The DB Dilemma

Options abound for plan sponsors looking to sustain, freeze or terminate their plans

What to do with a defined benefit (DB) plan requires careful consideration from a plan sponsor and all parties involved with the pension plan's management and administration. Generally, plan sponsors operating DB plans are facing three options: sustain the plan, freeze the plan or terminate the plan. These options, and ways to approach them, were recently discussed by a team of consulting and DB plan experts from MassMutual's Retirement Services Division: John Budd, national practice leader of Institutional Products; Kevin Osinski, consulting actuary; and Suzanne Amari, director and actuary of Pension Buyout Products.

PS: What is forcing plan sponsors to consider changes to their defined benefit plans?

Budd: In the past 12 years, two significant market downturns, combined with very low interest rates and an overhaul of the pension funding and public accounting rules, have created significant contribution and accounting volatility. Funding levels are now at historic lows.

Sponsors responded to these challenges by re-evaluating and redesigning their plans.

As you may know, possible solutions range from outright plan terminations to freezing benefit accruals to even converting to hybrid designs, such as cash balance plans. And these solutions have not been limited to the private sector but are also starting to impact public sector sponsors.

After exploring plan design, many plan sponsors have shifted their attention to new pension de-risking strategies. These could be either liability- or asset-focused but are designed to take some of the risks inherent in DB plans out of the picture.

While some DB plans focus on redesign, others think about removing risk to reduce their volatility and improve financial outcomes.

Liability-focused strategies include lump sums, annuity buyouts and annuity buy-ins. Lump-sum options can be offered to both vested and/or active participants. These transactions can trigger settlement accounting, and this strategy has met some opposition; offering lump sums can work contrary to the goals defined benefit plans have, to provide lifetime income to participants.

In an annuity buyout, assets move to insurance companies, in a full settlement that eliminates future plan risks and administrative responsibilities. This can also be done for all or part of a plan, which preserves its underlying benefit options.

In an annuity buy-in, there is a transfer risk to the insurance company but no settlement. A group annuity contract is held as an asset of the plan, and its market value needs to be determined.

PS: If a company wants to minimize contribution and accounting volatility, but is also concerned about the impact on employees, how does it get there?

Osinski: The first and simplest solution is to develop a longer term funding strategy with level contributions. The chart on the next page shows projected IRS minimum contributions under MAP-21 [Moving Ahead for Progress in the 21st Century Act] and Pre-Map-21 interest rates. Plan sponsors may want to consider a contribution policy that smooths the effect of MAP-21.

One alternative would be to fund the plan based upon the average of the current and following year's estimated IRS [Internal Revenue Service] minimum funding requirement to smooth out contribution volatility.

Another alternative would be to look at the long-term funding time frame. The IRS regulations would provide full funding of the plan over seven years. In light of MAP-21, plan sponsors may want to set their own full funding timeline using consistent, slightly more conservative assumptions. For example, the goal may be to achieve full funding after 10 years with level contributions. Therefore, a contribution strategy based upon a 10-year projection—assuming 6% interest and a generational mortality table—may get the plan there and satisfy the annual IRS minimum funding requirements as well.

Another low-participant impact approach is liability-driven investing [LDI]. Essentially, LDI matches asset and liability duration to reduce the volatility in the funded status. That means pension liability and assets move in the same direction under market influences, maintaining the underfunded liability gap so it doesn't grow. For many plan sponsors, it is the increasing liability gap that has been driving contributions and annual expenses. Typically, taking this approach means a greater weighting to longer duration assets and forgoing some of the higher equity returns.

Next, we get into ideas that will modify the plan design on a prospective basis to lower costs. With this approach, plan sponsors may still have significant contribution and annual expense amounts until the unfunded liability gap is closed.

The most drastic plan design option is a freeze. There are several types of freeze: soft, temporary and hard. In a soft freeze, the plan is closed to new employees. With that, plan sponsors will still have the cost of ongoing benefit accruals for active participants, plus the cost of closing the underfunded liability gap.

Plan sponsors could also implement a temporary freeze of benefit accruals. So instead of doing a hard freeze and making it permanent, turn off the benefit accruals until the underfunded gap is closed. Then turn them back on when the plan is better funded.

Alternatively, a hard freeze would turn off benefit accruals completely, so the entire contribution goes toward closing the unfunded liability gap.

Amari: Termination is another option that has its own inherent benefits. A company that decides to terminate and purchase a buyout annuity will be eliminating its accounting volatility.

It will also be reducing expenses, such as paying PBGC [Pension Benefit Guaranty Corporation] premiums, and it won't have to worry about increases in those premiums. Other plan administration costs will be eliminated as well, including actuarial and investment management.

From a risk management perspective, the buyout annuity is the strongest de-risking vehicle because it will transfer both the asset and the liability risk away from the plan sponsor and to the insurer underwriting the annuity.

The overall process will last about 12 to 18 months and involves developing a communication strategy for participants that's both sensitive in nature and involves frequent touch points along the way to keep the participants informed.

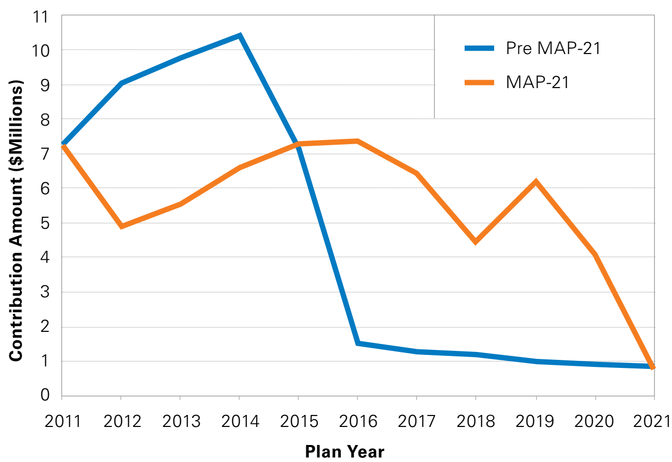
A company also needs to look at how it's managing its assets and establish a shorter investment horizon, given the pending termination. And it will want to make sure it protects against market risk.

This is also a time that the company can amend its plan documents. For instance, it might want to offer a one-time, cash-out lump sum to some of its deferred participants. The company will also want to confirm that all of its recordkeeping information is accurate, including participant data. It may want to contact any terminated employees to make sure that the company has their current information.

Plan benefit accruals must be frozen and benefits must be finalized. And, lastly, it'll end the process by purchasing the group annuity—the pension buyout annuity—from an insurer.

By purchasing the buyout contract, a company will be able to release its fiduciary responsibility and transfer that to the insurer that's backing the annuity guarantee. Until that occurs, however, the company maintains its fiduciary responsibility to the plan participants, including the decision regarding the selection of the annuity buyout contract provider.

PROJECTED CASH FLOW OF A SAMPLE COMPANY



Assumptions:
- IRS Minimum Contributions
- EROA 6.5%

WEIGHTED AVERAGE IRS INTEREST RATES

Year	Pre MAP-21	MAP-21
2011	5.80%	5.80%
2012	5.20%	7.09%
2013	5.20%	6.69%
2014	5.00%	5.59%
2015	5.00%	5.00%
2016+	5.00%	5.00%

Of course, this decision cannot be made on price alone. The Department of Labor [DOL] released Bulletin 95-1 some years ago, to provide guidance on how to evaluate the safest available annuity with lifetime income.

As a part of that evaluation, the plan sponsor must look at the quality of the insurers it is soliciting bids from and the size of each insurer relative to the size of the contract it is looking to purchase. It also must consider the financial strength of each insurer: The insurer's credit rating, as well as the level of capital and surplus, are measures that plan sponsors can consider in evaluating the financial strength.

While the decision to terminate the plan is not one to be taken lightly, it is an additional risk transfer strategy that plan sponsors can consider. ■

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