The risks of de-risking defined benefit plans

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As most plan sponsors have probably discovered by now, private sector defined benefit (DB) pension plans contain certain types of risks. Having seen two black swan investment events in the last decade, along with the accompaniment of record low interest rates, many plan sponsors have grown weary of them. With the inception of the rules of the Pension Protection Act of 2006 (PPA), where liabilities became more marked to market and asset smoothing was limited, pension volatility and thus pension risk management have come to the forefront. Almost every pension and investment advisor consulting with plan sponsors has mentioned the notion of pension de-risking in the last couple of years and with good reason. This topic hasn't overstayed its welcome and still is a significant discussion point for enterprises in 2014. However, it is also important to understand that pension risk management strategies have their own implied risks associated with them. Sometimes, the risk can be explicit in the form of an increased cost. Other times, the risk may not reveal itself until you get further down the road implementing a given strategy. This article examines a few of the risks of de-risking.

In the past couple of years quite a few plan sponsors have expressed interest in reducing their pension footprints. Several implemented lump sum windows during 2012 and 2013, giving former employees with vested benefits a one-time opportunity to receive single sum distributions. Once a lump sum distribution is taken by a participant, the plan sponsor no longer bears future pension risk with respect to that participant's benefit. Besides risk reduction, there are also other good reasons for this de-risking technique, such as lowering flat-rate Pension Benefit Guaranty Corporation (PBGC) insurance premiums and reducing future plan administration costs. However, plan sponsors must consider the opportunity costs associated with implementing a lump sum window. These costs include:

- Missing out on investment gains as assets leave the plan upon a lump sum cash out
- Anti-selection from participants
- Higher plan contributions

Assets that left the plan early in 2012 and 2013 missed out on the double-digit return potential of those years. When participants are offered a lump sum election opportunity, those in poor health are more likely to accept the offer while the healthier participants may elect annuities. Thus, the plan may be subject to more unfavorable mortality experience than it otherwise would have been if lump sums had not been offered. Moreover, private sector defined benefit plans operating under the rules of the PPA have to maintain certain funded percentage thresholds in order to allow lump sum distributions.

Generally, a lump sum transaction is likely to decrease a plan's funded status, as more assets are leaving the plan than the corresponding PPA liability reduction. Thus, the plan will be worse off from a funding standpoint and will have to maintain a certain funding level in order to avoid lump sum restrictions. The lower funded status will generally result in higher plan sponsor contribution costs. It may also result in a higher PBGC variable-rate premium. Lastly, the payment of large lump sums (in frequency or magnitude) could trigger settlement events under U.S. GAAP or International Accounting Standard (IAS) 19 accounting, and this could in turn lead to accelerated recognition of balance sheet losses and a higher one-time profit and loss (P&L) expense. Therefore, while the mathematics behind a lump sum transaction may suggest a net loss, plan sponsors may still have some strong reasons to go through with it. General Motors did it in a record $31 Billion lump sum settlement in 2012 because it wanted to reduce its liability figure, which was rivaling its entire market capitalization. It also paid a heavy premium in the process.

With the announced rises in PBGC premiums over the next several years, many plans sponsors have attempted to de-risk their plans of the rise in premiums by accelerating funding. With interest rates at record lows during 2012, some plan sponsors instituted borrowing strategies to fully fund their plans and reduce PBGC variable-rate premium costs. Other plan sponsors made decisions to use their available capital to fully fund their plans.

For plans that have achieved full funding positions, they will certainly have the advantage of showing pension surpluses on their balance sheets and recording pension income on P&L statements, all the while having the ability to take contribution holidays. However, should we experience another interest rate rebound as we did during 2013, or a sudden spike in interest rates should unemployment figures dramatically improve, several plans will find themselves greatly overfunded.

Pension plan funded status under PPA rules could also dramatically improve should the temporary funding relief provided under the Moving Ahead for Progress in the 21st Century Act (MAP-21) become permanent. A plan's overfunding does not get returned to the plan sponsor, unless the plan is terminated, and even then, there is still the payment of a large premium to an insurance company for taking on the pension risk, not to mention a hefty 50% excise tax. Therefore, while it is prudent to fully fund a plan, the risk of overfunding does exist and plan sponsors must carefully plan out funded status lock-in strategies when their ultimate funding goals are reached.

The last cautionary word is directed to those plan sponsors who are considering paring down their defined benefit plans and intending to offer replacement benefits through a defined contribution plan. It is important to give thought to the kinds of replacement plans that are available in addition to risk-sharing levels between employer and employee. It is also important to think about employee behavior in light of the changes in the retirement landscape. Could the competition pendulum swing? What will happen to your organization's ability to attract and retain talent?

Moving to a defined contribution plan that offers the same benefit replacement level as a defined benefit plan will increase costs for a plan sponsor. Moving to a defined contribution plan that offers a lower benefit replacement level may result in employee dissatisfaction and defection, given the shift in investment risk and the lack of longevity protection that an annuity would otherwise provide. Lastly, it is important to consider a situation when

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company cash is tight or is needed for use in another strategic venture, rather than being available for a profit sharing contribution or employer match as in a defined contribution design. Having a defined benefit plan available allows the employer to promise future benefits without immediately having to fully fund them. Besides the known tax deduction advantages for employers with defined benefit plans, there is also the opportunity to defer costs to a later time period and potentially even eliminate them through investment and demographics gains, something that is not possible in a defined contribution approach.

Therefore, while every plan sponsor and advisor should be thinking about pension risk management, it is important to exercise care in the strategy that is chosen and in the timing of implementation. Every pension de-risking strategy has its own pluses and minuses and most have an embedded cost associated with them, whether implicit or explicit. Risk management strategies must be customized for organizations depending on their risk tolerance and cash flow requirements. Once a strategy is selected, periodic refinement should also be considered. It's not a one-size-fits-all approach. Before proceeding down a particular direction, plan sponsors must equally be made aware of both the risk reduction opportunities and the risks of de-risking.

Thoughts

By Gene Hubbard

- Shower your love
- Never stop caring
- Embrace happy memories
- Happy hearts make happy people
- Fun is always fun
- Learn from life's lessons
- Helping always helps
- Smiley faces look good
- World peace begins with you
- Take care all ways, always

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