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Employers finding more reasons to de-risk retirement plans

Improvements in defined benefit plan funding status are positioning plan sponsors and fiduciaries to take action aimed at reducing future volatility in plan costs by moving liabilities out of the plan and aligning investment allocations with plan liabilities. Financial, compliance, and accounting considerations all play into the decision of the course to pursue, the segment of the population to be involved, and the time for action.

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Background

For nearly six years, defined benefit plan sponsors have been nervously watching their funding ratios in the wake of the financial crisis. Now that they are closing back in on being fully funded again, many want to take steps so this never happens to them again. De-risking — finding ways to better manage the plan's pension obligations — is (or should be) top of mind.

There are many factors at play in considering when to act and what approach to take. Some employers are waiting in anticipation of the Fed's next move on interest rates. Others are skeptical about their pension fund's equity portfolio, yet still hope it will continue to deliver improvements in funded status. Moving too soon could result in missed opportunity costs. So it makes sense that pension investment committee members may be apprehensive about taking action that might leave some money on the table. Other plan sponsors want to avoid large accounting charges associated with prior year's "losses."

Key reasons behind current activity

To help investment committees and other stakeholders debate the merits of de-risking sooner rather than later, we have identified some key reasons employers are acting now. For this purpose we consider two common types of de-risking strategies: (1) **settlements** in the form of lump sum cashouts or annuity purchases, and (2) **investments** using a dynamic asset allocation (i.e., shifting from risky assets to hedging assets) based on funded ratio triggers.

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Settling retirees, deferred vested, and active participants

More than financial considerations come into play when evaluating potential settlement options. Cashing out retirees in pay status presents an array of compliance issues. (See our August 27, 2012 *For Your Information*.) Cashing out active participants in frozen plans requires that the plan be terminated. On the other hand, offering cashouts for deferred vested participants is generally routine and is an approach that many plans have used all along.

Reason 1: Funded status improvements

Equity markets rebounded in 2013, and despite some fluctuation earlier this year, pension funding ratios have improved. That may have triggered an increase in fixed income allocation or a hedging portfolio based on some glide path strategies. For some plans, that increase may have removed funding restrictions that limit the ability to settle liabilities by paying lump sums or buying annuities.

Investment strategies. The expectation of rising interest rates and a possible anchoring bias towards equities have caused some plan committees to rethink their investment strategies. Experts recommend they review the original thinking of establishing the glide path and stay disciplined. Events like 2001-2002 and 2008 could happen again.

Settlement strategies. If distribution restrictions based on the plan's funded status had been holding the plan back from settling liabilities with annuity purchases or lump sum offers, the market rebound may have removed that hurdle for now. However, plan sponsors should note that settlement strategies could cause further deterioration of the plan's funded status that might prevent settlements unless additional contributions are made to neutralize the "math" of funding ratios.

Reason 2: Current certainty vs the unknown

Even if funding status improvements put the plan in position to pay lump sums or purchase annuities, it may be tempting to wait because of an expectation that interest rates will move higher and push those costs down — after all, current interest rates are still at historically low levels. But for plans that have moved into fixed income, those higher interest rates will push asset values and liabilities lower so there may be no advantage to waiting. And while holding out, lump sum cashouts and annuity costs will increase due to mortality improvements that work their way into IRS and insurer tables. See our February 14, 2014 *For Your Information* for further discussion of mortality improvements and volatile investment returns.

Funded ratio math

$8M in assets / $10M in liabilities
= 80% funded

What if $1M of liabilities settled with $1M lump sum cashouts?

$7M / $9M = 78% funded

Similarly for plans de-risking with investment strategies, waiting runs the risk of another market meltdown.

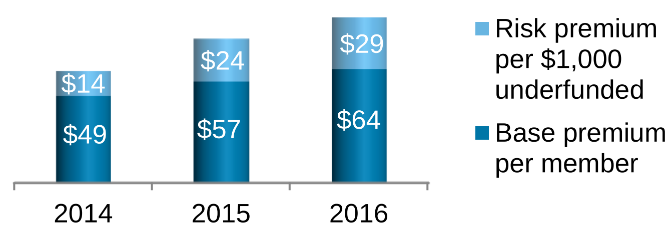
Investment strategies. If there is a strong committee view on interest rates, consider adding a dual trigger to the glide path based on interest rate levels to ease into the hedging portfolio over time.

Settlement strategies. Estimate the current cost of cashouts and annuities for vested terminees and retirees — or all participants if the plan is frozen and approaching fully funded status. Compare values based on current mortality tables and interest rates, with values using projected mortality and a forecast of higher and lower interest rates in the future.

Reason 3: Increasing PBGC premiums

Congress has increased PBGC premiums again. The base premium is $49 per plan participant with automatic increases to $57 next year and to $64 in 2016. Sponsors with underfunded plans pay additional risk premiums of $14 per $1,000 of plan underfunding (up from $9 in 2013). That will jump to $24 next year and $29 in 2016.

PBGC premiums on the rise



Investment strategies. Risk premiums will decrease as funded status increases. A dynamic asset allocation approach won't slash the premium cost immediately, but over time, the increase in funded status will reduce risk-based PBGC premium costs.

Antiselection …

means participants in poor health can be expected to choose a lump sum settlement rather than an annuity. Insurers may charge a premium for the remaining participants who elect an annuity when the plan is terminated under the presumption they will live longer on average.

Settlement strategies. Increased PBGC premiums will make cashouts more attractive, particularly for small benefits where even the flat rate premium may be costly relative to the benefit liability. The projected increases in premiums and administrative costs should be reflected when analyzing the cost of potential cashouts. Projections should consider the effect of "funding ratio math" as illustrated above. Cashouts may reduce flat rate premiums, but there may be an increase in overall unfunded liabilities that become subject to the risk premium charge.

Reason 4: Avoid one-time accounting charges

Lump sum cashouts may trigger one-time settlement charges under US GAAP sooner rather than later. A cashout strategy should be structured with this in mind. If material, consider targeting small benefit amounts to maximize PBGC savings and take-up rates (data indicates high lump sum take-up rates are more prevalent among participants with low benefit levels). This will minimize (or avoid entirely) settlement charges.

Settlement strategies. A possible tactic is to adopt mark-to-market accounting prior to a de-risking strategy that would have triggered settlement charges. When reflecting the change to mark-to-market in the financial statements, most of the impact may be "recast" into prior years with auditor approval. The trade-off is a more volatile pension expense going forward but if plan termination is imminent, the effect on earnings may be palatable.

ERISA Advisory Council recommendations

DOL's 2013 ERISA Advisory Council took testimony and developed recommendations for the DOL about "Private Sector Pension De-risking and Participant Protections." Its executive summary suggested the agency should provide the following guidance:

- Confirm that any annuity purchase from an insurer is a fiduciary duty not just in connection with a plan termination
- Explain the consequences of a breach of fiduciary duty in the selection of an annuity contract and what "appropriate relief" might be available to participants for breaches
- Require plan termination-type disclosures to participants, including information on inclusion of early retirement subsidies and the potential impact of tax penalties, when offering lump sums during a window period
- Educate plan sponsors on their options, the distinction between settlor and fiduciary functions, and the distinctions among disclosure, education, and advice to participants in connection with distributions, options, and elections
- Consider collecting relevant information on plan de-risking transactions

These recommendations present important technical considerations plan sponsors pursuing a **settlement** approach will want to carefully evaluate with their trusted advisors. While some might view this as a list of additional obligations to avoid by acting ahead of any additional DOL guidance, others may find it beneficial to consider enhanced disclosures and care in documenting their activities to minimize challenges later.

> Buck comment. Whether a decision to offer lump sums or arrange annuity purchases is a settlor or fiduciary function is an important point for selecting a settlement de-risking approach. Retirees from Verizon challenged the transfer of their liabilities to Prudential, in part complaining that they should have been consulted about the decision. In April, the federal district court for the northern district of Texas dismissed that complaint because Verizon was not acting as a fiduciary when it amended the plan; rather it was acting as the settlor and had every right to change the plan to direct the annuity purchase. An appeal of the decision is likely.

Now is a good time to get ready

To prepare for a cashout or annuity purchase, and to meet ERISA obligations, plan administrators should consider:

- Storing legacy data electronically in a searchable format
- Finding missing participants
- Validating accrued benefits if final calculations have not been performed

Administrators of ERISA plans are obligated to retain benefit determination data and communicate with participants:

- Is your data clean and completely up to date?
- Have you validated accrued benefits?
- Do you have a solid communication plan in place?

Finding missing participants

Options for finding former employees are shrinking. In 2012, IRS eliminated their letter forwarding service. Now, the Social Security Administration has followed suit and eliminated its letter forwarding service as well.

- Determining the expected timeframe and cost for completing individual benefit certifications for affected participants and available resources
- Establishing the process for a cashout or annuity purchase including buy-in from vendors and stakeholders, including evaluation of insurers under DOL guidelines
- Developing a participant communications strategy
- Requesting pro forma costs from the plan's actuary
- Identifying specific document changes that will be needed to implement settlement decisions made by the plan sponsor
- Communicating with senior management about the realistic timeframe for completing various tasks (they might have an expectation that is shorter than actually needed)

In closing

Plan sponsors need to weigh carefully the options they have to de-risk their plans. But changes in mortality tables, increases in PBGC premiums, funded status improvements, and the opportunity to avoid accounting charges all make it important that pension committees consider the merits of de-risking sooner rather than later.

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