Pension Plan Fix-It Handbook

Employee Benefits Series | THOMPSON | February 2014 | Vol. 21, No. 5

Considering, Controlling Risk Become Crucial to Prepare for 'Derisking'

By Mary B. Andersen, CEBS, ERPA

Mary B. Andersen is president and founder of ERISAdiagnostics Inc., an employee benefits consulting firm that provides services related to Forms 5500, plan documents, summary plan descriptions and compliance/operational reviews. Andersen has more than 25 years of benefits consulting and administration experience. She is a CEBS fellow and member of the charter class. She also has achieved the enrolled retirement plan agent designation. Andersen is the contributing editor of the Pension Plan Fix-It Handbook.

There is no one-size-fits-all approach for defined benefit plan sponsors when it comes to pension "derisking" — the shedding of benefit obligations to reduce costs. But with funding levels and market conditions more favorable to pensions than they've been in years, few plan sponsors can escape considering an approach to pension risk transfer. Each plan sponsor that undertakes derisking must have a plan, both strategic and operational. In January's column we discussed the various factors that have put derisking on most plan sponsors' radar, and touched on basic derisking strategies. In this month's column we discuss popular derisking techniques: lump-sum distributions, liability-driven investing and annuitization, as well as the administrative considerations each present.

Start with Funding Policy

A derisking plan starts with a funding policy, usually the greatest risk exposure for plan sponsors. This policy's purpose, in addition to fulfilling a fundamental ERISA principle, is to ensure that there are enough plan assets to pay benefits when due. Other risk factors inherent in potential derisking:

- investment risk;
- mortality or longevity risk;
- corporate financial condition;
- plan demographics; and
- regulatory environment.

Plan design can mitigate risk to a certain extent via the benefit formula used (for example, final pay, career average or cash balance plans) or the distribution options (such as lump-sum payments). However, many types of risk cannot easily be predicted: general economic conditions, market volatility, retiree lifespans and future government regulation.

The financial risk aspects can be addressed by developing a funding policy that is integrated with an investment policy. Such a tool provides the framework for a derisking strategy. To oversimplify the funding policy, if your plan is fully funded, your strategy will focus on what steps must be taken to maintain that funding status. If your plan is underfunded, your strategy will focus on steps to bring the plan up to a desired funding level. Your investment policy should tie into both.

If you are currently 90-percent funded but your goal is to be 95-percent funded, your investment policy (together with investment advisers) should guide you to the asset allocation necessary to achieve your goal. Once you reach your goal, your asset allocation may change to reduce risk associated with market volatility, and you may be ready to seriously begin investigating derisking strategies.

A derisking strategy can be internal; in other words, one that keeps the assets in the plan via a liability-driven investment approach, or external, removing assets from the plan by offering lump-sum distributions or annuitizing a portion of the benefit liability. Other, more-drastic derisking strategies include freezing or terminating the plan.

Lump-sum Distributions

Lump-sum distributions transfer risk to the participants. If elected, they reduce the longevity risk for plan sponsors, meaning the length of time that benefits must be paid. Lump-sum distributions and initiatives to "cash

See *Andersen,* p. 2

Andersen (continued from p. 1)

out" terminated vested participants remove liabilities from the corporate books, partly to reduce U.S. Pension Benefit Guaranty Corp. premiums. It is important to keep in mind that just because a lump-sum option is offered doesn't mean the participant will take it. Do not expect 100-percent acceptance of these full distributions; a reasonable expectation for takeup might be in the 20-percent to 40-percent range.

Liability-driven Investment

In a 2012 Vanguard research paper "Pension Derisking: Start With the End in Mind"[1] the authors describe liability-driven derisking strategies that vary based on whether a plan is frozen, closed to new participants, ongoing or is a cash balance plan. Plan sponsors should decide on the plan's maximum funding level and how the assets will be invested when the desired funding level is reached.

The method used to implement LDI is known as the "glidepath," which starts with the plan's current funding status and investment allocation. As the funding status improves, the equity allocation decreases and bond allocation increases. While this sounds simple, keep in mind that each plan differs by its own characteristics, as described above.

As one of its 10 Pension Risk Management Priorities for DB Plans in 2014[2], Mercer recommends adding interest rate triggers to glidepaths based on funded status. Any derisking strategy requires examining all applicable factors. Annuitization has made the headlines in recent years with companies such as Verizon and General Motors removing pension liabilities from their books by purchasing annuities for certain segments of their plan participant population. Annuitization transfers benefit payment risk from the plan sponsor to an insurer.

Be mindful of your fiduciary obligations when weighing annuitization. In her August 2013 testimony before the ERISA Advisory Council regarding private-sector derisking and participant protections, Karen Friedman, executive vice president and policy director of the Pension Rights Center said, "[W]hile we recognize that the insurance companies are under the watchful eye of state regulators, we also have seen that insurance companies — such as Executive Life and Mutual Benefit Life Insurance Company — can fail nevertheless."

Understand that there is a cost to annuitization, and each plan is priced individually. SEI Investments[3] notes that the cost of annuitization could be 15 percent to 25 percent of the pension's liability. Factors that affect the cost of annuitization include:

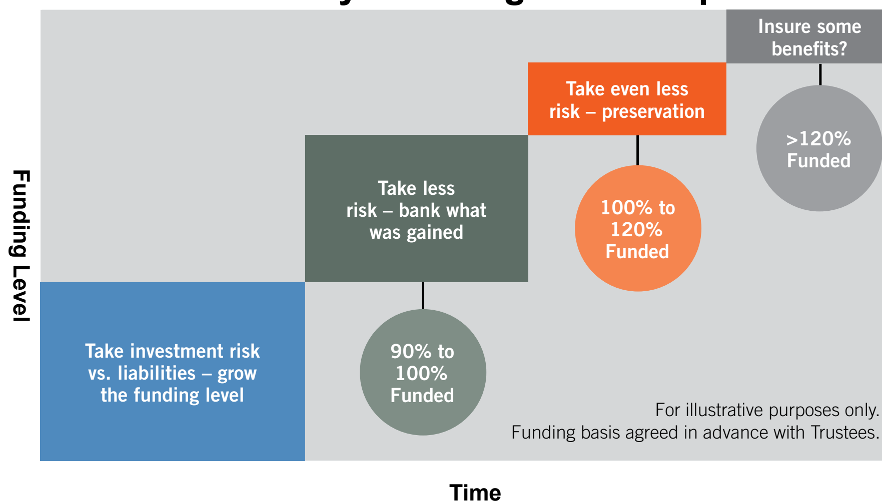
- plan demographics;
- how much is being annuitized;
- what are the interest rates; and
- insurance company charges for things such as mortality and administrative expenses.

Many plan sponsors may first investigate annuitization for their retiree population, as it can be priced more easily by insurance companies because the amount and duration of the group's payout is more predictable. Any derisking strategy requires a plan (see chart on Journey Planning below). Your plan must have:

- clearly defined objectives;
- an understanding of any necessary plan document amendments;
- an understanding of plan fiduciary obligations;
- the buy-in of the key players in your organization;
- identification of the team responsible for implementing the plan;
- a project management plan with key milestones;
- reliable data, as this is critical for any annuity pricing, cost estimates and communication efforts; and
- a communication plan. In the case of cashouts or annuitization a clear, consistent message is imperative. Any participant communication should be

See *Andersen*, p. 3

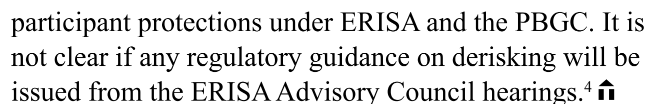
Journey Planning — Concept



Source: SEI Investments (Europe) Ltd., 2011, from "SEI Perspectives: Demystifying De-risking"

Andersen (continued from p. 2)

reviewed by legal counsel. In the case of an LDI derisking strategy, all pertinent members of the management team must understand the goal, the steps required to reach it and what happens when the goal is or isn't met as planned.

Finally, as noted, employee advocacy groups are concerned with derisking activities that remove existing 
participant protections under ERISA and the PBGC. It is not clear if any regulatory guidance on derisking will be issued from the ERISA Advisory Council hearings.[4]

Footnotes

[1]https://institutional.vanguard.com/iam/pdf/ICRPD.pdf
[2]http://www.mercer.com/press-releases/1572810
[3]http://www.seic.com/docs/Institutions/SEI-DB-Reducing-Pension-Liabilities-Annuitization-Lump-Sum-Options-March-2013.pdf
[4]http://www.dol.gov/ebsa/pdf/2012ACIssueStatement1.pdf

This article originally appeared in the *Pension Plan Fix-It Handbook*. © 2014 Thompson Information Services, Bethesda, MD. Go to http://www.thompson.com/public/offerpage.jsp?prod=mend for more information.