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The Effective Consultant: Those (Plan) Designs, They Are A'Changing

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Moderator: SILVIO INGUI
Panelists: JEFFREY A. LANZET
Recorder: SILVIO INGUI

Summary: Technology is changing the administration and design of employee benefits. Companies continue to examine alternatives to traditional retirement plans that meet competitive and work force needs. At the same time, there is a growing trend toward outsourcing some or all of their administrative functions. This session provides the opportunity for practitioners to share experiences and insights relative to:

- Defined benefit versus defined contribution plan designs, hybrid programs, and innovative designs.
- Alternative outsourcing approaches and their effects on fiduciary responsibilities, compliance, and employee relations issues.
- Integration of plan design with benefit communications and delivery.

Mr. Silvio Ingui: I'm a Principal with Milliman & Robertson in West Patterson, New Jersey. Our other panelist is Jeff Lanzet, a senior vice president with Aon Consulting and the regional practice leader for Aon's Benefit Administration Outsourcing Services. He is also Aon's Owings Mills, Maryland, office head and the general manager of Benefax. He has 19 years experience in the defined benefits and benefits administration. I will give you a brief overview of the hybrid plans and then Jeff will provide us with information on outsourcing retirement plans. The comments we make are our personal opinions and do not represent those of the Society or our employers.

A hybrid plan describes a retirement plan that blends features of both defined benefit (DB) and defined contribution (DC) plans. DB plans are very efficient

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providers of retirement income. However, they are difficult to understand and administer. In contrast, DC plans provide lump sum accounts and are more easily understood and appreciated by employees. Hybrid plans attempt to mix and match desired components of DB and DC plans and, one hopes, provide the best of both worlds to help employers meet the changing needs of today's retirement benefit requirements.

Some of the more commonly known hybrids are cash balance plans and pension equity plans. Probably the first time the term "hybrid plan" was used was in the early 1980's, when Bank of America introduced the cash balance plan. However, hybrid plans have been around for a long time, known as age-weighted profit sharing plans, floor-offset plans, and target benefit plans.

Hybrid plans are becoming popular for several reasons: the changing business environment, emerging demographic trends, the changing evaluation of employee benefits, and overfunded DB plans.

Changing Business Environment
You constantly hear about companies reengineering and downsizing, which we all know is just another term for employee layoffs. Companies are talking about a new employer and employee contract that involves a partnership versus parenthood. Many are empowering employees and asking them to share the responsibility of providing retirement benefits. The concept of the cradle-to-grave employment is now the exception and not the rule. Finally, technology has given us the means to administer more complicated plans.

Emerging Demographic Trends
The baby boomers are rapidly approaching retirement, and DC plans just may not cut it for them. A 401(k) plan may not give baby boomers enough time to start accumulating the retirement needs that they're going to have. In contrast, the rest of the work force is younger and more mobile, and this group wants portability. Also, many employees have been forced to retire either through restructuring or incentives such as early retirement windows.

Changing Evaluation of Employee Benefits
Retirement plans are being structured to be part of a total compensation package. Rather than thinking of benefits as entitlements, we hear more about shared responsibility between the employer and the employees. With this comes increased emphasis on employee understanding and, to some degree, control. Companies, furthermore, want to link the value of benefits to performance.

Overfunded DB Plans

This is probably the most important reason for the popularity of hybrid plans. With the current bull market, company pension plans have become fairly well-funded, at least on an ongoing basis; they may not be as well-funded on a termination basis. These companies want to go more DC, partly because their employees want it. Companies also are looking to reduce costs and don't know what to do with this overfunded DB plan. If they terminate it, they could have an underfunded plan. If they have enough money, theyre going to give away all the surplus, either to insurance companies or to pay lump sums. One way or the other, they're going to lose the surplus, and it ceases to be an asset.

For one client, we converted to a cash balance plan. The company had about $20 million in its plan, and its accumulated benefit obligation (ABO) on an 8% basis was only about $15 million. On a plan termination, it was about $23 million. If they terminated, they would have had to write a check for $3 million. By going to cash balance, we effectively created a $5 million asset for them to use to help pay for the cost of the benefits. There is no tax-efficient way to use the surplus, which is one reason companies are converting to cash balance plans. They're using that funding surplus to pay for the DC benefits they create in the cash balance plan. Later, if interest rates go higher and the cost of termination can be done on a more favorable basis, the company might consider terminating and going full DC.

Traditional DB Plans

A typical DB plan is usually based on final average pay. The average benefit is typically expressed as a percentage of final average pay per year of service, for example, 2% of final average pay times years of service up to 25 years. It can be integrated and might have a service cap. It's not uncommon to find subsidized early retirements in traditional DB plans.

Some advantages of these plans are they're efficient providers of retirement income, if that's all you're looking to do with a plan. Benefits are directly linked with final pay, so they automatically adjust for inflation. DB plans focus on long term service, people who work for you for 20, 30, or 40 years and then retire. They give you the ability to provide early retirement incentives and also "golden handcuffs." This can be both an advantage and a disadvantage, because in the case of a plan that has very rich subsidies, typically they come in on a cliff basis, generally at age 55. This means you might have a lot of people hanging around waiting for those subsidies to kick in, when maybe you'd prefer to see them to move on.

And there are some other disadvantages of DB plans. They're subject to IRS funding and compliance rules, and Financial Accounting Standard No. 87 expense calculations all of which require a fair amount of work and expense for employers.

DB plans also are covered by the Pension Benefit Guarantee Corporation (PBGC), so you have to pay premiums. Years ago this wasn't a big issue, but today it can be very significant. I've seen plans that are well-funded come out of full funding and go from $19 to $80 or $90 a head. Employers can't understand it; they were contributing zero last year, and this year they're making major contributions to the PBGC. This is becoming viewed as a serious negative aspect of DB plans.

DB plans can also be difficult to communicate, especially in the case of older plans that have been around a long time in some large companies and which carry a lot of baggage. Even as a pension consultant for twenty years, I've had to read some summary plan descriptions three or four times to figure out what the benefits are. As a result of not being easily understood, they're also not well-appreciated by employees.

DB plans typically provide increasing benefits, but if you have a lump sum, they don't always necessarily have an increasing lump sum value. From one year to the next, your benefit can go up and the lump sum value can go down. Many employees don't understand that concept, and it's very difficult to communicate it to them.

Let's look at the accrual pattern of your typical DB plan. Generally the benefits are concentrated at retirement. It's not surprising to see 50% of someone's benefit accrued in the last 7 or 8 years prior to age 65. That's typical of final pay DB plans: they provide very few benefits to early leavers or terminated vested employees. They tend to have that early retirement cliff as I noted earlier. This could be either an advantage or a disadvantage depending on how the employees perceive it. If it has a service cap, the benefits can flatten out later on, especially if salaries aren't increasing that rapidly.

Traditional DC Plans

DC plans have several advantages for employers: they are portable, the employee bears the investment risk, and benefits are fully funded at all times. DC plans are predictable and flexible. Employers can have any contribution levels they want, make the contributions fully discretionary, and link it to company performance. This way, the benefit accrual is generally spread throughout the employee's career. We all have seen instances where the DB final pay curve rises rapidly. The DC plan rises less rapidly, accruing more evenly over time.

DC plans are easier for the employees to understand, and, therefore, tend to be much more appreciated, even if they're not as valuable. I had to tell a group of employees that they were losing what I thought was a fairly good DB plan, and that

they were going to get a 2% cash balance plan, and they were clapping. We gave them a little extra in the 401(k) plan and they loved it. It was cash.
With a DC plan, there are no PBGC premiums to pay, and no actuarial valuations. With a DC plan, even though there's no guarantee to the employee on the contribution, there's definitely no guarantee on the investment performance. It will be interesting to see whether employees can make the right choices and, if we ever get into a bear market again, what will happen to employees when their accounts go down by 10% instead of going up by 20%.

Hybrid Plans
The cash balance plan basically employs a hypothetical account balance inside of the DB plan. The benefit is the account. The annual pay credits are added to this account each year, the account grows with a defined interest rate, and the benefits are generally paid as a lump sum at termination or retirement. But they also provide for the right to get an actuarial equivalent annuity. Cash balance plans provide many of the advantages of DC plans, only inside a DB plan. However, unlike DB plans, they can still provide for a minimum final average pay benefit. These are subject to all the baggage that comes with DB plans, including IRS rules and actuarial funding, which is good for us. If a client is putting in a simple 5% cash balance plan, that will typically run about 80% of the cost of a 5% DC plan because of the spread in the interest rate. Typically you declare an interest rate. The most common rate is 30-year Treasury rate, but I've seen some plans use just flat rates of 5%. You're guaranteeing that you're going to provide a 30-year Treasury rate as a credit to the individual's account, invest the assets and control them, and if you can't beat a 30-year Treasury rate over the long term, you should fire or sue your money managers. Typically, the spread in valuations is about 1–1.5%, which helps pay for the benefit. In the long run, a 5% cash balance plan costs about 40% of DC costs, although I use a rough rule of 80%.

The fact that the employer retains the investment control is a big advantage, too. When you give employees all this money in a DC plan, and tell them they're responsible for making all the investment choices, most will make very conservative choices. I call that "the opportunity loss of investment." If professional managers invest the money, in aggregate, they outperform the aggregate choices of all the employees, and that differential, even if it was .5% a year, would go a long way in providing extra benefits. To some degree, therefore, having some of the monies in the employer's control can go a long way towards providing better benefits to employees.

From the Floor: What is the whipsaw problem?

Mr. Ingui: The IRS has come out with some safe harbor interest rates. The way a cash balance plan really operates is that it defines a cash balance annuity: the cash value or the lump sum value of that annuity that is your lump sum. In theory, if you're using an interest rate that doesn't meet one of the safe harbors, it is quite possible that the present value of your cash balance annuity could be greater than your cash balance account. That's the whipsaw effect. You can avoid that if you use the safe harbors, and the most common is the 30-year Treasury rate. Let's say you use a fixed rate of 5%. If the 30-year Treasury rate drops below 5%, then your 417(e) lump sum basis is going to be under 5%. When you calculate someone's lump sum, you're projecting forward the cash balance account as a declared rate at the time, converting that to an annuity, and then taking the value of that using 417(e) rates. If you don't have something that's tied to those rates, you can have a whipsaw effect.

Pay credits are usually related to pay, but they don't have to be. You can theoretically have a cash balance plan that gives everyone $100 a year, or that is age- or service-related. In fact, most of the plans I've seen have put in some kind of age or service provision or both. It's a points-based system where you get so many points for each age and year of service you attain.

Cash balance plans can be integrated with Social Security, and you can provide ad hoc profit sharing credits in the plan. If you create a cash balance plan that mimics a profit sharing plan, though, you'll have to make an amendment to the plan every time you want to put an enhancement in for that year. But it is, theoretically, possible to make a cash balance plan operate like a profit sharing plan.

The interest credits are usually tied to an outside index, and there are several safe harbors under IRS Notice 96-8. You can also use a fixed rate such as 5% or 6%. Guaranteed minimums, such as 30-year Treasuries but not less than 4% or 5% are not uncommon. Some companies do that to provide employees with a guarantee in the event interest rates go down, they wouldn't be stuck with 2%. Some companies have actually been experimenting with or thinking about an equity index, which is a bit more involved. You can tie it to an index such as the Standard & Poor's 500. However, the spread that you use to reduce cost can start diminishing, especially if you use an index with a minimum, which can become actually very costly if the market starts turning. Because they are DB plans, cash balance plans have to provide definitely determinable benefits. This can become an issue, especially when you give employees a choice of having their account indexed either to an equity index or to a nonequity index. This might result in some real gray areas and probably some aggressive positions, but we'll see how this works out in the future.

Mr. Ingui: Apparently at least one member in the audience had a plan approved whereby participants had some choice about how to get their interest credit in their cash balance plan, and IRS has ruled favorably on that plan.

From the Floor: In the cash balance plan with investment choice, how did you get around the whipsaw issue?

From the Floor: We did not allow employees to withdraw lump sums before normal retirement age, and you could push the normal retirement age down. One plan that's been approved sets the normal retirement age at five years of service, and nobody was vested before five years of service.

Mr. Ingui: That was innovative Let's look at the accrual pattern of cash balance plans. Because they are basically career-average DC-type plans, the accruals are spread more evenly over an employee's career. They do provide higher benefits for those who leave early, which is common in the DC approach, but you can reduce the effect of that by using age or service weighting. There are generally no early retirement subsidies in a cash balance plan, but you can provide them if you want to. With cash balance plans, you can always provide some form of minimum final pay benefit with a subsidy in it, if that's what you desire.

One of the problems cited with cash balance plans is that they don't help the fast trackers, the employee hired as a mail person who turns out to be the chief executive officer. The accrual patterns of a typical career-average plan pose the same problem. Generally, most companies don't get too concerned about that because they give these special cases a nonqualified plan of some sort. But you can have other employees, not just the CEO but top sales people for example, who are moving up the ladder quickly. For these employees, cash balance plans won't be as attractive or keep pace with their careers as well as a typical final pay-type plan would.

Transition Approaches

Most cash balance plans are not new plans, so a transition is involved. As I said earlier, most of these plans come about because employers have had well-funded DB plans and did not want to go through the expense of termination. Cash balance was considered a good way to restructure the program. However, when you move from the final pay DB environment to a career-average DC environment, you generally have a large number of winners and losers. I have a client that provides the first 30% joint and survivorship (J&S) annuity benefits free. If you get a 50% J&S, you only paid a differential. If a client is deciding to go cash balance, and they also want to convert the existing accrued benefits to cash, one way to do a transition is to build some of the value of those subsidies—either early retirements

or your form subsidies—into the transition calculation of the value of those accrued benefits. For example, you could assume employees are going to retire at age 62 and build in the value of early retirement subsidies. Employees who stay beyond age 62 will get a premium over what they would have gotten in their regular DB plan.

Another fairly common way to effect the transition is through an interest-only conversion, discounting the value of the annuity for interest only. It builds a little extra value into the conversions and gives employees more value on transition.

An alternative transition method is to give additional pay credits or age weightings for certain classes of employees. Sometimes it's done for a five- or ten-year period in order to bring employees closer to where they would have been if the plan hadn't been converted.

Finally, it's not unusual to take a group of employees and literally grandfather them under the old final pay plan.

Pension equity is another type of hybrid plan. This is in reality a lump sum benefit tied to final pay. An example is a plan that provides, at retirement, a benefit equal to 10% of final pay for each year of service. After 30 years, a person would get a benefit of 300% of final average pay. You can also vary the credits by age or service, which will help provide large benefits to those who leave early. These benefits are typically paid as lump sums at retirement. Like cash balance plans, though, they provide the right to get an annuity. They are very visible because the benefit is actually defined in terms of a lump sum amount, and they take care of the problem of fast-track employees because they are final pay-based plans that provide very significant increases when salaries increase rapidly. However, for those employees who are not on a fast track, or if the plan has a service cap of 20 or 30 years, employees could actually be tempted to take their lump sum and leave; a positive or a negative depending on the company's perspective.

Pension equity plans also have some disadvantages. They are final pay plans, so costs are not as predictable as for cash balance plans. One of the things employers like about cash balance plans is that the costs are very predictable, similar to that of DC plans. Pension equity plans, however, do provide better transitions from a traditional final pay plan. You can easily match a pension equity plan curve to a typical final pay plan, especially if you try to integrate it with Social Security. Typically, the amount of grandfathering will be minimized as well. Some have argued that you could achieve the same objectives by offering lump sums in your final pay plan. It's a question of perception. Very few pension equity plans have

been adopted to date. My personal opinion is that cash balance plans are preferred predominantly because the costs are more predictable.

From the Floor: Are there any different approaches to the whipsaw problem for pension equity?

Mr. Ingui: There is no whipsaw problem because there's no interest credit; it's a cash lump sum. Floor-offset plans have been around a long time. They weren't very popular, but discussion of them has been revived along side the interest in DC plans. Floor-offset plans are DB plans that provide a "floor benefit" that is offset by the value of the DC account balance. I've seen them used when a company hires a lot of mid-term career employees who won't have a lot of service at retirement. If the company only has a DC plan and wants to provide something more adequate for this group of employees, they institute a floor-offset plan.

Higher cost is one of the big negatives of these plans because you are effectively administering two plans, a DB and a DC. Many times the benefits payable from the floor-offset plan will be very small, if any, maybe a very small fraction of the employees' gross benefit. Another disadvantage is the PBGC premium: if you cover 1,000 employees, you're going to pay a premium on every one of them, even if only 10% of them are projected to get a benefit from the plan. Arguments have been made that you could achieve the same objective with a cash balance plan, just by putting in a minimum formula.

From the Floor: Floor-offset plans can be very unpredictable, given the leveraging of that account, depending on the investment return.

Mr. Ingui: Right.

From the Floor: They're also difficult to manage financially.

Mr. Ingui: Costs are indeed all over the place.

From the Floor: Can you have a floor-offset plan using a DC plan with individual choice?

Mr. Ingui: You mean a DC plan where employees choose how to invest their money?

From the Floor: Yes.

Mr. Ingui: You can. There is definitely a lot of antiselection, but you can. I don't know why an employee would take an aggressive position in their investments.

From the Floor: If you can do that, can you impute the earnings based on one of the funds?

Mr. Ingui: I've never seen that done.

From the Floor: I've done something like that where the offset was based on a hypothetical DC account, not based on any real contribution.

From the Floor: Was it approved?

From the Floor: Yes.

Mr. Ingui: I guess the answer to your question is "possibly." Age-weighted profit sharing plans are DC plans trying to mimic the accrual patterns under a DB plan. Age weighting allows an employer to provide higher benefits for older employees. These were very popular in companies where one or two key people were very old, and the rest of the staff was very young. Annual nondiscrimination testing is required and a successful design depends on employee demographics.

From the Floor: Do you need to perform annual non-discrimination testing, other than every three years?

Mr. Ingui: If you're using it in a large plan where there isn't much change, you can probably get away with less than annual testing. But in a small plan, such as a doctor with two assistants, replacing one assistant could be viewed as a significant demographic change. For small plans, and maybe even on some mid-size and even larger plans, I would do annual testing just to be on the safe side.

Let's look at a case study. A cash balance plan made sense for one of our clients, a large, multinational company with several U.S. subsidiaries. Let's look at three subsidiaries of this foreign client. Company X maintains a very well-funded DB plan for its employees. Company Y maintains a DB plan and a 401(k) plan with a modest match. Company Z only sponsors a 401(k) plan with a generous service-related match. The objectives put to us by the parent were to design a single program for the employees of companies Y and Z, keep employees "whole" (meaning as close as possible), and try to make use of company X's pension surplus.

We amended company Y's DB plan to a cash balance plan covering both company Y and Z. We used partial prospective grandfathering to keep company Y employees

"whole." We gave them 80% credit from the old plan as a minimum. Then we merged this new cash balance plan with the overfunded DB plan of company X. Now we have a DB plan that has one group with a traditional DB formula—they didn't want to change—and the two other groups under a cash balance formula all wrapped into one plan so that all the surplus from this first plan is now paying for all the DC benefits under the other two plans. Finally, we merged the savings plans of companies X and Y with a service-based match. That's how we used cash balance plans to solve a problem and also to get to the surplus of the other plan.

In summary, hybrid plans may be the correct response for changing demographic and economic conditions. They're one way to reduce traditional plan costs, and they are an effective way to use DB surplus. However, I should caution that if you're going to convert a DB plan to a cash balance plan, it generally involves very extensive modeling and reviewing to design the plan that fits best, target the right kind of transition benefits to the right people, etc.

From the Floor: One problem we see now on a cash balance plan is that employees say, "What the heck is 5% or 6% credit?"

Mr. Ingui: Yes, that is a problem.

From the Floor: Also, if you're trying to use a very significant pension surplus to mimic a very rich DC plan, the fact of a pension 415(b) limit acting as a results limit instead of the DC limit acting as an input limit is a lot more confining. You could hit the 415(b) limit fairly quickly if it's in a really rich cash balance plan, whereas a really rich DC plan could go on forever.

Mr. Ingui: The first question was how do employees respond to the fact that the interest credit may only be 6%? That can be a negative. But most companies implementing the cash balance plan have a complementary 401(k) plan, and I tell them to promote the plan by getting employees to view the cash balance plan as one account in this large account that they have. Right now, if they're putting 20–30% of their money in, say, a stable asset fund or a fixed bond fund that is yielding only 5% or 6%, they should use the cash balance account as the stable asset fund and restructure what they put in their 401(k) plan. That works well for people who have some money that's diversified. People who are 100% in equity under the 401(k) plan might not think that's good enough. They may change their tune, though, as soon as the stock market turns around. It is a valid question, and we have tried to get clients to start communicating the program in combination with their 401(k) plan, because now they're giving benefits that are basically all cash to their employees, just in two different buckets. One benefit should not be totally at risk, and a cash balance plan will always rise in value. That's another way

companies have communicated the trade-off—it's there to give you stability on that part of your benefit.

From the Floor: What do you tell employees who are not vested in the cash balance plan about the trade-off? It seems to me that they can't balance their investments if they have a nonvested account in fixed-interest-type investments, whereas the rest of the money is invested in equities.

Mr. Ingui: If you have a 401(k) plan, and they're not vested, how do they balance their account?

From the Floor: Presumably they're vested in their own money.

Mr. Ingui: That's just a question of the deciding how to do it, which is an issue, but not a big one because the amount of nonvested benefits I find in plans aren't that substantial. It has never been mentioned by a client of mine, so it's never been a big issue as far as the way the employees perceive it. Having the employees starting to think of this as their stable assets fund is one solution. It may not achieve exactly the diversification they want because they might have a lot more in the cash balance plan than they would like to put in a stable asset fund. It isn't the perfect solution, but it's one way to try to sell the program.

Regarding the other question on the 415 limits, it's true that it is one of the limitations of a rich cash balance plan, especially with some of the early retirement benefits. You could try to get around it by putting in an ERISA excess plan, which will pick up the differential for the 415 limit. If the company is really that concerned about the cutback in employee benefits, that's one way of dealing with it. If not, the company can just say that's a limitation of the plan and blame the government.

Jeffrey Lanzet is going to talk about the outsourcing of benefits and how that all fits in with cash balance plan conversions.

Mr. Jeffrey A. Lanzet: Outsourcing is a very exciting and relatively new development. I'm not an actuary, although I have an actuarial background. The one thing that I would like to leave you with today is that DB outsourcing succeeds if the actuaries are very involved; an outsourced approach that doesn't involve the pension actuary is doomed to failure. There is a great deal of misunderstanding about what is included in DB outsourcing.

In the last half of this century, we've seen an incredible revolution in mechanisms for managing and delivering information, which also has led to an incredibly higher

expectation for the delivery of information. It used to be that three or four days to get a letter out was perfectly acceptable. Now, if somebody wants some input, and they don't have that answer the next day via overnight mail, it's totally unacceptable. The demands of the very near future will be absolutely instantaneous responses. This very exciting technology curve has that feature to it: the expectations have absolutely increased.

This technology also has allowed us to have a much lower marginal cost for delivery of information. In the late 1970s, the process of writing a letter in response to a client involved writing the letter, sending it to word processing, proofreading it, and sending it back for a correction. The whole thing had to be retyped and usually other mistakes were introduced. Getting that letter correct was a multi-day exercise, and then it went via regular mail, so it was a week or two before somebody got a written explanation. With hours and hours of people time required to get a simple letter out, costs were tremendous. Now things are much quicker, and the marginal cost of responding to each inquiry is much smaller. However, there's a flip side: even though the marginal cost of delivery of information is lower, there's a much greater investment required. Before, we were talking about a typewriter; now we're talking about complex computer systems and client server architecture.

Three trends that gained a lot of momentum in the early 1990s are driving the move to outsourcing. Companies wanted to (1) reengineer processes, (2) reduce head count, and (3) concentrate on core competencies. The reengineering trend was driven by wanting to simplify processes, allowing those companies to reduce head count. Consulting firms have done tremendous business in mapping out current administrative processes and coming up with new models with fewer steps. The net result is that it takes less people to do the same process and there's tremendous cost savings.

Another trend has been for organizations to concentrate on core competencies, and I believe there's a lot of merit to this. One of my clients, Johnson & Johnson, saw itself as being in the consumer product business, not the DB determination business. Many organizations are saying, "I'm going to do what I do best. I'm going to do what I make money at. Those processes and services that are not my core competencies will outsource."

The move on the part of companies to employ the use of experts is very similar to the trend toward core competencies. There's a quality component to it. When companies outsource, they're looking to use experts. Many want better quality in whatever it is they're outsourcing, and this is the most valid driver in the decision to outsource. Finally, organizations want to outsource for lower cost. There is a big question mark here. We have found that outsourcing DB administration, in

particular, or any benefit administration, doesn’t result in lower cost, depending on how you measure that. Many organizations have one 60-year-old person who does all the benefit calculations. That person has been there forever and is paid a relatively low salary. This doesn't come close to the cost of outsourcing. A lot of organizations are surprised that outsourcing costs as much as it does. I believe that if you look at all the components of cost, you will find that it's cost neutral, except for the risk-management aspect of outsourcing. Basically, anybody who has the responsibility for administering a DB plan has certain elements of risk and bears the full cost of that risk. By outsourcing, the company is spreading that risk and bearing only a portion of it.

Why would a company want to outsource a DB plan, in particular? Complex plan design is the biggest reason. It’s a law of nature that you can never make a DB plan simpler. Companies think their DB plan is too complex, amend it, and end up adding ways to grandfather provisions that just compound the complexity.

When cash balance plans were introduced, I saw a tremendous opportunity to simplify by getting that starting balance as the accrued benefit. But we found that these hybrid plans have very complex recordkeeping components to them that traditional plans didn't have. Organizations spend a lot of money maintaining DB plans and typically get very little appreciation from employees. The new hybrid plans are designed to better communicate the value of benefits. They're designed to be very visible and to increase employee appreciation. However, you're faced with the requirements of maintaining account balances and communicating this information.

Quality and consistency is the best reason to outsource a DB plan. When a prospect comes to me anticipating saving a ton of money, I tell them you've come to the wrong person. But, if they’re interested in increasing the quality of the administration, they have come to the right place. Perhaps one of the most important, if not the most important, aspect of quality in administering DB plans is consistency. It doesn't matter if you're wrong as long as you're wrong the same way all the time and everybody gets the same thing. When you outsource your DB plan administration, you should be doing it for quality and consistency.

Internal administration can be costly, especially for organizations with final average pay plan after final average pay plan. There is tremendous grandfathering involved and organizations are looking to outsource to reduce the cost. Even if outsourcing doesn't reduce the costs, it does one thing very well: quantify the cost.

Most organizations are not aware of the full cost of maintaining DB plans. They look at that 60-year-old clerk's salary and think that’s it, but it's not. You need to

take into account the overhead, maintaining the PC on that clerk's desk, and other factors that typically aren't included in the cost of administering a DB plan. However, the cost of administering the DB plan can be charged to the trust. When you outsource, it might be a big-ticket item, but it's quantifiable, and those charges can be charged against the trust.

Merger and acquisitions activity is another driving factor. We are in a period of unparalleled rate of change organizationally, and that translates to how benefits are determined and what the plan definitions are. As organizations acquire and divest, the plan definitions change at a very rapid pace, and that involves managing risk. Suddenly, there's a tremendous peak need for staff to manage that acquisition, things will calm down for a while, the company will do another acquisition maybe a few months later, and demand for staff to manage the benefit aspect of the acquisition jumps again. By outsourcing you can access and pay for exactly the resources you need at any point in time.

How prevalent is DB outsourcing? Aon Consulting conducted a study and found that 51% of organizations are currently outsourcing some aspect of their DB pension administration. In the past couple of years, this has gone up from about 30%. The same study found that 53% of employers were planning to outsource some human resources activities, but they didn't break this down. Not surprisingly, among larger employers, 64% are planning to outsource more in the future.

Outsourcing is a definite trend. Many people predict that it's one of those pendulum trends that is going to peak, or perhaps has already peaked. There's been a lot of change in our industry in just the past few months. But that pendulum may swing back, because outsourcing is here to stay.

Most people think of outsourcing as plan administration and customer service. When you're doing the administration, you are talking to plan participants. It's a scary concept, but that's what it is. However, there are three very important components of outsourcing that are typically overlooked: database management, personalized communications, and fulfillment.

Anybody who fails to realize that outsourcing is a tremendous exercise in managing data is woefully out of touch. First and foremost, what you do as actuaries—or what anybody does who deals with a DB plan—is deal with a mess of data. The other aspects of outsourcing are very important, but if you don't manage that data right, you're in for disaster. One other significant change in the past year in this field has been the sale of Mercer Management Consulting's outsourcing business—except DB—to A.D.P. The decision to sell was driven by large losses due to poor data management. Data management is key. If you do it right, you can make money; if

you do it wrong, you can sink the ship. The potential liability in the outsourcing business, particularly as it derives from data management, is huge.

Outsourcing—and DB outsourcing in particular— is an exercise in communication. Organizations are looking to get better appreciation for the value of the plans that they're sponsoring, and the way to do so is to communicate the benefits. Most cash balance plans include quarterly reporting similar to that of DC plans. You provide a quarterly statement to let participants see those big numbers. Lump sum benefits are much bigger than what people typically see in an annuity. Communication becomes such an important component of outsourcing.

Finally, we have the lost child of administration, fulfillment. Anybody who enters into outsourcing has to be prepared not only to manage the data, provide customer service, and calculate the benefits, but also to get that information into the hands of the participants. "Fulfillment," is what I refer to as one of those new-age terms. It's the printing, assembly, and distribution of all the communication materials. This is an area where you need a lot of resources and have great potential for quality problems if you don't address it correctly.

Several services are included in DB plan administration: eligibility determination, pension calculations (actual and estimated), active and inactive database management, retirement processing, inactive payroll coordination, payment reconciliation, beneficiary election, 415 and 401 (a)(17) testing, actuaries extract, pension statements, and form 5500 and SAR information.

The outsourcer is the person who determines who is eligible to participate in the plan. A big part of this task involves doing pension calculations and coming up with estimates.

The requirements for managing data in a DB plan vary significantly from any other human resources data management requirement. Most plans are based on historical earnings and service. Even though modern-day human resources and payroll systems can provide a very good snapshot of how much somebody earns, whether they are employed, and what their status is, most companies don't maintain those histories. A very important component of outsourcing is the recordkeeping on the active side—maintaining a history of plan participation, earnings, and status to accurately determine service. Human resources and payroll systems don't do a thing on the inactive side, but pension actuaries do. A big part of what we do in DB outsourcing is to maintain that inactive database. We are the keeper of records on who's getting paid, how much they're getting paid, and when that payment changes. Trustees and other inactive payroll providers are very good at knowing who's getting paid what. They're cutting the checks and have to be right because if

retirees don't get their checks, or if the check is off by a penny or two, thereare consequences. Inactive payers are not very good at knowing when amounts change, though. If you have a level income option or some type of supplement that's about to expire, we often find that the inactive payroll provider, usually the trustee, doesn't maintain that information.

We spend a lot of time processing retirements, taking participants through the estimation of what their benefit is going to be and choosing a retirement date. When they choose a retirement date, we send out a kit with the spousal waiver, an option election form, and all the tax withholding forms. We send out the forms, track them, give the participant a call when they don't return the forms, issue reminders, and finally process the forms. We send that information to the inactive payroll provider—initially on a monthly basis—to do an inactive payroll reconciliation. It's surprising, but most organizations don't reconcile what's being paid out of the trust, and there are an awful lot of dead people getting paid an awful lot of money right now. So, this is a real added value service that we provide as an outsourcer—reconciling what's being paid out of the trust every month, and making sure that it's right.

We do all the 415 and 401(a)(17) testing at a very simple level, where you don't run into any of the tough regulations. The tougher ones go to the actuary. We'll do the calculations, and when 415 or 401(a)(17) comes into play, we'll flag that and forward the calculation to the actuary. That's how most DB outsourcers work. It gives the client a good feeling, and a high-margin business, all in all a good marriage.

We provide actuaries with the information they need to do the active and inactive valuations. Because of our active and inactive database, we are the best source of this information. When we supply the data for an actuarial evaluation, it's clean and tracks from year to year to year. Lately I've started doing the reconciliation. I think that's a tremendous added value.

Pension statements are another exciting area. With a cash balance plan, we do a quarterly statement showing the value of the benefit, and we provide the information for government filings. We provide the counts in the format required for the filing, but typically don't do the filings.

How do we provide these services? I'm a big believer in a multiple-tier model. Tier 1 is customer service, the point of contact between the participant and the service center. It consists of two areas: (1) the self-sufficiency systems, which used to be just the interactive voice response (IVR) system but now includes IVR and Web-based systems; and (2) customer service representatives (CSRs). Tier 2 is plan

administration, the people who do all the data management in financial control functions. They do the calculations, receive fees from the client's payroll, and reconcile what's going out of the trust. Finally, Tier 3 is fulfillment, or forms processing.

The IVR system is a toll-free 800 number participants can call to access general information about the plan. It's boring and people don't listen to it. Nobody wants to hear about vesting from an IVR. But, they can get access to personalized information, and this is where the real value of the IVR comes in. One of the big challenges is when people want to know what their benefit is. A lot of pension calculation systems aren't quick enough to provide real-time calculations when somebody enters a termination and a commencement date. Many organizations batch calculate on a periodic basis accrued benefits projected to some key ages, such as 55, 62, and 65, and load them into the voice response system. Participants can access the system and get the value of their benefit accrued and projected to those predetermined key ages. Typically we only allow participants who are within some type of corridor of eligibility for retirement to get a date calculation. This prevents 22-year olds from calling up and saying, "What happens if I retire on May 1, 2024? What happens if it's July 1, 2024?" You can do transactions in an IVR by entering a retirement date. Or, it can transfer you to a CSR.

Web-based systems are very exciting. On the IVR, we present information in the normal form only. It's absolutely impossible for anyone to understand optional forms of benefits, such as the benefit on joint and 50, joint and 75, joint and 100, joint and 50 with a pop-up. It becomes meaningless. With their graphic capabilities, Web-based systems are a much better medium for presenting this type of information. Participants make the information more meaningful by using charts and graphs. Although not yet in widespread use, the Internet is going to be a very aggressive and dynamic form of self-sufficiency system, particularly for DB plans. It allows you to do much more advanced modeling.

CSRs are the heart of Tier 1 of customer service and provide the human touch. For retiree populations, Tier 1 totally consists of CSRs; don't even think about putting a retiree into an IVR. CSRs typically work on some type of team-based approach. There are really a couple of models for this. A 40,000–50,000 life employer might require a team of CSRs dedicated to that employer, and that's a very high-cost option. Every company gets a certain volume of calls from plan participants. There's a science to figuring out how many CSR centers you need for a certain volume of calls, but let's say you need five full-time employee (FTE) CSRs. As a manager and employer, I have found that my employees, much as I try to stop them, still get sick and take vacations. I don't understand it, but they do.

So, if you have a requirement for five FTEs to answer the phones, you have to hire and train at least eight, and that results in a significantly high cost for customer service. A model that I'm an advocate of in the smaller or mid-size client market—(employers with between 1,000 and 15,000 lives)—is to cross-train CSRs on multiple clients' plans. This way, you can take a team of, say, ten CSRs serving five clients who each have a requirement of two FTEs. The employer only pays for the two CSRs, even though I'm able to provide coverage with all the rest of the representatives on the team. It's a very cost effective way to do it.

CSRs are there to answer questions that can't be handled by an IVR or Web-based system. They can process transactions, but they are there, first and foremost, to deal with complaints. Most of their training is in how to deal with people who are unhappy, with retirees, and with somebody who's experiencing some type of traumatic event like a death.

Tier 2 is plan administration. Plan administrators also work in a team. If you can put a team of plan administrators together serving multiple clients, you realize cost benefits. Plan administrators are the functional experts performing those plan-level administrative functions I mentioned—easy calculations, CSR support, and client contact. The latter is an important function, because clients are calling not a CSR, but a plan administrator.

Tier 3 is fulfillment, fairly complicated systems that can print all the communications materials that are required on demand. Outsourcing is only cost-effective for fairly large organizations of 5,000 lives or greater. A great deal of communications materials must be produced for an organization of that size, and we can print those materials on demand. We also assemble personalized letters, calculation summaries, and worksheets and marry those materials with summary plan descriptions, tax forms, and election forms. Assembly is a big part of fulfillment, as is distributing that information and getting it done right.

Implementation for DB outsourcing can be anywhere from six months to two years, and with one client, it never ended. Usually it starts with a project manager who brings in business process specialists to do that reengineering. Then the manager brings in the DB analyst, the actuary, actuarial students, systems analysts, and programmers to construct the system. Some companies put the people who will be responsible for ongoing administration on the team. Eventually, there's a handoff from the people doing implementation to the people doing the administration. This is a tremendous knowledge transfer to effect. However, involving the people who will be responsible for ongoing administration throughout the implementation process makes the job much easier.

The biggest part of technology is the data clearinghouse. The data repository is where all the action occurs because it's the single point of access. It's one of those rules of nature again: the moment you put data in more than one place, it's out of sync. Somehow, somewhere, there's a gremlin in the works who's going to change a participant's first name slightly. That's why a single, central data repository that's accessed by any system or person is absolutely essential.

But technology doesn't stop there. For customer service you've got people calling in, so you need a PBX phone switch. The minimum investment for a phone switch is $150,000; a big one costs well over $1 million. Another important component of a call center is call recording. It's the state-of-the-art in customer service to promise your clients that calls are being recorded, and you need to do it. We discussed voice response systems. Then we have automatic call distribution (ACD) and computer telephony integration (CTI) systems. In the service center, the ACD component residing within the switch routes that call wherever it needs to go. It knows to give each client its own 800 number. Based on the number that was dialed, it knows that this is client A as opposed to client B, and it can route that call to the correct team of CSRs. However, when you marry this with CTI, you can do a lot more. When people think of CTI, they generally think of screen pop—having the participant's name and information pop up on the CSR's computer screen a few seconds before the call comes through. CTI is not screen pop, but rather a type of system that allows you to do screen pop. CTI, in general, is the marrying of telephony systems with computer systems. It allows you to do just about anything, including skill-based routing. With skill-based routing, if you knew what somebody in the IVR was doing, you could route that call to the CSR who is best prepared to handle it. For example, if you knew a retiree was calling, you could route that call to CSRs who are retiree specialists. CTI is very costly.

There are some core systems involved in outsourcing. A central data repository has to be a relational database. Five systems reside on CSRs' desktops:

- A hypertext system, which is a database of plan information.
- A work flow system that controls each of the processes in the administration work. It's not enough merely to define the processes, for example, "When somebody retires, this is what I'm going to do." That's just mapping out the processes. A work flow system enforces those processes.
- Contact management, or call tracking systems. These systems deal with "answer shoppers," participants who call up, fail to get the answer they're looking for, and call back again and again until they do. A call tracking system also allows us to record what people are calling about and provide meaningful information to the plan sponsor.

- An imaging system, which allows us to store and retrieve documents electronically.
- The DB calculation and administration system.

PROCESS APPROACH

Sample Process Map Process: Retirement from Active Service via IVR Step #1- Initial Processing Employee calls via IVRS Request for retirement Mutually exclusive event open? If YES, Transfer to CSR If NO, Open event and enter log Go to Step #2

The process approach is a life-event model that maps out every event that can occur in the service center. Then you create a process flow. It's not sufficient simply to map out the processes, though. I once took 10 months out of my life to move in with a client and create 13 4-inch binders of processes. We bound them up, they looked beautiful, and we put them on everybody's desktop. Nobody ever looked at them again.

Once you define the processes, you must build some type of system that enforces proper implementation of those processes so you can measure performance. This system allows me to see, for example, that Joe does his cases in two days, but Sam takes four days, on average. Now I know I have a problem with Sam, or maybe it's Joe. It allows me to report statistics back to the client and provides quality assurance. I can guarantee my client that every time a participant calls for retirement information that I'm doing exactly the same thing and keeping the cost consistent.

I believe outsourcing is extremely important because it manages risk. If you have responsibility for administering a plan, any type of plan, not just DB plans, there are certain aspects of risk. There's regulatory and technological risk because of the rapid rate of change. As a plan sponsor, if you have responsibility for administering those plans, you bear the entire cost of keeping up with the changes in regulations, Social Security, etc. In maintaining your plans, you want to provide state-of-the-art equipment and bear the full cost of that too. By outsourcing, you spread that cost. As an outsource provider, I have to keep up with regulations and technology anyway, and I spread the cost among my client base. If you're a plan sponsor, you have to staff for peaks. If you outsource, you just pay for the resources you need at any point in time.