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Defined Benefit Plans

Plan Sponsor De-Risking Likely to Continue Even With Higher Funding, Practitioners Say

The recent upswing in defined benefit plan funding levels might encourage plan sponsors to take some major steps to de-risk their plans.

The very volatility of which the upturn is a part could convince plan sponsors to make moves, such as purchasing group annuity contracts to transfer pension liabilities or offering lump-sum benefit distributions, practitioners said in recent interviews with Bloomberg BNA.

Pension regulations on plan terminations could also mean that improved funding levels are a catalyst for such steps, while increases in pension insurance premiums might help push the de-risking tide as well, they said.

''What is driving employers to de-risk is not so much their current funded status as it is the volatility in the funding status from year to year for both accounting and funding purposes,'' Kent A. Mason, partner with Davis & Harman LLP in Washington, said in an interview Jan. 16.

''To the extent that the Pension Protection Act takes a more market-value approach to funding and thus caused greater volatility in annual funding, it has no doubt contributed to employer interest in off-loading their plans,'' Norman P. Stein, professor of law at Drexel University in Philadelphia and senior policy adviser to the Pension Rights Center in Washington, said in an interview Jan. 9.

Funding Levels Up. Plan funding levels haven't been this high in several years, according to a series of reports issued in early January.

Towers Watson reported that the funding ratio of the 418 Fortune 1000 companies that sponsor defined benefit plans was 93 percent at the end of 2013, up from 77 percent the previous year and the highest level since 2007 (3 PBD, 1/6/14; 41 BPR 10, 1/7/14).

Milliman Inc. said 2013 was the best year for plan funding improvements in the 13-year history of its Milliman 100 Pension Index, as the funding ratio hit 95.2 percent at year-end, up from 77.2 percent at the end of 2012 (5 PBD, 1/8/14; 41 BPR 76, 1/14/14).

Mercer LLC said that equity market gains combined with interest rate increases wiped out 81.5 percent of the pension underfunding of defined benefit plans sponsored by Standard & Poor's 1500 companies in 2013, with the funding ratio hitting 95 percent at the end of the year, up from 74 percent a year earlier (2 PBD, 1/3/14; 41 BPR 11, 1/7/14).

The atmosphere has been ripe for some of the major and more controversial de-risking strategies. A number of large defined benefit plan sponsors—including General Motors Co., Ford Motor Co. (239 PBD, 12/14/12; 39 BPR 2389, 12/18/12) and Verizon Communications Inc. (51 PBD, 3/15/13; 40 BPR 681, 3/19/13)—have de-risked their plans in recent years by either purchasing group annuity contracts or offering lump-sum distributions, or both.

In a survey conducted in February 2013 by Prudential Financial Inc. and CFO Research, about 40 percent of the finance executives who participated said that they would ''seriously consider'' transferring their plan risk to a third-party insurer in 2014 or 2015 (148 PBD, 8/1/13, 40 BPR 1886, 8/6/13).

The improved funding hasn't changed conditions for such de-risking moves. In fact, in some ways, it might increase the likelihood.

Richard McEvoy, leader of Mercer's financial strategy group, said in Mercer's news release on its January funding report that the improving funding conditions could make 2014 a big year for ''risk transfer strategies such as annuity buyouts and voluntary cashouts to former employees, as improving conditions make these options much more feasible than before.''

Dave Suchsland, a senior retirement consultant for Towers Watson, said in his company's release on its end-of-year report that the ''improved funding environment will provide pension plan sponsors with some intriguing opportunities for 2014. We expect the actions we've seen among companies to de-risk their pension plans over the past several years will accelerate as funding levels continue to improve, especially in light of increases in PBGC premiums and mortality tables, and projection scales with increased life expectancy.''

Different Funding Measures. But the improved funding levels might not be quite all that they seem.

A defined benefit plan must be funded to a certain level to de-risk through an annuity purchase or lump-sum settlement, Mason said.

However, most recent reports of improved funding are based on accounting rules, which use spot interest rates, and not funding level rules, which generally apply an average of two years' prior interest rates, Mason said.

''Funding levels for funding purposes are not as improved'' under the funding rules as they are under the accounting rules, and the levels will fall off even more once the temporary interest rates stabilization provisions of the Moving Ahead for Progress in the 21st Cen-

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tury Act (MAP-21) continue phasing out next year, he said.

Nevertheless, he said, many plans are going ahead with de-risking because of continued volatility of their funding status, coupled with increasing PBGC premiums, especially for underfunded plans.

Higher PBGC Premiums. The Bipartisan Budget Act of 2013, a budget deal enacted in December (247 PBD, 12/27/13; 41 BPR 5, 1/7/14), includes the second set of congressionally mandated increases in PBGC premiums in less than two years (238 PBD, 12/12/13; 40 BPR 2862, 12/17/13). The law increases the flat-rate per-participant premium for single employers to $57 for plan year 2015 and to $64 for plan year 2016, and indexes them to the growth in wages thereafter. Variable-rate premiums will increase by $5 per $1,000 of unfunded vested benefits in plan year 2015 and an additional $5 in plan year 2016, and will also be indexed to the growth in wages after that.

''Increasingly, these higher rates are a material factor'' compelling more plans to explore de-risking, and may over time result in many sponsors no longer offering defined benefit plans, Mason said.

Staying Open. However, some defined benefit plans will view their improved funding as an opportunity to remain open to new hires, Alan Glickstein, a senior retirement consultant with Towers Watson in Dallas, said in an interview Jan. 8. A Towers Watson survey conducted in mid-2013 said that 70 percent of sponsors with open plans indicated they are committed to keeping their plans open, he said.

Many defined benefit plans remain open to new hires, and plan sponsors use this plan status as a tool to attract and retain qualified workers through the promise of a fixed benefit for the duration of the workers' lifetime after retirement, he said.

Glickstein said that plan sponsors heartened by plan funding improvements should review their investment strategy, possibly locking in higher funding levels and taking some risk off the table, especially if the plan is fully funded or close to full funding. He also said that plan sponsors should evaluate the retirement readiness of the plan participants, as well as plan design, and find ways to improve readiness.

Undue Panic. Karen Friedman, executive vice president and policy director for the Pension Rights Center, said in a Jan. 9 interview that plan funding levels are cyclical and respond to increases and decreases in the stock market and interest rates, and that plan sponsors should not panic when their plans are underfunded.

Friedman said that at a recent pension settlement conference she attended, the prevailing discussion was about finding ways for companies to remove pension liability from their books, with little consideration given that these plans provide guaranteed retirement income to workers.

''That's the wrong attitude,'' she said. ''We want pension plans to stay. Participants and corporations should work toward that goal,'' she said.

Next Steps. Friedman said that the Pension Rights Center continues to generally oppose de-risking strategies that involve converting the benefit to a lump sum, especially for retirees, or transferring the liabilities through an insurance company annuity.

''Either employers have to stay in the retirement plan game or come up with new alternatives,'' she said.

''We have to get back to a debate as to why pension plans exist and not make it a debate detached from retirees' interests about liabilities that must be taken off the books,'' she said.

Stein, the Drexel University law professor, said that plan sponsors can keep plans at high funding levels without breaking promises to workers and retirees, for example, by investing in assets that are safe and not risky. He also said plan sponsors should lobby Congress to change the funding rules so that funding is evaluated over a broader period of time rather than as a snapshot.

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