

The Role of Severance in Today's Employment Environment

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By Rob Gallman

Employers' search for low-cost labor and the focus on core competencies have ushered in an era of off-shoring and outsourcing. Technological advances enable companies to do more with fewer people — and they are. These developments, coupled with continued consolidation in some industries, have led to many reductions in force.

How companies respond to the business imperative of downsizing and layoffs, as well as how employers "take care" of terminated workers, is a critical element of business policy that affects both their business culture and, ultimately, the national economy. Traditionally, companies have extended severance benefits to employees who become unemployed for reasons other than "cause." Over the years, severance payments have become as standard as salary earned for time worked. (See *Severance: A Benefit Essentially Unchanged Throughout Changing Times* in the right column.)

This *InsightOut* addresses three issues related to severance benefits:

- Do some severance programs currently miss their mark?
- How can employers implement the kind of severance program that would be cost effective for them and equitable for employees? (The three options presented on page 3 can be used separately or in combination.)
- What savings might employers achieve by implementing each of the three severance program options presented?

DO EMPLOYERS' SEVERANCE PROGRAMS MISS THE MARK?

Given today's economic and social needs, most severance plans and programs do miss the mark at least in one or two specific ways. In general, many companies overspend on easing the unemployment burden of people whose skills set and work experiences make it possible for them to find other employment at comparable wages relatively quickly, while under-supporting those whose work history and current skills do not readily lead to new employment.

Severance: A Benefit Essentially Unchanged Throughout Changing Times

It is indeed ironic that, in our fluid global business environment, the practice of severance — easing the transition from employment to unemployment to new employment — has gone relatively unexamined, unchallenged, and, most important, unchanged.

More than 100 years ago, companies addressed job loss through severance-type programs, adopting severance plans to reward loyal employees at a time of employment upheaval. In addition, severance payments have served an employee relations function by sustaining morale. In the 1920s, severance provided relief during layoffs related to technological change. In the 1930s, severance was awarded as a result of wide-scale unemployment and, in the 1950s, severance was extended to ease the hardship of seasonal layoffs within the automotive industry.

Today, severance is 100 percent employer-paid: employees do not contribute. And, although there is no federal law that requires U.S. companies to pay severance, 61 percent of the 1030 employers responding to a survey on severance reported that they have a formal severance policy.¹ When the sole determinant is years of service, senior executives and executives tend to receive either one or two weeks per year of service, while lower employee levels receive one week per year of service. At all levels, except administrative, fewer policies than in 2001, an earlier survey year, offer two or more weeks per year of service.

¹ Severance and Separation Benefits, Lee Hecht Harrison, 2005

Specifically, many terminated employees continue to receive severance benefits even after they have begun receiving pay from a new employer. In essence, they are receiving a “new employment bonus.” In fact, the average length of unemployment is 19 weeks² and the median severance plan benefit ranges from a minimum of two to four weeks to a maximum of 26 to 52 weeks.³ As a result, the “average” terminated employee given a “median” severance package may receive from seven to 10 weeks of salary from both a former *and* new employer at the same time.

In contrast, other laid-off workers remain jobless long after their severance and unemployment insurance benefits have expired. In short, the fact that an organization’s available resources may not be going to those most in need can be a major issue.

Secondly, the total amount of the severance benefit can also lead to inequities. How can this occur? Consider the following. Some terminated employees receive state unemployment benefits — which the employer has partially funded — in addition to severance benefits. This can result in some former employees receiving more than 100 percent of the salary they had been receiving while employed.

Although these two examples of “double-pay” don’t necessarily occur by design, they are often overlooked by companies desiring to provide a “sufficient” benefit.

Today’s business environment is one of ongoing change for employers and employees alike. For instance, the majority of workers will not stay in one position, or at one company, for their entire careers. Instead, they may explore several different positions or career paths — even negotiating multiple career transitions throughout their working years, depending on the market for their skills.

For these reasons, terminated employees do need a financial bridge to their next employment. Severance, then, should be a means by which employers can assist employees as they manage and move through the job and career transitions required by our fluid economy.

² U.S. Department of Labor, Bureau of Labor Statistics, Nov. 2008

³ Severance and Separation Benefits, Lee Hecht Harrison, 2005

In addition to financial assistance, terminated employees need retraining or job training, as they often must find work in the next generation of their current job, or in a new field altogether. These workers often depend upon their employers for career counseling and outplacement services — expensive services that are more cost effectively underwritten in a large group arrangement.

In summary, the need for a career transition benefit period should be met by job training, counseling, outplacement, unemployment benefits, and continued access to health care — all of which could last as long as the worker is unemployed. Current severance arrangements are an anomaly because, often, they are based on tenure only and continue beyond the unemployment period.

SEVERANCE: A CAREER TRANSITION BENEFIT THAT MEETS EMPLOYEE NEEDS

Adopting a flexible approach to managing severance benefits would enable employers to better meet the varied needs of terminated employees. It could even allow employers to offer broader employee support during the employment transition period, while actually decreasing severance spend.

Three options, discussed here, can be implemented separately or in combination to save employers from five percent to 50 percent on annual severance spend. The savings realized can be redirected to meet broader employer goals. All three options ensure that terminated workers receive 100 percent income replacement from a combination of severance benefits and state unemployment insurance (SUI) payments throughout the severance period.

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Option One — Eliminate FICA Taxes

A win-win solution for organizations and their employees, this is the option that most companies find easiest to contemplate because it creates a gain-sharing opportunity at best and is net neutral to the employee at worst. Option One eliminates Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes for both the employer and the employee. Those savings either can be shared, or the employer can keep the entire gain with no impact to the employee's after-tax benefit amount.

When an employer sets up a trust and pays severance benefits on a periodic, installment basis with employee eligibility tied to ongoing unemployment, neither the employer nor the employee pays these taxes on the severance payment.

For example, a 20-week severance benefit paid at \$1,000 per week would total \$20,000. During that 20-week period, the company could save up to 7.65 percent (\$1,530) in employer FICA taxes — and up to 15.3 percent (\$3,060) if the employee piece of FICA is included as well.

From an administrative standpoint, the individual's continued eligibility for state unemployment must be monitored in order to maintain the tax savings. So, just as terminated workers need to report their employment status to their state each week, they also need to report in to the company or provider responsible for making the severance payments.

Option Two — Coordinate Employer Severance Payments With State Unemployment Benefits

The second option involves integrating severance and SUI benefits to provide 100 percent of pre-termination compensation to all former employees. This is the most equitable approach to severance — ensuring that all employees receive 100 percent of pay, but that no employee reaps an unemployment windfall.

Many current severance plans can contribute to inequities to the extent that states have different rules regarding the level of state unemployment benefits payable to their terminated workers. Coordinating the severance benefit with state unemployment benefits corrects these inequities. This option operates in the same way as occupational disability benefits and pension plan payouts offset by Social Security. Savings with this feature can range from 20 to 30 percent of total severance spend.

Option Three — Implement New Employment Feature

The third option is to reposition severance as a bridge to new employment, extending some form of benefits beyond the initial period for those who remain unemployed and suspending benefits for the terminated employee who finds and accepts a new job before the initial period ends. This option requires HR and Finance to grapple with corporate philosophy about the nature of support that will be provided to terminated employees.

This option reduces or stops severance payments when a terminated employee finds new employment. For example, a terminated worker might be awarded 20 weeks of severance but get another job after only 16 weeks. By adopting the new employment option, companies could save an estimated 20 percent of current severance expenses that could be used to fund other programs that support terminated employees who are not as well positioned with respect to finding new employment.

SAVINGS ACHIEVED UNDER THE THREE OPTIONS

The following explanatory figure demonstrates the severance plan savings that can be realized and ultimately used to better meet company needs. It assumes that 1,000 employees are terminated with average severance payments of \$20,000 per worker and state unemployment benefits of 30 percent of salary. It also assumes that another job is found 80 percent of the way through the severance period. (According to the U.S. Department of Labor, Bureau of Labor Statistics, on average, a new job is found approximately 75 percent of the way through the severance period.)

Figure One

Given:

- Number Terminated: 1,000
- Severance Spend: \$20,000,000

Resulting Savings:

- Option 1 only = \$1,000,000
- Options 1 & 2 = \$6,000,000
(including \$5,000,000 from Option 2)
- Options 1, 2 & 3 = \$10,000,000
(including \$4,000,000 from Option 3 and \$6,000,000 from options 1 & 2)

National averages indicate that, even without a downsizing event, employers experience an annual involuntary turnover rate of two percent.⁴ Severance savings and the more effective reallocation of resources are available to organizations at any level of churn. Evaluating needs and establishing an informed severance program enable an organization to proactively manage workforce needs, human resources policies, and business objectives. And, at whatever future point a larger-scale layoff might be required, the organization is positioned to assist terminated employees with career transition.

⁴ Saratoga Institute, 2000 Human Capital Benchmarking Report

CONCLUSION

By redesigning the employee severance policy, companies can reallocate sufficient excess resources toward those terminated employees most in need. “New” available resources may be used to extend severance for those who have not arranged new employment, to provide stronger outplacement benefits, to subsidize COBRA benefits, and more. As such, severance would be consistent with, and an integral part of, a career transition benefit program that helps employees get back to work: outplacement, job training, counseling, COBRA benefits, and state unemployment. Some companies may elect to pass along a portion of these “realized” financial resources to shareholders in the form of additional earnings or direct some of it toward retraining or benefit programs for retained employees.

About the Author

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