Benefit Strategies

## DE-RISKING YOUR DEFINED BENEFIT PENSION PLAN

De-risking is an important tool for effective management of an employer sponsored defined benefit pension plan. De-risking may take several forms. Employers may choose to retain all assets and liabilities and manage volatility by aligning a portion of the plan's assets (generally allocated to fixed income) to a portion of the liability. Alternatively, employers may choose to entirely eliminate the volatility and the interest rate and longevity risk by transferring the liabilities and assets to a third party. The following two benefit strategies are examples of the second approach and may be implemented separately or in combination. The first approach, also known as liability-driven investing will be addressed in a future benefit strategy article.

### Strategy One: Cash Out of Vested Terminated Benefits

The risk may be transferred to former employees by offering these former employees an immediate lump sum benefit from the pension plan in lieu of a monthly annuity sometime in the future. Normally this is accomplished by implementing a one-time window election for all or for a subset of the former employee population. Items to consider from a design standpoint include:

- The pension plan document must be amended to allow for a one-time window lump sum election by the former employee
- The former employee must be given the option to accept or reject the offer
- Spousal consent requirements and other distribution rules must be followed
- The former employee must be given the right to roll over the lump sum into an IRA or other qualified vehicle
- The interest rate and life expectancy tables used must produce values that meet or exceed a prescribed IRS minimum
- The employer may elect to impose limits on the maximum payout. For example, the plan may allow lump sum payouts whose value is below $25,000
- The employer should choose a subset of the population that will optimally manage the impact on cash flow and accounting costs and that will successfully address total compensation and benefit strategies. Large lump sum distributions could result in unwanted settlement accounting charges.
- The employer must ensure that the election does not result in discriminatory payouts

### Strategy Two: Annuity Purchases for Current Retirees

The risk may be transferred to an insurer by purchasing non-participating annuities for all or a subset of the retiree population. Depending on business objectives and cost considerations, this transfer may be accomplished through either a single purchase or a series of purchases. Items to consider from a design standpoint include:

- The annuity must retain all the same rights and features currently enjoyed by the retiree
- The employer should choose a subset of the population that will optimally manage the impact on cash flow and accounting costs and that will successfully address total compensation and benefit strategies
- The employer must act solely in the interest of participants and beneficiaries. As such, the employer must take steps to obtain the safest annuity available.

## Analysis

De-risking strategies have both advantages and disadvantages from the employer's point of view. An analysis of the risk/reward from transferring the risk of the obligation to another party is essential. The analysis should:

- Identify business goals and objectives of the risk transfer
- Determine if any impediments exist that restrict or limit the transfer
- Evaluate the financial risk/reward from both a cash flow and accounting perspective
    - Calculate the "settlement" accounting charge or credit and determine the change in the projected benefit obligation and pension expense
    - Determine the change in cash funding requirements
    - Determine any changes in the Pension Benefit Guaranty Corporation (PBGC) premium requirements
    - Estimate administrative and professional service fees associated with implementation
- Identify and evaluate any non-financial factors such as communication challenges
- Identify optimal timing of risk transfer and impact of potential delay

## Risk/Reward Tradeoff

In a low interest rate environment, a de-risking strategy may generate losses that adversely impact the balance sheet, income statement and cash flow requirements. However, an employer may decide to accept these consequences as a tradeoff for eliminating the uncertainty and volatility associated with the obligation. Cowden Associates has the experience and vision to help employers manage the process and meet business objectives. We help employers understand and manage the relationship between the lump sum interest rates, the segment rates for funding purposes, the discount rate for accounting purposes and the rates used for PBGC variable rate premium purposes.

**About Cowden Associates, Inc.**

Cowden Associates, Inc. is a Pittsburgh-based consulting and actuarial firm. We have a dedicated team of professionals with extensive experience in benefits, retirement programs, compensation, employee communications, benefits enrollment, actuarial and technology services. Using a total compensation based approach, Cowden Associates, Inc. provides a full range of consulting services helping clients establish and maintain high quality compensation and benefit programs aligning organizations business strategies and objectives. Cowden Associates, Inc. is a charter partner of United Benefit Advisors (UBA), the nation's leading independent employee benefits advisory organization.

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