SCHECHTER BENEFITS ADVISORS | UNCOMMON SOLUTIONS to Design, Educate & Manage

HR&BENEFITS UPDATE

March/April 2014

Effective Compensation Program Design

HUMAN RESOURCES

Compensation should always be an important consideration for organizations. After all, remaining competitively positioned in the marketplace for talent plays a central role in the retention of top performers. However, it is a particularly compelling concern for organizations at this point in time, as the economy continues to improve and many businesses resume their plans for growth and/or expansion to new markets.

Recognizing that a compensation program is potentially ineffective can be relatively straightforward. For example, current employees may voice dissatisfaction with their base salary or bonus, sales staff may complain that commissions do not adequately reward their results or resigning employees may report in exit surveys that they are leaving the company for higher wages elsewhere.

However, we should remain mindful that not all employee complaints or reports about inadequate or inequitable compensation are, at their core, actual compensation problems. In many cases, "compensation" is a convenient term to use when employees are simply unhappy about their jobs in general. In other cases, providing "compensation" as a stated reason for resigning from the organization is more politically acceptable than reporting "I can't stand my supervisor."

Therefore, while it is important to take seriously employee complaints, concerns and turnover that may be related to compensation issues, it is perhaps more important to ensure that we analyze and properly examine the organization's compensation system and how it compares to compensation offerings in the marketplace in which we compete for human capital. The following are some key points to remember before we begin the development and/or analysis of an organization's compensation system:

Consider the current culture and the culture you aim to create. Is the organizational culture a performance-oriented or entitlement-oriented one? How will we create a compensation program that attracts, motivates and retains top-flight performers? How will our

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Retirement Income Solutions with Guaranteed Minimum Withdrawal Benefits

RETIREMENT

Retirement income solutions (RIS) are retirement plan investment options designed to generate a post-retirement income stream from participant-accumulated retirement savings, and include guarantees of minimum withdrawal amounts for life. These products, generically known as guaranteed minimum withdrawal benefit (GMWB) programs, intend to address the very real issue of retirees exhausting their savings during their lifetime. These products incorporate benefits of equity investing (i.e., target-date funds) with annuity income features and minimum withdrawal guarantees for an added fee (presently 50–100 basis points depending on guarantee provisions).

RIS/GMWBs are currently experiencing dynamic product development and are attracting significant interest in the press and among plan sponsors.

As these products continue to evolve and become more accessible, this concept is also receiving support from Washington regulators who are concerned about the issue of retirement readiness of the population in general. Phyllis Borzi, assistant secretary of the Employee Benefits Security Administration (the enforcement arm of the Department of Labor [DOL]), is stimulating a national dialogue on the topic of participant retirement readiness and potential solutions to the well-documented problem that few participants are on track for successful

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compensation system drive the achievement of our business and financial objectives?

All of these questions should be considered and resolved before developing a new compensation system or analyzing the current one.

Decide where the organization wants to position itself in the marketplace. The organization must decide on a pay policy, which illustrates how it intends to react to market changes and pressures.

In doing so, the organization establishes whether it will:

- Lead the market by paying employees above-market wages
- Match/follow the market by paying employees comparable marketplace rates
- Lag the market by paying employees below-marketplace wages for their respective jobs

Organizations that pay above-market rates often do so to attain or retain marketplace dominance, or to secure and retain the "best" talent available.

Those that pay below-market rates may do so because of an overly abundant supply of labor in the market. However, more often, these organizations pay lower wages out of necessity — they simply cannot afford marketplace pay rates and/or the organization itself is in a period of decline/demise.

Most organizations choose to take neither a leading nor lagging role with respect to wages, and instead pay comparably with that of other employers in the relevant labor market.

Determine the relevant marketplace for labor. Regardless of where the organization positions itself in the labor market, it must determine the relevant marketplace in which it competes for labor. This is not necessarily the same marketplace as the one in which the organization does business or competes for customers.

Several factors are involved in determining the relevant labor market, such as:

- ***Geographical location(s):*** Where does the organization operate? From where do we recruit employees? From what area(s) do candidates come to us for employment?

  One organization may recruit in the only metropolitan area in which it operates. Another may source candidates from several areas in which it has multiple operations. Others may seek qualified candidates on a statewide, regional or even national basis in order to remain competitive. Most organizations have a mixed approach, with many positions sourced locally, while some positions require a broader recruiting net.

  Before establishing a compensation system, the organization must define the appropriate geographical area from which it recruits each individual position.

Effectively designing a new or revised compensation system requires the organization to first invest time in considering and analyzing important internal and external factors.

However, the result is a compensation strategy and program that can be more effective in recruiting, motivating and retaining exceptional talent, and increasing organizational performance, productivity and profits.

- ***Revenue and size:*** The organization's revenue and number of employees are important factors as well. Larger organizations with healthy revenues are generally more willing and able to pay employees competitive wages, while smaller organizations with fewer resources may be less so. This is not always the situation, however, as in the case of a large employer that is in a period of decline/demise, or a smaller employer that is in a period of rapid growth.

  For purposes of defining the relevant labor market, though, we generally choose to compare the organization to those of similar size with respect to revenues and number of employees.

- ***Industry type:*** The types of industry or industries in which the organization operates and in which it competes for talent are also significant factors in determining the relevant labor market. Declining industries, such as manufacturing or railroads, generally pay less competitive wages while "sunrise" emerging or high-growth industries can often afford to pay more generously. In addition, as we define the relevant labor market, we must include any related industries with which the organization competes for talent.

Perform a competitive analysis. Once the organization has considered its unique culture, decided its market pay policy and determined the relevant marketplace for labor, then it should benchmark compensation for every position and repeat the process in regular intervals every one to two years.

This complex analysis requires the use of survey data (commercially available to HR/compensation practitioners) to compare base pay, bonus/incentive/commissions pay and total compensation of each position with that of the same or similar positions in other organizations in the relevant labor market. This process is undertaken to determine external (marketplace) equity.

A separate analysis may also be completed to determine internal equity for each position. This process involves the hierarchical ranking of all positions to determine their relative worth in the organization. The ranking process is undertaken to ensure that each position is compensated according to the value of its contributions (both tangible and intangible) to the organization. It can also be utilized to determine if individual employees within a particular position/job classification are compensated equitably as compared to one another, given each incumbent's education, experience and work history.

At the completion of these efforts, the organization has sufficient information to build a competitive and equitable base compensation grid, including pay grades and pay ranges, or salary bands, depending on its approach. It also presents a starting point for designing bonus/incentive and commissions plans for some or all positions.

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retirement. Interested parties are predicting that these products may receive similar support as auto enrollment received from the Pension Protection Act of 2006.

Interest in GMWBs at the plan level does denote certain fiduciary implications. Offering a GMWB as a core plan investment option is a fiduciary decision and carries the responsibilities that any fiduciary decision entails.

How Should a Fiduciary Prudently Consider These Products?

First, utilize the same process in making all investment fiduciary decisions. Recent DOL guidance on selecting and monitoring qualified default investment alternatives (QDIAs) may be applicable to RIS and GMWBs. This process includes what the Internal Revenue Service considers "procedural prudence," and consists of the following steps:

- Identify and gather information to be considered.
- Evaluate the information as a prudent expert (hire an expert if necessary).
- Determine the most prudent course of action to benefit participants.
- Take appropriate action.
- Document activity.
- Periodically revisit the decision to ensure that it continues to be prudent.

Second, evaluate factors unique to GMWBs and RIS products:

- **Guarantees –** The existence and viability of guarantees make these products attractive. Considerations include: What are the guarantees? What is the financial strength of the provider supporting these guarantees (evaluate capital/surplus/reserve adequacy)? What is the experience and expertise of the insurer with this or similar products? Is the cost/benefit analysis of the product "reasonable" per DOL standards? Would this product produce a significant benefit for participants?
- **Hedging –** A significant component in RIS products, how is the hedging accomplished? What is the history and strength of their services?
- **Administrative capabilities –** What is the provider's experience administering RIS? What is the history and strength of their services?
- **Portability –** What accommodations are available to participants in the event of fund or provider removal? Or upon eligibility for distribution? Are there alternative solutions available? Might this issue be better addressed with an "out of plan" solution, thereby avoiding the fiduciary issues?

Every provider's version of RIS/GMWB is different. Each has unique provisions that need evaluation, such as the nature of guarantees of income, participant access to their account balance, annuity purchase rates, etc.

It is anticipated that RIS or similar products will play a meaningful role in participant retirement planning in the near future. It is still early in the stage of product development, and there is not yet any direct guidance or safe harbor provision from the DOL for fiduciaries. These products are likely to evolve considerably over the next few years. The interest rate environment may become more conducive to providing attractive annuity purchase rates. Based on regulator support, there soon may be fiduciary safe harbor for fiduciaries. As these products evolve and conditions change, some of the above questions will be easier for a fiduciary to answer.

The development of products that can serve the participant in a meaningful way is to be applauded. Your plan consultant would be happy to assist if you decide that RIS/GMWB is timely to consider for your plan.

Compliance FAQ

Question: May an employer pay or provide reimbursement, on a pretax basis, for the cost of an employee's individual policy?

No. Many third-party administrators or vendors are currently marketing products to employers claiming that the employer may reimburse employees for individual policy premiums on a pretax basis. These products may have a name such as Section 105 plan, Health Reimbursement Plan or Premium Reimbursement Arrangement. No matter what the product is called, effective in 2014, an employer may not pay or provide reimbursement, on a pretax basis, for the cost of an employee's individual policy.

In order for an employer to provide tax-advantaged health benefits to employees, it must do so through a permissible arrangement, such as a Section 125 cafeteria plan, a health reimbursement arrangement (HRA), health flexible spending arrangement (FSA) or health savings account (HSA). Most of the products being marketed to employers fit the definition of an HRA. An HRA is a self-funded arrangement under Section 105 that is 100 percent employer funded and provides reimbursement for qualified medical expenses, which historically included premiums. However, on Sept. 13, 2013, the Internal Revenue Service issued guidance (Notice 2013-54) clarifying that an employer may not use a stand-alone HRA to reimburse the cost of an individual policy. To do so would violate the Patient Protection and Affordable Care Act's (PPACA's) prohibition on annual dollar limits for essential health benefits and the requirement to cover preventive services. For plan years starting on or after Jan. 1, 2014, an HRA must be integrated with a group health plan.

In regard to cafeteria plans, the Internal Revenue Code excludes individual marketplace coverage from the list of benefits that may be offered through a Section 125 cafeteria plan. Further, Notice 2013-54 provides that other employer payment plans, which would include a cafeteria plan, may not reimburse employees for the purchase of an individual policy. Thus, an employee is not permitted to pay pretax premiums through an employer's cafeteria plan for an individual policy purchased either inside or outside of the marketplace.

Per existing Treasury Regulations, insurance premiums are not a qualified medical expense from a health FSA. Finally, an HSA only permits tax-advantaged reimbursement of premiums in limited circumstances related to COBRA

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or USERRA coverage, qualified long-term care policies, an individual who is receiving unemployment compensation or an individual who is aged 65 or older.

In summary, an employer may not reimburse an employee on a tax-advantaged basis for the cost of an individual policy or pay for such coverage directly. Failure to comply could put the employer at risk for a penalty under PPACA, which is $100 per day per affected individual.

This article is a high-level overview of the legal requirements related to this issue. The guidelines are discussed in greater detail in our white paper "The Future of HRAs and Employer Reimbursement for Outside Coverage." To request a copy of the white paper, please contact your advisor.