Preparing for a pension plan termination

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The American Express Company established the first private pension plan in the United States in 1875.[1] In the years since, defined benefit (DB) pension plans have provided many Americans with fixed incomes for life after retirement, based on salary and years of service. They peaked in 1985 with 112,000 plans covering roughly 40% of American workers.

In the 30 years since, we've seen major corporate employers such as General Motors and United Airlines terminate their single employer pension plans. And, while pension plans remain a valuable benefit and a differentiator in recruiting and retention, many U.S. companies are freezing or terminating their plans and shifting to defined contribution (DC) models, where employers and employees share the responsibility and cost of retirement savings.

Companies cite various reasons for making this shift, such as reducing costs, enhancing competitiveness, decreasing volatility in funding obligations, and for mergers and acquisitions. Therefore, plans with soft freezes eventually move toward hard freezes, and the desire of most corporate plan sponsors with frozen plans is to move toward termination.

Whatever the reason for the DB plan termination, it's important for plan sponsors to prepare for the process, understand the ramifications, and have trusted advisors who can guide them through it.

This white paper addresses:

- The difference between a freeze and a termination
- Types of terminations
- The path to termination
- The termination process

Terms to Know

Fractional termination: Any distribution or series of distributions of assets relieving liability obligations; a single benefit payment, lump sum window, or annuity placement for groups of participants.

Total termination: A rigid regulatory process ending with a single and complete distribution of all assets of the plan, relieving all plan liabilities, subject to Pension Benefit Guaranty Corporation (PBGC) audit.

Hard freeze: Service accruals stop for all active participants. Assets remain in the plan and are paid out when participants retire or leave, but the participants' benefits do not grow with additional years of service.

Soft freeze: The plan is closed to new entrants while those participants already in the plan continue to accrue benefits.

Deferred vested participant: A former employee who earned vested benefits in a pension plan, but who left the company without receiving a retirement benefit immediately.

Pension Benefit Guaranty Corporation (PBGC): Federal agency created by ERISA to protect pension benefits in private-sector defined benefit plans.

Accumulated benefit obligation (ABO): Approximate measure of a company's pension plan liability.

Accumulated other comprehensive income (AOCI): Unrealized gains and losses flowing through OCI recently as losses/expense charges, and into shareholder equity under GAAP financial accounting.

Pension Protection Act of 2006 (PPA): Legislation that provides for stronger pension funding rules, greater transparency, and a stronger pension insurance system.

1 Employee Benefit Research Institute (March 1998). History of Pension Plans. Retrieved July 21, 2015, from http://www.ebri.org/publications/facts/index.cfm?fa=0398afact.

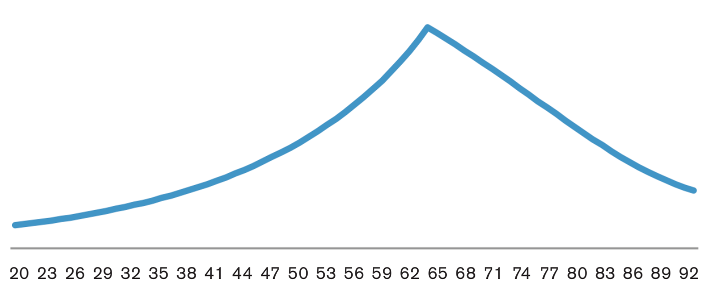
FREEZE, THEN TERMINATE?

Freezing a plan may help reduce long-term cost and volatility, while terminating a plan relieves sponsors of all management tasks and costs.

To say a plan is frozen typically means the monthly pension benefit amount is fixed, no longer growing with service or pay. A pension plan formula typically has a pay component and a service component. When only one of these (as compared with both) is fixed, it is usually only in a transition phase, reflecting grandfathering of benefits perhaps. When both the earnings and service factors are frozen, so that the monthly benefit is therefore fixed as well, the plan is usually called "hard frozen." By contrast, a "soft frozen" plan doesn't fix the benefit formula factors, but rather changes the plan population by closing it to new participants.[2]

More important to the finances of the plan is the value of the benefit, the liability. The benefit itself is a series of cash flows expected to commence when participants reach age 65. A value at any time before that is simply a present value reflecting the time value of money. This tells us several things—for example, for any given monthly benefit amount, the younger the participant the smaller the liability value, and the older the participant the higher the liability value. Said differently, the value of $1,000 of monthly benefit grows as someone gets closer to distribution at age 65, as illustrated in Figure 1.

FIGURE 1: VALUE OF $1,000 OF BENEFIT BY AGE



Once benefit payments commence, the value of the remaining pension declines. A plan whose participant population is weighted toward retirees might see the total liability decline year to year. A plan with few retirees and more active or term vested participants will see liabilities grow year over year. Freezing a plan slows the growth of plan liabilities but does not stop it.

Now let's move on to plan termination

Terminating a DB plan eliminates liabilities through plan asset distribution of lump sum cash outs and annuity purchases. After the successful completion of a plan termination, the corporate DB plan ledger accounts are all zeroed and closed, operations cease, and legal and other risks are mitigated.

So when should a plan sponsor make the move from active or frozen to termination? One answer is when the pain is the least. Further, in addition to the usual circle of advisers and auditors, federal agencies take a keen eye and may come knocking when plans are terminated. The good news is that, when followed prudently, a well-planned termination process will lower risks and pain significantly.

TERMINATION SPECTRUM

When considering a DB plan termination, plan sponsors have two termination approaches—fractional and total. Total termination results in total abolishment of the plan with nothing remaining, neither liabilities nor assets, going forward. It's a total termination because it's the big one, a big bang. It's a serious transaction that requires employers to follow what are perhaps the most stringent time frame and reporting processes facing a DB plan. Its fractional termination brother, on the other hand, offers greater flexibility and, perhaps, a lesser financial impact.

Every time a lump sum is paid, a plan is just a little closer to termination. One example of a fractional termination is a lump sum cash-out initiative, which batches individual lump sums into large groups of lump sums. Over time, numerous fractional terminations can almost add up to a total termination. A one-time total termination takes this further and either offers lump sums or annuitizes all participants at one time.

Two additional points: 1) a terminating plan must be frozen, but a frozen plan need never terminate, and 2) freezing a plan impacts only liabilities, while terminating impacts both assets and liabilities.

Figure 2 shows different stages of a plan termination for both assets and liabilities.

FIGURE 2: BALANCE SHEET LEVERS

STRUCTURE CHANGED	EXAMPLES
Assets	Liability-driven investing (LDI)
Liabilities	Final pay to career average, cash balance, soft and hard freeze
Both	Fractional termination, total termination

2 A hard frozen plan is also closed to new participants.

THE PATH TO TERMINATION

To determine whether a total termination is in the best interest of the plan sponsor, it's important to understand certain key considerations before making the final decision. Each of the factors shown in Figure 3 should be taken into account.

FIGURE 3: KEY CONSIDERATIONS

Economics	Funding / Timing	Income Statement	One-Time Fees	Investment Policy
Participant Data	Plan Document	Benefit Calculations	Annuity Carrier Strategy	Communication

Economics

Cash, of course, is required for plan termination. For example, a legacy plan with $200 million of ABO liability and a $190 million asset market value might need additional cash of $40 million to pay all termination liabilities–three times greater than the net pension liability on the corporate balance sheet.

Timing a plan termination can be like playing a roulette wheel when your number doesn't show up. Some plan sponsors have been wagering on interest rate increases for some time now to little or no avail.[3] Often the decision to bite the financial bullet and terminate comes from boards of directors, often motivated by competitors' actions.

Mortality improvement and longevity risk also come into play. Plan obligations increase with discrete updates of life expectancies such as the current implementation of the Society of Actuaries' RP/MP 2014 mortality table and mortality improvement scale set.[4] Another factor is that a history of successful lump sum de-risking events can lead annuity carriers to assess surcharges in placements, which is due to anti-selection concerns.

Buyer's remorse

Plan sponsors may experience buyer's remorse when they consider the risk that subsequent rate increases might be soon and large, making yesterday's decision a costly one. Lump sum cash-out initiatives had once been interest rate plays but now have grown into ways to reduce exploding PBGC premiums. When assessing cost savings, it's important to consider scenarios of rate increases reducing required lump sum amounts versus a one- or two-year premium payment in the meantime. In this case, a series of fractional terminations, which end with a smaller-bang total termination, might benefit the sponsor in a manner similar to dollar cost averaging.

Waiting out rate increases in some cases might reduce the noncash accounting charge on settlement, which is looming on the corporate balance sheet under the beastly acronym of AOCI–accumulated other comprehensive income. The AOCI entry has emerged in around 30% of pension obligation for many plan sponsors and has substantially risen as interest rates have declined over the past 20-plus years, inflating those obligations significantly. Hoped-for rate increases might reverse these accumulations and lead to lower settlement charges on termination. Recent risk management trends might prevent this, however. Every time a benefit is paid, actuarial losses in AOCI get locked in as those assets and liabilities are no longer available to generate offsetting gains with better-than-expected asset returns or interest rate increases. This is as true in the case of monthly pension checks and lump sum windows as it is in the ultimate termination event.[5]

Funding/timing

While the Internal Revenue Service (IRS), Financial Accounting Standards Board (FASB), PBGC, and consulting firms define liability in many ways, a plan termination is generally concerned with two types of liabilities–lump sums and annuity premiums. These are the two methods to effect a termination, which settles liabilities through a payout of assets.

Terminating a plan requires participants to select between a current lump sum or rollover today, or an annuity contract for deferred future payments. In our experience, we've found that almost all retirees will continue their pensions via an annuity contract with an insurance carrier[6] and the vast majority of non-retirees will select a lump sum or rollover. This ratio nurtures the ability to estimate the gross termination liabilities of the plan, and can be broadened to provide a range of estimates. If termination estimates extend into the distant future, additional assumptions must be made for future interest rates and intervening investment returns and contributions.

With PPA, lump sum values are generally in line with IRS funding target liabilities, though some differences exist. Annuity values, however, are known to be larger than funding liabilities. The difference, ranging from a 10% to 40% additional cost, is due to two factors. First, selling annuities is the carrier's core business, which means a profit must be generated while facing risks. Second, the premium must provide for administration (and other) costs for the lifetime of the contract.

3 It is the author's opinion that waiting to "win" has led many sponsors to lose patience and begin fractional terminations even in light of the seemingly unfavorable economics–thinking that something, anything, needs to be done.
4 A brief window currently exists before the Internal Revenue Service (IRS) is expected to update regulations requiring use of these new tables for either or both minimum funding requirements under IRC §430, and lump sum determinations, under IRC §417(e).
5 Obviously, this changes as settlement account thresholds are breached and those losses re-class and become "chiseled in stone," resulting in debits to retained earnings.
6 Generally, retirees have already selected their benefit forms and are not given another opportunity to choose. They simply have an annuity bought for them.

In the end, assessments need to show the range of likely cash contributions, noncash accounting charges,[7] and administrative costs[8] involved with terminating the plan. They can be prepared for each year into the future using some set or sets of assumptions. Experience shows that extraordinary noncash charges might be readily explained away to shareholders, but a commitment of a large chunk of cash is tougher to do, away from capital expenditures for example.

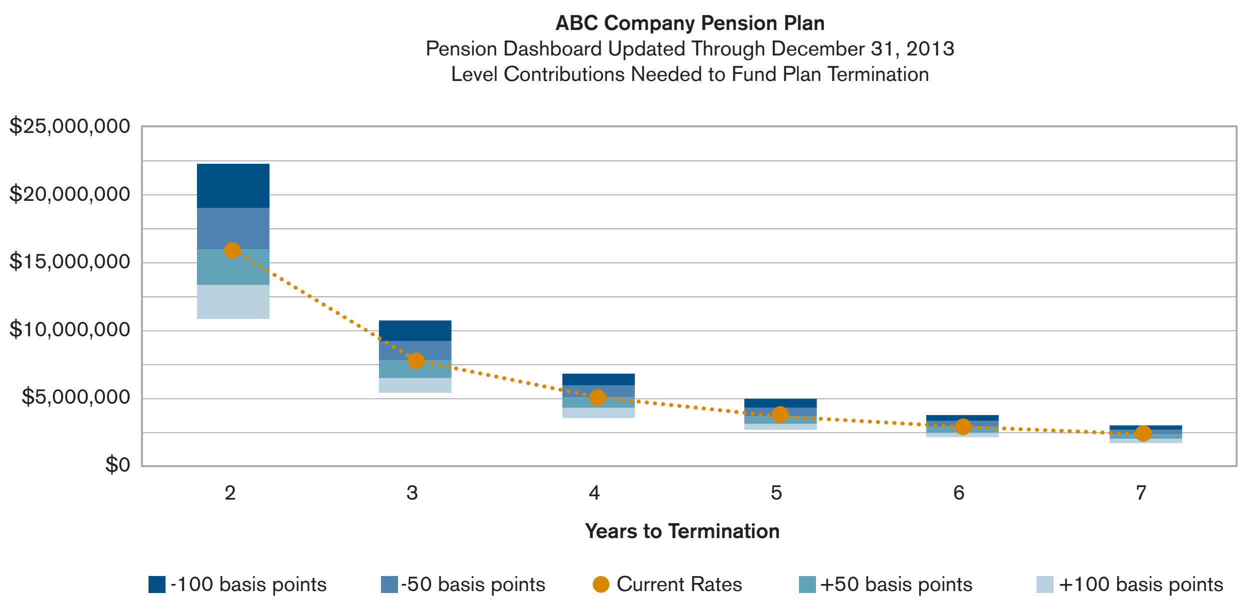
When planning for a termination, it's important to assess both the time frame for termination and the amount of cash to commit in the budget. The graph in Figure 4 shows an example of a company that needs about $8 million in each of years 2 and 3 to be fully funded and able to terminate at the end of year 3. But we can also see that if the company can only commit to $2.5 million in annual contributions, then it can terminate at the end of year 7. This type of assessment allows the plan sponsor to select a termination horizon based on the annual cash contribution level that best supports the budget.

Word to the wise: An actuary with broad experience in plan freezes and terminations can help plan sponsors assess funding requirements and time horizon for a plan termination.

Example

Let's say we have a 35-year-old employee with a vested benefit who selects an annuity purchase upon termination. Ongoing administrative fees for a pension plan are typically slightly less than 1% of assets per year. The annuity carrier needs to bundle all future years' expected administrative fees up front into the annuity premium to pay for future contract services, even though the plan actuary doesn't bundle them into funding liabilities under PPA.[9] That makes the present value of a lifetime of annual 1% costs about 25% for our sample employee, translating into a carrier's expense charge of 25%[10] above the benefit value itself. Lump sums only provide the net value while annuity premiums must provide the gross value to deliver the benefit.[11]

FIGURE 4: PENSION PLAN EXAMPLE



Note: The first year's contribution is fixed. The range on the bar in each year shows the sensitivity of required contributions to interest rate changes.

7 The premium carriers charge over and above the lump sum value adds to unrecognized losses.

8 These include costs of the termination process itself, but also savings related to lower PBGC premiums, audit fees, actuarial expenses, and administrative costs, which might be soft internal resources. These latter expenses are comparable to the extra cost related to purchasing annuities.

9 Under PPA, we add to normal cost the amount of expenses expected to be paid from trust assets in the upcoming year, but the liability, the funding target, is not reflective of these expenses. Some companies include such a gross up in the projected benefit obligation (PBO) liability but not many.

10 Current mortality and a modest 3¼% interest rate produce a life annuity present value of approximately 25. The current 10-year Treasury rate is closer to 2% and if used as a carrier pricing proxy, the present value and hence expense charge would be much higher.

11 A lump sum has a one-time administrative charge, that of writing the check or wiring the rollover, and is borne by the company.

Income statement

Large defeasance events such as a plan termination trigger an accounting event called a "Settlement." Such accounting requires the unrecognized actuarial losses, which have accumulated over the life of the plan and typically amount to around 30% of plan liabilities (though ranging widely), to be reclassified through net income from one side of the shareholder equity bucket (AOCI) to another (retained earnings). The existence of these losses in AOCI is a sign of the times, as valuation interest rates have declined for decades, delivering poor investment "returns."

Indeed, an ongoing supposition among sponsors is that such rates will soon rise, thus reversing these losses via other comprehensive income (OCI) rather than expense.[12] Rates may very well rise before termination, dramatically lowering liability values relative to asset values, possibly leading to an overfunded plan. This view should be tempered by two facts. First, investment markets might not like the broad environment generating the rate move and deliver lower asset returns. Second, the key liability measure in a termination environment must reflect some estimated annuity premium above that of funding liabilities and lump sums.[13]

Most DB plan sponsors now reflect a large AOCI debit for unrecognized actuarial losses, which for some plan sponsors approaches 30% of plan obligations. Distributing lump sums and annuities in bulk causes immediate recognition of them as OCI credits and net income debits. That is, the company takes a noncash accounting charge on its income statement.[14] Absent a Settlement, they would otherwise have been re-classed over some[15] future period. On the one hand, accepting a Settlement now means forever locking in reduced retained earnings. On the other hand, higher interest rates might organically reduce these losses via interest rate[16] gains.[17]

One-time fees

Plan sponsors generally engage a team of outside professionals in both the path to termination and the termination process itself. While these professionals, such as those shown below, may already be involved with the plan, the plan sponsor will incur additional one-time fees for the termination project.

- ERISA attorney
- Plan fiduciary
- Plan actuary
- Plan administrator
- Communicator
- Annuity broker
- Annuity carrier
- Custodian

Many sponsors outsource virtually all of the day-to-day plan administration to pension experts whose termination experience, skills, systems, and resources far outweigh those available in-house. These experts perform tasks such as:

- Cleaning up incomplete historical participant data sets
- Calculating and certifying benefits
- Locating missing participants
- Developing employee communications, required notices, and notifications

Even when services are outsourced, internal resources will play a critical role at key decision points such as changing financial factors and contingencies, delays that are due to data issues, and gaining necessary approvals from management or the board of directors, etc.

Therefore, sound project management is key. Solid work plans and time frames should be developed and managed with teams involved with its success.

Investment policy

When a decision to terminate is made, the plan's time horizon dramatically shortens. This has direct impact on the investment policy. In the extreme, this means that sponsors will need to liquidate all assets at minimal loss at the right time at minimal expense. Investment advisors will work with the actuaries to understand time frames, cash flows, and risks involved to shift the policy toward its new goals. Contingencies include distributing assets in lump sum windows, small tactical annuity placements, in-kind asset transfers, and other preparatory security positioning. If not in place or only partially implemented, an LDI framework and accelerated allocation canon will be evaluated. Illiquid investments need to be scheduled for disinvestment in the most beneficial manner to the plan.

Word to the wise: Good communication with custodians is also critical. They will require lead time to prepare for the generally large volumes of checks and transfers to come, and need good files to indicate participant elections and instructions.

Participant data

Because termination means distributing assets to everyone in the plan, everyone in the plan must be located—dead or alive. Regulatory guidance requires that a diligent search be done to attempt to locate missing participants. Indicative data elements impacting the calculations of benefit amounts should be finalized, and the benefit

12 Another view is that rates won't decline further, therefore lessening any pain to the wait-and-see position.

13 Some observers relate annuity premiums to GAAP ABO measures; in this case, however, funding liabilities were used to avoid pension relief variances and incorporate current rates.

14 Many other strategies exist, such as spinning off the retiree group into its own plan and then terminating the left-behind plan at a lesser (fewer annuity premiums) cost. Presumably, one could poll participants on their choice between an annuity and lump sum and spin off all annuity electors into their own plans to wait out interest rate increases while terminating the other plans with lump sum distributions.

15 Most frozen plans use a period equal to average future life expectancy, around 30 years.

16 Other sources of gains might be realized, such as asset returns, mortality, etc. Interest rates are generally the most expected gain source.

17 Even in the case of no settlement, distributions of any size lock in the losses historically attributed to them, with recognition coming at future settlements, regardless of subsequent gains on remaining obligations and assets.

amounts need to be certified as accurate by administrators.[18] Sufficient lead time must be allocated so that all data issues are sufficiently resolved when statutory notification processes begin and so that increasingly fine-tuned liability estimates can be put together to update the plan's financial position. The plan sponsor and its ERISA counsel will determine the approach to handling those participants who left the company in a non-vested status but who have yet to incur a five-year break-in-service, referring to the plan language and regulations for guidance.

Word to the wise: Carrier quotes will also reflect the accuracy, real and perceived, of the data provided to them. This single largest job in a plan termination must not be shortchanged or left poorly managed. That's why it is important to partner with a defined benefit plan administrator who can clean up your data and calculate benefits using an automated, streamlined process to ensure accuracy.

Plan document

Freezing plan benefits and terminating a plan both require appropriate plan language and execution of amendments to the plan document. ERISA counsel should clearly document sponsor intentions into the plan and have the plan comply with the latest federal requirements. Don't forget: Amendments freezing plan benefits also require timely disclosure notifications to plan participants.[19] If this step has not yet been taken, sponsors can gain efficiencies by combining required freeze notices and communications with those required for termination.

Word to the wise: A key decision regarding the plan document is not whether to submit it in final form to the IRS in requesting a final determination letter but rather whether to wait on IRS approval prior to moving forward and distributing assets. This decision significantly affects termination process timing. Obtaining the optional, final determination letter prior to asset distribution is prudent risk management but adds several months to the overall process.

Calculations

Administrators, with complete and accurate participant data in hand, will complete any outstanding benefit certifications for all participants, including those required for alternate payees under qualified domestic relations order (QDRO) offsets. Actuaries then will reflect any changes to benefits and lump sum interest rates (and perhaps mortality tables) and carrier quotes to update plan termination liabilities and the plan's net funding position. After data is received, gross termination liability updates take only a few days when carriers have been properly partnered into the process. The update process continues as data changes are reflected, the lump sum basis changes, investment returns vary, time passes, and the plan continues to operate. The actuary and sponsor will also update funding strategies.

Annuity carrier strategy

All DB plans are required to offer participants an annuity upon plan termination, except for participants with very small benefits, so annuity carriers and placement brokers will be involved.

Annuity brokers

Annuity brokers act as intermediaries between the plan sponsor and the half-dozen insurance companies that make up the annuity placement market. Annuity placement specialists usually act as fiduciaries to the plan when placing an annuity. Following the U.S. Department of Labor regulations, guiding the selections of safest available carrier for each placement make up the core of their services. These services are supplemented with bidding techniques that solicit competitive pricing from the carriers. These specialists have experience with the carrier data requirements to assure that missed information exchanges do not lead to higher risk charges in the annuity premium. They get involved in early marketplace quotes to assist with first estimates of market pricing, sometimes identifying participant subgroups that might be attractively priced. They continue to work for the plan toward a smooth final placement and exchange of data with the carrier to complete the transaction, with periodic payments established and annuity certificates placed in participant hands.

Asset-in-kind (AIK) transfers

Many DB plans hold a large portion of their asset portfolios in long corporate bonds, driven perhaps by LDI strategies. In these cases, asset-in-kind (AIK) transfers can be negotiated with carriers to accept the direct transfer of approved securities from the plan's trust to their accounts, passing along some of the resulting savings. Generally, carriers want to hold some of the same assets of the plan as financial backing to the annuity contract, especially when following an LDI approach.

AIK transfers can reduce carrier risks and cost—and hence sponsor costs—by:

- Keeping their funds invested from day one, thereby avoiding lost opportunity when accepting cash premiums and taking a while to get those funds invested
- Avoiding transaction fees
- Better situating ERISA plans to buy and sell securities without concern for taxes, which is not the case for an insurance company

Word to the wise: Placement specialists and other specialized advisors work with carriers to identify acceptable assets to be part of an AIK. Identifying acceptable portfolio repositioning takes time and research, so be sure to build it into the time line.

Communication

Robust participant communication is essential for a successful termination, as it impacts employee attitudes and actions as they transition from the outgoing retirement program to the new, ongoing program. Because this change impacts a sponsor's total rewards strategy, it's important to leverage the termination campaign to not only communicate the changes, but to educate participants about other employer-sponsored programs that can help them save for retirement.

18 Such as gender, date of birth, service, pay history, etc.

19 For example, notice and disclosure requirements required under ERISA §204(h).

Converting regulatory "model" notices into engaging, user-friendly communication takes a seasoned professional. All materials should align with human resources and benefit department branding efforts. Call center resources should be in place and prepared to handle the influx of participant questions. In addition to print media and employee meetings, the employee base may respond well to other technology-based communication methods integrated into the strategy.

Standard termination process

More than one federal agency is involved in the plan termination process, but the PBGC has the single greatest involvement. Strict procedures and time frames are regulated, along with model notices. Under a standard termination, the plan sponsor commits to funding all accrued benefits under the plan.

The termination process usually takes 12 to 18 months from start to finish, assuming the sponsor commits to fully fund the plan, data is clean and complete, and the plan is already hard frozen.

However, the process can be shortened to five months with some bundling of notices and filings and if the plan sponsor and counsel decide to distribute assets without waiting to receive the IRS determination letter.

Note that the plan sponsor can stop the process at any time.

If IRS determination letter requested

The process shown in Figure 5 assumes that plan has already been frozen and the plan sponsor has requested an IRS determination letter.

FIGURE 5: TERMINATING A PENSION PLAN

1. CORPORATE RESOLUTION AND PLAN AMENDMENT TO TERMINATE
   - ▶ No required timing
2. ISSUE NOTICE OF INTENT TO TERMINATE (NOIT) AND NOTICE OF STATE GUARANTY ASSOCIATION COVERAGE OF ANNUITIES
   - ▶ 60-90 days before proposed termination date
3. ISSUE NOTICE TO INTERESTED PARTIES FOR IRS FILINGS
   - ▶ 10-24 days before IRS filings
4. REQUEST DETERMINATION LETTER (IRS FORMS 5310, 6088)
   - ▶ Before PBCG Filing
5. FILE STANDARD TERMINATION NOTICE (IRS FORM 500)
   - ▶ On or before 180 days after proposed termination date
6. PROVIDE NOTICE OF ANNUITY INFORMATION
   - ▶ If any benefits distributed in annuity form
   - ▶ No later than 45 days before asset distribution
7. DISTRIBUTE BENEFIT ELECTION FORMS
   - ▶ At least 30 days before asset distribution
8. DISTRIBUTE ASSETS, PURCHASE ANNUITIES
   - ▶ Later of 180 days after expiration of PBGC 60-day review period or 120 days after receiving a favorable IRS Determination Letter
9. FILE POST DISTRIBUTION CERTIFICATION (PBGC FORM 501), SEND NOTICE OF ANNUITY CONTRACT
   - ▶ No later than 30 days after final asset distribution
10. FILE FINAL IRS FORM 5500
    - ▶ No later than 7 months after complete distribution of assets

Assumes Standard Termination of frozen plan with optional IRS Determination Letter filing.

Source: PBGC Standard Termination Filing Instructions

SUMMARY

For plan sponsors who are considering the termination of their defined benefit pension plans, the decision requires significant due diligence and research, along with the help of trusted advisors, to assure that a fully informed decision is made. Much diligence must be dedicated to understanding the options and the process required to execute that decision. Before stepping forward on the path to termination, successful plan sponsors should take the time to prepare, to understand key considerations, and to consult with trusted advisors for guidance through the complex pension plan termination process.

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