Is your defined benefit plan ready for termination?

By Charles Cahill & Kevin Morrison

All good things must come to an end, and the end for every defined benefit plan that is closed to new participants, or has frozen benefit accruals, is settling its liabilities in a plan termination. The challenge facing plan sponsors is understanding when termination will occur and what needs to be done leading up to that final day. In other words: what do frozen plan sponsors need to do to make "the end" a good one?

This article digs into four critical areas that plan sponsors need to assess so they can plan for a smooth plan termination, i.e. a good end.

First, what is the plan's funded status on a plan termination basis? The cost of terminating the plan is different from the accounting or funding bases sponsors wrestle with each year. Understanding the true cost to terminate is critical to knowing how close you are to "the End".

Second, how much funded status risk does the plan carry? Every defined benefit plan faces a myriad of risks that can affect the funded status, including changing interest rates, volatile investment markets, demographics, and regulatory changes. These risks provide opportunity to plan sponsors. But, as the plan nears full funding, these risks need to be brought down and eventually eliminated. If they are not, sudden changes in interest rates or stock markets can set you back years on the road to termination.

Third, is the plan administration clean? Defined benefit administration is complicated and includes many facets (e.g. forms, notifications, and plan documents). These facets will all come under scrutiny by the regulatory agencies as part of the plan termination. Almost all plans have some minor issue that needs to be addressed. Minor issues can create major headaches if they are found during the plan termination process, rather than before. Major issues can stop a plan termination.

Fourth, is the data complete? There is a lot of data needed to go through a termination. Ideally, plan sponsors will have all the pieces (e.g. pay and service histories) that were used to calculate benefits, complete census information, beneficiary data and every participant's current address. Compiling any missing information will take a lot of time and effort and should be done before starting the termination process.

Funded status - things to understand

The plan's termination liability is different than the numerous liabilities plan sponsors see annually. Understanding the true cost of termination allows sponsors to understand the financial shortfall for termination and to build a plan for funding and accounting for that shortfall. Each year your actuary calculates different liability amounts for different purposes: minimum funding requirements, PBGC premium calculations, plan audits, and financial reporting. Each of these liability measures is different since each is used for a different purpose and is subject to different rules and requirements. However, when planning for a plan termination the only liability that matters is the cost to fully settle all the plan's obligations.

The cost of terminating a plan is the amount that is needed to settle the plan's obligations (aka the liabilities). Typically, settlement is achieved through a combination of lump sum distributions and annuity purchases. Lump sum payments are first offered to active and terminated, not-in-pay participants. These participants cannot be forced to take a lump sum (unless their benefits are very small) and must be given the opportunity to elect to have a deferred annuity purchased by the plan. Retirees can also be offered lump sums as part of a plan termination but the large majority of sponsors do not choose to make these offers for a myriad of good reasons. The sponsor will purchase an annuity from an insurance company for all remaining participants – in-pay participants (e.g. retirees and beneficiaries) and the not-in-pay participants who did not elect a lump sum payment.

The total cost of plan termination will ultimately depend on how many participants elect a lump sum and the cost charged by the insurer for the annuity purchase. Depending on plan provisions and complexity, lump sums are typically between 10% - 40% cheaper than purchasing deferred annuities from an insurer. The percentage of participants who elect a lump sum when offered (the "take rate") varies but is usually well above 50% and sometimes can be close to 100%.

The annuity purchase premium for retirees is driven by demographics and market conditions. For deferred annuitants, the premium will also depend on plan provisions, as subsidized benefits and complicated features will increase the purchase cost. The higher the subsidies and the more complicated the plan the higher the purchase price. Sponsors should note that some plan features may not be protected by ERISA and some other complicated provisions are unnecessary. Removing these provisions may make the plan easier to terminate (see Plan Administration section below).

Some actions to consider:

Funding costs: Sponsors can understand the range in the cost of the plan termination by modelling termination liabilities under different lump sum "take rate" assumptions. This allows plan sponsors to understand the range of costs to fully fund the plan and devise a plan for funding the deficit immediately or over time.

Financial impact: It is also important to understand the potential financial reporting impact due to fully settling liabilities, which will differ under various accounting standards. Under US GAAP an unrecognized loss must be fully recognized when the liabilities are settled. This can be a big number and a big surprise – more good information to know ahead of time.

Annuity buyouts: The annuity markets are impacted by the interest rate environment and market conditions. Sponsors can buy annuities for retirees before plan termination. Increases in interest rates or new entrants to the annuity market can provide opportunities to lower the cost of termination.

Funded status risk

A plan's funded status is subject to interest rate, investment, and regulatory risks. Understanding and appropriately mitigating these risks is important as the plan progresses toward plan termination. A fully funded plan with an inappropriate asset allocation can quickly find itself in a poorly funded position due to changes in interest rates or a fall in the stock markets.

Most funded status risk is associated with the pension plan's asset allocation. Assets can be thought of as being in one of two buckets: liability matching and return seeking. Liability matching assets are a mix of fixed income securities that closely match the duration and cash flow characteristics of the plan's liabilities, so when interest rates change the liabilities and assets change in synch. All other plan investments are return seeking assets that are intended to outperform the liability growth. Return seeking assets take on risks to accomplish this outperformance and lower the amount of contributions the sponsor will need to reduce the plan's unfunded liability.

The allocation between liability matching and return seeking assets should be appropriate based on the plan's funded status and the plan sponsor's funding policy and risk appetite. As the plan's funded status improves, sponsors no longer need to take as much risk. Once the plan is fully funded on a plan termination basis then there is no reason at all to have any material investment risk in the plan's portfolio (i.e. 100% of assets should be invested in liability matching assets). Note that the correct liability-matching portfolio is likely to change significantly in the final year before plan termination and it takes an investment advisor with an intimate knowledge of the plan termination process to understand how to respond appropriately.

Sensitivities to specific economic risks should be measured by analyzing the investment portfolio in tandem with plan liabilities. Only by measuring those risks can plan sponsors make informed decision about how much risk they can bear.

Sponsors should also continue to review economic and regulatory environments to reduce their liability risks. Risk transfer strategies (i.e. lump sum offerings and annuity purchases) can be implemented in the years leading up to plan termination to lower ongoing costs and reduce overall risks. These should be prudently considered as interim steps toward an eventual plan termination.

Changes to the investment allocation can be implemented and risk transfer strategies considered immediately. Risks should continue to be monitored going forward as changes in funded status and market conditions may necessitate future changes.

Action items: Plan sponsors should measure the risks they have in the plan and be able to answer some important questions: How sensitive is my funded status to changes in interest rates? What would happen to my plan under various economic conditions (e.g. "flight to safety", stagflation, bull market)? How will my asset allocation change as funded status improves? How will plan contributions be invested? What risk transfer strategies should I implement and when? How should my assets be managed differently in the final year of the plan's existence?

Plan administration

Before starting a plan termination sponsors will want to make sure the various aspects of the plan's administration are buttoned up tightly. These aspects are numerous and include documents (the formal document and summary plan description (SPD)), election forms, notices, and benefit administration. It is hard to keep all these details perfect. As part of the plan termination the PBGC and IRS will review documents, notices, and election forms. Many, if not most, plans will be audited by the PBGC (all plans with more than 300 participants) or the IRS (or both!) either during or after the termination. Time and money will be saved by identifying any issues before the termination process begins. Issues that arise during the plan termination process can slow down or potentially stop the process.

Some aspects to consider:

Plan documents: Technical required regulatory amendments that have little or no impact to the plan are often missed. The plan document should also contain language specific to a plan termination (e.g. annuity purchase, asset reversion, non-vested terminations, etc.). SPDs need to be updated every 5 years – even frozen plans. You should consider having your plan document reviewed by ERISA counsel to ensure all necessary provisions are included. This is especially important now that the five-year determination cycle has ended.

Benefit provisions: Ancillary benefits that exist within your plan can scare away annuity providers and result in a higher cost to terminate. Certain unprotected provisions can be amended out of the plan to mitigate this impact. This maximizes the number of annuity providers interested in the purchase and helps reduce the purchase cost. Benefit accruals will need to be frozen for all participants prior to beginning the plan termination process and participant notices need to be sent prior to freezing benefits.

Plan administration: Even well run plans can fall into traps. Election forms get stale with time and need to be compared against the plan document to ensure consistency. Vested terminated participants disappear but should be put into pay status once they reach their minimum required distribution date (typically around age 70.5). Proper spousal consents can also be difficult to obtain if they weren't originally done correctly.

Action items: Sponsors should audit all aspects of their plan administration. Are the plan documents up-to-date and ready for termination? Are the administrative forms complete, consistent, and compliant? Have the benefits for all participants been properly administered? Are all plan provisions required to be maintained? Reviewing and amending provisions now will better position the plan and help expedite an eventual plan termination. The plan document review may also identify unnecessary or over complicated provisions that can be removed to lower the cost of buying annuities. Discovery of a document or operational failure as part of an IRS or PBGC audit during the plan termination process could cause serious delays and jeopardize its completion.

Data quality

A smooth plan termination requires having complete data and there is a lot of data that is needed to successfully terminate a pension plan. In order to administer an ongoing plan you need to have very good data but for plan terminations it needs to be as close to perfect as possible. Sponsors need to be able to communicate with each and every participant and need to provide detailed information on each participant's benefits.

Each participant will receive a Notice of Plan Benefits (NOPB). For not-in-pay participants this notice will need to include the historical data that supports the benefit they earned in the plan. For in-pay participants, the benefit amount, form of payment, and beneficiary information will need to be communicated. Missing or inaccurate information can cause delays and serious problems upon plan termination. The PBGC will review the NOPB making it critical that it is complete and accurate.

On an ongoing basis contacting participants, including terminated vested participants, is necessary to ensure benefits are paid on time and required notices are distributed. Often these terminated vested participants fall off the radar. Contacting participants is essential during the plan termination process to ensure that required notices are received and benefit elections can be made and processed. While return mail is an obvious indicator of bad addresses, this only covers a subset of this population. Address searches and outreach campaigns can find additional address issues and ensure all participants are reachable during the plan termination process.

Timely notification of participant and beneficiary deaths is necessary to properly administer death benefits and measure liabilities. Most plans only rely on notification from the participant or the estate for this. It may not be critical to keep track of spousal deaths when a retiree is still in pay status. At termination missing beneficiary information can result in overpaying benefits and overstating liabilities. Death audits should be performed to avoid these situations. The process of cleaning this up after a failure occurs is often much more time consuming than ongoing prevention processes.

Action items: In advance of plan termination, a detailed review of participant data, including the quality level of accrued benefits, addresses, and demographic information, should be performed. Missing information should be noted and accrued benefits certified. It will be easier to improve the data quality and find missing information now than it would be at plan termination. Death audits should be performed to true up beneficiary information and verify whether terminated vested participants are still alive. The process of cleaning up this data during the termination is more time consuming and could lead to overfunding.

How do I know if I'm ready to terminate?

As we've discussed in this article, there are a number of areas plan sponsors need to assess before embarking on the actual plan termination process. Evaluating the plan's funded status on a plan termination basis is a necessary first step. But it is also necessary to focus on other matters than can impede the termination. Sponsors will also want to:

- Assess funded status risk and devise a plan for mitigating risks as the plan gets closer to terminating;
- Clean up and verify plan administration including election forms, notices, and plan documents; and
- Ensure that all necessary data is collected and validated.

Getting prepared for a successful plan termination takes time and effort. Neglecting any of the steps above can jeopardize a plan getting to a good End.

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