Milliman

PRACTICAL INNOVATION

Emerging Ideas in Employee Benefits

As plan sponsors cope with the uncertainty in the financial and healthcare markets, Milliman focuses on Practical Innovation to provide tomorrow's solutions.

Milliman recently demonstrated its thought leadership in applying its robust modeling capability to keeping clients compliant with the Pension Protection Act. We also assisted the IRS in training its agents on an ultra-complex section of the tax code. And we have worked with clients from Dallas to Amsterdam to develop strategies for weathering these tough times. These are just a few examples of Practical Innovation–the hallmark of our Employee Benefits practice.

AN AUTHORITATIVE
VOICE ON 409A
COMPLIANCE

BRINGING
GROUP BENEFITS
TO INDIVIDUALS

AN EXEMPLARY
BENEFITS
PROGRAM

REVERSING
THE
CURVE

ROBUST, PPA-READY
ASSET-LIABILITY
MODELING

DUTCH
SYNERGY

Section 409A is so complex, even the IRS turned to Milliman for help.

AN AUTHORITATIVE VOICE ON 409A COMPLIANCE

Normally when the IRS contacts you, it's not good news. But for New Jersey-based employee benefits consultant Dominick Pizzano, hearing from the IRS was one of the high points of last year.

The story begins in April 2009, when Milliman published Dominick's white paper entitled "Can nonqualified deferred compensation plans brave our new world?" (available at www.milliman.com/ndcp). The paper reviewed the history of nonqualified deferred compensation plans (NDCPs): how they were created as a legitimate tool for attracting and rewarding key employees. However, the Enron debacle showed that unscrupulous executives could use an NDCP to grab a failing company's assets before shareholders and rank-and-file employees even realized there was a problem. More recently, the failure of risk-management processes at major financial institutions has put a spotlight on all forms of executive compensation. As a result, the IRS created new rules governing NDCPs that are known as Section 409A.

THE AUDITS ARE COMING—FOR INDIVIDUALS AND ORGANIZATIONS

Describing these new rules as "sprawling" and "onerous," Dominick's white paper noted that the IRS is preparing an aggressive audit campaign: "The IRS now has the authority, the support of the public and politicians, and mountains of motive to aggressively pursue NDCPs that violate tax code section 409A." Dominick adds that these audits, "could bring in additional tax revenues via imposition of the hefty 409A penalties for noncompliance."

Although it is the NDCP plans themselves that may be noncompliant, the penalties have the greatest impact on individual plan beneficiaries. If the IRS discovers a violation, money that was previously deferred becomes taxable and is treated as a late payment. Interest penalties are assessed, plus a 20% excise tax. Thus, there's a major incentive to comply.

In practice, Section 409A compliance has proven to be so difficult that the IRS has implemented two separate "self-correction" programs, which can provide partial or full relief for plan sponsors who rectify eligible errors before they or the individual participants are audited. Fortunately, the IRS realized that the extreme complexity of the 409A rules could very well lead to many unintentional errors—whether through mistakes in plan operation or improper plan documentation.

MILLIMAN TO THE RESCUE

That also explains why Dominick received a message, last November, from the IRS; it was a request to use the "brave new world" paper as a training tool. From Dominick's perspective, this was the ultimate endorsement and, of course, Milliman was happy to grant the request.

The paper methodically addresses the key issues plan sponsors (and IRS agents) need to understand about Section 409A, delving into the many intricacies. But there are big-picture issues involved as well. Because Section 409A is so broad in scope, it covers almost any conceivable type of compensation arrangement—including informal ones. As a result, organizations may not realize that they have a "plan" that is subject to the new rules. For example, a company's HR department may not realize that the CFO or in-house counsel has set up special arrangements for upper-echelon executives.
Another compliance pitfall stems from the perception that the IRS is only targeting corporations. In fact, the audits are impacting all types of organizations, including colleges, hospitals, and not-for-profit entities. As Dominick puts it, "No one is really immune from the possibility of an NDCP audit."

AN URGENT NEED TO REVIEW—AND CORRECT

What can organizations do to prepare themselves? First, it's essential to act quickly. The initial need for speed is because relief is conditioned on fixing problems in plan documents and operations before they are audited. In addition, the document relief program provides complete relief for certain errors corrected before December 31, 2010. And, on the plan operations side, it's important to try to fix any problems in the same tax year. Because NDCPs are designed to defer taxes, the operation correction program is more forgiving of problems that are corrected before tax ramifications arise.

Dominick also recommends that organizations pull together a multi-departmental team that includes everyone in a position to know about existing compensation programs. The team should prepare an inventory and then call in an experienced firm to review all of the documentation and operations for Section 409A compliance. Says Dominick, "We're helping our clients identify trouble areas and suggesting ways to fix them. It's quick and efficient and, most important, it provides our clients with the peace of mind that they will be 409A-OK—if the IRS happens to call."

Freelancers Union works with Milliman to innovate a new retirement savings plan for independent workers

BRINGING GROUP BENEFITS TO INDIVIDUALS

Talk to entrepreneurs—the kind that operate as sole proprietors—and you'll hear a consistent theme: They love what they do; the only downside is benefits.

The problem for self-employed workers is systemic: Health insurance requires large groups to pool risks; and the attributes of a quality 401(k) plan—access to top investment options, plus web access and efficient recordkeeping—are only affordable to multi-million-dollar retirement plans.

LEVELING THE BENEFITS PLAYING FIELD

It took an entrepreneur to solve this problem. In 1996, Sara Horowitz founded Freelancers Union as a non-profit whose mission is to advocate for independent workers nationwide, with a specific focus on leveling the benefits playing field. "We now have 135,000 members nationally," says Sara. "The world of independent work is about a third of the current workforce. People these days are increasingly going from job to job and from project to project. What we're trying to do is to set up benefits that allow for this kind of portability."

Freelancers Union's first step was to pool its members to create an affordable group health insurance policy. "Freelancers used to figure out health insurance on their own but now we can offer them affordable group rates," Sara says. "By grouping people together, you get so many economies of scale. Now we can afford as a group to hire Milliman to help us figure out the best way to manage the group to make sure that it's sustainable in a non-profit way over time."

Working in conjunction with Milwaukee-based Milliman health consultant Mike Sturm, the Freelancers Union health plan now offers health insurance to about 23,000 New Yorkers. This pilot program is the first of its kind.

A QUALITY 401(K) FOR THE SELF-EMPLOYED

Freelancers Union then determined that the ability to save and invest in an affordably priced 401(k) vehicle was the next priority. At the time, a comprehensive retirement solution simply wasn't available. So the nonprofit turned to Milliman to get answers.

Milliman helped Freelancers Union design a plan that offers a degree of support and direction similar to that of an employer-generated 401(k). "We do all the record keeping," says Laura VanDomelen, head of Operations for Milliman's Southern Employee Benefits Region. "And we basically do a lot of the footwork for participants. We make sure that their contribution limits are watched, that they don't make any glaring errors, that they get their forms filed if they need them. What we don't say is, 'the instructions are online, you go figure it out.'" The bottom line is ease of participation: "The plan has an automatic payroll deduction feature—it's entirely elective and, of course, they can make changes."

This kind of automatic enrollment was a key feature in the nonprofits plan design. "We really wanted to take the principles of behavioral economics and have a system in place that had a default option," says Sara.

A second critical aspect of the plan is its robust investment options. Milliman selected a variety of mutual funds representing a dozen asset classes to help ensure adequate diversification. All investments are monitored by Milliman on a quarterly basis.

To eliminate the guesswork in combining asset classes properly, Laura's team also created age-based target-date model portfolios. Participants can tweak their investment allocations, but asset allocation "defaults" are set out for those who would rather leave the investment decisions up to professionals. An online calculator helps participants determine how much they can save into the plan based on income—and the tax savings this will generate for them.

AND YES—LOW FEES

Prior to the creation of the Freelancers Union 401(k) plan, IRAs were really the only affordable option for independent workers' retirement savings. However, compared to a traditional IRA, a 401(k) plan provides the advantage of much higher contribution limits. Before the Freelancers Union's product was available, individuals who wanted to set up a 401(k) had to do it through a broker, where the fees tended to be prohibitively high. And for those seeking to diversify their investments, there was also the added burden of meeting set minimums per fund within the plan. That's why the low fees, zero minimums, and investment flexibility of the Freelancers Union plan are such important benefits.

"This truly is a unique product that is advantageous to participants," Laura says. "Freelancers Union has been a great partner to work with: It takes innovation on both sides to come up with smart solutions. And we're still at it—we'll be rolling out more customizable features throughout 2010."

With Milliman's help, Parkland Hospital has found innovative ways to consolidate, clarify, and enhance its benefits system

AN EXEMPLARY BENEFITS PROGRAM

Almost a decade ago, Dallas's Parkland Health and Hospital System looked ahead to its employees' future retirement and saw the need for a change in its retirement benefits administration. Parkland's challenges included a roster of more than 8,000 employees who frequently shifted job titles and full-time vs. part-time status. Legacy sources of employee data included paper records, as well as databases that had undergone a series of conversions as technology evolved.

Parkland knew it needed a complete overhaul in order to offer employees a new generation of benefits, whose centerpiece would be reliable online access to benefits information. By providing a "self-service" benefits portal, Parkland hoped to increase awareness of the value and extent of its benefits package and demonstrate how competitive it was in the Dallas market.

ENVISIONING WHAT THE FUTURE SHOULD LOOK LIKE

"From the outset, we worked with Parkland to understand its total benefit picture, both defined benefit (DB) and defined contribution (DC) administration—as well as the need for communicating the importance and value of these plans to employees," says Milliman consultant Greg Boland. "Our practice leader, Mark Trieb, was heavily involved from the start in plan design. Parkland managers Jim Johnson and Candy Knowles knew they wanted all aspects of the DC and DB programs to work together, consolidated into a single clear picture that would be easy for employees to understand."

Greg's focus has been on transforming the DB side of Parkland's retirement program. He and his team worked to create a "hierarchy of trust" for diverse information systems to accurately record employees' compensation history, contributions, and employment status for specific time periods. Developing this confirmation and consolidation process took close to three years, but the end result was well worth the work: "Parkland and its plan participants now have confidence in the information it gets from the system. It gets it quickly and directly from the plan website, and it trusts the numbers it's getting." An invaluable benefit is the self-service environment that's been created. "The employees are happier because they're a lot more self-sufficient. And Parkland's HR staff has the tools to administer these plans effectively."

THREE-FOLD BENEFITS FOR DC PARTICIPANTS

Milliman DC specialist Pat Hargrove began working on the Parkland outsourcing project in 2002. DC plan design enhancements have always been a significant focus and, along the way, three separate DC plans have been integrated into one.

"What we've done," says Pat" is to combine a 403(b), a 401(a), and a 457(b) in a way that's seamless to participants." How can they do that? "Parkland is unique in that it's a governmental entity and it's also a teaching hospital. Because Parkland is a governmental entity, employees are eligible for 457(b) benefits and therefore they have the ability to double up on deferrals." For example, for 2009, once Parkland's employees contribute the basic salary deferral up to the $16,500 maximum allowed into a 403(b), they can contribute an additional $16,500 into the 457(b) plan. "Then, to enable participants to put in as much as possible, we place the Parkland match and after-tax contributions in the 401(a). In some cases, this means that employees can triple their contributions."

Participants don't have to worry about the rules for contributing to the separate plans; their contributions automatically get distributed to the right plan in the right sequence. Diversification is now also "automatic," thanks to a more diversified default portfolio that draws from a wider range of investment offerings.

METRICS SHOW THE CHANGES ARE WORKING

Best-of-class investment vehicles still need participants who know that funding them adequately is in their best interests. Both Pat and Greg emphasize how essential effective communications have been to the success of the Parkland relationship.

"Nancy Kariel, Parkland's lead Milliman communications consultant, is involved on a daily basis in ensuring that everything done from a communications standpoint is in line with Parkland's overall plan," says Pat. "Parkland's communications are unique to its retirement program, and include advanced tools that consolidate benefits information and show the value of these for employees."

Employees are getting the message. Participation in the Parkland DC plan is up 21%, with an average DC deferral rate of 8%. "We're helping employees become better investors, and maximizing their engagement with the entire retirement benefits process," says Pat.


Longtime client recognized for
tilting the cost of their pharmacy
benefits downward

REVERSING THE CURVE

This year the total medical cost for a typical American family of four is 7.8% more than last year, and that rate of increase is actually pretty good compared to some other years in the last decade. The increase—$1,303 this year alone—can be disheartening. But there are some very promising examples of effective cost control that can allow for more affordable care while also preserving quality.

Milliman's New York health and welfare practice has recently seen a prime example of this in a longtime client's efforts to control prescription drug costs. Many of the ideas underlying this effort to control costs are not particularly new—the logic behind controlling utilization to control costs has been around for years—but what really stands out here is the result: In an environment marked by such stark year-to-year healthcare cost increases, this client has actually reversed its pharmaceutical cost trend.

The 1199SEIU Benefit Funds are self-insured, self-administered Taft-Hartley funds in the New York region that provide benefits to employees, retirees, and dependents at hospitals, nursing homes, and home health organizations. The 420,000-member funds have been a Milliman client for more than 30 years. Since 2004, the benefit administrators and trustees at the funds have actively worked with Milliman experts about controlling healthcare costs.

"For years we've been having work groups and cost-containment meetings and we've shared ideas on cost savings and how to go about implementing them," says Milliman principal and benefits consultant John Bauer. "We've introduced various experts from Milliman into the discussion and have had an ongoing, open dialogue around the topic of controlling costs while maintaining quality benefits. During collective bargaining periods we've offered financial impact projections of the different decisions they could make in their benefit composition. They came to us with a new approach to their pharmacy benefit. It was entirely a plan of their own invention. We projected what kind of results they might expect—they looked quite promising—and the program has since been implemented and has actually received an award."

The 1199 concept is built on a novel yet simple premise: Members that work with the plan design spend nothing on medications, while those that work against the plan design incur costs. Rather than capping or restricting the utilization of pharmacy benefits, the 1199 design encourages the most efficient utilization by rewarding the most cost-efficient delivery of the right prescriptions and requiring cost sharing for members that opt for less advantageous usage.

For example, mail order is mandatory for long-term medications and the prescriptions are filled for 90 days instead of 30 days. Anyone who chooses to buy 30-day prescriptions via their local pharmacy has to pay out of pocket. For members who really want to visit a pharmacy, the 90-day prescriptions can also be filled at the Rite Aid pharmacy chain. Generic drugs are strongly encouraged where they are available, with no participant cost sharing on these prescriptions. Members pay the cost difference between the brand-name drug and the generic drug when the generic choice is available. Members also pay the difference in cost between non-preferred and preferred brand drugs based on a carefully researched preferred drug list, with no participant cost sharing on preferred brand drugs.

The result? The 1199 Funds have saved more than $200 million since 2005. The prescription cost trend has not only decelerated but was negative in 2008 and 2009, in an environment where seemingly every other cost component has gone up (we mentioned the 7.8% average cost increase this year in total medical spending; the pharmacy trend built into that number is 6.1%).

In recognition of these impressive results, the 1199 pharmacy benefit design was recognized this year for its cost-containment efforts by the Pharmacy Benefit Management Institute. The Funds are one of four 2010 honorees.

"This has been an ideal example of client initiative," says Bauer. "Milliman provided support and financial guidance, but the people designing the 1199 benefit became experts in their own health costs and developed this sophisticated approach that is very impressive. The results speak for themselves."


Today's models need to bring
the volatilities of assets and
liabilities into sync

ROBUST, PPA-READY ASSET-LIABILITY MODELING

For corporate pension plan sponsors, it seemed that 2009 might go down as one of the most frustrating years on record. After weathering the storm of 2008, when the U.S. stock market declined 38.5%, 2009 was a lot better. Stocks made up more than half the loss, surging 23.4%. Good news—right?

"Not exactly," say Bart Pushaw and Alan Perry, consulting actuaries from Milliman's Dallas and Philadelphia practices, respectively. "While the 23% equity return was good news, the poor CFO is bound to get heartburn after learning that liabilities grew even faster than investment returns," says Alan.

Based on an analysis of the Milliman 100 Pension Funding Index, corporate pension funds (with an average equity allocation of approximately 50%) had a cumulative asset return of 13.2% in 2009. For the same period, the cumulative liability return increased 13.5%.

PPA MANDATES MARK-TO-MARKET ACCOUNTING

The jump in liabilities wasn't caused by a rash of employee retirements or layoffs. It was simply the result of an actuarial calculation mandated by the Pension Protection Act (PPA). As Bart explains, "Prior to PPA, liabilities were treated as a static part of the equation. The funding rate was self-determined, under the dominion of the actuary, and liabilities were guaranteed to grow only at that hurdle rate, which rarely moved."

PPA changed all that. Now, pension funds must value their liabilities using mark-to-market rules that tie liabilities to fluctuations in high quality corporate bond yields. As a result, sponsors need to model their liabilities because they may be even more volatile than the portfolio's investment returns.

That's what has caused the heartache for so many CFOs. Bart says, "For many plans, the net funded status came down. This created a cost control issue and a budgeting issue. The CFO has a full plate, piled high with both risk allocation and capital allocation problems."

SOPHISTICATED ASSET-LIABILITY MODELING NEEDED

The solution lies in modeling assets and liabilities together. Asset-liability modeling (ALM) allows sponsors to see the impact of different strategies on the plan's funded status going forward. Then they can implement investment strategies to control their funding risk. These strategies are generally known as liability-driven investing (LDI). The most basic LDI strategy buys a portfolio of high-quality bonds with an average duration matching that of the liabilities. This way, the volatility of the investments closely matches that of the liabilities.

To cope with decreased expected returns (and increased pension expense) from the reduction in equity exposure, Milliman and others have created more sophisticated LDI strategies that, for example, use one part of the portfolio to immunize the liabilities and the other part to seek higher returns. The point is, the level of sophistication needed to manage a defined benefit plan's funding strategy increased dramatically as a result of PPA.

Interestingly, the computational power to handle the modeling for LDI strategies is not widely available. Alan observes that investment advisors have, historically, focused on assets, so many of them don't have much experience in liability modeling. And traditional shortcuts no longer suffice. Alan explains: "Plan sponsors used to be able to get liability numbers from the actuary, and use them as baseline assumptions they could roll forward. Arguably, you could get away with that before PPA—but not anymore."

Milliman is fortunate that its ALM capability has always been robust. Long-time clients such as Axa and Metropolitan Life have extremely complicated pension plans that require detailed analyses of risk; as a result, Milliman developed systems that are capable of doing projections of full actuarial valuations under thousands of economic scenarios going forward 10, 20, 50, or even 100 years. This proved to be excellent preparation for the demands of PPA modeling.

LDI AND ENDGAME STRATEGIES

For all of its clients, Milliman provides a full range of ALM capabilities and LDI strategies that include the use of derivatives for hedging, risk budgeting, segment matching, and surplus management.

Also, because PPA requires plans to become fully funded over the next five to seven years, many plan sponsors are now trying to formulate an endgame plan. As Alan describes it, "We're helping to design investment strategies that allow sponsors to make a series of planned contributions while steadily de-risking the asset portfolio to protect their higher funded status. After that they never have to put in more money; either it's self sustaining, or they can terminate the plan and buy annuities.

That may sound like the end of the line, but Bart cautions, "even though the plan might be frozen, you can't just put it on the back burner and not worry about it. These things have a nasty habit of coming back to life when least expected. Continuing to use ALM is particularly important—to avoid surprises."

Last year, HV&P joined Milliman's Netherlands consulting business—and helped its Dutch pension fund clients respond to 2008 market lows

DUTCH SYNERGY

2009 was a very busy year for Jeroen Hilbrands and Pieter van Schijndel, cofounders of Amsterdam-based HV&P Adviseurs en actuarissen. Not only did their employee benefits consulting firm merge with Milliman's Dutch practice—but they were also engaged in helping pension fund clients to construct recovery plans after global markets lurched downward in 2008.

A BIG MARKET IN A SMALL COUNTRY

As a nation with a defined-benefit-dominated retirement system, the Netherlands takes its pension funding requirements seriously. "Our pensions are a big market in a small country," Jeroen explains. With a population of about 16 million and more than 500 pension funds, there's a significant amount of capital invested in pension pools. Total assets are just under $1 trillion, making the Netherlands one of the world's largest pools. ABP, the Dutch government employee pension fund, typically ranks in the top three in the world, with approximately $300 billion in assets.

"The merger with Milliman was a natural fit," says Jeroen. HV&P Adviseurs en actuarissen had been earning accolades as an Amsterdam-based employee benefits consultant for almost a decade. It was looking to expand its services to existing clients and to broaden its reach outside the Netherlands. For its part, Milliman had previously established a strong Dutch presence in the insurance and healthcare consulting arenas and wanted to serve a growing employee benefits sector in the Netherlands. The two firms merged in August 2009, to become Milliman Pensioenen vof. "We are the first Milliman EB practice in Europe," notes Pieter.

FOCUS ON SOLVENCY

Not surprisingly, much of the focus last year was dealing with the repercussions of the global market downturn. In most regards, Dutch governing rules are considerably more stringent than those dictated by the U.S.'s Pension Protection Act. In 2006, the Dutch government tightened its pension funding requirements. Since that time, the "low" level for funding is 105% of obligations, with a mandated three-year period to regain solvency when markets slide or obligations soar. Certain pensions are tasked with achieving 120% of obligations, but with a period of 15 years to achieve that number. Compare this to the U.S., where pensions have been mired below 80% funding status for most of the last year.

By the beginning of 2009, says Pieter, "Almost every pension fund in the country had to make recovery plans to show the Dutch regulator that they would be in good shape again within that three- or 15-year period. We had helped these pension funds and their boards to create their plans. Now we are helping them with financial structures—working with the sponsors to level up the premiums. It was a difficult time for these pension funds, but a good time for us to demonstrate our consultancy skills."

QUICKLY GAINING GROUND

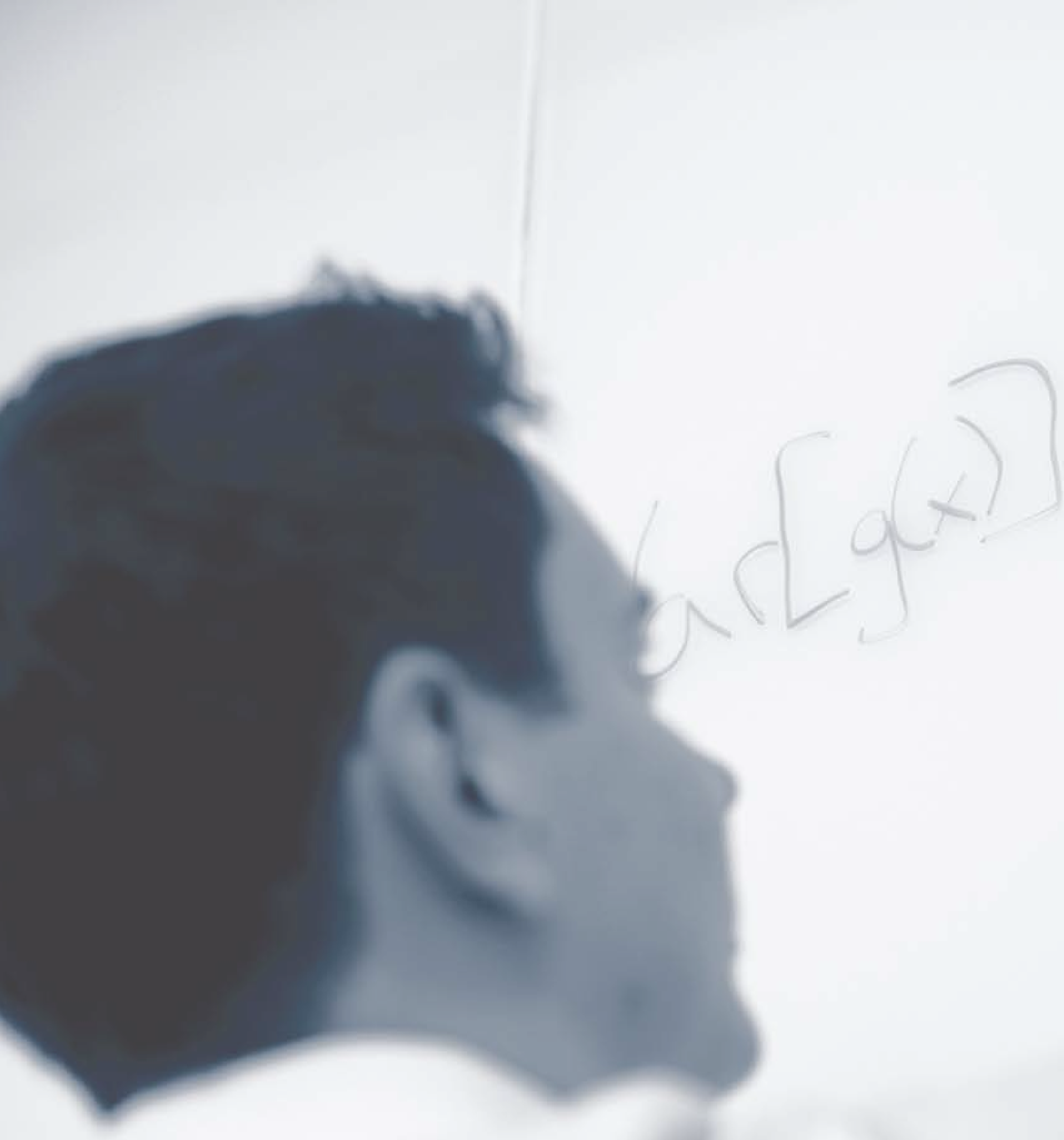
And demonstrate they did. For Dutch plan providers and their consultants, a pension fund that's even marginally below 100% funded is in "really bad shape," Pieter emphasizes. "You have to work within a very short time frame to recover as soon as possible."

Their Dutch fund clients were experiencing, on average, about 95% solvency after the market downturn. By early 2010, most of them were comfortably back up to 105% to 110%. It helped enormously that the stock market recovered and that the Dutch discount rate rose—keeping liabilities from rising faster than assets, which has been one of the biggest problems for U.S. pension funds (in 2009, the pension liabilities for the largest 100 pensions declined a total of $105 billion).

THE SYNERGIES ARE REAL

Looking beyond the current crisis, Jeroen and Pieter's work focuses primarily on what the Dutch call "the second retirement pillar." The first pillar is the Dutch government pension. At age 65, all Hollanders get a retirement pension of about €15,000 per year. "Above that, second-pillar pension plans are provided by the employer—sometimes, but not always, with an employee contribution," says Jeroen. That defined benefit is up to 60% to 70% of the salary earned by employees at age 65. The third pillar is similar to a U.S. defined contribution plan or IRA.

Jeroen and Pieter plan to leverage Milliman's extensive capabilities in risk management and investment consulting to help their clients make sure the "second pillar" stays stable. Currently, he says, they're working on transforming existing Milliman financial models to reflect the complexities of Dutch pension funds, "to help us create more breadth in what we can do strategically for our pension fund clients." They're also working on a hybrid defined benefit/defined contribution model that "provides DC flexibility for the employer, but DB benefits for the employee." This model could be adapted for the U.S. market, demonstrating that the planned synergies are already starting to materialize.



Milliman is among the world's largest independent actuarial and consulting firms. Founded in Seattle in 1947 as Milliman & Robertson, the company currently has 52 offices in key locations worldwide. Milliman employs over 2,400 people, with a professional staff of more than 1,100 qualified consultants and actuaries, including specialists ranging from clinicians to economists. The firm has consulting practices in healthcare, employee benefits, property & casualty insurance, life insurance and financial services. Milliman serves the full spectrum of business, financial, government, union, education and nonprofit organizations. For further information, visit milliman.com.

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