A Midsized Proposition—

Benefits Outsourcing Is Not Just for Large Organizations

by Steve White and Penny Plante

Recent trends make now a good time for midsized companies to consider extending benefit administration outsourcing to defined benefit and health and welfare plans. As the outsourcing market has matured, several factors are serving to shift the balance of the cost comparison between outsourcing and internal administration. At the same time, complexity and rising service expectations have increased cost pressures for internal administration. These trends, along with the risks and limited flexibility that come with internal administration, may tilt the balance in favor of further outsourcing. And the best part is that once an organization has transitioned to outsourcing, the plan sponsor can refocus on the strategic decisions that have greater impact on the organization and its employees.

You have just finished the 2011 annual enrollment for your 1,500 benefit-eligible employees and are now taking a deep breath for the next phase: notifying carriers of the changes and entering the information into your payroll system. With luck and help from outside your health and welfare (H&W) plan administration team, you will be done by year-end.

After that, it's time to revisit the other work that has stacked up during the peak season. In addition, your internal pension administration staff will also be playing catch-up for several months, after being loaned to the H&W team to get through open enrollment.

In the unlikely event you have no unplanned projects, you hope for a return to normalcy by April. As you unwind briefly during the holidays, you wonder: "Isn't there a better way?"

Expanded benefits outsourcing is the answer whose time has come for the midsized market. Outsourcing is common for most plans at large companies. In addition, outsourcing has been the norm for 401(k) and other defined contribution (DC) plans of all sizes, as well as for the Consolidated Omnibus Budget Reconciliation Act (COBRA) and flexible spending account (FSA) plans. However, many midsized organizations have maintained in-house administration for two important functions:

1. H&W administration, including enrollment, carrier feeds, billing and call center/online services
2. Defined benefit (DB) pension plan administration, including database maintenance, benefit calculations and call center/online services.

Many firms have looked at outsourcing this work in the past, but ultimately retained their internal structure. Higher costs for outsourcing was most likely the deciding factor, but other reasons may have included concerns about preserving the culture in dealing with employees and concerns about the risk of trusting an outside vendor to do this correctly.

However, now is a good time to take another look. Outsourcing costs have trended flat, at the same time that complexity and rising service expectations have increased cost pressures for internal administration. These trends, along with the risks and limited flexibility that come with internal administration, may tilt the balance in favor of further outsourcing. Employers should take a closer look.

THE CHANGING COST COMPARISON

For many midsized organizations, costs have been the primary barrier to outsourcing benefits administration. Fees can be substantial, and often it is difficult to compensate for the fees to the outsourcing vendor with corresponding cost reductions for internal staff. Additional factors can make this comparison look worse:

- Outsourcing often comes with implementation fees, and there is typically no internal savings to offset this expense.
- Effective outsourcing requires effective vendor management, and this requires skilled internal staff. Internal cost savings are reduced to the extent that roles for internal staff shift from administration to vendor management.

Some organizations may also be resistant to cuts in internal staff to support outsourcing. Any move to outsourcing will require evidence of cost savings, which these organizations have not seen in their prior reviews.

As the outsourcing market has matured, however, several factors are serving to shift the balance of the cost comparison.

First, if a plan sponsor has benchmarked outsourcing fees in the past and repeats that exercise now, the sponsor may be surprised. Fees will likely be similar to those quoted several years ago, and may even be lower. Several factors are influencing this:

- **Maturing industry.** Benefits outsourcing has matured as an industry. Processes have become more efficient over time, and systems development costs have stabilized. These changes mean higher potential margins and outsourcing firms hungry for new business. The result for buyers is more negotiating leverage—particularly for implementation fees, but also for ongoing fees. Although a full waiver of implementation fees for DC outsourcing has been the norm for many years, this is not the case for H&W and DB outsourcing, in part because the implementation work is more involved. However, the trend is clearly in the direction of lower implementation fees.
- **Increased competition.** The maturing industry has also brought more clarity to the list of possible vendors. These firms are more likely to be committed to this business long term, whereas in the past the initial foray for many into administration outsourcing could be viewed as an experiment. The remaining players are looking to grow and improve their services. There is clear competition to gain new clients, and this serves to moderate potential fee increases.
- **Offshoring.** Many outsourcing vendors have utilized offshoring for portions of their work. Administration outsourcing capacity and talent in India and other countries has grown rapidly, with the result that an increasing number of services are completed or supported in offshore locations. This change requires an initial investment, but can ultimately result in significant cost savings. While the wage gap for offshoring may shrink over time, it is still wide for many analyst-level positions. This provides a cost-efficiency opportunity for outsourcing firms that is effectively not available with in-house administration.

The second element of the cost comparison is the cost of internal administration. Here, the underlying drivers are working in the other direction. Plan sponsors have probably found that it is increasingly difficult to maintain internal administration at the same cost level. There are pressures on both administrative staff and information technology (IT) staff. These include the following:

- **Internal administrative staff.** The increasing complexity of the benefits administration landscape simply requires more knowledge and more work from internal staff. This makes it difficult to maintain consistent staffing levels, in terms of both numbers and pay. More complexity also leads to more employee questions, and this puts additional pressure on internal call centers or administration support groups.
- **IT expenses.** Systems requirements are increasing for effective administration. Plan changes and compliance and security requirements are sources of change. Another source is the desire for online tools and other enhancements intended to service employees. Both factors result in administration system enhancement requests that require more IT expertise and increased capital needs.

The cost comparison is shifting with time. Competitive pressures are serving to limit costs for outsourced administration at the same time that administration requirements are increasing costs for internal administration.

RISK CONSIDERATIONS

In addition to costs, an organization must evaluate financial risks associated with its administration structure. In the past, a midsized employer may have viewed outsourcing as the riskier approach, and it may still appear risky to trust this work to an outside firm when it is adequately functioning already.

But a longer look shows a different picture. Similar to the cost comparison shifting in favor of outsourcing, several risk factors have also shifted in the same direction. A thorough evaluation of these risk considerations may tilt the administration decision to an outsourcing structure even if total costs are slightly higher. Factors such as staffing risk, systems risk, database risk and error risk have been in place for many years, but the magnitude has increased with time. We will examine each in more detail.

Staffing Risk

The technical details of benefits administration can be overwhelming. New compliance requirements seem to arise on a regular basis, while prior requirements do not go away. Pension administration complexities include requirements such as relative value comparisons, benefit restriction limitations, minimum distribution requirements and much more. H&W requirements include Medicare secondary payer (MSP) reporting requirements, extension of coverage for children up to the age of 26, impending automatic enrollment requirements and implementation of wellness initiative surcharges/discounts, such as tobacco use surcharges.

Staffing risk refers to the risk of losing internal staff with the current and historical knowledge necessary for accurate administration. For midsized organizations that administer plans internally, much of this knowledge may reside with one or two individuals. Often these employees have many years of experience, as well as the skills to keep up with the increasingly complex legal environment of these plans. They are critical to the success of plan operations. Losing these employees can severely impact the ability to maintain an internal administration structure.

Addressing this risk through succession planning is difficult. Retaining sufficient experienced staff to ensure redundancy and smooth staff transitions can be cost-prohibitive. Planning to train new staff in advance of expected retirements can be risky if the experienced administrative staff leaves unexpectedly. In addition, it is difficult for new staff to acquire institutional knowledge in a short learning period. Finally, it can be difficult to attract new staff with experience. With the overall shift to outsourcing, the experienced benefits administration talent has gravitated to the outsourcing firms, and many view positions at those firms as the source of greatest career advancement.

A move to outsourcing provides an opportunity to formally document administration procedures and capture the historical knowledge within a team. Through this transfer of knowledge, the plan sponsor ensures the successful transition of responsibilities to the outsourcing partner. In addition, the sponsor gains a tool for measuring its partner's success in meeting certain performance guarantees.

Systems Risk

With the exception of very small plans, benefits administration is dependent on computer systems and electronic data. These systems can be developed and maintained internally or leased from an outside firm. Systems capabilities vary in structure and features, but the common element is that they are necessary for the ongoing operation of the plan. *Systems risk* refers to the impact on the plan if the system becomes obsolete.

There are two main reasons why an administration system can become obsolete. First, the entity maintaining the system may decide to discontinue system support. This may be the internal IT staff or the third party leasing the system. This typically occurs for an older system based on an old software program. The second reason is that new system requirements emerge, and the current system cannot be enhanced to meet them. New system requirements can be triggered from several sources, including plan design changes, new compliance requirements, new security and confidential data requirements, and new service features such as online tools.

Regardless of the source, the requirement for a system conversion brings risk and expense to the internal outsourcing structure. The risk may be reduced by planning ahead, but competing demands for internal IT resources are common, and the internal systems conversion can be difficult at best.

Database Risk

Complete and accurate data is required for benefit administration. By *database risk*, we refer to the risk that historical data becomes incomplete, corrupt or not well-organized. This risk lies mainly with pension plan administration, where data dating back 30 years is still required to administer current benefits.

Complete and accurate database maintenance is possible with internal administration. But if a plan sponsor uses multiple databases or paper files, it often leads to a data structure that is not complete. This can result from inconsistencies among multiple data sources, organization changes such as mergers or acquisitions, physical loss of files or loss of key personnel.

This incomplete data structure can lead to multiple problems, including:

- Inefficient administration, which is due to reliance on paper files or multiple sources
- Processing errors if incorrect data is used
- Incomplete or inaccurate data used for data transmissions, actuarial valuations or benefit statements
- Inability to produce accurate benefit statements or online estimate tools.

A by-product of the conversion to an outside vendor is the opportunity for data cleanup as discrepancies such as those stated above are discovered. Discovery during the implementation allows for the data documentation and organization. This can mean correcting an administration practice that is not allowed under the plan or formalizing documentation to acknowledge the practice.

Error Risk

Benefits administration is not easy. With increasing complexity comes increasing opportunity for error. *Error risk* refers to the cost of correcting administration errors, including hard dollar costs of unrecovered overpayments as well as the time required to correct the errors.

Outsourcing vendors are not immune from errors. However, they are better positioned to set up adequate controls and checks to minimize errors. In addition, the outsourcing vendor is responsible for its work required to correct an error, and the sponsor may be able to recover some or all of any hard dollar costs associated with an error.

Overall, increasing complexity and service requirements have elevated the risks associated with internal benefits administration. A well-organized internal administration structure may be able to address most of these risks, but this is difficult to do and difficult to maintain.

MEETING EMPLOYEE EXPECTATIONS

Clearly, costs and related financial risks have caused many employers to choose outsourcing for this detailed work. However, equally important is what a plan sponsor gets for its administration dollars. Here, trends are moving even more in favor of outsourcing.

From an employee service perspective, the benefits of outsourcing are compelling. Demands have increased for accuracy, timeliness, attention to detail and customer service. Employees, regardless of their ages, expect ready access to information on their benefits. Employees who have had this for many years with their 401(k) plan will increasingly lose patience with slow-motion, paper-only options for their pension plans and paper enrollment forms for H&W benefits.

With outsourcing, an employer is able to tap into the administration technology of the outsourcing vendor. An employer may be able to deliver administration services in-house, but it is difficult to offer the same level of service without a disproportionate investment in administration technology. Examples of outsourced administration options that are difficult to replicate internally include the following:

- Online sites providing access to tools and resources:
  - —Online H&W enrollment elections
  - —Pension benefit modeling
  - —Quick access to summary plan descriptions and other important documents
  - —Links to provider sites including wellness sites and the Social Security Administration
  - —Health plan cost estimators and other tools to assist employees with choosing the health plan that fits their needs
  - —Integrated tools to communicate multiple benefits, including total retirement planning tools reflecting combined amounts from DC and DB plans
  - —Plan communication and disclosures.
- Expanded capacity to ensure consistent service:
  - —Full-service call center with expanded hours, recorded lines, training and metric measurements to ensure consistent delivery
  - —Consistent turnaround of administration functions regardless of competing internal demands
  - —Quick implementation of plan and regulatory changes or significant changes in the plan population.

Regardless of whether an employer outsources or not, benefit administration costs are not trivial. However, they are still low relative to the total costs of the plans. Now more than ever, employers have the opportunity to enhance plan and benefit visibility not only to their employees, but also to the employee's partner or spouse. Outsourcing allows the sponsor to leverage the administration costs to maximize the understanding and appreciation of the plans, thereby maximizing the value of the plan costs for the sponsor.

EMPLOYER FOCUS AND FLEXIBILITY

A final consideration in the in-house versus outsourcing comparison is how the decision affects the focus and flexibility of the sponsor's human resources (HR) department.

A shift in HR focus from administration to strategy has long been hailed as the primary benefit of outsourcing. The outsourcing vendor handles the transactional work that otherwise limits an HR team's time and allows the team to pursue the more important role of strategic planning for benefits and other HR functions. Over time, this argument for outsourcing has been strengthened, as benefits have become only more costly and complicated. In particular, with health care reform taking effect in increments, it is essential to stay on top of the changes, their effective dates and the implications to the employer's plans.

Under an outsourcing structure, the plan sponsor cannot ignore plan administration. Vendor management remains an important function. However, the sponsor's role transitions to one of understanding administration best practices, and not implementing and maintaining them. The sponsor is then free to work with the outsourcing vendor to provide administration features to enhance the value of the plan.

Plan sponsor flexibility is also a positive result of outsourcing. Annual enrollment and other times with high administration workflow can place serious strain on internal HR capacity. Any of the following can present a major challenge to internal benefits administration:

- Plan design and security changes that impact administration requirements
- New employer groups or plans added through acquisition
- High transaction volumes driven by a reduction in force or location closure
- Administrative changes driven by new legislative or regulatory compliance.

In an outsourced structure, these events may bring challenges and additional fees from vendors. However, the plan sponsor is better positioned to meet the challenges. In an internal administration structure, capacity constraints may simply limit the ability to meet challenges in a timely manner, at least without major strains to other HR needs and staff. Certainly, a structure where plan design is driven more by administration feasibility than by employer strategy is not ideal.

IS OUTSOURCING RIGHT FOR YOU?

The analysis of outsourcing versus in-house benefits administration is evolving. For many midsized organizations, a prior analysis of outsourcing for H&W and pension administration showed higher costs and little compelling reason to move. However, the cost dynamics have shifted in favor of outsourcing, and hidden costs associated with the risks of in-house administration provide more support for outsourcing.

If the cost comparison is close, the further benefits of outsourcing are compelling. Administration costs represent a small component of total plan costs, but effective administration can have a tremendous effect on perceived plan value. An outsourcing solution's ability to enhance employee service, online tools and communications should weigh heavily in the decision. In addition, the potential flexibility gains in terms of plan design and supporting one-time events may become critical in the future.

If any of the following apply to an organization, we recommend the organization reconsider the outsourcing decision:

- Staff is limited, so they struggle to keep up during annual enrollment or when other new changes are implemented.
- One or two people on the HR team hold much of the historical knowledge.
- The system (or worksheet) currently used is out of date and difficult to modify.
- It's difficult to get support from the IT department.
- Records are not centralized—some in paper files, some in other databases.
- The organization struggles to keep administration consistent with the most recent law changes.
- Calculation or administration errors have led to costly legal settlements.
- It is desirable for employees to have online tools so they could model their own pension estimates instead of calling HR.
- Staff can't get daily work done because of participant calls.

A shift to outsourcing is not easy, but the case for outsourcing is strong. Many have made the move, and very few have turned back. And the best part—once an employer has transitioned, it can refocus on the strategic decisions that have greater impact on the organization and its employees. Staff can spend the year-end thinking about strategy for the following year, and not merely surviving the administration crunch. ◀

▶ THE AUTHORS

Steve White is a principal and consulting actuary with the Seattle office of Milliman. He directs pension administration outsourcing services for single employer retirement plans. White also assists clients with the design of defined benefit and defined contribution plans, negotiations on pension plan changes, the valuation of defined benefit plans, experience studies, asset/liability projection studies and participant communications.

Penny Plante is a principal and benefits consultant for the health and welfare outsourcing practice with the Seattle office of Milliman. Since 1999, she has focused on the full complement of administration services for a client's health and insurance plans—both the active employee and retiree population. Plante also consults with employers regarding administration compliance audits and conducts dependent verification eligibility audits.