

Managing Workforce and Benefit Program Risks during an Economic Downturn

The United States, along with most countries around the world, is in the throes of a severe economic downturn. The world economy is being buffeted by rising unemployment, capital markets that are volatile and much reduced in value, restructuring in the housing and financial sectors and, in some cases, inflation or deflation. Though no one can be certain when the economy will reach bottom, many expect that the current downturn will continue through 2009 and into 2010.

As in all downturns, some companies will decline, others will carry on as usual, and still others will find ways to prosper and grow. Whichever category an organization finds itself in, professionals in Human Resources, along with those in Corporate Finance, will need to develop and implement strategies in four areas: talent management, benefit programs, risk management, and communications.

This *InsightOut*:

- Presents some of the issues U.S. organizations should be aware of along with strategies to address them
- Poses questions to help employers determine how they can apply these strategies in their actual circumstances

Future issues of *InsightOut* will focus in more detail on how employers can manage strategically during an economic downturn.

TALENT MANAGEMENT

Recent events remind companies of the value of three potent talent management concepts: workforce planning, performance and rewards, and employee engagement and retention. An intelligent, future-looking approach will enable organizations to recover quickly when the economy improves. Here are some specifics.

Workforce Planning. An employer who panics and makes across-the-board cuts in its workforce may endanger its business. A more prudent employer takes the time to identify specific business units, jobs, and skills that it can reduce, stabilize, or invest in. This employer considers alternatives to

layoffs, such as reduced hours, unpaid time off, and job sharing, that are less invasive — and more reversible — ways of reducing costs.

In arriving at its workforce-management decisions, an employer should use strategic workforce planning as a component of business planning. This includes using financial and economic scenario modeling that incorporates attrition, retirement, and other trends to make more efficient and effective workforce adjustments. Longer-term strategies, such as off-shoring, outsourcing, and contingent workforces, increase flexibility and adaptability by replacing or relocating full-time staff.

Performance and Rewards. In a weakened economy, organizations often have to adjust some strategic and operational objectives. They sometimes neglect, however, to alter incentive plans and realign business unit, functional, departmental, and individual goals. Aligning rewards with new priorities and accelerating time frames for achieving them can heighten urgency and focus attention on the most critical activities. Tightening the performance management process also maximizes the return on reward dollars by managing low performers out of the workforce.

To stay competitive in a downturn, organizations should use rewards more selectively — reserving salary increases and bonuses for a smaller proportion of the workforce, focusing on critical jobs, or shifting fixed compensation to variable arrangements. Equity programs require special attention to preserve both their motivational value and the alignment of employee and shareholder interests.

Employee Engagement and Retention. Employees' uneasiness in an uncertain economy affects their work lives. If layoffs are necessary, a compassionate approach to separation and severance reduces the counter-productive effects of survivor guilt. In addition, wellness programs and third-party financial counseling can provide support during difficult times to both current employees and those who have been terminated.

Before implementing a severance or even a restructuring that might result in severance benefits, the employer should review the severance plan as well as the summary plan description (SPD) to make sure that they are updated to reflect the employer's needs and any plan amendments. The terms and conditions of the severance program should also be discussed with managers to make sure they understand the program and can correctly communicate its terms to affected employees. In addition, the SPD should be distributed to employees so that they are familiar with the benefits available.

Finally, even in a down economy, employers must remember that top performers have other choices. Companies must identify high potential employees, hard-to-fill positions, and key leaders, and design retention plans to keep them on board. For the broader workforce, a strong, differentiated employer brand and value proposition will inspire employee commitment.

BENEFIT PROGRAMS

Health and Welfare Plans

Most employers have established their health care plan strategies for 2009. At this point, they should turn their attention to managing health care delivery in ways that control costs without cutting benefits or increasing employee contributions. Plan audits are one way to achieve this. Such efforts can include the following plan audits.

Dependent Eligibility Audits (DEAs). The eligibility status of any dependent population is in a constant state of change. DEAs identify ineligible dependents and remove them from benefit plans, and also educate employees regarding the plan's eligibility guidelines. Identifying and removing an ineligible child or former spouse can produce several years of savings.

Health Care Management Audits. Health care management audits provide an objective assessment of care management services. They help employers determine if employees are

receiving the care they need when they need it, and if the program is consistently delivering the quality, cost-effective care the employer and its employees expect — and pay for. These audits can assess the entire care management program or a specific area like utilization review, discharge planning, case management, disease management and specialty programs, or quality management. Organizations use audit results to modify their strategies, develop performance guarantees with providers, and as leverage during plan negotiations.

COBRA Compliance Audits. Many employees who are downsized will want to continue their health coverage under COBRA. Compliance audits help employers avoid potential liability by confirming that they are offering COBRA to their affected employees as required by law. In addition, these audits can help employers save money by confirming that appropriate premiums are being collected and that COBRA coverage is terminated as soon as legally possible.

RETIREMENT PROGRAMS

Volatility is an immediate issue for defined benefit (DB) plan sponsors given the potential effect of widely fluctuating interest rates and asset values on a company's financial results. Defined contribution (DC) plan participants also feel volatility when they are responsible for managing their own account balance.

Depending on participants' characteristics and a sponsor's objectives, specific plan designs and features can help participants and sponsors adjust to this continuing volatility. Furthermore, with several large employers suspending their DC plan match (e.g., General Motors, Dollar Thrifty Auto Group, Frontier Airlines), it is increasingly important that participants be given the tools to help maximize their own savings in this difficult environment.

Participant-Directed DC Plans

The following types of funds can help participants manage the impact of market volatility on their accounts:

Increased Use of Managed Accounts. With the advent of auto-enrollment and the concept of qualified default investment alternatives, target date maturity funds have become an increasingly popular asset class. However, the 10 percent and

higher losses many participants in their sixties have suffered have surprised them as they near retirement. When one adds participants' inability to customize the fund for their personal capital preservation requirements, risk tolerance, and outside assets, many participants might now be uneasy about a fund they left on autopilot.

A managed account product, on the other hand, does allow for personalized investment goals based on a participant's individual circumstances. Sponsors can consider making a managed account product their default investment alternative either for all participants or for those above a certain age level (as permitted under the QDIA regulations).

In-Plan Annuities. In-plan annuities, or guaranteed income products, can be made to operate like any other fund in a 401(k) plan. Participants contribute to the fund over time rather than purchase an annuity at retirement with a single lump sum. The annuities, which can be either variable or fixed, offer a guaranteed income stream in retirement. In addition, many of the variable annuity offerings have a guaranteed minimum withdrawal benefit that will base any postretirement benefits on the participant's highest account balance while in the plan, even if the market value is lower at retirement.

These products haven't yet become widely popular but the ability to guarantee an income stream in retirement might be increasingly appealing to participants worried about their savings eroding. Some advisors are devising schemes to spread the annuity over several different providers to avoid depending on the financial health of any single institution.

DB Plans

Traditional DB plans typically provide retirees with a guaranteed income stream. This may be an increasingly attractive prospect to employees who see their 401(k) balances diminishing.

From a sponsor's perspective, however, DB plans are subject to risk and volatility from several sources including salary increases, interest rates (including lump-sum rates if applicable), discount rates, and investment returns. These risks may be managed by changes in plan design, assumptions, and investment strategy.

For example, the impact of future increases in salary (as may occur in a high inflation environment) can be limited by either placing a dollar cap on considered pay or adopting a career pay formula. Discount rate risk (e.g., volatility caused by changes in the interest rates used annually to value the plan's liabilities) may be mitigated by amending the plan to permit lump-sum payments or period certain annuities. Matching the investment policy to the plan's liabilities will help manage the discount rate risk as well as the investment return risk.

Sponsors of a traditional DB plan also may consider converting to a cash balance plan. Because cash balance plans are defined as an account balance rather than a string of payments payable after retirement, they have less inherent volatility due to interest rate fluctuation than traditional DB plans. They also provide employees the security of guaranteed return that is not subject to market fluctuations.

Regardless of whether sponsors are considering design changes at this time, the impact of the economic downturn on plan assets will result in the prospect of larger than expected contributions for virtually all sponsors. Sponsors unwilling or unable to make these unanticipated contributions to plans that become less than 60 percent or 80 percent funded will be forced to impose certain restrictions on plan benefits to comply with provisions of the Pension Protection Act of 2006 (PPA).

In addition, if their plan's vested liability is less than 100 percent funded, sponsors may find that they will be required to pay a variable rate premium to the Pension Benefit Guaranty Corporation (PBGC) for the first time. Sponsors may have the opportunity to use a plan's credit balance, if any, toward reducing required contributions or to raise the plan's funded percentage in order to avoid benefit restrictions.

Efforts are underway from several employer organizations (e.g., ERIC, ABC) to have legislation enacted in the very near term that would provide relief for DB plan sponsors. Buck has helped these organizations prepare material to be brought before members of Congress.

Investment Policy. Investing the assets of a DB plan is a fiduciary act. ERISA requires that plans "... provide a procedure for establishing and carrying out a funding policy and method consistent with the objective of the plan ..." Given the current market, organizations should review their existing investment

strategy or the investment manager's strategy and then document that review. Organizations that haven't yet done so may want to put their investment policy in writing or update any existing written policy.

Organizations may also want to consider:

- Reviewing investment strategy of funds to allow for near term liquidity needs, risk control among asset classes, and policy rebalancing.
- Revisiting and adjusting asset allocation models used for target year funds for the changes in interest rate spreads and revised expectations for risk. Specifically, updated expectations for bond volatility and asset class correlations will affect asset allocation modeling in investment policy statements.
- Reviewing stable value funds (e.g., money market funds). These funds have had market risk problems and may need to be further diversified and invested for less risk that will result in lower yields over the near term.

RISK MANAGEMENT

Litigation Risks. Employee claims of discrimination increase during times of economic instability. Therefore, it is imperative that managers be trained or retrained with respect to the legal standards and the organization's policies. However, it takes more than training to protect the organization from unwanted litigation.

In making any decision regarding hiring, firing, promoting, or any other employment decision (such as a wage freeze or a change in the bonus structure), managers must document that the decision was based on merit and was not influenced by any protected trait such as age or race. Furthermore, employers may want to revise their policy so that at least two managers, or a manager and the manager's supervisor, sign off on any employment decision.

COMMUNICATION STRATEGIES

In times of economic uncertainty, leaders who embody resilience, integrity, and the ability to communicate a vision can re-instill confidence and motivate the workforce. Employee communications should seek to calm employee fears, correct any rumors, comply with certain legal obligations, and protect the employer from litigation.

One major area of concern is retirement security. Employees naturally look to their employers for guidance. However, employers are often uncertain what role they should play in this area. Is it to provide reassurance, stressing the long-term nature of retirement savings and the protections provided by government agencies? Or, is it to educate employees about the importance of retirement saving and planning and the basic concepts of investing? Some would argue that communicating on this topic should be left to the fund managers and pundits who follow the economy and analyze the markets every day.

The correct approach depends on factors unique to each employer's circumstances. However, all employers must identify the correct balance among meeting fiduciary responsibility, avoiding fiduciary liability by offering "investment advice," and responding to the needs and expectations of employees.

Effective communication on all topics related to the economic downturn requires employers to develop an effective plan to deliver timely and appropriate messages, starting with the business reasons for their actions and acknowledging the personal implications for employees. Equipping managers and HR representatives with tools and resources to help build employee understanding and commitment is essential.

The best methods and vehicles to deliver the message depend on the organization's environment. For instance, messages from the CEO, the Retirement Plan Committee, or the Vice President of HR might be perceived differently. Also, the nature of the message may determine the form of communication. For example, ERISA requires certain communications in hard copy, whereas a salary freeze may be better communicated in a face-to-face meeting with the employee's manager. The choice of electronic communication or hard copy also will depend on the sophistication of the workforce and its access to technology.

Now What?

Since no two employers have identical economic circumstances, workforce demographics, and benefits programs, each employer will need to identify the strategies that are applicable to its situation. We ask the following questions to assist you in that identification process.

- Has your company integrated strategic workforce planning into business planning? Have you modeled economic scenarios to enable rapid and intelligent responses to changing economic circumstances?
- If you have made changes to business strategy and objectives as a result of the downturn, have you altered your incentive plans to reflect the new goals, and communicated these priorities to employees?
- Have you reviewed your rewards programs to ensure you are spending scarce dollars wisely — e.g., focusing on performance, substituting variable compensation for fixed, and considering scheduling alternatives to reduce hours?
- Have you used dependent eligibility audits, health care management audits, and COBRA compliance audits as a means of controlling health care costs and confirming that employees are getting the care they need?
- If a significant percentage of your 401(k) plan participants have suspended their contributions, have you considered introducing a managed accounts investment alternative or an in-plan annuity, or a guaranteed income product?
- If your organization sponsors a DB plan, have you surveyed (or do you plan to survey) employees on their perceptions of its value as an employee benefit?
- Does your DB plan feature a lump-sum payment option and/or a career average pay benefit accrual provision? Does it impose a cap on salary to be considered when determining benefit accruals? If not, have you investigated these plan design changes to mitigate risks?
- Does your DB plan have a written investment policy? Has it been reviewed in the last 12 months?
- How do you define your role — as an employer — in addressing employees' concerns about today's economic

environment? Is it one of reassurance, stressing the long-term nature of retirement planning, for example? Or do you perceive your role as providing education about such issues as retirement planning, basic investment concepts and general finances? Or do you think it's best to do nothing and leave the communicating to others, like fund managers and the media?

- Have senior leaders identified employee concerns regarding the economy, crafted key messages to address them, and identified the appropriate spokespersons and communication vehicles?

Conclusion

Employers and employees alike face much uncertainty over the economy. This uncertainty may only increase in the months to come. Business organizations and the HR professionals who serve them should review the suggestions noted earlier so they are prepared to deal with it. HR professionals with capabilities in planning for contingencies and managing the impact of change, as well as managing the organization's HR and benefit programs, will play a strategic role in guiding their organizations through the new economic realities.

Authors:

Patricia Gibney, Employee Communications
Patricia.Gibney@buckconsultants.com

Jean Herreman, Human Capital Management
Jean.Herreman@buckconsultants.com

Leslye Laderman, Health Care Plan Consulting
Leslye.Laderman@buckconsultants.com

Lee James, DB Plan Consulting
Lee.James@buckconsultants.com

Chantel Sheaks, Government Affairs and
ERISA Compliance Consulting
Chantel.Sheaks@buckconsultants.com

Alan Vorchheimer, DC Plan Consulting
Alan.Vorchheimer@buckconsultants.com

Michael Wright, Investment Consulting
Michael.Wright2@buckconsultants.com