The Plan That Didn't Bark

To solve the mystery of benefit plans, analysts must learn to think like detectives

BY SUSAN MANGIERO, CFA

"Sometimes the questions are complicated and the answers are simple."

The author of that statement, Theodor Geisel (better known as children's author Dr. Seuss), might as well have been talking about employee benefits. When inquiring minds ask how much risk shareholders bear as a result of investment strategy or plan design, the simple truth is "We don't know." To find the answers to such questions, financial analysts must dig deep, go beyond published numbers, assess economic vulnerabilities, and ask tough questions about the fiduciary investment process. Unfortunately, when it comes to disclosure, there is no entertaining Cat in the Hat, only a Grinch in the form of incomplete—and arguably misleading—financial disclosures.

Quantity ≠ Quality

A complete discussion of benefit plan reporting is outside the scope of this commentary. Suffice it to say, quantity does not beget quality. Despite well-intentioned efforts on the part of rule-makers, economic risk is often clear as mud to analysts if they must depend solely on mandated disclosures. In the case of pensions, summary plan descriptions (or SPDs) for defined-benefit and defined-contribution plans are generally unavailable outside of distribution to participants and beneficiaries. Obtaining an investment policy statement for a corporate plan is a rare event. In the United States, Form 5500 annual return information is made public after a significant time lag and is overly broad. Schedule H filings for large plans and Schedule I filings for small plans report assets and liabilities. Disappointing to analysts, these documents deliver scant details, if any at all, about asset allocation, security/sector concentration, risk drivers, and vendor relationships.

One bright spot is a recent proposed rule by the U.S. Department of Labor that would shed light on compensation "for services rendered" to a retirement plan. The adoption of this new rule, the result of surging ERISA lawsuits and regulatory inquiries about the reasonableness of vendor fees and consultant–money manager conflicts of interest, will likely stimulate change. What remains to be seen is whether competing mandates for transparency will confuse or clarify matters for financial statement users.

Alas, things in health care land are not much better. William Wiatrowski, an economist in the Office of Compensation and Working Conditions at the U.S. Bureau of Labor Statistics, describes a parade of data-collection "horribles"—decentralization, lack of uniformity, moving-target inputs (retirement age, choice of plan), Medicare benefit offset, and much more. According to Dr. Michael Kraten, professor of accounting with Suffolk University, there are no requirements in the MD&A sections of the annual reports of the health plans to disclose and/or discuss detailed "churn rates" of the subscriber base, "turnover rates" of the provider base, or the quality of care "outcomes data" of the network itself. "It's pretty sad," he says, "because most analysts believe that those are the three most important factors that drive long-term value."

Recent attempts to improve financial reporting in the form of FAS 106 and GASB 45 (for public plans) sound good on paper. Yet the response from private and public sponsors, perverse but not surprising, is to abandon "costly" plans that allegedly improved accounting rules sought to protect but now show up as large drags on earnings and cash flow.

A Widening Gap

As the clock ticks, the gap between what we know about employee benefit plan economics and the true impact on share price is getting dangerously wide. Unless sponsors get lucky (and current market volatility presents a challenge) and employees stop getting old (not a pleasant thought), proper management of employee benefit plans will become increasingly urgent. Growing liabilities and liquidity needs affect debt ratings, growth, flexibility, cash, cost of capital, and the power to attract and retain productive workers. (This last point is especially noteworthy as employers prepare for a skill drought in the years ahead.) Add greater liability insurance premiums (fiduciary and D&O) and million-dollar legal fees tied to allegations of fiduciary breach, and shareholders may be getting more than they bargained for.

Making matters worse, the current regulatory environment is complex. Change is one of the few constants. Financial strategies abound, but as Milton Friedman urged, there is no free lunch. Proposals for alternative solutions, such as the use of financial derivatives, partial or full termination of plans, or change in strategic asset allocation, must consider economic effects (both now and later) as well as the fiduciary impact. This holds true for all plans, regardless of type and purpose. Bad investment and design decisions can push a plan into non-compliance or motivate disgruntled employees or retirees to seek redress. What's to be done?

The Missing Carrot

For many years, strong equity markets and relatively benign accounting rules lured some sponsors into complacency. Countless companies regarded pension plans as surplus piggybanks and regularly used them to boost net income (to the extent legally allowed). But things have changed a lot in the past few years. The Pension Protection Act of 2006 in the United States (as well as equivalent reform in other countries) and disclosure such rules as FRS 17, IAS 26, FAS 106, 123R, and 158 force CFOs and board members to involve themselves with benefit plan decision making, as never before. Forward-thinking firms that look at employee benefits as part of enterprise risk management wisely adopt a holistic approach that links financial, compliance, and strategic human resources objectives.

Unfortunately, three significant problems remain. First, employee benefit decision making is asymmetric. Do something right, and no one applauds or rewards plan fiduciaries. Do something wrong, and the consequences are dire—litigation, harm to reputation, low employee morale, noncompliance penalties, cash outlay and/or balance sheet/income statement impact (depending on the prevailing accounting rules). Fiduciaries can be held liable, professionally and personally. There are some who believe that the ERISA–Sarbanes Oxley connection exposes corporate fiduciaries to criminal penalties for poor internal controls or misrepresentation as related to post-employment benefit schemes.

Second, when organizations do take the right actions regarding their benefit plans, few spend money to publicize why a particular decision is made and what advantages are likely to accrue as a result. Consequently, shareholders, current employees, and taxpayers are left in the dark and cannot distinguish heroes from villains. The information void continues to get worse because the carrot that might otherwise encourage voluntary best practices (including transparency) does not exist.

Third, C-level executives and directors struggle with their duty to shareholders versus their obligations to plan participants. Notwithstanding the legal exigencies, conflicts often arise. For example, a company that shuts down a traditional pension plan and beefs up its defined-contribution plan(s) in order to lower expenses gets a pat on the back from Wall Street in the form of higher share price. That same action, however, may cause some employees to retire earlier than originally planned, leaving the sponsor with fewer productive workers. Skewed payoffs, agency conflicts, and moral hazard are a few of the unhappy characteristics of the current global benefits system.

Fiduciary Forensics

The situation in which analysts find themselves is not hopeless, but it is difficult and demands that interested parties know enough about employee benefit plan economics and laws to ask the right questions. Consider a situation in which a sponsor seeks to reduce traditional plan benefits or lock out new employees. There are numerous solutions, each with its own set of risk–return trade-offs and related financial statement impact. Annuitizing the legacy plan may be deemed as a way to hand off fiduciary responsibilities and simplify administration, but decision-makers are still responsible for the proper selection of an annuity provider, not to mention the fact that such a move does not entail an immediate end to liability under the statute of limitations.

Others may decide that plain-vanilla interest rate swaps offer a panacea but later conclude that counterparty risk or collateral management are logistical roadblocks. Another possibility—reducing equity in favor of bonds—could expose fiduciaries to accusations of malfeasance for ignoring a positive equity risk premium.

Health care plans and defined-contribution offerings are no less complex when it comes to carefully comparing alternative ways to achieve a stated goal. Whatever the situation, an analyst must understand how and why a particular action was selected, determine its likely short-term and long-term impact on the plan sponsor's economic profit, and assess whether poor governance might lead to incremental costs.

The question of process versus outcome is best left to jurists but is nevertheless paramount when it comes to plan administration, oversight, and review. Financial analysts really have no choice but to become forensic detectives. They cannot rely solely on published numbers but instead must ask lots of pointed questions about how plan sponsors identify, measure, and manage myriad types of risk. Knowledge of accounting rules is only a beginning, and a humble one at that. Economic, fiduciary, and regulatory factors count too. When the hard investigative work begins, analysts may be reminded of additional words from Dr. Seuss: "Oh, the places you'll go."

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