

Terminating your DB Plan

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The past decade has proven challenging to many defined benefit sponsors to say the least. Regulation changes, interest rate fluctuations and investment declines leave sponsors questioning the viability of their defined benefit (DB) plans. According to TowersWatson only 35% of Fortune 1000 companies still have an actively accruing DB plan. There are numerous philosophical and economical decisions to consider when terminating your defined benefit plan. While each decision is important, knowing the right questions to ask is critical.

Declines in interest rates coupled with recent equity market performance have made a well funded plan a rarity. Several industry sources estimate the average funded status of US Pension Plans at below 80%. Furthermore, regulatory changes have forced plan sponsors to commit large sums of cash to keep plans at certain funded levels, diverting working capital away from value-added projects and into DB plans. When evaluating your defined benefit plan, a sponsor should consider the long-term impacts rather than focus on short-term fixes which often do not exist.

In 2012 the valuation of lump-sum payments will be fully phased into the provisions of the Pension Protection Act of 2006 (PPA). New rates will be used to determine lump-sum distributions. These valuations have phased in a change from Treasury rates to corporate bond rates over the past five years in equal 20% increments. Even though this change might not seem dramatic, it is still in a company's best interest to investigate the potential impact. Many plan sponsors feel this will present an attractive opportunity to terminate or at least remove a portion of the liabilities.

If plan termination becomes an attractive option, a plan sponsor should thoroughly evaluate the key considerations of the termination process beginning with the effective date.

Key Considerations

Plan termination entails specific administrative steps and timelines detailing the various required notices and form filings. Some of the basic steps are outlined below and the PBGC website can be accessed for additional information.

Plan assets must be sufficient to satisfy all accrued plan benefits. If plan assets are sufficient to cover all accrued benefit liabilities, the plan sponsor can voluntarily decide to terminate the plan with the PBGC under a "standard termination."

- The PBGC must be informed at least 60 days and no more than 90 days before the termination date (Notice of Intent to Terminate).
- A Standard Termination Notice, PBGC Form 500, must be filed on or before the 180th day after the proposed termination date.
- A Notice of Plan Benefits must be issued to participants, beneficiaries and alternate payees no later than the time the Standard Termination Notice is filed.



Annuity information/contracts, missing participants and post-distribution certifications among other items necessitate additional requirements which can be found at the following websites.

<http://www.pbgc.gov/res/factsheets/page/termination.html>

<http://www.pbgc.gov/prac/terminations/standard-terminations.html>

While not a requirement, it is a good idea to file an IRS determination requesting a “favorable determination letter.” This step should occur before the PBGC Form 500 is filed. The determination filing ensures the qualified nature of the plan at termination. Not filing might increase the chance of a future IRS audit on the termination of the plan.

Distressed terminations are entirely different and can only be approved if the sponsor would not be able to continue their business unless the plan is terminated. A distressed termination is usually the result of sizeable company layoffs, business failures or bankruptcy filings.

Investment Considerations

Your actuary or investment consultant can provide an estimate of the termination liability which will help determine if your DB plan has enough assets to cover all accrued benefits. The best determination occurs after all lump-sums have been paid and the annuity providers have locked in quotes for the annuity payments. Estimating the value up front provides the opportunity to consider amending the plan to change or add lump-sum payments. The sponsor should consider the impact on other existing retirement programs, qualified or nonqualified, to determine if replacement benefits will be provided. This is especially important if the plan is not already frozen.

Sponsors are strongly encouraged to hire an expert with prior experience soliciting bids from group annuity providers. The annuity quotes often differ dramatically and are not guaranteed over a specified period. It is common practice to obtain preliminary quotes from multiple different providers and set an anticipated future date for locking in the rate. Sponsors may conduct several rounds of preliminary quotes depending on the interest rate environment and the plan’s asset position. During the bidding process, sponsors frequently narrow down the number of annuity providers bidding on the final day and also may have more than one round of final bidding before selecting the winning provider(s). Typically, the final quote remains valid only for that business day, requiring sponsors to move quickly on the final bidding day. The locked-in rate will determine the total value of assets necessary for the annuity provider to assume the risk and liabilities of the plan.

The liquidity of your plan assets becomes extremely important if plan termination is pursued. Once the termination process begins, the plan sponsor must adhere to strict deadlines. Illiquid investments could result in penalties and additional cash contributions. Know the terms of your investments for any private equity, private real estate, hedge funds, securities lending funds or other potentially illiquid securities. It is also a good idea to review your trust agreements in anticipation of closing the trust after termination.

An investigation of your employee base to ensure the accuracy of the participant data is also recommended. Reviewing this data will help the sponsor identify any missing participants and pre-audit the files before terminating or submitting an IRS determination letter. It can be very costly to find out you’ve missed participants or beneficiaries entitled to benefits after the process has begun.



Other Considerations

Most plan sponsors consider freezing their plan or closing the plan to new entrants before termination. Freezing manages your liabilities as future accruals cease growing. Freezing your plan should be evaluated based on your population demographics and company philosophical beliefs on offering retirement benefits. Other plans such as cash balance, 401(k), profit sharing or nonqualified plans may provide replacement benefits to certain populations as you seek to remove those participants from a traditional defined benefit plan.

Exploring philosophical questions will determine your company's approach to helping employees reach a secure retirement. 401(k) plans were not initially intended to be the sole retirement vehicle for employees. As they have evolved into the sole retirement vehicle for many participants, plan sponsors should consider their plan's role. The use of more automatic features such as automatic enrollment and automatic –deferral escalation or higher matching contributions may make more sense for your plan. Competition for talent and employee retention can also impact the use of retirement vehicles. Eliminating a defined benefit plan while your competitors still offer one could cause the loss of valuable talent over time. Recruiting and retaining senior level talent might lead to a company adding a nonqualified plan for executives as a replacement for a defined benefit plan.

Economical factors also play a key role in determining the likelihood of maintaining a defined benefit plan. The recent increase in cash contributions has strained many companies at a time when revenues may be suffering. Assumed rate of return assumptions in the 7%-8% range have been difficult to come by over the last decade and might be too lofty a goal in the future. Lowering these assumptions might seem like the right decision based on the current investment landscape but doing so could cause pension expenses to escalate damaging the company income statement.

Terminating a defined benefit plan involves many complex factors and decisions. Making the termination decision should be based on what is best for the long-term goals of the company. The plan sponsor will need a coordinated effort and well-constructed strategy from the actuary, legal counsel, investment committee, benefits department, administrative provider and investment consultant. While the process is strenuous and may take over 12 months, the time and effort spent may ultimately provide benefits to the company and its employees.

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