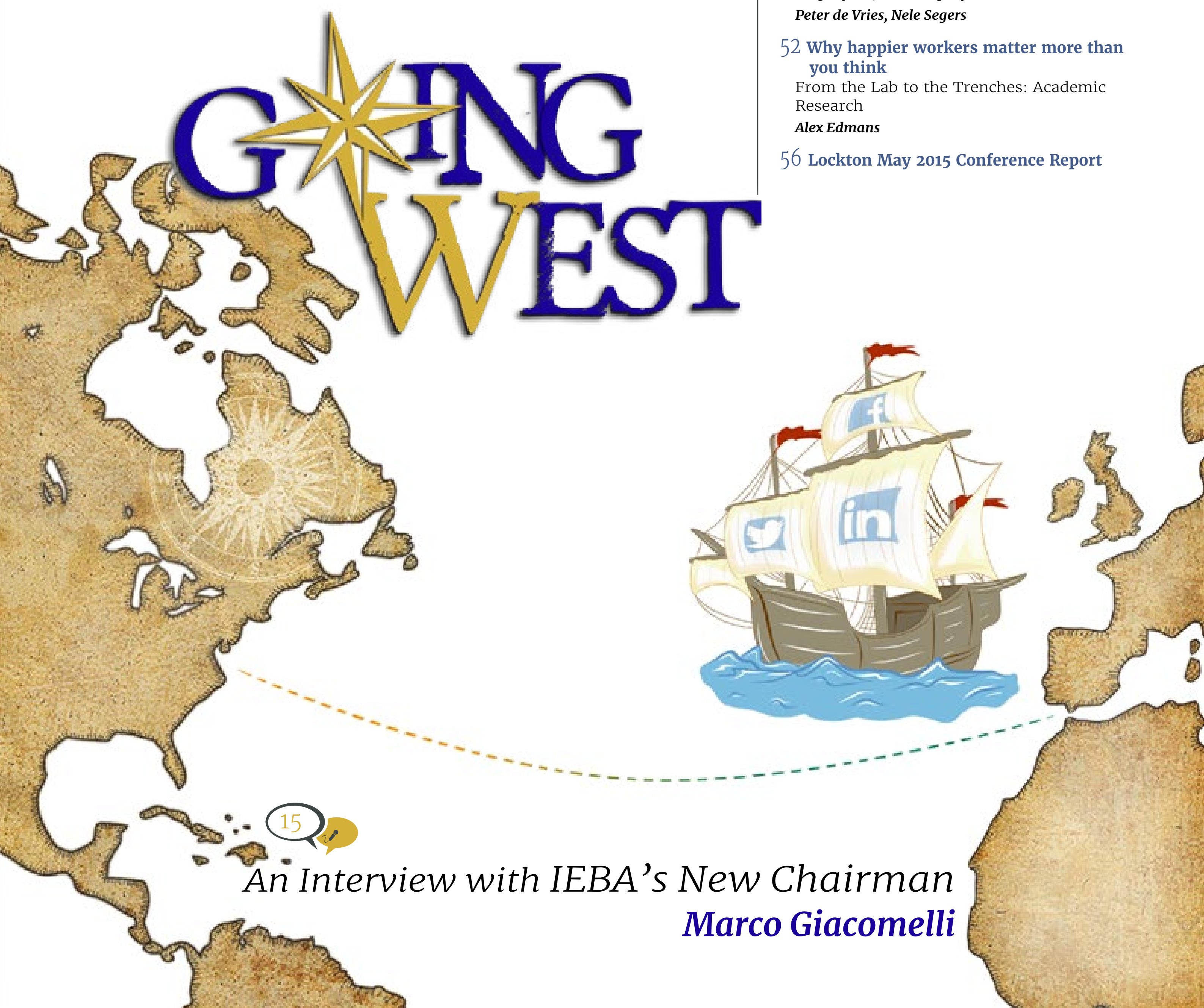
Global Benefits Vision

Knowledge & Wisdom for Global Employee Benefits Professionals



An Interview with IEBA's New Chairman
Marco Giacomelli

GLOBAL BENEFITS VISION

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The Human Well

Founder

Paul founded The Human Well in 2003; a boutique practice providing international and domestic HR advice to boards and senior management. He has more than 30 years of human resource experience and consults on matters focused on improving the return on investment in people.

Paul has led successful HR teams including global employee benefits management at Massey-Ferguson, Laidlaw, Japan Tobacco International (formerly RJR Nabisco), and Alcan where he integrated HR practices world-wide following the merger with Pechiney. He also led the HR practice for Andersen and the international practice for Mercer in Canada.

He was responsible for the HR integration teams in the $8 billion acquisition of RJR International by Japan Tobacco in 55 countries, the $12b IPO of Novelis Inc., and in delivering $20m in savings from global rationalization of HR at Alcan.

He is a former member of the Conference Board of Canada's Council of Human Resource Executives, speaks at conferences and publishes articles globally as well as serving as an expert witness.

He has lived in the UK, Canada (Quebec and Ontario) and Switzerland and worked extensively in many other parts of the world and is currently located in Toronto. He is an accountant by training and served on the boards, including as chair of several not for profit organizations.

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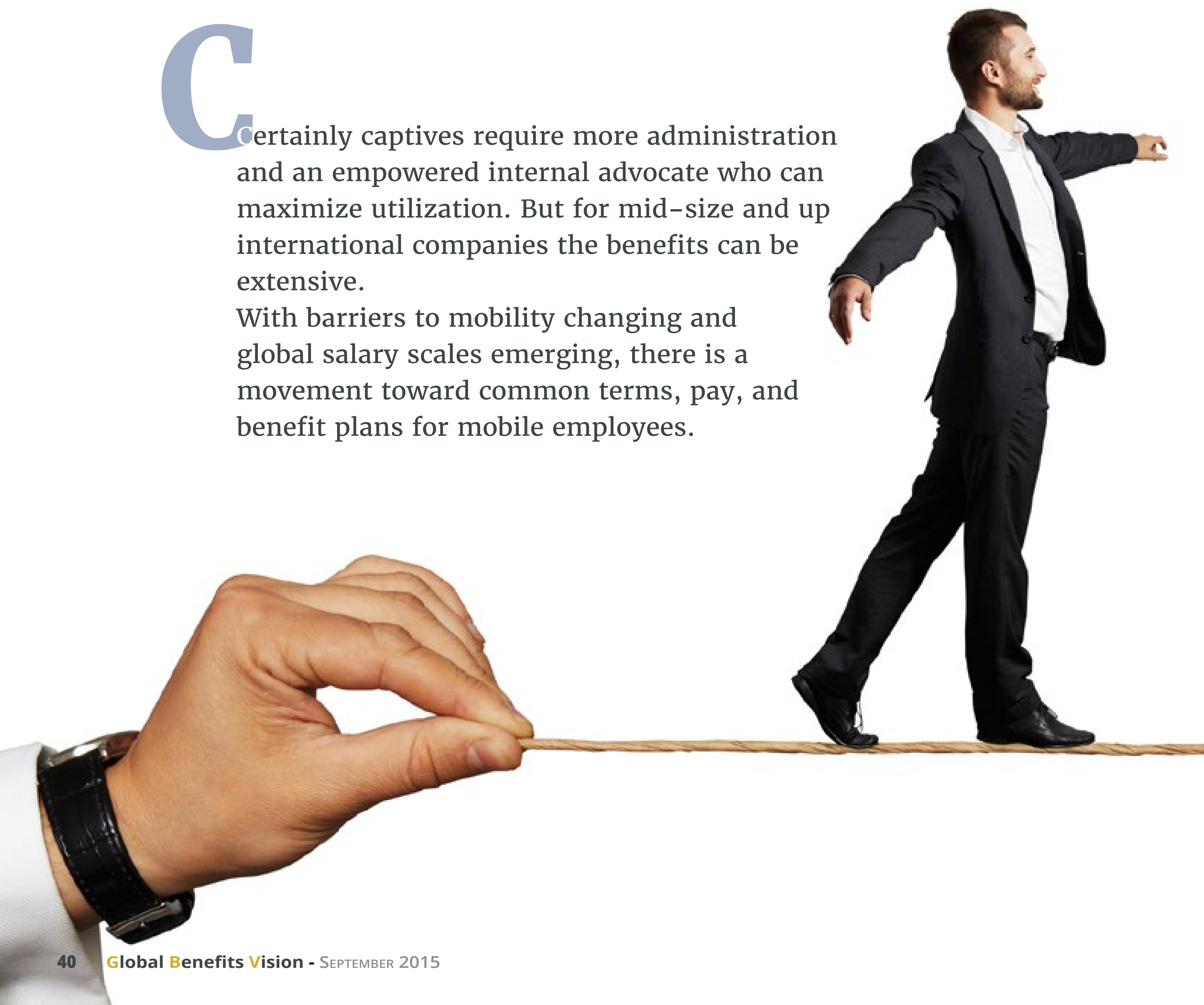
Employee Liabilities and Risk Management

Certainly captives require more administration and an empowered internal advocate who can maximize utilization. But for mid-size and up international companies the benefits can be extensive.

With barriers to mobility changing and global salary scales emerging, there is a movement toward common terms, pay, and benefit plans for mobile employees.



Paul Pittman

This article discusses the management of liabilities associated with employee benefit plans and other areas of employment excluding payroll costs, how these risks have changed and how companies should improve the management of those exposures to reduce costs, improve cash flow and attract talent.

For many employers the largest liability related to employees after payroll-related cost is employee benefits. Subject to a turbulent and volatile past, now largely over, some management vestiges remain. Employers should examine the management of employee benefits and how tailored it is to their company's current risk profile and cash flow.

A HISTORY OF EMPLOYEE BENEFIT LIABILITIES

As a Global Benefits Director in the 1980s and early 1990s, my role, and that of my peers at companies with retiree plans (including, in North America, medical and life insurance programs), was to reduce this exposure. While employee-benefit liabilities had grown unchecked for years and represented major risk to the parent, they received little attention from risk-management specialists.

Human Resource departments were usually responsible for benefit design, just as they are today, though often through negotiation with hourly paid unions, with the new features subsequently passed on to salaried employees and retirees. Finance departments concerned themselves with the required method of reflecting current cost, to ensure that product pricing remained competitive in the marketplace.

This continued for some years, with no apparent concern for the demands that were being placed on future cash flow. In fact, retirement benefits were a desirable and common negotiation feature precisely because their cost could be amortized over an extended period. HR negotiators could always fall back on enhancing a retirement benefit to conclude a negotiation, knowing that there was no immediate cash or significant cost impact.

Things changed in the 1980s with the introduction of FAS 87 and a new accounting practice that introduced a more realistic period over which costs were to be spread, and made plans more transparent. A few years later FAS 106 did the same for all other post-retirement benefits other than pensions. The change in recognition of these liabilities, coupled with the unforgiving rises in medical inflation (particularly for the aged) and the cost of administering defined benefit plans, signified the start of their demise.

An international debate followed over the ownership of surpluses in pension plans, with the U.K. enacting refund laws to bring them into corporate taxable income. This removed a significant cushion against adverse investment, mortality, and covered salary experience. The final nail in the coffin of post-retirement defined-benefit plans was when actuaries concluded that employees actually were living longer than had been assumed for most plans, and were being paid more as well.

THE NATURE OF RISK MANAGEMENT

While inflation, accounting changes, and mortality risk represented major threats, actuarial, accounting, and legal ramifications obscured traditional risk oversight. Each of these risks, however, represented a major peril to corporate health, and in some cases when realised, did mean the end of a number of already weakened companies. This now began to change albeit belatedly. Risk Management expertise began to become involved but by then employers were rapidly unwinding deferred benefits, or modifying their design to transfer or mitigate major exposures.

Risk management is a term more usually used today in the context of asset management in defined-benefit plans and refers to the science of matching assets to liabilities, and the transfer of risk through design, to plan participants (e.g., the hybrid or defined contribution plan). Accounting standards also have continued to evolve, and FAS 158 imposed further requirements on the transparency of a plan's funded status. Fundamentally, risk management for defined-benefit pension plans serves the same purpose as insurance for other employee benefits. They both seek to mitigate the effects of adverse experience, either investment or claims.

Oversight of employee benefits has not changed significantly, falling to the same several functions; however, the nature of that oversight has in some subtle ways. Benefits design informed largely by competitive practice continues to lie with Human Resources, which also focuses on tactical claims management, particularly in health care. Risk Management professes to worry about potential spikes in cash flow, though these have been pretty well eradicated. Procurement now often manages the purchase of insurance products, and Finance ostensibly is now concerned with ensuring a predictable cost.

Due to an unwarranted fear of unmanaged risk, Risk Managers have an overly influential position in the management of employee benefits. Often a broker is involved; motivated by direct-sales commissions or at least a commission mind-set, he fuels the fear and points to insurance as the only possible solution. As a result employee liabilities are not addressed in a wider context, and the "risk" of lost opportunity is perhaps a bigger concern.

With the announcement that Willis is to buy Towers Watson, one of the last remaining independent employee-benefit consulting firms has fallen into the hands of a broker. Mercer was the first, purchased by Marsh; Hewitt followed, purchased by Aon. Towers Watson, of course, is itself a merger of venerable independents, including an actuarial partnership, Wyatt and Towers Perrin. Other than Hewitt, which in its latter years went public, these were all private enterprises; I wonder, ironically, whether limited resources with which to fund the retirement of their founding partners was the genesis for these mergers!

The brokers that made these purchases are all global leaders in property and casualty, and all recognise the importance of serving clients globally through a network of wholly-owned subsidiaries around the world. The consolidation also however, reflects a shrinking defined-benefit pension market and extends the perception that employee-benefits management belongs with Property and Casualty management, and by extension, insurance is the most appropriate solution. (An interesting alternative view can be found with the *Self-Insurance Institute of America.*)

Non-pension employee-benefits management is a lower-margin business unless a commission arrangement can be secured with a long tail. The market barriers to entry to employee benefits brokerage are relatively low and in parallel to this growth at the top of the market smaller benefits brokers and this quite lucrative opportunity are across North America reportedly attracting the attention of business consolidators.

The independent firms mentioned above typically operated on a fee-for-service basis and will today if asked. But out of curiosity, ask if they would prefer to be paid via a commission arrangement.

WHY EMPLOYEE BENEFIT RISK DIFFERS FROM P&C

Risk Managers typically come from *Property and Casualty* **(P&C)** backgrounds, where they deal with perils that may or may not occur: What if the corporate jet crashes, the factory burns, the mine collapses? Employee Benefits, on the other hand, comprise events that will occur; in contrast a question of how much and how often. This suggests quite a different philosophical approach.

While employee-benefit plans will absolutely be impacted by catastrophic events, those occurrences should be mitigated on a holistic basis, including the residual impact on employee benefits. Such risks can only be alleviated with insurance. Normal employee-benefits management should not include reserving for the cost of the extraordinary event.

Because its function is managing absolute rather than relative risk, a **P&C** mindset will miss opportunities in employee-benefits management. By way of example, a company that we recently worked with was comfortable taking certain types of employee-benefit financing into its captive. Because, we suspect, of being overly influenced by **P&C** thinking, it wanted to create a reserve in addition to transferred *Incurred but Not Reported* **(IBNR)** and *Claims Fluctuation Reserves* **(CFR)** before doing so, thus tying up scarce working capital.

THE TRUE NATURE OF EMPLOYEE BENEFIT RISK

Day-to-day risk in employee benefit plans is adverse experience caused by higher-than-expected mortality, disability, or medical inflation, often resulting from safety lapses or an economic downturn. At least for the time being, structural risk affecting the premise on which benefit plans are based has largely disappeared. It may return, of course, for example, if the governments were to remove their underpinning for most corporate plans, implying that the corporate plan would fill the gap. Traditional risk management has a role to play in anticipating and managing the likelihood of this happening, but unlike natural disasters or system failures, there will usually be substantial advance notice.

Insurance is the default method of accommodating adverse experience exposure. Insurance, however, typically comes via a broker, who is sometimes sponsored by an insurance company and whose remuneration increases with the size of the insurance premium. It became very popular several years ago to involve procurement folks when negotiating insurance, partly to cut through the mystique of the insurance world and the perceived bias, but also quite simply to secure a better rate. This was a beneficial exercise, but with employee benefits (and some would argue with other insurance, too) a company is really securing a loan to pay for its experience. So negotiating an unrealistically low premium simply means deferring cost. There is no incentive for a broker or a procurement expert to examine alternative methods of providing for these risks in the context of the employer's financial profile or business cycle.

Day-to-day risk contained in employee-benefit plans ceased to be a threat to business health some years ago, and transferring this

P&C
Property and Casualty

IBNR
Incurred but Not Reported

CFR
Claims Fluctuation Reserves

"risk" to insurance companies that are often smaller than the insured organization may not be an optimum approach. Such so-called risks pose a significantly smaller threat than most of the hazards employers face in their daily operations.

Using insurance to manage employee benefits means removing volatility, but it often comes at a high cost. Employers will pay for their claims experience sooner or later; the degree of insurance used (i.e., experience rated, fully insured, etc.) determines how long it will be before they see these costs. For example, with self-insurance the cost is seen immediately, while experience-rated policies spread any increase in premium over time. With high-impact claims, such as life insurance, some insurance may be desirable to assist in managing a particularly cold winter or virulent flu strain.

Insurance premiums are made up of claims; commissions, typically less than 10% of premium but sometimes as much as 20% for some benefits and groups; reinsurance premiums or risk charges, which usually fall between 1% and 3%; and the insurance company's administration and profit, usually 12% to 20% but higher if the group is international. Last but not least is the cost of capital tied up in reserves prescribed by regulators that is not attracting the employer's internal rate of return. This latter point is a critical issue when considering the interest rates paid by insurance companies on reserves and how much they might earn if they were invested internally.

International growth means more opportunities to tailor the funding of employee benefits to fit the parent's profile. Their design largely follows a similar pattern from country to country, with more or less of the burden carried by government plans (often called Social Security). Medical procedures tend to be less costly than in North America, but employee usage may be higher in some locations, where eligibility includes extended families (e.g., multiple spouses or parents), as in some jurisdictions in Africa. The primary opportunity is scale. Bigger populations mean less volatility, with exposure generally remaining relative to the size of the sponsoring businesses.

GETTING STARTED ON EMPLOYEE BENEFIT MANAGEMENT

The first step toward effective employee-benefit management is to create an inventory of employee insurances within the organization: their purpose, their design, how they are funded, the advisers employed, and so on. This exercise alone will highlight cost-saving opportunities. For example, we discovered that one of our clients had two brokers in France for the same plan, both receiving commissions. This may lead to the elimination of brokers completely if you determine to provide all insurances with one carrier globally. Looking at employee-benefit risk on a global basis enables decisions around increased self-insurance in certain plans or at certain levels, or consolidating purchase of reinsurance. These are just some of the opportunities that will become evident and available to reduce cost and improve cash flow.

Gaining a holistic picture of employee benefits and related risks will enable a companywide strategy tailored to the company's financial strength and business cycle, rather than each plan or country making its own decisions based on local factors. A company located in one country can arrange benefits with less or even no insurance, and broker's commission can usually be eliminated, with a commensurate reduction in premium, and consolidate purchasing for multiple divisions in the same country or different countries.

Whether to adopt and which structure to use for managing multiple benefit plans is a personal decision. Many companies decide that they need to improve the tracking and reporting of employee-benefit plans around the world but want to remain within an insurance environment. A multinational pool may be sufficient for this purpose, allowing the company to assume more risk while continuing to retain a degree of insurance. This structure attracts less administration and compliance, improves reporting, and can partially release reserves—an appealing combination.

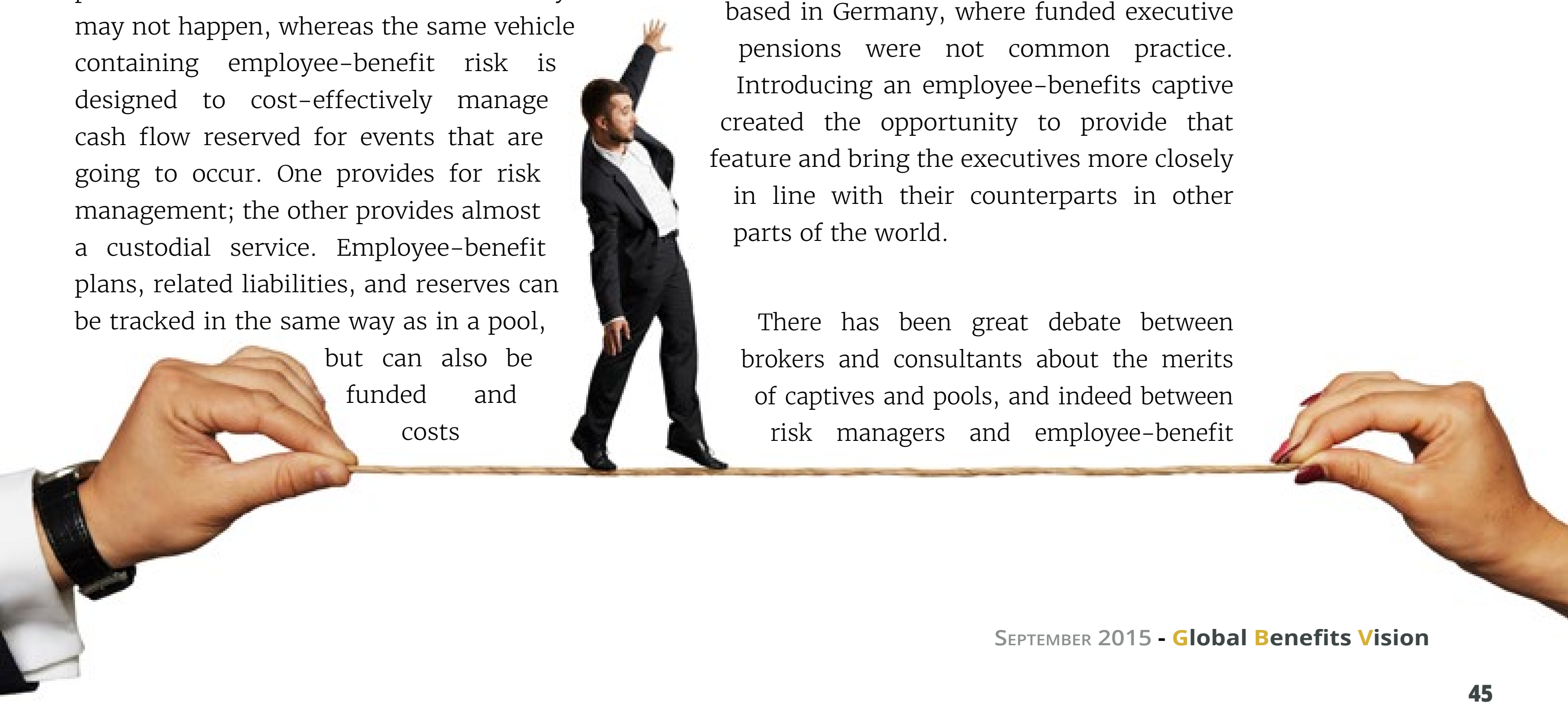
The alternative is a captive insurance company, technically a re-insurance company, to which a global insurance carrier, with admitted rights to each of the countries in which benefits are provided, cedes the employee-benefit risk. This option protects the tax-deductibility of premiums and the delivery of benefits without tax deduction to beneficiaries.

We would always suggest that this be a separate vehicle from that which carries P&C risk, as it essentially performs a very different job. The P&C captive creates reserves and purchases insurance for events that may or may not happen, whereas the same vehicle containing employee-benefit risk is designed to cost-effectively manage cash flow reserved for events that are going to occur. One provides for risk management; the other provides almost a custodial service. Employee-benefit plans, related liabilities, and reserves can be tracked in the same way as in a pool, but can also be funded and costs shared in a manner that is tailored to the circumstances and risk tolerance of the company.

Taking an inventory of employee insurances will reveal any gaps in employee-benefit coverage, such as individuals who cannot participate in a plan because of pre-existing conditions or who relocated between countries and lost the ability to participate in a company or state pension, Social Security, or disability plan. The captive gives the company a vehicle for providing these individuals with alternative "insurance", creating a stronger entitlement for the individual and a better definition of the commitment than the dreaded "we promise to keep you whole when your employment ends" letter that often emerges from a personnel file at the end of a career. Inevitably prepared with the best of intentions, such letters beg several questions—including the exact definition of "keep whole" and whether employment ends when you leave the company or when you retire.

We worked with one company several years ago that had a number of senior executives based in Germany, where funded executive pensions were not common practice. Introducing an employee-benefits captive created the opportunity to provide that feature and bring the executives more closely in line with their counterparts in other parts of the world.

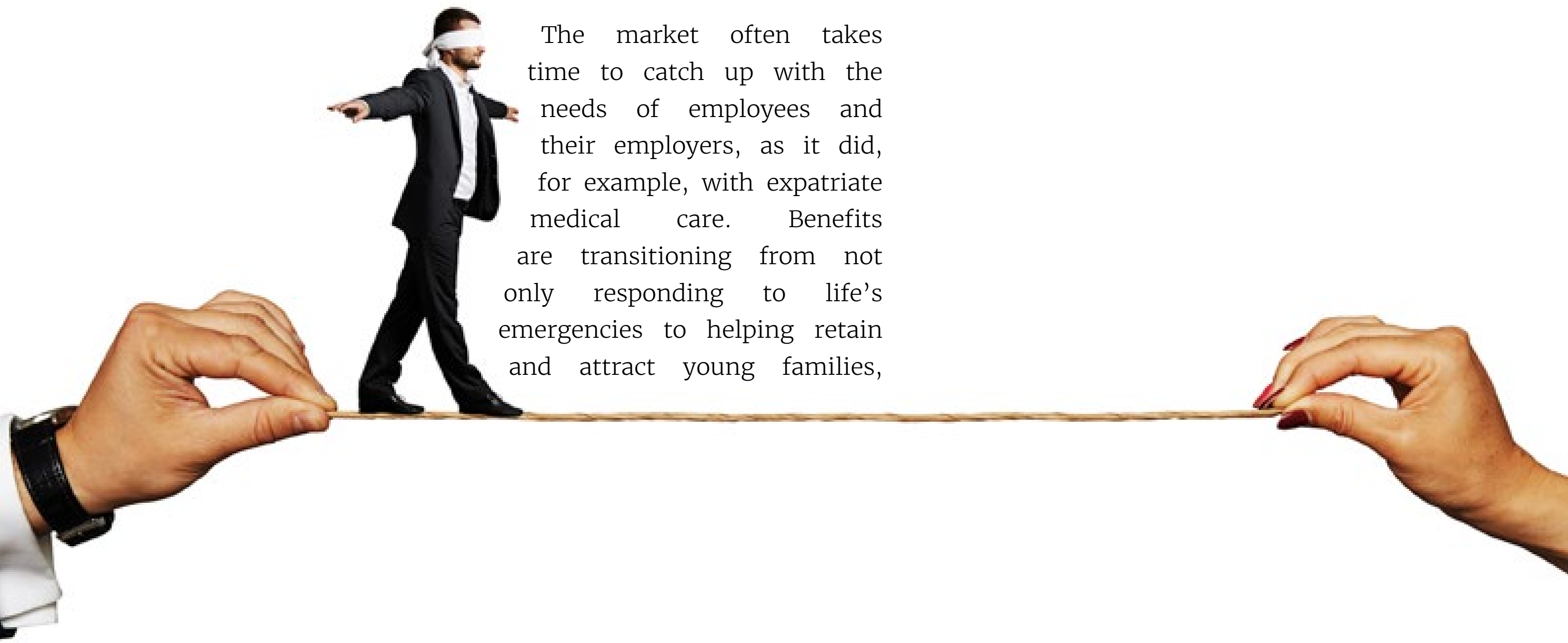
There has been great debate between brokers and consultants about the merits of captives and pools, and indeed between risk managers and employee-benefit



practitioners over whether P&C and employee-benefit risk should be mingled. I can only say that from personal experience the arguments against using a captive exclusively for employee benefits are theoretical and mostly made by professionals who have never had the opportunity to manage one. A captive brings to light significant opportunities for funding individual and group shortfalls and releasing working capital, resulting in savings and governance superior to any of the alternatives. Certainly captives require more administration and an empowered internal advocate who can maximize utilization. But for mid-size and up international companies the benefits can be extensive.

THE SPECIAL CASE OF EXPATRIATE BENEFITS

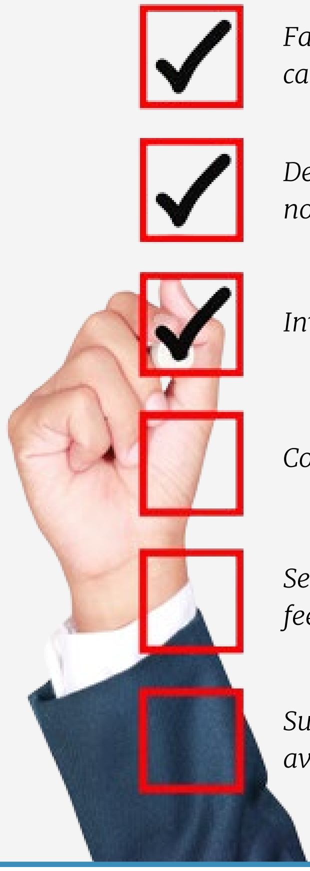
Employee benefit liabilities represent a relatively small percentage of employer assets, but they are likely to play an increasingly important role as the talent pool continues to shrink. The ability to attract and retain valuable employees is becoming an important differentiator, and the likelihood is that more lifestyle benefits will be required.



The market often takes time to catch up with the needs of employees and their employers, as it did, for example, with expatriate medical care. Benefits are transitioning from not only responding to life's emergencies to helping retain and attract young families, especially those who are internationally mobile. A company with its own mechanism for managing employee benefits (e.g. pool or captive) is better equipped to provide, track and fund these arrangements. Examples might include a legal-aid fund for expatriates, assisting with such unique mobility issues as rewriting wills in certain jurisdictions, a global Employee Assistance Plan that provides personal services for expatriate families, or additional tax protection for personal events that incur unforeseen tax while on assignment.

Traditionally, employers have managed their expatriate employees by country of origin. But with barriers to mobility changing and global salary scales emerging, there is a movement toward common terms, pay, and benefit plans for mobile employees. This makes the liability less volatile and somewhat easier to self-insure. Accompanied by an employee liability captive, this development offers a convenient vehicle through which to fund and manage these arrangements and the newer offerings that likely will become necessary in the future.

A Checklist for the Successful Management of Employee-Benefit-Related Liability:



Factor the employee benefits tail into business recovery plans and remove catastrophic exposure from normative employee-benefit management.

Deemphasize risk management oversight of employee benefits, as it is mostly no longer required.

Inventory benefit plans to identify opportunities and gaps.

Consolidate insurance to reduce cost and align with the company risk profile.

Seek independent, business-context employee risk insurance advice on a fee-for-service basis.

Support recruitment needs by creating new plan designs before they are available in the marketplace.

CONCLUSIONS

Employee benefits no longer represent an unacceptable internal risk for most employers. Belatedly introducing risk-management oversight, when no longer realistically warranted, has in many cases resulted in lost opportunities in cost saving and efficiency.

The unfolding talent shortage demands creativity around employee offerings to help distinguish an employer in the recruitment market, and employee-benefits management is likely to be at the forefront of that.

The case for central governance of employee liabilities will provide flexibility and enable creativity and a tailored approach to a funding strategy aligned with the financial resources and cash flow of the company. ∞