During the early months of 2017, companies with calendar-year defined benefit (DB) pension plans will be reviewing their funded status, expense levels, and future contributions, realizing that not much has really changed. In our experience, many companies say that, in addition to curtailing pension benefits, they are focused on managing the risks posed by their DB plans. Specifically, they are concerned with reducing the volatility of funded status reported on balance sheets and the level of required contributions. This trend is a result of:

- Accounting transparency mandated by the FASB
- Pension Protection Act (PPA) time-frame squeezes to address funding gaps
- Phase out of temporary funding relief programs provided by Congress
- Lack of a significant enough rise in interest rates or improvement in market conditions
- Updated mortality tables released by the Society of Actuaries magnifying longevity risk.

These tables have been widely adopted for accounting purposes and beginning in 2018 will likely form the basis for determining minimum funding, PBGC premiums, and lump-sum payments.

One of the objections to de-risking is, Why not simply wait for market conditions to improve? Relying on improvements in market conditions to close funding gaps is a risky proposition, because equity markets and interest rates can be volatile and are unpredictable. Plan sponsors may also be misjudging the risk they are taking based on the belief that the recent rise in short-term rates will assist in improving funded status. Actually, an interest rate increase for long-duration investment-grade corporate bonds would benefit plan sponsors more than an increase for shorter-duration bonds. This is because DB plans are required to discount future liabilities based on the prevailing rates on investment-grade corporate bonds that match the duration of their plans’ liabilities. Moreover, a rise in interest rates for these bonds will not benefit the typical plan sponsor if it coincides with an equity market decline.
As a result, companies have significant incentive to reduce funded status volatility. For some plan sponsors, the prospect of engaging in a pension risk transfer, via the purchase of non-participating annuity contracts for current retirees, or offering a lump-sum window for deferred vested participants, may seem cost-prohibitive. The cost of transferring risk is lower than what many sponsors perceive, as the transaction will generate a long-term savings on expenses that the sponsor would otherwise incur, including:

- **Administrative Expenses and PBGC Premiums** – Plan sponsors incur annual expenses related to participant servicing and plan administration, estimated at $40 - $75 per participant, per year. The PBGC flat rate per participant premium is $69 for 2017 and will increase to $74 in 2018 and $80 in 2019, with indexing thereafter. The PBGC variable rate premium, charged per $1,000 of unfunded vested benefits, is $34 in 2017 and will increase to at least $38 for 2018 and $42 for 2019, with indexing thereafter. It should also be noted that there is a per-participant cap on the variable rate premium of $517 in 2017, with indexing thereafter.

- **Investment Management Fees** – Plan sponsors incur investment management expenses related to managing the assets within a DB plan, which can range from 25-40 basis points per year.

- **Mortality Table Changes for Funding** – The IRS has issued proposed regulations that identify an update to the mortality tables used for pension funding obligations and PBGC premiums for the 2018 plan year. New tables for lump sum calculations have not been identified yet, but they are likely to be based on the new funding mortality tables and also effective for the 2018 plan year. Liabilities for funding purposes are expected to increase by roughly 3%-5% as a result of the new tables, although actual results will depend on plan design and participant demographics. Given this, 2017 affords plan sponsors with another opportunity to offer lump-sum windows for deferred vested participants in a favorable manner as compared to accounting liabilities.

As a final note, plan sponsors may be concerned with the fact that DB risk-reduction strategies may harm certain financial measures and therefore cause a lower company value when first implemented. Reducing DB risk will most likely narrow the projected range of cash contributions.
In addition, by removing volatility for a portion of the liability, future cash flow will be favorably affected. As most companies are measured on the basis of available cash flow, it would seem that de-risking strategies would be a positive.

The underfunded size of the pension is debt. However, there is a growing view among corporate CEOs and CFOs that pension debt is a riskier form of debt than traditional debt, because pension debt carries additional volatility. As such, there should be a premium associated with managing that risk and companies are weighing up this risk alongside others. This is a fact regardless of whether or not the DB pension plan is a strategic part of a Company’s Total Compensation offerings.