De-Risking Strategies

The viability of lump sums and other strategies in 2016

The combination of rising Pension Benefit Guaranty Corporation (PBGC) premiums and the prospect of significantly higher mortality charges was responsible for plan sponsors' continuing strong interest last year in paying lump sums to specified groups of participants. Up for debate is whether this kind of de-risking will remain viable. Below are questions and answers about the interrelationships of factors that drive lump-sum transactions, as well as other de-risking alternatives.

Q: What are the factors that defined benefit (DB) plan sponsors need to consider when deciding whether to offer a lump sum window, and how have they changed over the last 12 months?

A: A lump sum window in which a group of participants not in pay status can elect during a specified window of time to receive payment of all of their plan benefits is one way to reduce a defined benefit plan's exposure to market and longevity risks. If done at the right time, this strategy can result in significant employer savings.

A window program can eliminate 2016's $64 per participant flat-rate PBGC premium—as well as future annual premiums through the life expectancy of every participant accepting a lump-sum offer. There is also a per-participant cap on PBGC variable rate premiums geared to the plan's funding level, so that reducing head count through a window program can produce additional savings of $500 for each participant taking a lump sum.

Interest rates, however, are another matter. With the Federal Reserve's decision to raise short-term rates this past December, followed by continuing strong economic results and low inflation, interest rates will inevitably rise. However, the interest rates used in lump

 Illustration by Daniel Zender

sum calculations are the three spot segment rates for short-, medium- and long-term liabilities; these, pursuant to the plan document, are usually set for a full calendar year based on the rates as of a date in the previous calendar year. Therefore, for many plans, the relatively low segment rates established in November 2015 will be applied to lump sums paid in 2016.

Additionally, the new mortality tables and improvement scales issued by the Society of Actuaries in October 2014 project future mortality decreases, based on the underlying assumption that people are living longer. Increased longevity, in turn, will increase plan liabilities and result in bigger lump sums. In its Notice 2015-53, the Internal Revenue Service (IRS) indicated that it expects to issue proposed regulations revising mortality rates and projection factors to reflect the new tables. It also stated that the new regulations will not apply until 2017, although some speculate that the effective date will be even later. Offering a window plan in 2016 before the new mortality factors take effect will not reduce current costs, but it will prevent future increases in benefit costs resulting from the new mortality factors.

Q: De-risking can mean more than offering lump-sum payouts. What are other ways to reduce a defined benefit (DB) plan sponsor's financial commitment and liability exposure to the plan?

A: Market risk has long been addressed by liability-driven investing (LDI), matching plan assets with liabilities in order to smooth cash contributions. In its Advisory Opinion 2006-08A, the Department of Labor (DOL) held that implementation of such an investment program, designed to reduce funding volatility, should not, in and of itself, result in a violation of the rule in the Employee Retirement Income Security Act (ERISA) requiring loyalty to participants' interests.

Some sponsors have purchased group annuities from insurance companies on subsets of plan participants. The plan sponsor pays premiums to the insurer in exchange for a guaranteed stream of income that matches pension liabilities. The annuity is, in effect, a liability matching asset.

In contrast to such a buy-in, the plan can buy out a pension liability by purchasing and distributing an annuity to a participant, in which case both investment risk and longevity risk will pass to the insurer.

Q: If a plan sponsor shifts defined benefit (DB) liabilities to an insurance company by purchasing annuities for participants, what are the criteria for selecting an annuity provider?

A: Selection of an annuity provider is a fiduciary act governed by the Employee Retirement Income Security Act (ERISA)'s standards of prudence and loyalty to the interests of participants and beneficiaries. To meet these responsibilities, plan fiduciaries must take steps calculated to obtain the "safest annuity" available, which typically translates to the most expensive annuity available. The fiduciary process required by the Department of Labor (DOL) entails conducting an objective, thorough and analytical search to identify an annuity provider with solid claims-paying ability and creditworthiness. To guide decisionmakers in this process, DOL regulations set forth six factors fiduciaries should consider (failure to implement a procedure that considers each of these factors in detail could result in a fiduciary's personal liability):

1) Quality and diversification of the insurer's investment portfolio;

2) Size of the insurer relative to the proposed annuity contract;

3) Level of the insurer's capital and surplus;

4) The insurer's lines of business and other indications of its liability exposure;

5) Structure of the proposed annuity contract and whether it includes guarantees, such as use of separate accounts insulating the annuity from claims against the insurer's general account; and

6) Availability of additional protection through state guaranty associations.

While the goal is to distribute the safest available annuity, the DOL acknowledges that there may be situations where the safest annuity is only marginally safer—but disproportionately more expensive—than competing annuities, in which case, the cheaper annuity may be a viable option. This issue needs to be carefully navigated in the current economic environment. It appears that several major carriers declined to accept new defined benefit plan business in the final months of 2015, although they indicated they would likely reopen their doors for this business in 2016.

If done at the right time, this strategy can result in significant employer savings.

Marcia Wagner is a specialist in pension and employee benefits law, and is the principal and founder of The Wagner Law Group, one of the nation's largest boutique law firms specializing in the Employee Retirement Income Security Act (ERISA), employee benefits and executive compensation. A summa cum laude and Phi Beta Kappa graduate of Cornell University and a graduate of Harvard Law School, she has practiced law for more than 28 years, 19 with her own firm. She is recognized as an expert in a variety of employee matters, including qualified and nonqualified retirement plans, fiduciary issues, all forms of deferred compensation, and welfare benefit arrangements.