ACTUARIAL

Replacing Betty

Why DB Plan Outsourcing Makes Sense

Betty may be a sweetheart, but she's only human. If she's having trouble keeping up with changing pension regulations, maybe it's time to outsource.

BY DAVID W. BENBOW, CPC, QPA, QKA

Defined benefit plans are often regarded as the dinosaurs of the retirement plan world. While defined contribution plans have become the preferred retirement plan structure in the United States, it's well documented that they may not provide a livable income for many retirees. DB plans provide retirees with a stable source of retirement income, which is why many companies continue to offer them to their employees.

One of the main drawbacks of DB plans is their administrative complexity, but it hasn't always been that way. Administration became more complex over time due to a virtual alphabet soup of government regulations: ERISA, TRA, TEFRA, OBRA 87, EGTRRA, PPA, and so on. Plan sponsors were forced to rely heavily on their actuaries to help them navigate the legislative landscape in order to keep their plans in compliance. Eventually, some of the larger actuarial firms began offering a spectrum of outsourcing services to their clients, ranging from simply calculating pensions to building administration systems to full-service call centers with integrated web modeling.

The rules have changed over the years, but the logic remains the same: In order to provide adequate retirement benefits, you need a DB plan, which means you need expertise to administer it.

SKELETONS IN THE CLOSET

As if complicated laws weren't enough, DB calculations depend on extensive data. Usually, the longer a plan has existed, the more data are needed to calculate the pension and, if the plan has changed hands through mergers or acquisitions, this data may not be centralized or easy to obtain. Companies that have administered their DB plans in-house often have one key person—let's call her "Betty"—who has been calculating the pensions for 35 years. Betty has all the historical knowledge; she knows which employee groups are special and why; she remembers when she has to go look someone up in the red binder to get the frozen amounts that are listed in it. Betty is friendly, reliable and indispensable. And Betty is 62.

As impossible as it may be to imagine life without Betty, we know her days are numbered and someday she'll retire. So far, cloning Betty isn't an option and training others isn't really Betty's strong suit, but we have to find a way to take the knowledge out of Betty's brain and document it for posterity.

Could it be time to think about outsourcing the DB plan? Outsourcing sounds expensive, and our culture has always been to take care of our own employees. Then again, we may be forced to take the plunge.

It's very common for a pension plan to have some data-related skeletons in the closet, and experienced pension administrators have seen it before. By looking at samples of Betty's calculations, they can identify the key pieces of data, store them in a central, accessible location, and have the mysterious red binder keypunched so it can be automated. Betty will still be around to use as a resource, but with the processes automated instead of sitting between Betty's ears, there won't be any surprises when she retires.

THE OUTSOURCING SPECTRUM

There is a lot of grunt work involved in administering a DB plan. Someone has to gather data, calculate pension amounts, prepare retirement paperwork, review election forms, answer participant questions, and set up payments. Virtually all of these tasks can be outsourced or done in-house. However, there are three common places along the spectrum where the tasks are usually divided up.

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"Old school" outsourcing. This is where a third party (usually an underling of the plan actuary) performs pension calculations using data provided by the plan sponsor. Typically, the third party will also prepare the election paperwork, but the plan sponsor will mail the packet and process the elections. The advantage to this old-school approach is that it's less expensive, but has enough actuarial oversight to ensure that the calculations are compliant with current legislation. However, the process may be very slow, depending on the actuary's workload.

"Co-sourcing." Often, a third-party administration firm will create and host a DB administration system the client can use to administer pensions in-house. This blend is often called "co-sourcing" because the third-party firm will collect data and maintain the system, while the sponsor does most of the daily tasks. This is advantageous for companies who are reluctant to let go of the daily administration and want to maintain the face-to-face interaction with their own employees. However, it can be slow during periods when the sponsor's benefit department is very busy (such as open enrollment). Often, this service is nearly as expensive as full outsourcing.

Full outsourcing. Under this approach, a third-party administrator will receive regular payroll data feeds from the plan sponsor and do all the administrative tasks. Usually this will include a call center for fielding participant questions, and many firms will host a website that participants can use to monitor and model their pension benefits.

PLEASANT SIDE EFFECTS

In addition to the obvious time savings that comes with outsourced administration, there are some other processes that suddenly become much easier from having a centralized and automated system. For example, the process of gathering data for the annual pension valuation is streamlined by having one centralized database, and the data can include a pension calculation as of the valuation date, which can be run in batch on the system. Other projects, such as pension statements and participant mailings, are also more efficient on a centralized system.

OUTSOURCED CALL CENTER

This is one area where not all service providers are created equal. Plan sponsors should examine the call center carefully because they'll be representing your firm. On the plus side, using an outsourced call center often allows you to record and review participant phone calls and have representatives who speak different languages. Consider that some call centers may be overseas, which can present communication challenges. For best results, look for a firm with a U.S.-based call center that has immediate access to participant information. It's very common for a plan sponsor to request a tour of the call center to see if they have the necessary technology and culture fit to represent their organization.

STICKER SHOCK

Let's face it. DB plan outsourcing isn't cheap, but as is often the case, you get what you pay for. I know that Betty is reliable, but has she ever made a mistake? She's human, just like the rest of us. Compare the cost of pension outsourcing with an administrative error (with potential legal implications) and it suddenly seems more reasonable. Betty has a wealth of historical knowledge of your plan, but has she kept up with new legislation, such as PPA benefit restrictions, that could cause the plan to be administered incorrectly? Would Betty's work stand up to audits by IRS or DOL?

Even some firms that provide

pension administration services but don't consider it to be their main focus may be out of step with current laws or plan rules. Sometimes, a third-party administrator may offer to take over the administration so they can manage plan assets or sell some other product. But if their focus isn't on the administration, it could lead to quality problems.

CASE STUDY 1

A client with two defined benefit pension plans—a 450-employee union plan and a 3,500-employee salaried plan—was looking for a new plan administrator to unburden their one-person administration group.

Because most companies have hidden administrative problems, it's necessary to dig deep to uncover any issues. During a two-day site visit to get acquainted with the client's processes, we discovered that the prior administrator had limited pension knowledge. They had ignored many important things, including Suspension of Benefits Notices and terminated participants over age 70½. Furthermore, we identified several inconsistencies in how the prior administrators calculated age and service, and which factors they used for early retirement reduction. In addition, participants and retirees with pension questions would call the client's benefits department directly, with pension calculations taking 30 to 60 days to produce.

Suspension of Benefits Notices are now being sent. The participants who had been missed received one-time actuarial adjustments to make up for the delinquent period. Terminated participants over age 70½ were identified, located, and paid retroactively back to their required beginning dates.

We provided a dynamic website that gave participants access 24 hours a day to produce their own pension estimates. In addition, they can request retirement paperwork, which reduces turnaround time for calculations. Furthermore, instead of burying the client in questions, participants and retirees have access to a full-service call center.

Pension administration became much more consistent because calculations were produced by a pension system instead of by people using different spreadsheets. In order to iron out some of the past inconsistencies, we created administrative rules and got both the client and the prior administrator to agree that our rules were consistent with the plan document.

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The client is thrilled with their new pension system and the support of the administrative team. Calculations are not only more consistent, but they're produced more quickly and accurately.

CASE STUDY 2

A client was looking for a new administrator for its frozen multiple-employer DB plan. Previously, the plan was administered by a small actuarial firm and the client was frustrated by the lack of service and multiple calculation errors. Participants often wouldn't receive their pension calculations for several weeks, creating anxiety and costing the client a lot of time fielding phone calls.

In a typical conversion, we ask probing questions and look at several sample calculations in order to adapt our ongoing processes to past practice. The previous actuary was reluctant to share their calculations, providing us with only two partial samples from which to program our system. During this process, we discovered several fundamental quality issues that required correction prior to implementation.

After the plan was implemented, we noticed a calculation with a very large benefit. In most plans, the IRC §415 benefit limit isn't an issue, but this plan had a very generous formula before it was frozen and had many older, long-service participants. It turned out that several participants had benefits that exceeded 100% of average compensation. Paying benefits above the §415 limit is a compliance problem and, if not corrected, could cause the plan to be disqualified.

We proactively examined the employee population and identified people whose benefits would be limited by §415. By correctly administering this little known rule, the plan remained compliant and excess money wasn't paid to retirees.

Pension administration is much more streamlined because calculations were automatically produced by the system and mailed within a few days, instead of being backlogged for weeks.

The client enjoys having ready access to their pension data. Even before the system was built, the client commented several times about how much more prompt and attentive the outsourced team was, compared with what they were used to. Calculations aren't only consistent, but they're produced more quickly and accurately. Ultimately, the client has confidence that their pension plan is in good hands.

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