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Plan Sponsor Basics Webinar Series

Design and Implementation of Pension De-Risking Programs

Webinar 1 of 5

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Pension risks

- Participant longevity and change in mortality rates
- Interest rates
- Investment returns
- PBGC premium increases
- Funding targets
- Participant litigation
- Law changes

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Pension risks are increasing

- New proposed mortality table (increased life expectancy)
- Interest rate volatility
- Market conditions/volatility in equity markets
- Moving Ahead for Progress in the 21st Century (MAP-21) sharply increased PBGC premiums
- Changes in accounting rules (FASB Statement No. 158) accentuate volatility of pension plan exposure

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Costs of de-risking have decreased

- Pension Protection Act of 2006 (PPA) changes result in the potential for calculation of smaller lump-sum payments than prior rules
- Plans are generally better funded due to PPA-related funding requirements and improvements in the markets since 2008
- Higher discount rate provided under MAP-21 (Interest Rate Stabilization) allows for full lump-sum payments
- Strong balance sheets and access to inexpensive capital may allow more aggressive funding

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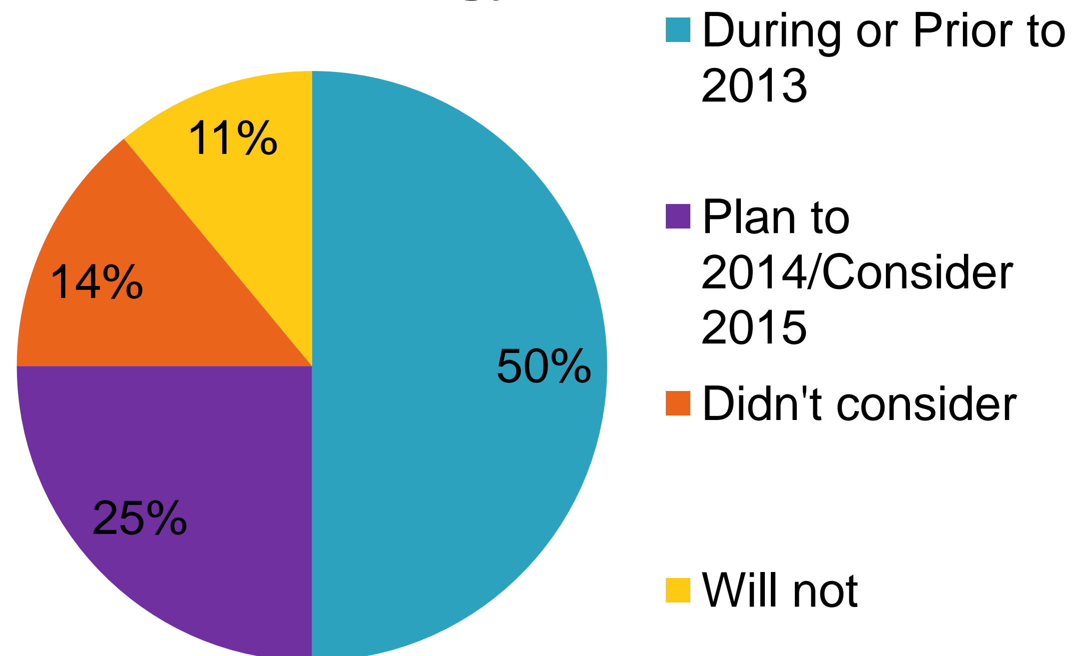
What other employers are planning

- In mid-2013, Towers Watson and Institutional Investor Forums surveyed 180 organizations about defined benefit plan risk management practices. Of the respondents:
  - 71% plan to implement an LDI strategy before 2015
  - 70% of their plans are soft frozen, 34% are hard frozen for all participants
  - 58% have already offered or expect to offer lump sums

Towers Watson and Institutional Investor Forums, "U.S. Pension Risk Management – What Comes Next?" November 2013 (pdf available at http://www.towerswatson.com/en-US/Insights/IC-Types/Survey-Research-Results/2013/11/us-pension-risk-management-what-comes-next)

What other employers are planning

- Mid-2013 survey of 180 employers revealed that 75% had already implemented or were considering implementing de-risking strategies this year or next year



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Methods of de-risking

- Manage assets
  - Liability-driven investment
  - Annuity buy-in
- Limit future liabilities
  - Soft or hard freeze
- Eliminate some or all liability
  - Lump-sum option (window or added plan feature)
  - Annuity buy-out or plan termination

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Choosing a de-risking strategy

- Conduct evaluation of cost, funding, and accounting consequences prior to adoption.
  - Impact on plan funding and cash flow, company contribution obligations, savings from reduced administrative costs and PBGC premiums, financial reporting and account consequences, etc.
  - Dialogue with 1) company's finance organization; 2) plan's actuary/recordkeeper/trustee; and 3) the plan sponsor committee, board, or individual with the authority to amend the plan.

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What we'll cover

- Walk-through of de-risking approaches
  – Liability-driven investment and annuity buy-in
  – Limit future liabilities through soft/hard plan freeze
  – Eliminate liabilities through lump-sum option, annuity buy-out, or plan termination
- Implementation issues and considerations
- Lessons learned from earlier de-risking initiatives

Liability-driven investing

- What it is: Hedged investments so that investment of assets is matched with duration of plan's liabilities
- Dynamic or static
  - Fixed-income securities; hedging or derivative strategies
- Why it helps:
  - Can help reduce investment volatility
  - Avoid settlement accounting
  - Can help plan maintain funded status if contributions are being made, move toward full terminal funding

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Liability-driven investing (cont'd)

- Why now: Avoiding the next "market correction"
  - 2013 very strong year for equity
  - Downturn in markets can create skewed perceptions of funding status
  - FASB standards
- Continuing costs/risks:
  - Underfunding is locked in and additional employer contributions likely required
  - Continue to incur plan administrative costs and PBGC premiums

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Liability-driven investing (cont'd)

- Fiduciary considerations:
  - Intersection of "settlor" funding strategy and "fiduciary" plan investment issues
  - Addressed in DOL Advisory Opinion 2006-08A
  - Special considerations for fiduciary governance
    - *Normal structure for investment policy statements may not work*
  - Special considerations when negotiating investment management agreements for LDI managers

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Annuity buy-in

- What it is: Purchase of bulk annuity as a plan asset
- Why it helps:
  - Annuity provider assumes liabilities and associated risks
  - Avoids settlement accounting at buy-in
- Why now: Market volatility and investment fluctuation
- Continuing costs/risks:
  - Underfunding is locked in (and may be increased for liabilities not covered)
  - Continue to incur plan administrative costs and PBGC premiums

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Annuity buy-in (cont'd)

  - Annuity provider premium (108-112% of GAAP liability)
- Fiduciary considerations
  - Similar risks to liability-driven investing
  - Must evaluate and consider viability of annuity provider
    - *Risk of bankruptcy or default of annuity provider DOL*
    - *But likely not subject to DOL standards for annuity buy-outs (more below)*
    - *Evaluate features of the annuity contract (surrender charges, etc.)*

Plan freeze

- Soft plan freeze:
  - What it is: Amendment that closes the plan to new participants
  - Why it helps: Stops the plan from incurring additional liabilities for new or rehired employees; number of participants will not grow
  - Why now: Increasing PBGC premiums; first step on path to hard freeze
- What to consider:
  - Does not manage or reduce existing liabilities, potential collective bargaining issues, creates two “classes” of employees, and discrimination testing issues

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Plan freeze (cont'd)

- Hard plan freeze
  - What it is: Amendment that stops benefit accruals under the plan
  - Why it helps: Stops the plan from incurring any future increases in liabilities
  - Why now: Eliminate new liabilities and additional PBGC premiums
- Considerations
  - Some of the same drawbacks as soft plan freeze (doesn't change existing liabilities, some awkwardness/complexity of transitioning to new retirement program, etc.)

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Lump-sum payments

- What it is: Offer class of participants the option to take their entire benefit in actuarially equivalent lump sum
  - Voluntary offer (plan participants are not required to accept, unlike an outright termination)
  - By far the most common and approachable de-risking approach
- Why it helps:
  - Eliminates liabilities and overall magnitude of pension risk
  - Eliminates PBGC premiums and administrative costs
  - No annuity purchase costs

Lump-sum payments (cont'd)

- Why now:
  - Update in mortality table will increase plan liabilities in the relatively near future (likely effective in 2016 for funding purposes, but accounting impact may be sooner)
  - Possibly favorable interest rate environment (more below)
  - Some uncertainty in the legislative and regulatory environment (particularly for lump-sum offers to retirees in pay status)

Lump-sum payments (cont'd)

- Financial considerations: Funding, cashflow, settlement accounting, etc.
- Design considerations:
  - Temporary window and/or permanent distribution option
    - *Permanent windows cannot be eliminated for accrued benefits due to Code/ERISA anti-cutback rules*
    - *For temporary windows, consider IRS regulations prohibiting any "significant detriment" on participants who do not elect distribution*

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Lump-sum payments (cont'd)

– Terminated vested participants and/or retirees

- *2012 private letter rulings for Ford/GM concluded that lump-sum offers to retirees in pay status did not run afoul of the Code's required minimum distribution (RMD) rules*
- *Recent IRS statements limit rulings to specific circumstances; IRS moratorium on new rulings; good possibility of different ruling position or other regulatory guidance*

– Lump-sum factors and calculations

- *Code Section 417(e) assumptions establish interest rate through "look-back" month and "stability period" concepts*
- *Even if no lump-sum feature, plan likely has existing look-back month and stability period for small benefit cashouts*

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Lump-sum payments (cont'd)

  - *Consideration to selecting different look-back month and stability period for lump-sum window*
- Determine whether the value of early retirement subsidies or other incentives should be included in calculating lump sums – cost vs. take-up rate
- Cap on amount/value of lump-sum distribution

- Implementation considerations
  - Coordination of internal and external resources (HR/benefits staff, legal counsel, actuaries, external consultants, trustee)
  - Data integrity and clean up

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Lump-sum payments (cont'd)

- Internal Revenue Code and tax-qualification based compliance considerations:
  - Funding-based benefit restrictions on lump-sum distributions (Code Section 436 requires 80% AFTAP)
  - Nondiscrimination issues depending on the group of participants eligible for the lump-sum distributions
  - Complex and detailed disclosure requirements including relative value disclosure, spousal consent requirements, etc.

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Lump-sum payments (cont'd)

- ERISA and fiduciary-based compliance considerations
  - Plan fiduciaries are responsible for the implementation and communication of any lump-sum program
  - ERISA establishes certain statutory disclosure obligations for plan fiduciaries (SPD, benefit statements, etc.)
  - ERISA's duty of loyalty also gives rise to more generalized disclosure obligations as developed in the courts
    - *At a minimum, communications must be clear, complete, and accurate, and satisfy statutory/regulatory requirements*

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Lump-sum payments (cont'd)

- *Fiduciaries must respond fully and truthfully to any participant inquiries*
- *Fiduciaries don't have to predict every range of possible considerations for individual participants*
- *In certain circumstances, fiduciaries may have duty to disclose information to participants if fiduciary has reason to know that information may be important to participants or that failure to disclose may be harmful to participants*
- *Fiduciaries may have duty to disclose future or pending plan amendments that are under "serious consideration"*

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Lump-sum payments (cont'd)

– Consider possible scenarios against this backdrop of these fiduciary disclosure concepts
  - *What, if anything, should be disclosed to participants who submit retirement/distribution elections while company is considering the offer of a lump-sum window program?*
  - *What sort of information must be included in disclosure of lump-sum window program about factors used to calculate the amount of the distribution?*
    – Changing nature of interest rates used?
    – If applicable, fact that new/different look-back/stability period selected to calculate distribution?
    – Future impact of mortality table changes?

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Lump-sum payments (cont'd)

- *What about situations in which the company has a long-term plan to de-risk pension plan that might involve future lump-sum window offers and/or a permanent lump-sum feature?*

– Possible increased litigation concerns given focus of advocacy organizations (e.g., Pension Rights Center), participants having second thoughts, etc.

– Critical to develop a thoughtful communication strategy and carefully implement it

Annuity buy-out

- What it is:
  - The plan transfers all assets and liabilities to a third-party insurance company
  - Because the transaction is at the level of the plan, no participant consent is required
  - Verizon buy-out – transfer of $7.5B in pension liabilities to Prudential; class action lawsuit dismissed
    - *District court held that the decision to direct the annuity purchase was a settlor decision*
    - *Affected individuals are no longer participants; recourse only against annuity provider under state law*

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Annuity buy-out (cont'd)

- Why it helps:
  - All the risk is transferred to the third-party insurer
  - No direct participant involvement (no consent needed)
  - Eliminates all future costs (administrative, funding, PBGC premiums, etc.)
- Why now:
  - Participant groups, the DOL, and the IRS are concerned about the loss of ERISA rights and lack of participant input (opportunity may go away or be limited through legislation)

Annuity buy-out (cont'd)

- What to consider:
  - Selection of annuity providers is a fiduciary issue
    - *DOL "safe harbor" for annuity selection*
    - *Advisory council recommended clarification and addition of safe harbors to Interpretive Bulletin 95-1*
  - Accounting consequences (settlement)
  - Cash flow and insurance premium/profit margin
  - Public relations
  - Potential litigation/taking steps to mitigate risk

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Plan termination

- Usually the end game of other pension de-risking strategies
  – Plan must be fully funded on a termination basis (roughly 108-112% of GAAP liability)
- Decision to terminate the plan is a settlor decision, but the implementation of the termination invokes fiduciary considerations (including compliance with 95-1)
- Need to follow fairly strict 12-18 month process (PBGC and IRS filings, participant communications)

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Questions?

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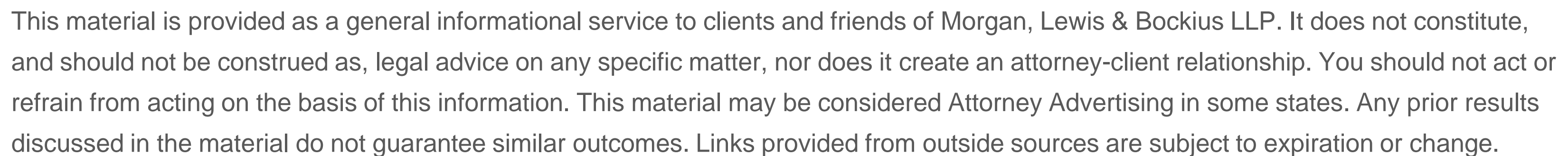
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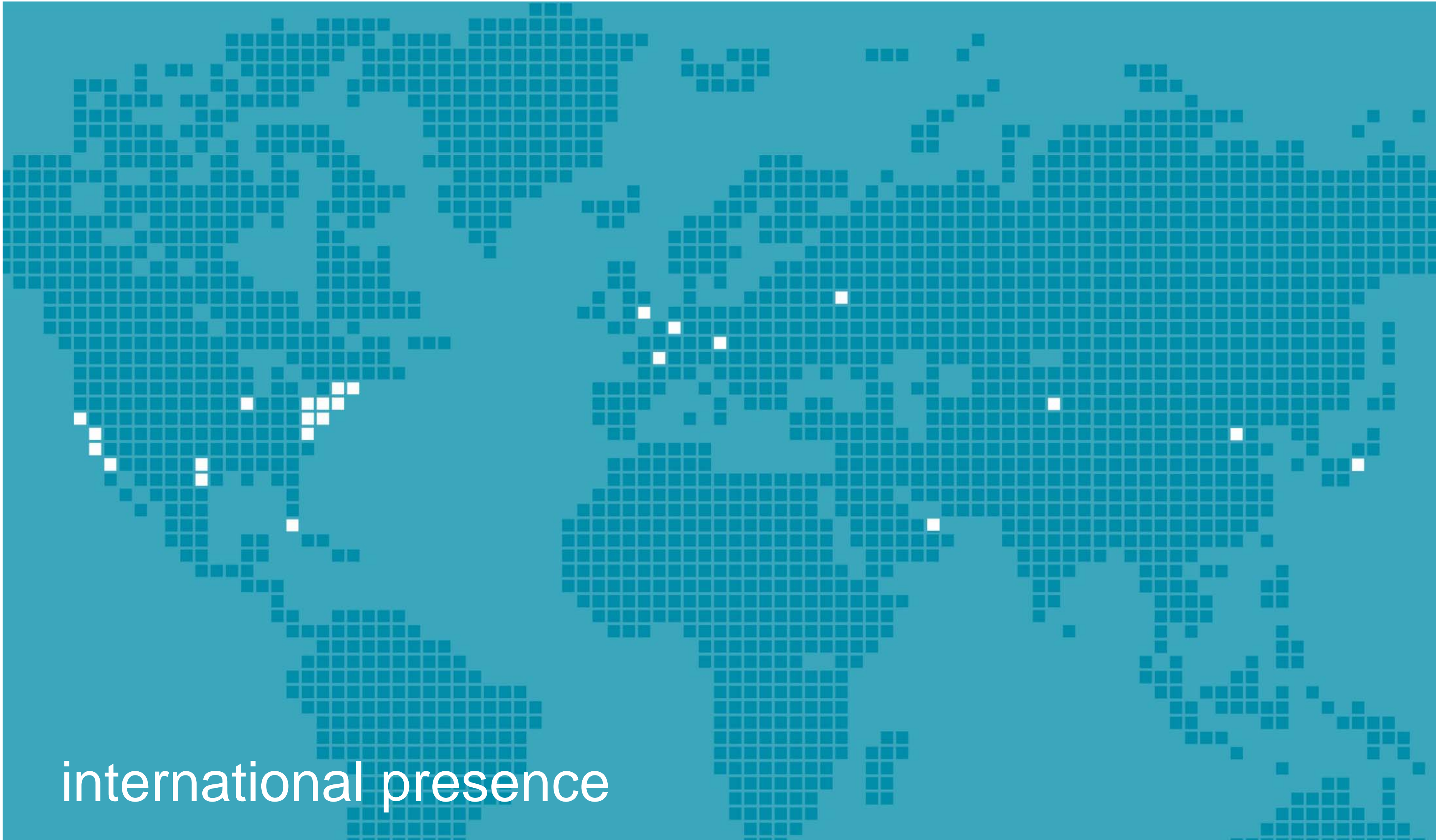

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