savings Accounts to a large portion of the population. The legislation allows employers or employees to put money pre-tax into an account of an employee with a high-deductible health plan. These accounts can accumulate interest, and funds can be withdrawn tax-free to pay for qualified health expenditures. The advantages of such an account are many:

- It encourages people to save for periods of unexpectedly high health expenditures, and it is not tied to any one plan or employer and is therefore portable.
- It moves toward giving covered and uncovered health care equitable tax treatment, reducing the incentive for overinsurance and the accompanying moral hazard.
- It makes health spending more transparent, giving consumers the incentive to demand efficiency from providers.
- While health insurance premiums can in general not be paid for with HSA funds, HSAs can be used to pay for COBRA continuation coverage, reducing the likelihood of someone having to drop insurance coverage in the event of job separation.
- The account can be used in retirement to pay for Medicare premiums, out-of-pocket expenses, and employee share of employer-sponsored retirement health care coverage once an individual becomes eligible for Medicare.

Research using data from the RAND Health Insurance Experiment has shown that HSAs could reduce health care expenditures by 4 percent to 8 percent over a traditional indemnity plan.

Now that HSAs are law, both the government and employers have some implementation issues to deal with. Our Office of Tax Policy is now sorting through some of the issues. They released some guidance last month detailing how preventive care benefits may be exempted from the deductible of a high deductible health plan. The guidance also provides transition relief for people to use HSA funds for qualified medical expenses incurred before the establishment of the HSA.[1] They expect to offer further guidance very soon on whether contributions may be made to an HSA while an individual has a Health Reimbursement Account, or HRA, or a Flexible Spending Account, or FSA, and to what extent prior medical expenditures may be reimbursed by an HSA. And in June, they plan to address a host of other questions that people have raised about HSAs and high deductible health plans.

Employers are also confronting implementation issues. For those who offer employees high deductible health plans, they must decide whether they want to contribute to HSAs, how to set the deductibles, and what kind of copayments they will expect of their employees. They also must decide if high-deductible health plans combined with HSAs will compete side-by-side with low-deductible plans giving employees the choice of plans, or whether they will move to exclusively high-deductible plans.

HSAs are an important new choice to people to help control and manage their health care expenditures in the short and long term.

Long-Term Care

[1] For instance, some HDHPs exempt prescription drugs from the deductible; thus, contributions may not be made to an HSA with this kind of arrangement, and employers have not been able to adapt their plans in time. The Treasury is allowing these plans to still be eligible for HSA contributions until 2006.

There is one other use of HSA funds that I have not mentioned; they may be used to pay long-term care insurance premiums. This is useful, because our society is not prepared to handle the issue of financing care for the elderly disabled. While the incidence of disability is declining, the growth of the population where disability is most prevalent is more than offsetting the decreasing disability rates. Furthermore, like the rest of the health care sector, costs of long-term care services have been rising.

Medicaid spends $46.4 billion on long-term care services for the elderly, a number that has increased by 25 percent since 2000. If per capita LTC cost growth exceeds real GDP growth by 2.5 percent, in other words, stays on the historical growth path of nursing home cost inflation, federal and state Medicaid spending on elderly long-term care will jump from under 0.5 percent of GDP in this year to over 2.5 percent of GDP in 80 years—and that assumes reductions in disability rates continue indefinitely. If that does not sound like a lot to you, think of it this way: total Medicare outlays are not even 2.5 percent today. The details of our calculation are included in an Appendix.

And the recent increase in obesity rates, coupled with many people turning to Medicaid to finance their long-term care needs, mean these projections could understate the financing problem federal and state governments face. Furthermore, some have claimed that people are incorporating Medicaid into long-term retirement and health care planning. This was certainly not the intention of the program's creators. It is therefore an open question whether eligibility rules should be tightened or more strongly enforced, and more generally, how to encourage appropriate long-term planning for long-term care finance.

The Administration would like to encourage people to plan for possible long-term care needs by improving incentives to purchase long-term care insurance. Right now, individuals may deduct qualified long-term care insurance premiums up to certain limits, but only if total medical expenses exceed 7.5 percent of adjusted gross income. The President's 2005 budget requests that individual LTC insurance premiums be fully deductible. Long-term care insurance will undoubtedly play an increasing role in the financial security of Americans, and this policy will help that happen.

Long-term care insurance has been one of my personal research interests for many years. Together with research colleagues Chris Murtaugh and Brenda Spillman, I have been working on developing a concept that would make long-term care insurance more appealing and affordable by combining it with a life annuity. The insurance product would work this way: In return for a single premium, an insurance company would make steady periodic income payments to a retired household (individual or couple), and would increase them substantially when a member of the household is disabled to an extent that would typically cause extra expenses for long-term care to be incurred. Empirical research has shown that, compared to the two components of life annuity and long-term care insurance sold separately, an integrated product can be offered somewhat more cheaply to a larger population that importantly includes people in relatively poor health—individuals who currently cannot purchase any long-term care insurance at any price

because they cannot pass through underwriting. These advantages can occur because the product combines two different risk pools into one population.

A particular advantage of this approach, which is timed for those nearing retirement and recently retired, is that it does not demand that households make purchase decisions regarding long-term care insurance early in their life cycle. Early purchase is the alternative approach advocated by some to get around the underwriting problem of long-term care insurance sold at older ages.

It is admitted that the life care annuity cannot serve the needs for long-term care insurance coverage for all populations, especially low-income retired households. Nevertheless, its potential scope is quite large, including households with all types of retirement financial assets, including tax-favored forms, and owner-occupied housing (through reverse mortgages). This innovation could significantly improve the economic security of most retired households, substantially reduce dependence on the public means-tested Medicaid welfare and Medicare insurance programs, and encourage further product innovations. Several variations are possible in product design, both in the nature of provision of long-term care benefits and in the income annuity benefits, and in the level of benefits provided. In particular, the product can be designed to fit into state Medicaid partnership programs.

But there are still a few steps that need to be taken before this product can become marketable. With my colleagues in the Treasury's Office of Tax Policy, I am exploring the different tax treatments of the product. There are several open issues, depending on how such a policy is structured, that is, whether it is structured as two separate products for tax purposes, or whether it is treated as an annuity for tax purposes. Legislative and regulatory changes may be required to ensure such a product is legal and taxed appropriately. Furthermore, insurance companies may want more experience or protections, such as participating policies, before they commit themselves to selling long-term care-related policies in which the entire premium is paid for upfront.

LSAs and RSAs

The Administration is also examining ways to better encourage saving for retirement and other long-term needs. The current system of IRAs and Roth IRAs is very complex, subject to rules regarding eligibility, contributions, tax treatment, and withdrawal. The list of non-retirement exceptions within IRAs, which is expanding, weakens the focus on retirement saving. The restrictions on withdrawals for certain purposes discourage individuals from contributing to these accounts, afraid that they will not have funds to cover unpredictable expenses. The President has asked Congress to consolidate the different types of IRAs into one account dedicated solely for retirement, and to create a new account that would encourage saving, but could also be used for any expenses a taxpayer wanted.

Retirement Savings Accounts, or RSAs, would be dedicated solely to retirement savings. Individuals would be able to contribute $5,000 per year, indexed to inflation. In contrast

to the current set of IRAs, there would be no income limits on contributions. Like Roth IRAs, contributions would not be tax deductible, but earnings would accumulate tax-free and qualified distributions would be excluded from gross income. Existing IRAs would be rolled over to RSAs.

Like with RSAs, individuals could also contribute up to $5,000 annually to a Lifetime Savings Account, or LSA. Contributions to LSAs would also have to be in cash, they would be nondeductible, yet earnings would accumulate tax-free. But unlike with RSAs, *any* distributions would be excluded from gross income, regardless of the individual's age or use of the distribution. Thus, there are no mandates on use of funds. However, because the LSA accumulates earnings tax-free, individuals would have a strong incentive to leave funds in the account.

By simplifying and enhancing the tax preferences for savings, people will take advantage of the incentives to plan for short- and long-term needs.

Social Security

Any discussion involving financing retirement must touch on the issue of Social Security. The recently released Social Security Trustees Report shows once again that the program, as currently structured, is unsustainable. However, the problem of financing Social Security is fixable. The President has issued three guiding principles for reforming Social Security:

- The program should protect seniors, meaning that retirees and near-retirees should not face a cut in benefits.
- Personal retirement accounts should be made available, to give individuals different options to plan for their retirement.
- Reforms should make the program permanently sustainable, so we do not have to revisit this topic repeatedly, making generation after generation fear that their retirement will not be funded as promised.

If we keep these sensible principles in mind as we work through reform proposals, we should be able to find a solution that will guarantee many generations a secure retirement.

Fundamental Pension Reform and Measurement Improvements

1. Introduction

I would like to spend the bulk of my discussion here talking about needed reforms to the private pension system. We all want to improve the retirement security for the nation's workers and retirees by strengthening the financial health of the voluntary defined benefit system that they rely upon. We believe that with improvements, the DB system will continue to be a viable and important part of the American retirement system.

I will discuss the Administration's proposals and ongoing activities aimed at strengthening the long-term health of the defined benefit pension system and thereby improving the retirement security of defined benefit pension participants. I don't think it will come as a surprise to anyone that I, the Treasury Department and the Administration all believe the ERISA rules can be improved.

What might surprise some of you is that we are actively engaged in developing a proposal for comprehensive reform of the system. While we are not ready to unveil a fully formed proposal for comprehensive reform of the pension funding rules, I can discuss some of the areas we are studying and provide what I believe are important guiding principles for the process.

2. Facts

Some basic facts about the DB system and PBGC's financial health suggest that we need to be concerned about the current set of funding rules:

- PBGC's single employer plan ended 2003 with a record deficit of $11.2 billion. This deficit is the result of two consecutive years of staggering net losses. Net loss for 2002 was $11.2 billion. Net loss for 2003 was $7.6 billion.

- PBGC's multiemployer program reported a year end deficit of $261 million. This is the first deficit in more than 20 years and the largest ever.

- In 2003 PBGC absorbed 152 terminated single-employer plans covering 206,000 participants.

- Including multi-employer plans, at year-end, PBGC was responsible for the pensions of more than 930,000 people.

- PBGC's single employer plan continues to face significant exposure from troubled companies with underfunded plans, particularly in the air transportation and steel sectors. PBGC estimates that total underfunding in single-employer plans exceeded $350 billion as of the fiscal year-end. Underfunding in multi-employer plans is estimated at $100 billion.

- This is not a transitory problem: PBGC uses stochastic modeling to evaluate its exposure and expected claims. The results of this modeling are quite sobering. The distribution of PBGC's potential 2013 financial position has a median deficit of $18.7 billion. There is only a 19 percent probability of a surplus of any amount – and an equal probability of deficits exceeding $32 billion.

3. Administration's Proposal to Improve the Accuracy and Transparency of Pension Information

Before discussing comprehensive reform, I would like to briefly discuss the proposals that the Administration has already put forward in this area. In July 2003, we released the Administration's Proposal to Improve the Accuracy and Transparency of Pension Information. This proposal was designed to strengthen and secure Americans' pension security by:

- Improving the accuracy of the pension liability discount rate;
- Increasing the transparency of pension plan information; and
- Strengthening safeguards against pension underfunding.

We have been disappointed that Congress has not acted on the majority of the proposals we put forward.

The proposal that has generated the most discussion and debate is our proposal to use a yield curve based on high-quality corporate bonds to discount pension liabilities and smoothed over 90 days for the purpose of computing current liability.

To determine minimum required funding contributions, a plan sponsor must compute the present value of the plan participants' accrued future benefit payments, which is known as the plan's current liability. The present value of a benefit payment due during a particular future year is calculated by applying a discount factor to the dollar amount of that payment. This discount factor converts the dollar value of the future payment to today's dollars. Current liability is simply the sum of all these discounted future payments.

Pension liabilities must be accurately measured to ensure that pension plans are adequately funded to protect workers' and retirees' benefits and to ensure that minimum funding rules do not impose unnecessary financial burdens on plan sponsors. Liability estimates that are too low will lead to plan underfunding, potentially undermining benefit security. Pension plan liability estimates that are too high lead to higher than necessary minimum contributions, reducing the likelihood that sponsors will continue to operate defined benefit plans.

Choosing the right rate is the key to accurate pension discounting. The wrong rate leads to inaccurate estimates of liabilities that can be either too high or too low. Therefore, the primary goal of the Administration's proposal to replace the 30-year Treasury rate can be summed up in one word: <u>accuracy</u>.

Each pension plan has a unique schedule of future benefit payments - or cash flow profile - that depends on the characteristics of the work force covered by the plan. In general, plans with more retirees and older workers, more lump sum payments, and shrinking workforces will make a higher percentage of their pension payments in the near future, while plans with younger workers, fewer retirees, fewer lump sums, and growing workforces will make a higher percentage of payments in later years.

Current liability computation rule apply the same discount rate to all future payments regardless of when they occur. This approach produces inaccurate liability estimates because it ignores a basic reality of financial markets: that the rate of interest earned on an investment or paid on a loan varies with the length of time of the investment on the loan. If a consumer goes to a bank to buy a Certificate of Deposit, he will expect to receive a higher rate on a five-year CD than on a one-year CD. Likewise, that same consumer who borrows money to buy a house expects to pay a higher interest rate for a 30-year than a 15-year mortgage.

Pension discount rates must recognize this simple financial reality which is the main thrust of our proposal.

Beyond the discount rate, there were two other reform tasks that the Administration recommended for immediate attention.

- First, the transparency of information pertaining to pension plan funding needs to be increased.

    - We propose requiring that each year sponsors disclose to participants the value of their defined benefit pension plan assets and liabilities measured on both a current liability and a termination liability basis.

    - In addition, we proposed that certain financial data already collected by the PBGC from companies sponsoring pension plans with more than $50 million of underfunding should be made public.

- Second, the Administration proposed to restrict benefit increases for certain underfunded plans whose sponsors are financially troubled. When firms with below investment grade credit ratings increase pension benefit promises, the costs of these added benefits stand a good chance of being passed on to the pension insurance system, frustrating the benefit expectations of workers and retirees and penalizing employers who have adequately funded their plans.

    - Under the Administration's proposal, if a plan sponsored by a firm with a below investment grade credit rating has a funding ratio below 50 percent of termination liability, benefit improvements would be prohibited, the plan would be frozen (no accruals resulting from additional service, age or salary growth), and lump sum payments would be prohibited unless the employer contributes cash or provides security to fully fund these added benefits.

    - When a plan sponsor files for bankruptcy the PBGC's guarantee limits would also be frozen.

We felt this was a constructive, forward looking set of proposals that would have helped ensure PBGC and plan solvency in the short-term, while setting the table for more fundamental reforms.

4. Fundamental Reform

Making Americans' pensions more secure is a big job that will require comprehensive reform of the pension system. Americans have a broadly shared interest in adequate funding of employer-provided defined benefit pensions. Without adequate funding, the retirement income of America's workers will be insecure. This by itself is a powerful reason to pursue improvements in our pension system. At the same time, we must always be mindful that the defined benefit pension system is voluntary. Firms offer defined benefit pensions to their workers as an employee benefit, as a form of compensation. Our pension rules should thus be structured in ways that encourage, rather than discourage, employer participation.

Key aspects of the current system frustrate participating employers while also failing to produce adequate funding. We thus have multiple incentives to improve our pension system, and to thus better ensure both the availability and the viability of worker pensions. We have begun the hard work needed to create a system that more clearly and effectively funds pension benefits. We will develop a pension system that will be less complex, more flexible, logically consistent, and will achieve the goal of improving the security of defined benefit plans.

While the Administration continues to consider comprehensive reform measures, I'd like to discuss some of the goals for reform/principles that underpin my thinking about reform and discuss the major areas of pension law that I believe require our prompt attention. First some starting principles for a reform proposal that:

- **Current regime has failed to ensure adequate plan funding.** Current defined benefit (DB) pension funding rules are needlessly complex and fail to ensure that many pension plans remain prudently funded. The rules attempt to ensure adequate funding by micromanaging plan behavior.
- **Funding rules should focus on outcomes not process.** The government has an interest in defining a minimum prudent funding level and maximum tax deductible funding. Many other funding decisions are best left to plan sponsors. Sponsors of adequately funded plans should be given maximum flexibility. Sponsors of minimally or underfunded plans should be required to take timely corrective actions.
- **A successful proposal will center on the use of real incentives to motivate desired behavior and frees responsible plans from burdensome regulation.**

It may be clear to some of you that I am suggesting a real overhaul of the ERISA rules may be necessary. Let's discuss some general areas of concern that we are studying.

1. Funding Targets

We will seek to develop better, more economically meaningful, funding targets.

Asset Measurement. Under existing rules, assets can be measured as multi-year averages rather than current values. Pension funding levels can only be set appropriately if both asset and liability measures are current and accurate. Failure to accurately measure assets and liabilities contributes to funding volatility.

Liability Measurement. We also intend to examine how the application of actuarial assumptions in the current rules may contribute to funding volatility and to inaccurate measurement of pension liabilities. We will examine:

a. *Retirement Assumptions*. Retirement assumptions made by plan actuaries need to reflect the actual retirement behavior of those covered by the plan.

b. *Lump Sums*. Liability computations for minimum funding purposes need to include reasonable estimates of expected future lump sum withdrawals that are determined by methodologies that are broadly consistent with other estimates of plan obligations.

c. *Mortality.* Treasury is in the process of updating mortality assumptions.

2. Funding Path

The current system of funding rules and asset and liability measurement has been constructed, in part, to dampen the volatility of firms' funding contributions. Yet current rules fail to do so. After years of making few or no contributions at all, many firms are facing precipitous increases in their annual funding requirements. This outcome is frustrating to business and it has failed to provide adequate funding for workers and retirees. Improvements to funding rules should mitigate volatility, provide firms with the ability to make more consistent contributions, and increase flexibility for firms to fund up their plans in good times. Specific issues in the funding rules that need to be examined include:

a. *Contribution Deductibility.* Together, minimum funding rules and limits on maximum deductible contributions require sponsors to manage their funds within a narrow range. Raising the limits on deductible contributions would allow sponsors to build larger surpluses to provide a better cushion for bad times.

b. *Credit Balances*. If a sponsor makes a contribution in any given year that exceeds the minimum required contribution, the excess plus interest can be credited against future required contributions. These credit balances - mere accounting entries - do not fall in value even if the assets that back them lose value. Credit balances allow seriously underfunded plans to avoid making contributions, often for years, and contribute to funding volatility.

c. *Volatility Caused by the Minimum Funding Backstop*. The current minimum funding backstop, known as the deficit reduction contribution, causes minimum contributions of underfunded plans to be excessively volatile from year to year.

d. *New Benefit Restrictions.* The current Administration proposal is to restrict benefit increases for certain underfunded plans whose sponsors are financially troubled. We are looking at areas where it may be appropriate to expand this proposal.

e. *Benefit Amortization*. The amortization period for new benefits can be up to 30 years long. This may be excessive. We will also look at other statutorily defined amortization periods.

3. Other Issues

a. *Extent of Benefit Coverage*. It may be advisable to limit or eliminate guarantees of certain benefits that typically are not funded, such as shutdown benefits.

b. *Multi-employer Plan Problems*. Multi-employer plans operate under a different set of rules than single-employer plans. Despite these regulatory differences, the same principles of accuracy and transparency should apply to multi-employer plans, and we will be reviewing the best ways to accomplish this.

c. *PBGC Premiums*. PBGC's premium structure should be re-examined to see whether it can better reflect the risk posed by various plans to the pension system as a whole.

Conclusion

To briefly conclude, we have mounting challenges facing us with our system of financing retiree health care, long-term care, and pensions. Waiting to deal with these problems until they become a crisis will sharply limit our options. Because we know these problems will only get worse, it is imperative that we commit ourselves to addressing them now. I believe the policies I have mentioned today shows the Administration is committed to addressing these challenges.

Appendix:

- The aging U.S. population will create increasing demand for long-term care services.
- Medicaid is an important source of financing for both institutional and home-based long-term care. For instance, Medicaid funds 49 percent of aggregate nursing home expenditures.
- The CBO projects that in 2004, Medicaid will spend $46.4 billion on long-term care for the elderly, an increase of 25 percent since 2000.
- Even though incidence of disability is declining, price inflation and demographic changes are likely to increase the federal burden, through the Medicaid program, of financing long-term care.
- Assuming a continuation of historical rates of decline in disability, as well as historical cost inflation of long-term care services, Medicaid financing of long-term care for the elderly will amount to 2.5 percent of GDP in 2082, up from 0.4 percent of GDP today. This would make it larger, as a share of the economy, then the entire Medicare program today.
- This projected growth rate could understate what will actually occur. Actual growth rates will exceed GDP plus 2.5 percentage points if (1) people increasingly structure their finances so as to rely on Medicaid for long-term care needs; (2) the obesity epidemic increases disability incidence; or (3) the reduction in fertility rates leads to increasing reliance on professional services for long-term care.