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Reshaping the Multiemployer Health & Welfare Investment Landscape

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Executive Summary

Multiemployer Health & Welfare plans are in the midst of an economic climate where rising healthcare costs will be transformative for both insured and self-funded plans. Increased cost implications, as a product of several factors such as the Affordable Care Act (ACA) provisions, increased insurance premiums and rising pharmaceutical drug prices have a direct financial impact on Multiemployer Health & Welfare plan assets. This paper aims to identify how rising health care costs will factor into how Multiemployer Health & Welfare plans make critical investment asset allocation decisions moving forward.

Introduction

Whether considering the new federally mandated provisions set forth by the Affordable Care Act (ACA), looking at the ever increasing prices of pharmaceutical drugs, or increased insurance premiums, healthcare costs in the United States are on the rise. It is now timely for Multiemployer Health & Welfare plans to determine the specific investment implications rising costs will implicitly have on broad plan asset allocation decisions. In order for plans to prudently mitigate the risks and uncertainty associated with the rising costs, they will need to assess several key asset allocation decisions. These asset allocation decisions, tailored to a plan's specific type (insured or self-funded), contributions, and liabilities, will directly play a role in the longevity and solvency of plan pooled assets responsible for providing healthcare benefits to plan participants. Consequently, determining which factors to

rising healthcare costs will be most impactful and implementing asset allocation decisions to account for those factors will help decrease the burden on the employers and employees of Multiemployer Health & Welfare plans.

Implications of Insured Vs. Self-Funded Plans

Multiemployer Health & Welfare plans can be categorized into two buckets: insured plans and self-funded plans. Fully-insured plans are preempted under the Employee Retirement Income Security Act of 1974 (ERISA), the legal framework regulating the provisions of employer-provided Pension and Health & Welfare plans, to comply with federally mandated minimum essential health benefits coverage. Insured plans pay a fixed monthly premium to a third-party insurer in order to cover administration costs and claims incurred by plan participants. Although insured plans are exposed to the totality of costs associated with ACA provisions and increased insurance premiums, their costs are less volatile because the premiums paid to the insurer are guaranteed for a fixed time period (i.e. 12 months). The ACA has effectively removed maximum limits on annual and lifetime claims and required that dependents under the age of 26 be covered. Although these provisions introduce new complexity to plan expenses which will likely increase premiums for these plans, insured plans experience relatively limited excessive volatility with expenses and liabilities.

Self-funded plans, on the other hand, are not covered by a third party insurer and, in turn, are not fully- preempted under ERISA to comply with federal statutorily mandated benefits. A plan's self-funded status allows for more flexible plan discretion over the benefits offered to the participants and allows for a cost-effective process in choosing those desired benefits. While self-funded plans enjoy the anonymity from the statutorily mandated minimum essential coverage which insured plans are subject to, self-funded plans are directly liable for all participant claims (however small or large), administrative expenses, as well as additional expenses that may be incurred from long-term rising healthcare costs. The potential for large drawdowns due to high claims or a large macroeconomic event is a significant risk that can be detrimental to a plan's ability to anticipate expenses and budget reserve assets. Stop-loss coverage, an insurance policy for self-funded plans, can play a critical role in preventing these large drawdown events. With the effective removal of maximum limits on annual and lifetime healthcare coverage by the ACA, the cost of stop-loss coverage will likely rise in the future. Also, should any self-funded plan pre-existing the ACA, also known as "Grandfathered" , materially change the plan's structure, such as the benefits offered, employee contribution rate, etc., the plan will lose its Grandfathered status and be subject to additional provisional costs mandated by ACA. Maintaining the Grandfathered rights or deciding to forgo Grandfathered status introduces additional investment implications for self-funded plans. Nevertheless, understanding the fundamental differences between insured and self-funded Multiemployer Health & Welfare plans is vital for a plan sponsor to make the most beneficial asset allocations decisions with these rising healthcare costs in mind.

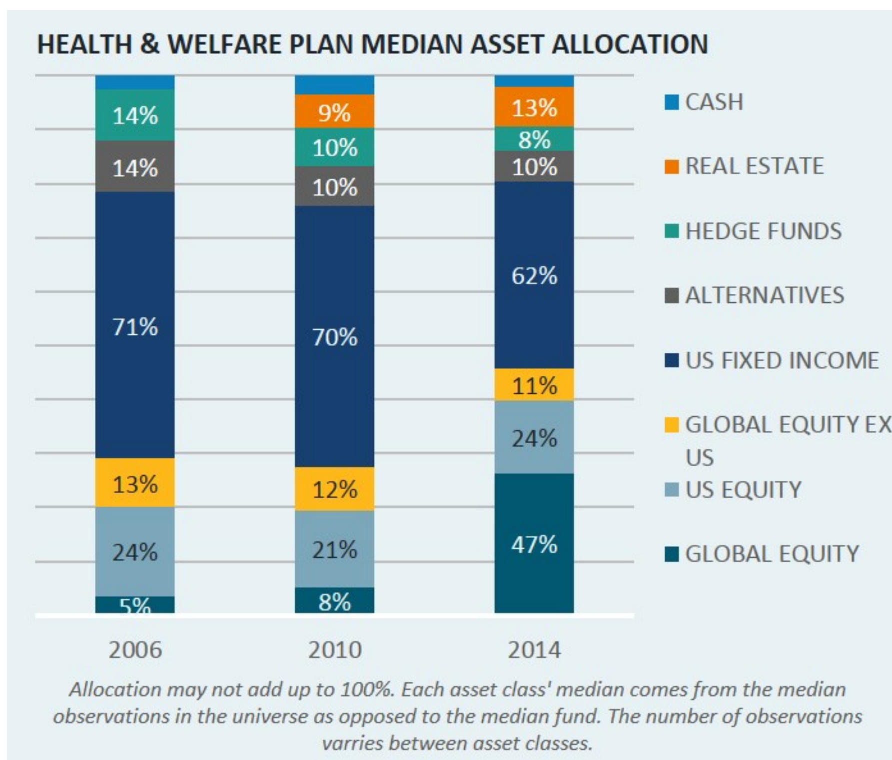
Key Asset llocation Considerations

Conventionally, a plan's asset allocation diversification is correlated to a plan's cash flows. Multiemployer Health & Welfare plans are a collective pool of assets in which asset inflows consist of contributions and investment income. Asset outflows consist of benefit or premium expenses and operating expenses. Participant premiums or claims typically make up 88% to 92% of total plan costs, while other expenses account for only 8% to 12%.2 The collective pool of assets are held as either liquid, cash reserves (restricted reserves) or investable assets (unrestricted reserves). Restricted reserve assets are specifically held to maintain liquidity and pay off monthly expenses. Unrestricted reserves are not immediately needed to cover expenses and are diversified into an investment portfolio predominantly consisting of core fixed income assets. Below is a chart that is representative of a plan in which total quarterly expenses are sufficiently covered by restricted reserve assets. Plan assets that are in excess of the restricted reserves, and not required for quarterly expenses, are invested.

The primary risks associated with the unrestricted reserve assets are interest rate risk, inflation risk, active manager risk and equity market risk. Components of the expanding healthcare costs directly impact the conventional structure of a plan's cash inflows and outflows and, in turn, the long-term asset allocation diversification of the plan. The risk profile and projected long-term cash flow assumptions for restricted and unrestricted reserves will be unique for each specific plan. In general, a longer time horizon of reserve assets will allow a plan to assume more risk. Each plan will need to individually assess the long-term time horizon of reserve assets in order to make the appropriate asset allocation decisions. With a comprehensive understanding of plan type distinctions and implications of projected long-term cash flow assumptions, below are several broad asset allocation proposals for individual plans to consider in light of mounting healthcare costs.

Investment Asset Allocation Decision - Los Rising Cost Scenario

A low rising cost scenario impacting expenses for both insured and self-funded plans is exemplified by an excise tax, otherwise known as the "transitional reinsurance fee."3 This regulation, unexpectedly imposed on both plan types to help subsidize the private insurers who offer coverage to the exchanges, charges insured and self-funded plans a $63 fee per plan participant in 2014. In 2015, an additional $44 fee per plan participant will be charged to insured plans, but fully self-funded plans will largely be exempt. In order to account for this relatively smaller, unexpected increase in asset outflows, plans with healthy reserve assets (as seen in the Plan Structure Chart) should consider diversifying their unrestricted bond portfolio to include assets that raise the overall expected return of the plan. This can be accomplished by allocating a percentage of assets to non-treasury, spread yielding asset classes such as high yield debt, emerging market debt, or floating rate debt. Albeit more inherently risky, these assets have low correlations to core bonds and offer additional yield to increase the expected return of the plan. Largely dependent upon the long-term cash flow assumptions and financial solvency of plan assets, diversifying to higher risk assets such as domestic or international equity would also increase the overall risk profile of the plan. The chart below is illustrative of the broad asset allocation of the median Health & Welfare plan over time. Preceding 2010, plans had a median allocation of 71% to US fixed income assets. Looking forward to current day 2014, plans have further diversified their portfolios by reducing their median US fixed income exposure to 62% (9% decrease in total fixed income allocation).



Allocation may not add up to 100%. Each asset class' median comes from the median observations in the universe as opposed to the median fund. The number of observations varries between asset classes.

Generally, insured plans will be able to diversify their unrestricted reserves to a larger extent than self-funded plans because their restricted reserve cash assets are more stable and do not experience the volatility of inflows and outflows self-funded plans do. As the transitional reinsurance fee does reduce plan revenues and restricted reserve assets, it will not be feasible for all plans to accept more risk and, in turn, some will need to pursue a portfolio that ensures financial stability in a volatile market environment. This scenario is detailed below.

Investment Assets Allocation Decision - High Rising Cost Scenario

Comparatively, high rising cost scenarios will have a more significant effect on cash flows and the future risk profile of both insured and self-funded plans. Examples of high rising cost scenarios are a general rise in insurance premiums or the healthcare reform tax coined the "Cadillac Tax."[4] Forecasted for 2018, the Cadillac Tax is a provision that imposes a 40% tax on annual cost of healthcare coverage above $10,200 for individual coverage and $27,500 for family coverage. This provision will largely affect Grandfathered self-funded plans in which benefit coverage, although costly, far exceeds the benefits offered by private health care exchanges created by the ACA. The Cadillac Tax will be a relatively large provision that will effectively increase costs, reduce net inflows and introduce more risk and uncertainty to a plan's financial stability. Consequently, with less certainty regarding a plan's fiscal ability to pay for benefits or premiums, Multiemployer Health & Welfare plans with a shorter time horizon for reserve assets may need to consider a more stable, risk adverse investment portfolio. This can be accomplished by diversifying the unrestricted reserve bond portfolio and reducing the duration of fixed income assets.

The primary investment risk facing Multiemployer Health & Welfare plans is interest rate risk to the unrestricted reserve core bond assets. As the U.S. Federal Reserve Bank continues to wind down its Quantitative Easing (QE) programs, investors are anticipating a period of rising interest rates. A bond portfolio should be positioned to mitigate capital losses during this rising interest rate event in order maintain financial solvency and be able to incur additional costs such as the Cadillac Tax referenced above. The main tool used to hedge a bond portfolio against rising rates is to shorten the average duration of the fixed income assets. For example, a 1% increase in interest rates would reduce the value a core bond portfolio with an average duration of 6 years by 6%. Comparatively, shortening the average duration of the bond portfolio to 2 years only reduces the value of the portfolio by 2%. Although allocating a percentage of the unrestricted reserve assets to short duration bonds is the most effective means to protecting capital in a rising interest rate environment, the portfolio will sacrifice yield (income) as a trade-off for principal capital protection. With that being said, as rates rise, income generated from the short duration allocation can be re-invested at higher yields..

The Important Role of Multiemployer Health & Welfare Plans

Although the investment landscape of Multiemployer Health & Welfare plans is ever-changing and plans will inevitably face new challenges with the rising cost of healthcare in the U.S., the traditional Multiemployer Health & Welfare plan is undoubtedly a core component of the

healthcare coverage marketplace as a whole. Distinctions in coverage is one factor that sets the Multiemployer plans apart. The ACA-created healthcare exchanges typically offer health coverage plus dental and vision coverage. Multiemployer plans provide health coverage, including dental and vision, but also offer non-health benefits to participants such as "loss-of-time" coverage, extension of benefits when work is unavailable, life insurance, and accidental death insurance.

Another distinction benefiting Multiemployer plans is explained in "Multiemployer Plans vs. The Exchanges: Digging In or Letting Go"

> *Another crucial area of divergence is that Multiemployer plans are nonprofit entities that exist solely for the benefit of their participants and beneficiaries. Multiemployer plans are often self-funded and typically spend 90 cents to 95 cents of every dollar directly on providing healthcare. Administrative costs are extremely low and there are no profit incentives. On the other hand, the exchanges will be dominated by insurance companies, which by law can spend as little as 85 cents of every dollar on healthcare in the large employer market. Insurers have a different mission than multiemployer plan trustees because they are not focused exclusively on providing benefits, but must also look to growth, profit, overhead, research, marketing and other business-related costs.*

From the relatively low rising cost scenario to the high rising cost scenario, rising healthcare costs may seem like a formidable hurdle for Multiemployer Health & Welfare plans moving into the future, but there remain many inherent characteristics unique to them that will greatly benefit the participants' healthcare coverage in the long run.

Conclusion

Rising healthcare costs will be transformative for Multiemployer Health & Welfare plans which have been providing reliable and comprehensive health benefit coverage to workers since 1974. New and increasing costs for both insured and self-funded plans will have long-term implications directly affecting how plans pay for benefits offered to participants. Facing increased uncertainty regarding the full consequence of rising healthcare costs moving forward, Multiemployer Health & Welfare plans must be cognizant of the financial challenges brought on by the evolving healthcare marketplace. In light of these financial challenges, strategic asset allocation considerations will be critical in mitigating the impact of rising healthcare costs and ensuring Multiemployer Health & Welfare plans endure to provide the all-encompassing health benefit coverage to participants well into the future.

Notes & Disclosures

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3. 3Maher, Kris and Trottman, Melanie, "New Costs From Health Law Snarl Union Contract Talks." Wall Street Journal. http://online.wsj.com/news/articles/SB10001424052702303749904579580604081967202
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