

# Pension Liability Mitigation after the Storm: A New Approach

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Is there a better example of how the financial world is changing than the dramatic shift in qualified plans from the defined benefit (DB) pension plan to defined contribution (DC) plans? For many years now companies have been moving their qualified retirement plans to DC plans and leaving the DB world behind. This change represents a significant shift in the responsibility from company to individual for providing for financial security during retirement. However, before that shift is totally complete, companies with current DB plans have plenty of financial liability and responsibility left to tackle.

Given the extent of their pension liability, companies are seeking ways to mitigate the existing liability, shift risk, and clean up their balance sheets - whether they are terminating their DB plan, freezing it, or leaving it be. This focus, in large part, is to prepare for the 2012 deadline enacted by the 2006 Pension Protection Act (PPA), requiring DB plans to be fully funded. This focus has intensified in the last twelve months as pension assets dropped due to market losses and will continue as short-term government funding relief measures end. This article focuses on one solution that transfers a portion of the

DB plan liability and the associated risk off the company's balance sheet.

This is an ideal time for DB plan sponsors to consider the benefits of transferring some or all, of their plan liability (and future risk) to an insurance company. This transfer involves the purchase of commercial annuities and shifts the burden of future risks and liabilities, and the costs associated with benefit payments, to the insurer. Don't over focus on rates. Although it is generally true that when annuity rates are up, the timing for plan sponsors may be better to take advantage of this strategy, it is smart, regardless of rates, to, at the very least, explore the merits and mechanics of the strategy to not only benchmark it against other options, but to put the plan in a position to capitalize when rates do rise, if a rate increase is important to make this work.

This is a way to not only mitigate the liability, reduce costs, and clean up the balance sheet but it also creates a level of certainty a CFO wants. These factors include: exposure to mortality/longevity and investment risks, escalating Pension Benefit Guarantee Corporation (PBGC) costs, PPA funding and Financial Accounting Standards Board (FASB)



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balance sheet disclosure requirements. Even though in recent years efforts have been made to reduce the asset/liability mismatch including the utilization of a liability-driven investment, the current gap created by the market crash of '08 have many plans gasping for air and plan sponsors looking for solutions. Interestingly, eighteen months ago this was not attracting the attention of CFOs, pension managers, or HR teams in charge of the pension liability like it is today.

It has long been a practice when terminating a DB plan for the sponsor to offer plan participants an annuity from an insurance company or a lump sum cash settlement. Although there has been a significant increase in the number of plan terminations, many companies do not want to fully terminate their DB plans due to the costs required to do so. Obviously, if a plan is underfunded, the company would have to make additional contributions in order to terminate the plan and settle all benefit obligations. For this circumstance, some of the latest thinking is to transfer (shift, sell) only a portion of the pension obligation. This strategy is sometimes referred to as a "carve out" or "buy out" and enables the plan sponsor to eliminate the liability and costs associated with a certain subset of plan participants and transferring this cost and liability to a company whose core business is managing risk and benefit administration. Groups of pension participants to consider in utilizing this strategy are: retirees, terminated vested participants in the plan, or plans inherited from acquired companies.

The plan sponsor should seek the advice of a qualified independent expert who has can evaluate the potential benefits of this type of transaction satisfy the DOL "safest available provider" rule for insurance company selection. Independence

from the current plan and experience are crucial factors when choosing a provider. The process begins with the preparation of participant data (census) along with benefit data and plan documents. This typically requires very little time on the part of the plan sponsor as most of the information is readily available from their current pension actuaries.

As a first step, the independent firm's actuaries will analyze the data and both determine and demonstrate the most advantageous group(s), or subset of participants in the plan for shifting to an insurance company. Once the populations and associated liabilities have been understood and segmented, a request for proposal is created for the multiple life insurance carriers, after careful due diligence on each of the carriers. The firm earns its keep by working with multiple carriers and understanding how to derive the best offers and pricing by creating bidding wars. The objective is to compare the cost of transferring the liability to the insurance company to the plan's current liability for the particular subset of participants. For example, on a \$100 million plan liability, getting insurers to compete for the "low bid" of \$98 million or \$97.5 million, for example, is the goal. Once the insurers have been vetted and prices assessed and negotiated, the pricing required to purchase a single-premium group annuity contract (one actual annuity per participant) is presented and the numbers are then compared to other future funding strategies and thought through with the plan sponsor.

Either current plans' assets or current/future plan contributions can be used to purchase the annuity. This gives companies flexibility. Often a company will employ a multi-year funding strategy sometimes referred to as a "remove as you go" strategy to make this work.

The benefits to plan sponsors:

- Remove unwanted pension liabilities from the balance sheet
- Reduce volatility of plan earnings and funding levels
- Reduce the impact of future regulatory changes
- Minimize the impact of adverse benefit option selection by participants; i.e., subsidized early retirement or lump sum options)
- Custom-design a risk transfer schedule

Once the liability is transferred to the insurer, the independent firm assisting the plan sponsor will provide participant communication and host group meetings to ensure the integrity of the transition. One of the key selling points of this idea is that the participants are actually better protected under the insurance company than the plan sponsor company because state guarantee associations, the entities that backs up failed life insurers, offers superior protection than the PBGC.

An alternative to the "buy out" plan is to keep the annuity purchase inside the plan, a so-called "buy in." This is very popular in the U.K. where, since 2007, over £10 billion of pension liability has been settled in such a manner. This strategy allows the plan to hold the annuities as an asset of the plan, while eliminating certain risks and effectively covering benefits for a selection of pensioners like an insurance policy. Unlike many other pension assets, the annuities provide for a perfect "asset to liability match" and thus a viable de-risking strategy that should be considered by most plan sponsors.

Implementation of the buy-in method allows for a smooth transition to the buy-out method in the future if, and when, it makes sense to best address the needs and objectives of the plan.