POST-RETIREMENT MEDICAL SCHEME ("PRMS") CONTRIBUTIONS

Paper on:

FUNDING PRMS CONTRIBUTIONS
Issues for Members and Employers

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Introduction

This document has been drafted to position Old Mutual’s view in respect of the protection and funding of post-retirement medical scheme (“PRMS”) contributions.

Old Mutual is at the forefront of assisting many employers who subsidise the PRMS contributions of some or all of their retired employees. This document therefore provides insight into some of the difficulties and challenges faced by members wishing to secure their medical cover in retirement as well as employers who provide such subsidy benefits.

Old Mutual is aware of papers that have been distributed by National Treasury and the Department of Social Development that deal with this subject. This paper is not a response to those papers but is merely intended to add to the debate.

A critical issue remains one of funding. PRMS contributions are typically funded directly by members and employers, and indirectly, by other medical scheme members (through cross-subsidies) and government (through tax subsidies). This paper focuses predominantly on the PRMS contributions funded directly by the members and the employers.
Understanding the employers’ role in PRMS contributions

1. The subsidy has the benefit of promoting & rewarding service loyalty ...

One of the key reasons for employers introducing PRMS subsidy benefits was to ensure that employees continued to enjoy medical cover in retirement. This has the effect of promoting loyalty amongst staff by virtue of it being conditional on, and thereby encouraging members to retire from service with that particular employer.

2. A PRMS subsidy is a defined benefit obligation ...

When a company or institution provides a PRMS subsidy, it undertakes to pay a portion of the monthly medical scheme contributions in respect of its pensioners for as long as they, and or their dependants survive, and remain members of the medical scheme. A post-retirement medical aid subsidy is therefore similar to a defined benefit pension arrangement, whereby an institution undertakes to pay a predetermined monthly Rand amount to its pensioners and their spouses for as long as they live.

3. The subsidy is typically expressed as a fixed percentage of medical aid contribution rates ...

Research conducted by Old Mutual suggests that the majority of entities that offer the PRMS benefit still express the subsidy as a percentage of the monthly contributions required by their nominated medical scheme, with these percentages generally varying between 50% and 100%. In these cases pensioners enjoy some protection against future increases in medical scheme contribution rates, as the subsidy will continue paying a fixed percentage of the pensioners’ medical aid contributions during retirement. At the same time this type of retirement benefit exposes companies to price increases in the medical scheme industry, which, historically have exceeded general consumer inflation.

4. The costs associated with this benefit are significant and expected to grow ...

The applicable accounting standard (IAS19 Employee Benefits) requires companies to provide for the cumulative costs associated with this subsidy in a particular manner. Old Mutual estimated that Corporate South Africa had accounted for a liability of more than R30bn for its collective PRMS subsidy obligations by the end of 2004. This figure has increased and will continue to do so over the medium term as the accounting provision spreads the costs of the provision over the working lives of their employees. Thus a key driver of the growth in the provision is the additional service rendered by employees that qualify for the subsidy.

5. Most employers have not set funds aside specifically for this purpose ...

Even though employers are making adequate provision for the costs of this healthcare-related retirement benefit in their financial statements, research suggests that the majority of employers are adopting a pay-as-you-go approach in meeting this obligation. This implies that the payment of future PRMS subsidies are not absolutely secure but remain dependent on the future financial health of the employer.

6. But acknowledge that this is a significant benefit for pensioners ...

In today’s terms a typical PRMS subsidy provides a significant benefit to pensioners as it allows them to remain members of their private medical schemes at a relatively low cost, exactly at a time when their income levels have reduced significantly. This is based on the following observations:

- Old Mutual estimated in 2005 that the average PRMS subsidy being provided by companies was in excess of R1000 per pensioner per month. The reason for the relatively high number is that most companies still subsidise the medical scheme contributions of both the main member and his/her adult dependent.

- Old Mutual estimated that the average contributions made by pensioners to their medical aid schemes are in excess of R1250 per month, before allowing for the impact of the subsidy. Note, however, that this figure can vary significantly between individual pensioners, depending on the level of cover they can afford and the medical scheme to which they belong.

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1 Old Mutual Healthcare Survey 2005
2 Old Mutual Healthcare Survey 2005
3 Based on behaviour of the pensioners of the Old Mutual Staff Medical Aid Scheme during 2004/05.
Thus, on average, employers that offer a post-retirement subsidy to their pensioners are typically contributing between 50 and 100% of their pensioners’ medical aid contributions in today’s terms. The subsidy therefore allows pensioners to remain on their private medical aid schemes during retirement and share in the cross-subsidisation benefits offered by the private medical scheme industry. A pensioner who belongs to a private medical scheme can therefore typically gain access to medical benefits and services at 20-30% of their true costs due to the fact that their contributions are being subsidised by younger, healthier members of the same scheme.

In addition, the subsidy benefit is significant if compared to the disposable income of a typical pensioner. Old Mutual estimates that the average pensioner earns between R2500 and R3000 per month as a pension from their company sponsored retirement fund. A subsidy of R1000 per month therefore equals 30-40% of the pensioners’ main source of income.

7. Generally speaking employers are trying to manage their costs down...

Even though a PRMS subsidy offers significant benefits to current and future pensioners, the obligation has exposed Corporate South Africa to a very volatile and expensive industry. In particular, increases in medical scheme contributions have historically outstripped CPIX increases by a factor of two. Corporate South Africa has reacted to this issue by removing or reducing the subsidy benefit. The following section considers the various reactions and highlights the possible implications.

The majority of employers no longer offer this benefit to new employees. These employees will not enjoy a medical aid subsidy in retirement and will have to pay 100% of their medical scheme contributions if they want to remain members of their medical schemes. Based on the numbers quoted above, this would imply that a typical pensioner would have to sacrifice 40-50% of their income to maintain the level of medical cover they enjoyed just before retirement. If this cover is not affordable to them, they can reduce the chosen level of medical cover, i.e. move to a cheaper medical scheme option. However, they may not be able to afford even the cheapest level of private scheme cover and be forced onto the public healthcare system.

A number of employers have capped their exposure to future cost increases by limiting the rate of increase in the subsidy to either CPIX or salary inflation. If medical scheme contribution rate increases remain significantly higher than CPIX, this trend will gradually reduce the real value of the subsidy and, in extreme cases, lead to the subsidy no longer being sufficient to allow pensioners to remain members of their private medical scheme. Once again the end result will be a movement of pensioners from the private to the public healthcare system.

A number of employers have settled their future obligations with their current employees by offering them alternative forms of compensation, e.g. cash lump sum or additional contributions to their Retirement Funds or other savings vehicles. A key result of these settlement offers is that the risk of future medical scheme contribution increases are transferred from the employer to its employees. If actual medical scheme contribution increases outstrip the allowance for future increases included in the offer amounts, the offers may not be sufficient to allow future pensioners to remain members of their medical aid schemes in retirement.

As employers seek to settle or amend their PRMS subsidy obligations in the manner set out above there is then less incentive for members to preserve these settlement amounts for their intended purpose.

=> There is a real need to protect this funding and to incentivise employers to continue to subsidise the PRMS contributions of their employees.

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4 In South Africa medical aid schemes are not allowed to set contributions according to risk factors such as age and condition of health. The result of this policy is that younger, healthier members subsidise older members who are in poorer health.

5 Old Mutual estimates, based on work performed by the Risk Equalisation Fund Technical Committee.

6 Based on the average monthly pensions paid by Old Mutual to the pensioner of its institutional client base of more than 130,000 pensioners.

7 Over the 10 years to 2005.
8. A small number of entities have tried to set monies aside to safeguard these benefits...

A number of employers have set aside or ring-fenced funds specifically to meet this obligation. A variety of vehicles have been used for this purpose, including the medical aid scheme itself, retirement funds and insurance policies. None of these vehicles currently offer an ideal solution particularly since the regulatory environments are often complex and unclear:

- The Council for Medical Aid Schemes no longer allows companies to use the medical scheme as a funding vehicle and employers that have followed this route were instructed to find alternative vehicles before July 2006. An extension was subsequently granted to this deadline due to the difficulties faced in doing so.

- Funding through the retirement fund is not currently ideal, particularly due to the legal requirement of minimum withdrawal benefits. The discussion papers on Retirement Fund Reform, issued by National Treasury, seems to want to address this by allowing employers the use of the Employer Surplus Account to fund their PRMS obligations. However, a large number of practical issues remain unanswered. For example, the use of employer surplus accounts within retirement funds does not cater for the payment of a PRMS subsidy.

- Funding through a properly structured insurance policy meets most of the needs of the employers, employees and pensioners. It was the vehicle supported by the South African Institute of Chartered Accountants in a letter submitted to National treasury in April 2004. They concluded that the only remaining concern with this option was to ensure that the appropriate tax deduction was given for the insurance premium payments made.

- In the past various types of benefit funds as defined in the Income Tax Act, have been created to provide a means for funding. The concern around these structures is that they operate in an unregulated environment and in addition their ongoing sustainability is not clearly understood which may be problematic for the participating employers and members concerned.

9. The life insurance industry is well positioned to assist with this ...

The underlying risks of the PRMS subsidy obligations fall squarely into the arena of life insurance. Although there may be components of this risk that are not insurable, the transfer of the bulk of the associated risks to an insurer and regulated management of the balance carries significant appeal for the employer and shareholders. This is understandable as it provides certainty and protects and benefit and therefore the underlying membership.

10. Good governance suggests that a separation of assets to cover these costs is ideal...

Using the retirement fund industry as a reference point, there is clearly a need to separate the assets supporting post-retirement medical aid subsidies from other company assets to ensure that the rights of current and future pensioners are protected and not dependent on the future financial health of the company.

=> Encouraging employers to set assets aside in a secure manner in approved funding vehicles, protected from the employer’s operations

=> Provide support for those vehicles that are appropriate in a way that they can address the employers’ needs. Too much focus is placed on vehicles that may not be suitable
11. Clarity required on the tax treatment …

Employers generally struggle with the concept that they may only claim a tax deduction for PRMS contributions many years after the period in which the related service has been delivered and the expense has been incurred. This is aggravated by the fact that the revenue arising in the employer’s business, presumably as a direct or indirect consequence of the employee’s service, is taxed in the employer’s hands in the period in which it arises i.e. the period of the service.

It seems that the employers merely seek to be placed in the same position they would have been had the expense been paid out in the form of a medical scheme subsidy or as a salary whilst the members were providing the related service. The underlying uncertainty of the liability, which is often used as the reason for a delayed deduction, relates specifically to the quantum of the liability. This uncertainty is one that is dealt with in the actuarial calculation on which the valuation of the accrued service liability is based.

As mentioned earlier, employers have used a range of vehicles in their efforts to ring-fence funds specifically to meet this obligation. The tax treatment of the funds paid into these vehicles is not always clear and seems to have been inconsistent in its application. Clear guidance should be provided for instances where there is a genuine intention by the employers to place these funds in a vehicle that is ring-fenced, protected and can only be used for the provision of PRMS subsidies.

It is our understanding that Government policy objectives include encouraging individuals to provide adequately for their own retirement, to encourage employers and employees to provide for retirement funding as part of the employment contract, and to reform the tax system to support and enhance these objectives. In light of this, perhaps an opportunity exists not only to provide clarity, but also to make it attractive for these employers to pre-fund for this obligation in order to achieve this common objective.

12. Clarity required on the use of an employer retirement fund surplus for PRMS contributions …

One way that is currently open to the employer for using its balance in the employer surplus account to deal with PRMS subsidy obligations is to arrive at a settlement agreement with pensioners and employees in terms of which they agree to the employer terminating its PRMS subsidy in exchange for an improvement of Fund benefits funded from the employer surplus account.

Among the options for benefit improvements for existing pensioners is the purchase of additional pensions from an insurer, subject to appropriate amendment needed of the Fund rules. By arrangement with the members, medical scheme and insurer these could be paid across to the medical scheme to meet the contributions due by the member. The amounts so paid will, however, accrue to the member.

Employers are finding this option restrictive, as it does not allow the employer the option of enforcing membership of the medical scheme in order for the members to receive the benefit. In order for the employer to use such surplus, the condition of medical scheme membership therefore needs to be released and the members would consequently be free to utilise the proceeds in any manner they see fit.

Whilst this may be appropriate in some rare circumstances it defeats the objective of encouraging medical scheme membership. What is required is greater flexibility in the use of the balance in the employer surplus account for PRMS contribution purposes.

13. Management of the uncertainties emanating from the proposed reform initiatives …

Many employers have expressed concern at the uncertainty created by the proposed reform initiatives referred to in the various discussion papers released by National Treasury and the department of Social Development. It is likely that the sooner that guidance can be provided on any proposed changes, the more positive and proactive employers will be in responding to any PRMS contributions changes.

In addition, it has been suggested that regulators should be issuing ‘best practice’ guidelines to assist employers and employees alike in dealing with possible changes in employment practice that may arise from a change to regulations around PRMS contributions.

⇒ With clear communication & support from Government, employers should be more willing to commit accumulated reserves to the challenge of PRMS contributions
14. Education ...

PRMS contribution costs should be a key component of any retirement plan for individuals who will continue with medical scheme membership in retirement. One hopes that all financial advisers take into account the potential increase in the PRMS contribution on retirement, at a time when income levels and other expenditure will either remain the same or reduce.

There are actuarial tools in the market that can assist in the measurement of the projected PRMS contribution costs and convert that to a savings program while in service. Many argue that employees are already saving at the limit of what is possible and therefore PRMS contribution costs will merely be sourced from their retirement fund savings.

A view shared by many is that this type of response should not be assumed. Rather, the use of informative education and communication programs that deal with PRMS contribution requirements should be made readily available to employees and additional retirement savings encouraged.

15. Expand the opportunities to pre-fund in light of the move to TGP remuneration structures ...

There is an expectation that the retirement reform initiatives currently being explored will provide greater opportunity for individuals wanting to save for PRMS contributions to do so. Although not the major focus within the bigger retirement reform context, PRMS contributions may be something that could easily be addressed if given a little more attention.

The opportunities that do exist to pre-fund outside of the standard retirement fund option, for example PRMS targeted provident funds and retirement annuities, typically end up being significantly expensive and in many instances fail to keep track with medical scheme inflation. Another aspect is the issue of vesting and the need to preserve freedom of choice for the retired members. One hopes that the reform initiatives will ultimately address these concerns.

16. Employees retiring early may be significantly worse off than expected ...

Legislation currently allows retired members to receive a subsidy paid by the employer without being taxed thereon irrespective of age, provided that they have retired from service. Retired members that do not receive an employer subsidy will only enjoy the same unlimited tax relief once they have reached the age of 65. The view shared by many is that the incentive to retain medical scheme membership should extend to all retired members, given that many are forced to retire early for reasons outside of their control. The possibility of removing the age 65 restrictions should therefore be explored.

=> Many employers acknowledge that the opportunity exists to educate employees on the issue of PRMS costs. Support from the various regulatory bodies could assist in this process.
In conclusion, there are real issues and challenges facing employers and employees with regard to PRMS contributions. What is clear is that if these are not addressed soon it will have an impact on the ability of retiring employees to access adequate levels of private health care whilst in retirement. Ultimately this will place increased pressure on an already burdened public health care.

As set out in the body of this paper, the following may present a reasonable framework for debate:

- There is a real need to protect this funding and to incentivise employers to continue to subsidise the PRMS contributions of their employees.

- Employers should be encouraged to set assets aside in a secure manner in approved funding vehicles, protected from the employer’s operations.

- Support should be provided for those vehicles that are appropriate in a way that they can address the employers’ needs. Too much focus is placed on vehicles that may not be suitable.

- With clear communication and support from Government, employers should be more willing to commit accumulated reserves to the challenge of PRMS contributions.

- Many employers acknowledge that the opportunity exists to educate employees on the issue of PRMS costs. Support from the various regulatory bodies could assist in this process.

This may be a start in preserving the role of the employers and encouraging employees to self provide.