Defined Benefit Plan Challenges and Potential Exit Strategies

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Today's presenters

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Learning objectives / Topics

- Understand the current environment of retirement plans and designs
- Understand funding requirements, regulatory reporting and PBGC requirements
- Identify market trends and potential exit strategies
- Discuss best practices for plan governance and the role of the fiduciaries in plan administration, sustainability and accountability

Three main types of retirement plans

1. Traditional Defined Benefit Plans
   - Benefit at retirement defined by plan formula
     - Accrual rate (%) x salary ($) x years of service (#)
     - Flat dollar benefit ($) x years of service (#)
   - Monthly benefit payable for life (i.e., annuity income)
     - Optional forms of payment available
   - Generally employer-only funded plan
     - Public sector / government plans typically require employee contributions
   - Many assumptions made during lifetime of plan
     - Economic (i.e., asset performance, etc..)
     - Non-economic (demographic) (i.e., participant experience)

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Three main types of retirement plans

2. Defined Contribution Plans
   - Employer contribution defined by plan formula
     - Fixed percent of pay (% x $)
     - Percentage or "match" of employee contributions
     - Discretionary
   - Benefit at retirement is accumulated account balance
     - Balance dependent upon contributions made and investment earnings
     - Payable as a lump sum or monthly annuity
   - Generally employer and employee funded
   - Many assumptions made during lifetime of plan
     - Economic
     - Non-economic (demographic)

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Three main types of retirement plans

3. Cash Balance (Hybrid) Plans
   - Defined Benefit plan with a Defined Contribution "feel"
   - Account balance at retirement defined by plan formula
     - Annual accrual is typically a percentage of salary
     - Interest credits to account are defined by plan
     - Payable as a lump sum or monthly annuity
   - Generally employer funded
   - Benefits accrued more evenly over working career
   - Many assumptions made during lifetime of plan
     - Economic
     - Non-economic (demographic)

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Defined Benefit Plan Requirements

Funding, Reporting and Administrative Requirements

- Actuarial valuation to determine minimum required and maximum deductible contributions
  - Need to follow certain IRS rules and regulations
- Adjusted Funding Target Attainment Percentage (AFTAP) Certification
- Annual Funding Notice (AFN)
- Form 5500 and related schedules
- Accounting disclosures
- PBGC premium filing
- Employee benefit statements
- Individual benefit certifications
- Non-discrimination testing

Defined Contribution Plan Requirements

Funding, Reporting and Administrative Requirements

- Calculation of periodic employer/employee contributions
  - Need to maintain individual accounts for each participant
- Summary Annual Report (SAR)
- Form 5500 and related schedules
- Accounting disclosures
- Employee benefit statements
- Non-discrimination testing

Where have we been?
Recent history impacting defined benefit plans

High investment returns in the 1990s

- Low or no required employer contributions
- Pension plan improvements were often granted
- Back-burner issue for pension boards

Then came the early 2000s

- Dot-com bubble burst
- Stock market crash
- Lower interest rates
- Resulting spike in employer contributions

Where have we been?
Recent history impacting defined benefit plans

Mid/late 2000s

- Some stabilization through 2007
- Bottom fell out in 2008 and 2009
  - Accounting and funding regulatory changes
    - FAS 158, PPA
  - Liabilities based on short-term interest rates
  - Move toward market value of liabilities and assets
  - Created volatility with balance sheet and plan contribution requirements

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So where are we now?

Historical events highlighted the financial risks of defined benefit plans

- Investment, interest rate and longevity risks borne by employer
- Relative size of pension liabilities and cash requirements can impact credit rating, borrowing costs, investments in internal growth and financial reporting requirements to stakeholders

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So where are we now?

Historical events highlighted the financial risks of defined benefit plans *(continued)*

- Changing regulations, poor asset returns, low economic environment and increased lifespans have led to increased defined benefit pension plan costs
- Temporary funding relief granted through increased valuation interest rates, but not for financial disclosures or PBGC premiums
- Plan sponsors are looking to minimize risk exposure and resulting cash requirements

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So where are we now?
Reactions to the current environment

Actions considered can depend on funded status of plan and risk tolerance of plan sponsor

- Status quo
- Close defined benefit plan to new hires
- Freeze defined benefit plan
  - "Soft Freeze" v. Hard Freeze"
- Terminate defined benefit plan
  - Conduct plan termination study
- Implement cash balance (hybrid) plan
- Merge multiple plans into a single plan
- Enhance current defined contribution plan

Potential implications of plan actions

Human Capital Strategy / Administration implications

- Plan closing, freezing or termination
  - *Talent acquisition and retention implications* – may undermine efforts to recruit and retain key talent
  - *Succession Planning Interruption* - may cause participants to delay retirement, changing the employee demographics, and the orderly transition of employees and roles
- Can increase administrative responsibilities, costs and potential risks
  - *Current staffing under pressure* - requires completion of additional forms, notices, documentation, filings with regulators and employee communications
  - *Adjustment to budgeting and financing approach to retirement costs* - Creation or enhancement of defined contribution plan
  - *Enhanced employee relations function costs and skills* – will result in need in developing prescribed employee communications and culture "respecting" communications to participants
  - *Regulatory Risk Assessment* – a plan closing may create future legal issues or risks

Potential implications of plan actions

Accounting – Settlement of costs of plan(s)

- Work with auditors (both plan and organization) to understand impact on organization financial statements and reporting
  - Reporting impact for a transaction that is "irrevocable"
  - Long-term benefit or optics associated with employer relief from pension obligations
  - Paying lump sums may trigger settlement accounting
- Impacts both the balance sheet and P&L (pension expense)

Implications of plan actions

Accounting – Curtailment

- An event that significantly reduces the expected years of future plan service of present employees or eliminates the accrual of defined benefits for some or all future services
- Plan freeze generally requires curtailment accounting
- Impacts both the balance sheet and P&L (pension expense)

Implications of plan actions

Funding

- Plan freeze would result in lower minimum required contributions over time
- Should consider contributing more than the minimum required in order to more quickly attain full termination funding

PBGC

- Lump sum payouts would decrease flat-rate premiums due to lower headcount

Responsibility for defined benefit plan

Parties responsible for making decisions about pension plans

- Employer/plan sponsor
- Fiduciaries (e.g., governing board, administrator)
  - Department of Labor issued broader fiduciary rules on April 6, 2016
  - Investment Advice Rule Expansion

Who is a fiduciary?

Fiduciaries are individuals or entities with authority to exercise discretion over the assets or operation of the plan

- Trustees
- Investment advisers
- Administrative committee
- Officers with control over the plan

The role of a fiduciary

Participation in the operations may make the person or entity performing them a fiduciary

- Using discretion in administering and managing the plan
- Controlling the plan's assets to the extent there is an exercise of discretion or control
- A plan must have at least one fiduciary named in the written plan document unless they are identified as a fiduciary based on a description in the plan of control

Who is not a fiduciary?

- Attorneys, accountants and actuaries generally are not fiduciaries when acting solely in their professional capacities
- Fiduciary status is based on the functions performed for the plan, not just a person's title
- A number of decisions are typically not fiduciary actions but rather are business decisions made by the employer
  - Decision to establish a plan
  - Design of plan benefit and program
  - Decision to amend a plan
  - Decision to terminate a plan

Who is not a fiduciary?

- When making these decisions, an employer is acting on behalf of its business and not the plan, and therefore is not acting as a fiduciary
- However, when an employer (or someone hired by the employer) takes steps to implement these decisions, that person is acting on behalf of the plan and in carrying out these actions may be a fiduciary

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Responsibilities of a fiduciary

Some fiduciary responsibilities include:

- Acting solely in the best interest of plan participants and their beneficiaries, and with the exclusive purpose of providing benefits to them
- Carrying out duties prudently
- Following the plan documents (unless inconsistent with ERISA)
- Diversifying plan investments
- Paying only reasonable plan expenses

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Fiduciary Governance (Investment)

- Assemble an investment committee if not done already
- Committee should meet on a regular basis
- Adopt an Investment Policy Statement (IPS)
- Monitor and review plan investments in accordance with IPS
- Collect and review information on service providers
- Perform benchmarking study to ascertain pricing and offerings
- Hire investment experts and/or investment managers if necessary

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Fiduciary Governance (Administrative)

- Assemble an administrative committee if not done already
- Committee should meet on a regular basis
- Ensure that governing plan document is up-to-date and in compliance with applicable rules and regulations
- Ensure that plan is being operated in compliance with the plan document
- Collect and review information on service providers
- Perform benchmarking study to ascertain pricing and offerings
- Hire experts if necessary

Service providers

Plan sponsors should reach out to their related service providers for their expertise on the issues

- Actuaries/retirement plan consultants
  - Provide projections of liabilities, assets, contribution requirements, pension expense, etc., before and after considered plan changes
  - Perform sensitivity and/or scenario analyses
  - Discussions around impacts of retirement program redesign(s)
  - Assist plan sponsor with required forms, notices, employee communications
- Investment managers
  - Provide insight on specific de-risking alternatives
  - Recommend alternative asset classes and allocations
  - Perform sensitivity and/or scenario analyses
- Outside counsel
  - Preparation of plan amendments
- Auditors / Tax Advisers
  - Preparation of Audited Financial Statements
  - Align proper reporting of plan liabilities with organization's balance sheets and overall financial reporting
  - Assist with plan filings and any related corrections (if necessary)

Questions and Answers…

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