PENSION DE-RISKING:
A PRIMER FOR GOVERNMENTAL SPONSORS

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Pension plans are a risky venture – and the sun rises in the east, and it's dark at night – Have we enlightened you so far? Sponsors of traditional defined benefit pension plans shoulder the risk for a host of uncertainties, all of which can lead to unsustainable contribution requirements, when the unexpected happens. These can include:

- Plan investments not earning enough to support the promised benefits
- Pensioners living longer (collecting more payments) than expected
- Inflation or other events causing spikes to final-average-pay benefits
- Employees taking advantage of early retirement subsidies in a manner not expected

What Is It?

De-risking, in the context of a pension plan, is an action that eliminates uncertainty associated with the pension liability. Short of a wholesale plan termination, employer-risk related to pension benefits cannot be completely eliminated. Incremental steps can be taken, however, to mitigate some of the risk.

Who's Doing It?

Most de-risking activity to date has been among private-sector employers who continue to sponsor defined benefit pension plans. The private-sector sponsors have been motivated to scale back defined benefit obligations in response to more-stringent ERISA minimum funding requirements, severe increases in PBGC premiums, and FASB accounting disclosure requirements, where balance sheet volatility is common, but not welcome.

What Can Be Done?

De-risking actions can include the following broad categories:

- Changes to plan benefits or eligibility
- Changes to plan investments
- Actions related to terminated or retired participants

Benefit Changes

Governmental as well as private-sector sponsors have taken de-risking actions related to plan design (i.e. reducing future benefits in some manner). Private-sector sponsors typically have more flexibility in altering benefits. The ability of governmental sponsors to change benefits is often restricted by statute or bargaining agreements, or both. Some governmental sponsors have implemented two-tiered benefit provisions, with less-generous benefits provided to employees hired after a certain date. (PSERS is an example.) Other governmental organizations have frozen plan participation and cover newly-hired employees under a defined contribution plan.

Investment Changes

A de-risking action related to plan assets is to shift to more conservative investments, to reduce the risk of asset loss. This is sometime called *liability-driven investing*. More specifically, the aim is to control the volatility of the funded status (liability minus assets), when the liability is measured using current market interest rates. In theory, the value of properly selected fixed income investments will move in tandem with the liabilities as measured using current market rates. This has appeal for plans that are close to full funding, for purposes of preserving that status, and, possibly, in preparation for a plan termination.

Liability for Inactive Participants

An action that is currently popular among private-sector pension sponsors is to eliminate liability for retired and/or terminated vested participants, by transferring it to someone else. This can be done by:

- An annuity purchase, where an insurance company takes on the obligation for lifetime payments, or
- Offer of a lump sum payment to the participant.

Annuity Purchases

With interest rates at recent, historic lows, annuity purchase prices have been significantly higher than plan liability as measured for funding purposes (meaning that an annuity purchase will end up increasing the unfunded liability and, consequently, increasing the annual contributions). Nonetheless, corporate pension sponsors have elected to purchase annuities for blocks of retirees, to control FASB-style balance sheet liability and reduce future PBGC premiums.

Lump Sum Windows

A lump sum offer can only be made to terminated vested participants. The IRS disallowed offering lump sums to participants in payment status in 2015. The offer is usually made on a *window* basis, with limited time for the participant to elect. The exercise is a significant administrative undertaking, requiring a strict timetable for notices, elections, and payouts; development of communication materials; extensive calculations; and, possibly, a data clean-up effort to ensure that the benefits are correct.

Private-sector plans typically have large numbers of terminated vested participants, and a lump sum window provides an opportunity to simplify administration by shrinking the membership roll. Governmental plans, on the other hand, tend to have fewer terminated participants with deferred benefits.

Governmental pension plans are not required to use the IRS Section 417(e) interest rates that are mandated for lump sum calculations under private-sector plans. Some plans may have provisions that generate lump sums that are *less than* the funding liability. Careful consideration, with guidance from legal counsel, would have to be given in deciding whether a governmental plan might be able to offer lump sums to its terminated participants.

Conclusion

Pension de-risking activity to date has largely been confined to private-sector plan sponsors. De-risking for governmental plans may become more prevalent as interest rates rise and as the funded status for such plans is subject to increased scrutiny.

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