Managing Human Resource Cost in a Declining Economic Environment

by Edward M. Pudlowski

The human resource (HR) function can be the biggest and fastest growing cost an organization has to manage. Employer responses to HR costs during the recent economic downturn have varied, but many focus too quickly on changes that directly affect their employee populations. Instead, the focus should first be on transparent cost-saving opportunities—those that are nondisruptive to the employees' understanding of their program of benefits. Once transparent and minimally disruptive approaches are considered, employers may want to assess the competitive level of their benefit plans. This article gives examples of the type of savings these approaches can achieve, all without significant disruption to the employees' benefit design.

CREATIVE, NOT DISRUPTIVE, COST CUTTING

In a slowing or declining economy, organizations look at controlling internal expenditures to improve the bottom line. Human resource (HR) costs are typically the organization's biggest expenditure and can often be the first area targeted for cost reduction or control. Disruptive changes such as reducing benefit levels or eliminating programs often leave a bad taste in the mouths of employees, who are the company's main asset during the tough economic period. Often, transparent HR cost-reduction opportunities (those that are nondisruptive to employees' understanding of their programs and, therefore, have no impact to employees) are overlooked mainly due to a lack of coordination between HR and finance functions. Organizations need to look first for these opportunities before deciding on more disruptive approaches that may leave the organization without the critical talent needed to manage through difficult times.

According to the 2007 *Employee Benefits Study* by the U.S. Chamber of Commerce, employee benefit programs account for nearly 43% of employee payroll or an annual cost of $21,527 per employee. These figures include health care, welfare benefits, retirement, paid time off, legally required benefits, unemployment and workers' compensation, and federally required payroll taxes. These statistics do not account for HR-related costs such as those required to administer payroll and benefit programs, including certain vendor costs, recruiting, training and development, talent management, succession planning, on-boarding, award programs, HR information systems, payroll processing costs, etc. When all these are added up, the HR function can be the biggest cost an organization has to manage.

The HR function is also one of the fastest growing costs an organization has to manage. As health care costs continue to climb at a rate two to three times that of general inflation, HR budgets are impacted more so than other departments. The July 2007 report issued by the California Health Care Foundation, *Employer Health Insurance Costs in the United States,* claims that while wages and salaries increased an average of 3.7% between 1996 and 2005, health insurance cost rose an average of 7.8% during the same period. It should be noted that this period also saw one of the lowest health inflation cost increases for employers over at least the last 25 years, as health care trends were zero or even negative for a two- to three-year period in the late 1990s.

We may see other employee benefit program cost increases at rates higher than normal inflation as stresses continue in the insurance and financial markets. It has been speculated in news media that many insurance companies would like to consider and apply for federal government bailout dollars but fear the message it would send to customers and the general public. Although they may require or need the infusion of dollars available from the federal bailout, they may try to do without to avoid panicking the markets. The financial crisis that may be overtaking many insurance and financial institutions may result in significant cost increases for their products and services to cover mounting losses. Life and disability insurance products and other benefit-related services, like dental insurance, that are typically offered by non-health care insurance carriers may experience an increase in administrative and risk charges to cover current or expected losses.

We are also starting to see increases in defined benefit pension plan contributions due mainly to the new funding requirements resulting from the Pension Protection Act (PPA) and the lower or diminishing rate of return from assets in pension funds. Some organizations that have been well-funded as defined by the laws before PPA—and have not had to make pension contributions for the past ten years—are now seeing the possibility of being unable to avoid a minimum pension contribution requirement for 2009.

Add to these issues the facts that the workforce is becoming increasingly global and that the employee population is aging, and we see that we have an even more complex environment in which HR personnel must manage the responsibilities and costs associated with their function. Employer responses to these issues have been varied, but many focus too quickly on changes that directly affect employees.

TYPICAL EMPLOYER RESPONSE

It is easy to identify opportunities to reduce costs by shifting them from the company to employees. But, this disruptive approach does nothing to the underlying cost of the programs and, therefore, requires little or no interaction with vendors that provide services to support the programs. Fewer resources and less effort are required to implement these types of changes, and they can typically be done in a very short time frame. The issue then becomes determining whether the changes are market competitive and what effect they may have on recruitment and retention.

A November 13, 2008 *New York Times* article reported that many companies with fewer than 500 employees were suspending contributions to employees' 401(k) plans. It may not be long before we see this action extend to much larger organizations.

Since health care plans are both a significant cost item in the HR budget and one of the fastest growing, it is not surprising that these plans become a major target for cost reduction. However, the typical response to increase employee cost sharing (deductible amounts and copayments for physician office visits, specialists, emergency room visits, prescription drugs, out-of-pocket limits, etc.) makes the plans less desirable and less affordable to those who use the health care system. These are typically young families whose children require frequent visits to the doctor or older employees, who are typically higher users of services than their younger counterparts.

Even the movement to a consumer-driven approach—whereby a large deductible plan is augmented with a savings account feature—often achieves savings by increasing the employees' cost-sharing amounts rather than through an increase in consumer awareness of cost and quality. When comparing the cost sharing required under the prior plan to the new consumer-driven plan, we see that the employee pays more out of pocket, since the employer contribution to the savings account feature (e.g., a health reimbursement arrangement or a health savings account) often does not completely offset the new deductible or other cost-sharing requirements.

Another more popular nontransparent approach is to increase the cost required by employees to participate in the health care plan. Increases in employee contributions over and above the actual increase incurred by the employer mean that employees are now paying a higher percentage of the total cost than they did a year ago. In the 1990s, based on various surveys, we typically saw employee contributions run from 15% to 20% of total health plan costs. This was a response to the tight labor market as well as a time when the economy was running well. However, based on those same surveys, if we look to periods preceding the 1990s, we see that employee contributions typically ran from 25% to 35% of total health care costs. It now appears that the percentage employees are being required to pay for the total health care bill is rising to the levels of the pre-1990s.

These approaches are driven by what can be quickly and easily identified through traditional approaches and, often, without any coordination with the finance and risk departments. But, such coordination could result in other nondisruptive cost-reduction opportunities. The remainder of this article will focus on the approaches organizations should consider to achieve more transparent opportunities for consideration and some ideas that have resulted from these approaches.

THE HR COST-MANAGEMENT PROCESS

Three basic components should be included in any process to identify and implement cost-reduction opportunities. These components include a comprehensive "audit-like" review of all areas under the HR blanket, a rapid assessment, and an independent and coordinated approach with other departments.

Employers that have gone through this process of identifying items to consider often prefer an audit-like approach. This includes gathering information about the programs offered, including summary plan documents, HR policy statements, open enrollment materials and other employee communications needed to understand employee offerings. Employee offerings include, but are not limited to, the following:

- Pension or retirement plans
- Health care programs including medical, dental, vision and prescription drugs
- Life insurance
- Disability plans
- Paid-time-off programs
- Other leave programs such as family medical leave
- Employee assistance programs
- Special pay programs
- Employee awards
- Workers' compensation.

Employers that are in the best position to assess opportunities also have easy access to annual cost information for each individual employee program. Cost information should include annual gross costs as well as costs covered by the employee. Employee census and enrollment information by plan can also be useful and important information.

Employers should also collect vendor contracts to ensure an understanding of what services are being provided to employers and the costs associated with those services. Vendors include health plan claim administrators, pharmacy benefit managers, pension plan administrators, payroll processors, benefit plan administrators and other supportive vendors. Costs associated with the outsourced administration of the HR function should be captured and measured against best practices to determine areas for improved efficiencies and service delivery.

Employers should also capture internal costs associated with other HR functions including payroll processing, HR information systems, recruitment, retention, on-boarding, talent management, succession planning, training and development. Comparing these costs and processes to best practices can lead to cost-reduction opportunities and an overall improvement in service delivery.

Although this list of data collection items seems onerous at first, it should be information that is readily available and obtainable. Organizations that find this process difficult may have even greater opportunity for cost reductions than those that have the information readily available. As W. Edwards Deming said, "What can't be measured can't be managed, and what can't be managed can't be improved." Lack of ready access to this important information can be just one sign that the HR function is ripe for nondisruptive cost-reduction opportunities.

The next step is to conduct an assessment of all this relatively high-level information. Typically, employers will not look further unless the high-level data suggests an opportunity of significance; further review is warranted in order to validate the concept for implementation.

This high-level review provides the ability to assess opportunities quickly, move away from areas not likely to generate cost savings, and focus attention within the organization where needed. This process of collecting data and identifying value should take only about four to six weeks. This rapid assessment approach allows for the process to keep moving without losing steam or interest by key stakeholders.

The third component of a successful process to value identification is the inclusion and coordination of key leaders or stakeholders from outside the HR department. Using the talents and skills of individuals from other departments or organizations often leads to opportunities for cost reduction that might not otherwise be considered. Individuals with financial, tax, legal, actuarial and risk management skill sets can provide insights into aspects of the HR function that may not be possible if the review is conducted only by HR personnel. These individuals can bring their unique perspective to the process and improve the opportunity for transparent cost savings.

The review should also be conducted independent of any advice that might be considered self-serving or not in the best interest of the organization. If the company is considering using outside consultants to assist in the process, those consultants should be scrutinized for any possible conflicts of interest. Consultants who accept commissions or override payments from vendors may lead an employer toward an idea or opportunity that, in the end, also benefits them. Advisors may also provide other services such as benefit administrative services, asset management consulting or other related services that could influence their advice. These relationships or conflicts of interest should be known and disclosed up front, or the organization should seek an independent advisor that can be trusted to give advice aligned with the employer's goals and objectives.

A well-organized and defined process to identify cost-reduction opportunities will lead to "quick hits" the organization can begin to assess for further evaluation and consensus building or move right to implementation. The process should not be burdensome to any department, especially HR, and should take less than two months before any real value is identified.

TRANSPARENT OPPORTUNITIES

Transparent opportunities, or those nondisruptive to the employees' understanding of their program of benefits, should be the first area of focus. One area of transparent savings that should be assessed is the amount of risk an organization is taking on compared to the real level of risk the company can tolerate. Often organizations have purchased risk mitigation products mainly because of their size or perceived risk tolerance when, in fact, both may have changed significantly since the original purchase of these products. Risk mitigation products include fully insured arrangements for health care or disability plans or stop-loss coverage for self-insured arrangements. As companies grow, their need for risk mitigation changes. Other organizations may find themselves in a position where they have a greater tolerance for risk than they did in the past. When an organization purchases insurance, the insurer is assuming the risk and requires the organization to pay a charge built into its premiums. The charge covers not only claims over the set limits, but also a risk factor and profit margin in its administrative expenses. Organizations whose size in terms of the number of employees covered has changed since the original purchase of these products should reassess their risk tolerances. Eliminating these risk charges can result in significant cost savings.

Organizations with multiple business units operating under separate financials may feel the need to purchase insurance or stop loss for each unit in order to protect themselves from large claim fluctuations. In total, the organization as a whole may be large enough that insurance is not required, but each business unit is not. These organizations can look to an internal stop loss to achieve the risk mitigation needed within each business unit instead of purchasing insurance across the company. The internal accounting and spread of risk across the organization would still allow for each business unit to feel secure that large claims will not have an adverse impact on its specific financial statement and the cost to the organization as a whole. We have, in the past, seen this approach net approximately $2 million in annual savings for an organization of 10,000 employees spread over six separate business units. And best of all, the employees were unaffected.

Organizations undergoing a downsizing operation would also need to assess their new levels of risk and might need to increase the levels of insurance purchased. This does not necessarily create cost savings but would reduce the potential for harmful catastrophic claims that could have a significant impact on the bottom line.

Companies should also assess their ability to leverage market size to gain efficiencies in the purchase of products and services. In the global economy, organizations may find that they have multiple insurance arrangements operating in various countries around the world. The use of global pooling agencies has the potential to create significant cost savings and improve the reporting and management of the various insurance products through centralization.

A review of the recruitment and retention function may also find that dollars are not being spent wisely to achieve desired results. Employers should assess the results received against the dollars spent. In one instance, we found an employer placing ads in local newspapers for open positions where, unfortunately, the type of skill sets required for the positions were unlikely to be found in the readership of the papers based on their geographical market. Retention bonuses can often be overused, creating "black holes" that go undetected. The recruitment and retention function should be evaluated especially in a declining market, as the organization's focus may have changed, and this function should be adapted quickly to reflect the new direction.

Another area worthy of assessment is in the company's pension plan. Actuarial assumptions used to determine defined benefit pension plan contributions should be reexamined under current economic conditions. Pension plan assets may not be performing as well as they did even a year ago, creating a funding position that may lead to pension plan contributions for the first time in years or an increase over the amounts contributed over the past few years. Employers should assess other economic and demographic assumptions used in determining pension plan contributions. As an example, employee turnover (voluntary and involuntary) may have increased or be expected to increase more than the current assumption, and expectation for future increases in wages and salaries may be less than was estimated. Updating assumptions may lead to a more realistic determination of an employer's contribution expenses.

HR department operations should also be reviewed to determine where greater efficiencies can be achieved. Outsourcing arrangements that are not meeting needs as a result of the changing economic environment should be renegotiated or restructured. Returning some functions in-house may make sense. Comparing operations to best and leading practices can quickly identify areas for improvement or outsourcing/insourcing. HR metrics exist across a number of functional areas, including planning, recruitment, retention, developing, counseling, rewards, redeploying, retirement, managing employee information and general HR functions. The comparison will allow the organization to better understand where to focus efforts to improve operations and service delivery along with reducing costs.

Organizations should also assess tax implications of HR benefits for increased deductibility, especially in light of the decline in the economy. Claims incurred for health care services in a fiscal year but paid after the financial closing date can be deducted for federal tax purposes as if they were actually paid in the fiscal year. Opportunities exist to capture these tax deductions, whether funded through an Internal Revenue Service (IRS)-approved 501(c)(9) trust or simply paid through general assets of the employer without the need to divert assets to a trust.

Severance benefits that may be expected in the next several years have the ability to be prefunded in a qualified trust and paid out when due. The amounts prefunded, up to IRS-qualified limits, can be deducted for federal tax purposes as well.

Many federal and state tax credits are also available to organizations that increase employment, hire from targeted employee populations, and maintain or grow operations in certain targeted areas. Federal zone credits can be up to $3,000 per eligible employee each year. State zone credits can be as much as $37,000 per employee over five years. Federal work opportunity tax credits can be as much as $2,400 per eligible employee.

In addition, each year, federal, state and local governments provide approximately $5 billion in cash grants and tax credits to encourage workforce development and training. These incentives can help companies offset the cost of existing training for new and incumbent employees and provide "above the line" savings. Organizations can achieve greater tax savings and increase tax credits through a review of their historical benefit costs, existing employee demographics and geographical location of their operations. This review against the available deductions and credits can be yet another source of cost improvement in the organization. Obviously, this requires coordination with the tax department.

It should also be noted that in certain instances, any increased HR-related tax deductions may generate an overall net operating loss for the company. Such net operating losses might be eligible to be carried back for refunds for federal income tax purposes as well as in certain state taxing jurisdictions.

These opportunities represent a sample of the type of savings that can be achieved through a comprehensive review. These approaches likely are invisible to the average employee, which can reduce the need for disruptive approaches to obtain cost-reduction targets.

MINIMALLY INVASIVE OPPORTUNITIES

Companies with multiple benefit offerings—such as various choices for health care coverage using multiple networks and claim administrators—may find that consolidating vendors will create cost savings. During the tight labor market of the 1990s employers felt the need to offer a choice of plans to employees as a means to be competitive. The increased

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cost of internal administration and the loss of purchasing power were secondary to the need to recruit and retain qualified staff. This focus may have changed now as employers struggle through the downturn in the economy. Increasing purchasing power by consolidating vendors and administrators can create significant cost savings. Consolidating vendors still allows organizations to provide quality health care programs with little or no changes in benefits or employee contribution requirements. Consolidating vendors allows the organization to negotiate with a larger employee pool and provides an enticement to vendors to reduce administrative charges by spreading their fixed costs over a greater number of participants.

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When it comes to providing prescription drug benefits, employers can consider a number of cost-cutting options. Employers whose drug benefits are spread across various vendors through multiple health plans (where the drugs are handled separately through each health plan) can consolidate into one pharmacy benefit manager. This can be achieved even if drugs are administered through a health maintenance organization (HMO) or other fully insured arrangement. Consolidating pharmacy managers creates the same type of efficiencies as consolidating health plans.

Employers can also look to pharmacy benefit purchasing groups. These groups band together multiple employers to increase purchasing power, reduce administrative costs and pharmacy dispensing fees, and improve the ability to negotiate higher discounts and rebates than could otherwise be achieved by an individual employer. The benefit levels are still determined and administered separately for each employer within the purchasing group, so no plan design issues are compromised.

Hospital employers have a unique opportunity for cost savings by providing the drug benefit through the hospital's own pharmacy, rather than through a pharmacy benefit manager connected to the health plan. Hospitals can purchase drugs significantly below the price of retail pharmacies, creating significant savings to the health plan. A retail plan may still be needed to cover drugs needed on weekends or in the evenings when employees do not have access to the hospital pharmacy, but the cost savings can still be significant.

Employee and dependent eligibility for benefit plans—especially health care—has been a recent target area for large employers. Many organizations are concerned that ineligible dependents remain on health care plans, incurring costs that should not be borne by the employer. Child dependents who lose their student-dependent status, divorced spouses and even outright fraud are being uncovered in dependent eligibility audits. It may be surprising to many that as much as 3% to 5% of health plan costs are being reduced once ineligible participants are removed from the health care rolls, and the issue seems to exist regardless of the industry in which the employer resides.

These approaches provide an opportunity to control or reduce costs without significant disruption to the employees' benefit design. Again, considering these types of approaches can avoid the need for more disruptive changes as the organization seeks cost reductions.

MARKET-BASED OPPORTUNITIES

Once transparent and minimally disruptive ideas are considered, employers may want to assess the competitive level of their benefit plans. Information captured from employee exit interviews and other studies suggest that employee benefits are not necessarily the first reason an employee chooses to leave an organization or a candidate for an open position declines an offer. Salary or wages appear to be the primary reason followed by the employees' work environment, ability to improve their skills and knowledge, and satisfaction with their next level of management. Only when all of these factors appear to be in line between two competing entities for talent do benefit levels enter the equation. Organizations need to sift through employee complaints about benefit levels to truly understand what will affect recruitment and retention and what is simply "white noise."

Competitive practices change from year to year and are certainly influenced by each organization's financial position. Keeping pace with current market practices can lead to significant cost savings without any material impact on recruitment and retention. Survey data for such a review is widely available and makes for a quick and easy comparison. It should be noted, however, that a characteristic of any survey data is that it is already old once published. Therefore, any analysis with survey data is simply a look in the rearview mirror. It is still valuable information, but organizations also need to keep their pulse on what is happening with current market trends. Connecting with peers nationally or consulting with organizations that deal with these issues on a national level and across the globe can be critical to keeping pace in this rapidly changing environment.

Identifying transparent and/or minimally invasive opportunities can also create an opportunity for benefit improvement should a market benchmark analysis reveal the need to increase benefits for a program to compete for the talent an organization requires. Often cost savings from nondisruptive approaches are used for investment in other areas deemed by a market-based assessment to be deficient.

POSITIONING FOR THE FUTURE

HR-related costs have always been one of the most significant to manage. The current economic environment is generating an even more important mandate to do so. Organizations that take a proactive stance may be able to better weather the financial crisis and maintain the top-level productive talent that will be required to work through the difficult times to come. This author recalls working with a large organization in a major metropolitan area to help reduce the cost of the HR function and programs in order to improve the organization's financial position and maintain its ability to exist. The HR department was only one of many areas under review. But the steering committee overseeing the project looked at the estimated savings from each and every HR opportunity presented, divided by the average salary in the organization, to determine the number of jobs that could be saved if the opportunity were implemented. Although many other factors beyond the cost-savings estimate were presented and assessed, their focus on the cost per employee was very telling. Managing cost and doing so in a manner that keeps an employer's benefit offerings market competitive may be the key to keeping the talent an organization will need to navigate the economic downturn. Those who do a great job positioning themselves to take advantage of the opportunities for growth will emerge from the current recession as market leaders. ◀

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