The Defined Benefit

Pension Rescue Plan

by Ronald H. Snyder, JD, MAAA

Does your company maintain a defined benefit pension plan?

Would you like to terminate that plan?

Is the plan underfunded (i.e., less assets than plan termination liabilities)?

Have you shopped for terminal funding annuities?

Have you valued your PBGC termination liability?

If you answered "yes" to 3 or more of these questions, you have a pension plan problem and need a defined benefit pension plan rescue.

HOW DID WE GET HERE?

Over the past 30 years defined benefit pension plans have lost popularity among employers. This trend is due to a number of factors:

a) Laws and IRS regulations which impose substantial burdens upon such plans;

b) The open-ended requirement to fund at an actuarially-determined level without regard to the employer's financial condition;

c) A need to be competitive in the marketplace with competitors who have gone to a 401(k)/defined contribution retirement model for their employees.

In fact, many defined benefit plans would terminate today if they could afford to. Let us examine the foregoing factors in detail.

LAWS AND REGULATIONS

Burdens added to defined benefit plans (only) over the past generation include:

1. Minimum benefit accruals for top-heavy plans;
2. Inclusion of all employees of all entities in a controlled group for testing purposes;
3. Minimum benefit accrual requirements;
4. Minimum vesting requirements;
5. Imposition of a narrow range of actuarial methods and assumptions;
6. A "1.0" rule (now withdrawn) which severely limited defined benefit/defined contribution plan combinations;
7. Imposition of a interest rate requirement based on actual (formerly) and hypothetical (currently) Treasury security interest rates for benefit cashout purposes (including upon plan termination);
8. Involuntary membership in and coverage by the Pension Benefit Guaranty Corporation for plan termination insurance, necessitating a significant premium payment, and
9. Retirement benefits have neither favorable income nor estate tax treatment.

CONTRIBUTION LEVELS

When an employer adopts a defined benefit pension plan, it is aware that an annual contribution is required. The employer may even have actuarial projections to estimate and budget for contributions for future years. What the employer learns, however, is that the best laid plans of mice and men often go awry. The employer or its actuaries may not have anticipated:

- jobs with lower compensation levels being moved offshore and out of the plan;
- the fact that the group's average age would continue to increase as baby boomers work toward retirement;
- stock market fluctuations;
- changes in laws and regulations such as those mentioned above;
- the transition competitors are making from defined benefit to defined contribution based retirement plans;
- that its business was not prepared for a major recession;
- problems with suppliers;
- changes in the marketplace from in-person to internet;
- the increase in terrorism, hurricanes, flooding, earthquakes, tsunamis and other disasters;
- the effect of new technologies, and/or
- the era of corporate buyouts and mergers.

Yet the requirement to fund at an actuarially-determined level each year goes on notwithstanding these factors. The actuary calculates the minimum contribution level and the employer makes the contribution to the plan, whether or not it can afford it. In fact, approval from the Federal government is required to skip a contribution for a year.

EMPLOYEES' EXPECTATIONS

While most union members still tend to prefer defined benefit pension plans, most employees' expectations are now that they will have an "account" that they can manage. The account will consist of personal salary deferral contributions (with attendant investment results) plus whatever contribution the employer chooses to make for its employees (profit sharing, a 401(k) match). An employer which makes a matching contribution to the 401(k) is now regarded as desirable. In other words, employee's expectations have been lowered.

Employees never really understood defined benefit pension plans in the first place. And most employees under age 50 were much more worried about a potential rainy-day fund (hardship withdrawals or participant loans) than they were about retirement anyway. So employees never gave employers credit for a defined benefit pension plan, no matter how good it was for them.

THE RESULTS OF THE CHANGES

During the 1980s many Fortune 1000 companies began to replace their defined benefit plans (at least for new or blue collar employees) with defined contribution plans. The 1990s saw small and medium-sized employers jump on board. These employers would tell their employees what a wonderful matching contribution they would make to the updated 401(k) plan while saving 50% or more on pension costs.

Those employers who made the transition from defined benefit to defined contribution models have not looked back. However, many employers failed to "catch the wave" as it were.

WHAT ABOUT EMPLOYERS WHO STILL MAINTAIN DEFINED BENEFIT PLANS?

In some cases defined benefit plans may still be a good deal. For example, for some small companies, the tax savings for the defined benefit pension plan is enough to cover the cost of covering rank and file employees. Therefore, it is still a good deal for the employer.

However, it is more common that employers who maintain defined benefit plans now desire to terminate their plans but are unable to because:

1. They were so busy trying to stay afloat they failed to get around to terminating their pension plan, or
2. They were invested in the stock market until 2008 and lost 40% or more on their investments. They then chose to change investment approach to minimize losses and have not earned enough to recover their losses, let alone fund benefit liability increases.

In either case their defined benefit pension plan is significantly underfunded and unable to terminate because the employer lacks the financial ability or will to make up the funding deficiency.

DEFINED BENEFIT RESCUE STRATEGY

What can these employers do? A rescue solution is available to them, based upon proven principles.

> **Principle #1**
>
> A liability for a future amount due has a higher present value at lower valuation interest rates and a lower present value at higher valuation interest rates.

Termination liability is a moving target that constantly requires redetermination. Investment gains and losses, mortality gains and losses and other factors affect the present value of benefits payable. The greatest variable in such valuation is in the interest rate assumed. Insurance companies which issue quotations on terminal funding annuities use current interest rates in determining the cost of providing such an annuity to a terminating pension plan, while pension plans are locked into using Treasury rates.

Yet we see that General Motors sold off its pension liabilities and recorded a profit.[1] This was due to the fact that Prudential, who purchased the liability, can arbitrage investment returns. If GM asked them for a terminal funding annuity, they would quote it based on a 4.0%-4.75% discount rate, the going rate offered by insurers. However, by purchasing the liability (and attendant assets) Prudential can use its own investment return rate for funding purposes. And it knows that by using a prudent investment strategy, it can earn an investment return more like 6.75%-7.5%. Therefore, the value of the liability is billions less at their discount rate than at a rate they would guarantee.

Small companies can avail themselves of similar strategies.

> **Principle #2**
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> Even if you don't have $26 B, there are still ways to get the advantages of insurance company guarantees and investment returns.

Companies which have less than $50 M of pension assets may have the same problems as General Motors but lack the negotiating strength of Fortune 1000 companies. However, they can still use strategies similar to GM, but more appropriate to their position:

1. They can submit their underfunded plan to several insurance companies for terminal funding annuity quotes;
2. They can negotiate a sweetheart deal with an insurance company, and/or
3. They can simply create their own insurance company.

Few people are aware that for a few thousand dollars, a company can establish its own "captive" insurance company and that captive insurance company can issue a terminal funding annuity contract. While such arrangements are not common and don't *necessarily* get the employer off the hook for the underfunding, the approach includes several inherent advantages to the employer/plan sponsor without decreasing protections that employees enjoy under ERISA (the Employee Retirement Income Security Act of 1974).

Since pension plans are regulated by the U.S. Department of Labor, such changes to a pension plan must be reviewed and approved by the DOL. However, the DOL is convinced of the validity of such arrangements and has now provided an expedited approval process.

ADVANTAGES OF CAPTIVE INSURANCE ARRANGEMENT

Use of a captive insurance company to provide a vehicle for transitioning from an active defined benefit pension plan to a terminated plan for which the employer has no further responsibility proves effective in several ways:

1. It permits the employer/plan sponsor to move the unfunded liability on its audited financial statements from a liability to a footnote item.
2. It permits the plan to employ insurance company rules rather than pension rules and actuarial assumptions in valuing its liabilities.
3. It permits freezing accrued benefits as of a specific date, with no accruals thereafter.
4. It permits use of sophisticated investment strategies available to institutional investors ("qualified purchasers").
5. It simplifies the ultimate plan termination procedure with the PBGC.

INVESTMENT RESCUE STRATEGY

In order for any rescue strategy to be successful, it has to assure that investment returns equal or exceed the assumptions used. The rescue strategy, therefore, utilizes a cross-section of investments with various strategies and investments which have realized average returns of not less than 6.6% per year over the past 10 years. Such investments also must provide low (or offsetting) volatility and enjoy stable fund management.

Investment strategies include all of the equity investment styles (large, medium and small growth, value and blend funds) as well as fixed interest returns, international investments, multi-strategy funds, bond funds, and other hedge funds and ETFs.

Investors choose from among 20+ approved investments which meet our investment guidelines, with diversification which will reduce market risk and volatility. We require no fewer than 10 different investments with minimum and maximum percentages applicable to each one.

These funds have been vetted by a major A+ rated US life insurance carrier for performance and compliance with our criteria.

INVESTMENT OPTIMIZATION STRATEGY

In order to optimize investment returns, we have arranged for one of the top 5 banks in the world to provide low cost, asset-backed loans to enhance investment returns under appropriate circumstances. This has the potential to increase overall investment returns by approximately 50%.

CONCLUSION

As General Motors showed us, an underfunded defined benefit pension plan is a liability which can be turned into an asset which can then help overcome the underfunding. Using experts to implement the ideas set forth herein is a major step towards realizing that goal.

[1] Forbes reported that "Pension accounting is a volatile business, and depends on market returns, discount rates and worker mortality rates. Despite steady cash and stock contributions over the years, as well as a shift toward a more stable asset mix, GM's global pension plans are still $25 billion short of the company's expected obligation to current and future retirees." 6/01/2012, *GM Unloads $26 Billion in White-Collar Pensions*

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