Pension Strategy

Managing closed/frozen pension plans in today's business environment

September 12, 2018

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Agenda

- Current landscape of retirement programs
- Overview on compliance testing
  - Closed plan considerations
  - DC transitions
- Cost reduction tactics
  - Terminated vested lump sum window
  - Retiree annuity purchase
- Revisiting your retirement strategy
  - Addressing retirement readiness and harmonization

Speaker: *John Perara, FSA, EA | Retirement Practice Leader, Pacific Northwest | Willis Towers Watson*

John Perara has more than 30 years of experience in the Retirement line of business. He oversees all aspects of the business development and delivery of retirement consulting services in Willis Towers Watson's Pacific Northwest division. John specializes in consulting on plan sponsor issues related to the design, implementation, ongoing administration, and financial management of retirement programs. John's experience includes valuation of postemployment welfare plans, the bargaining strategy/process for union populations, and economic modeling of proposed changes. His clients are primarily in the manufacturing, energy, health care and mining industries.

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Definitions

- **Frozen plan** — A defined benefit (DB) plan in which either service, pay or all benefit accruals have ceased for all or some of the plan participants.
- **Closed plan** — A DB plan is not offered to new hires.
- **Traditional defined benefit plan** — A type of retirement plan that provides a guaranteed lifetime income at retirement. The benefit amount is based on a formula, which typically relates the retirement benefit to pay and years of service.
- **Hybrid pension plan** — A type of retirement plan that guarantees the amount of an employee's benefit, like a traditional DB plan, but describes the benefit as a lump sum account balance. These plans generally allow employees to take their account balance with them when they leave the company, or transfer it to another employer-sponsored plan or Individual Retirement Account (IRA).
- **Terminated plan** — A frozen DB plan in which all benefits have been settled through the transfer of assets and liabilities to a third party (typically an insurance company), or through payment of all benefit obligations directly to participants, or both.
- **Defined contribution plan** — A retirement plan, such as a 401(k) or 403(b), in which the employee elects to defer some compensation into an account that he or she typically manages, including choosing investment options. In most cases, the employer contributes to the account as well. These plans are generally portable, allowing employees to transfer their account to another employer sponsored plan or IRA.

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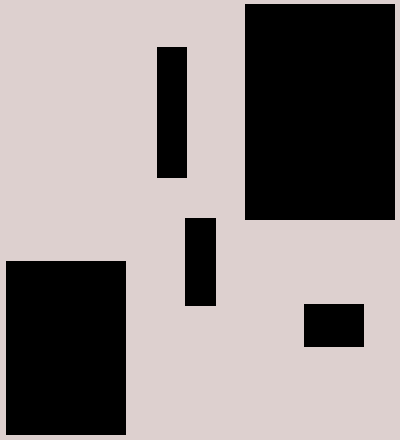
A historical look at the retirement plans of today's *Fortune* 500



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About the study

- Unless otherwise noted, this analysis looks at the current *Fortune* 500 list and tracks the changes to the retirement plans offered to salaried new hires since the beginning of 1998. Sponsorship is shown as a type of plan offered to salaried new hires at end of year.
- Trend data is shown for list of *Fortune* 500 companies and captures changes to retirement plans for these companies from 1998 through June 2017.
- If different salaried segments had different plans, the study focuses on the primary plan offered to the salaried workforce (typically the one that covers management).
- In earlier years, sums may not equal 500 due to the fact that some current *Fortune* 500 companies were not in existence in 1998.
- All information is derived through public disclosures (10-k, Proxies, 11-k, plan documents filed with the Department of Labor).

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Highlights

16%

of *Fortune* 500 companies offered any type of DB Plan to salaried new hires in 2017, **down from 59% in 1998**

3%

of *Fortune* 500 companies offer a traditional DB Plan to new hires. **Down from 49% in 1998**

These transitions have left employers and employees navigating an **increasingly complex benefit environment** with considerably more **complicated retirement structures**. Many employers now administer and fund different retirement programs for different employees, with workforce dynamics that can ensue when all employees do not receive the same retirement benefits.

Some sponsors have **closed or frozen their salaried plan but still maintain open plans for hourly or collectively bargained workers**.

According to a recent Willis Towers Watson survey:

25%

of companies that sponsor both union and non-union plans **had open non-union plans**

41%

of companies that offered both a union and non-union plan **sponsored an open union plan**

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Highlights

59%

of *Fortune* 500 companies sponsored a DB Plan in 1998. Among these companies 93% still manage obligations and assets associated with these plans

50%+

of DB plan sponsors still have workers **actively accruing pension benefits**

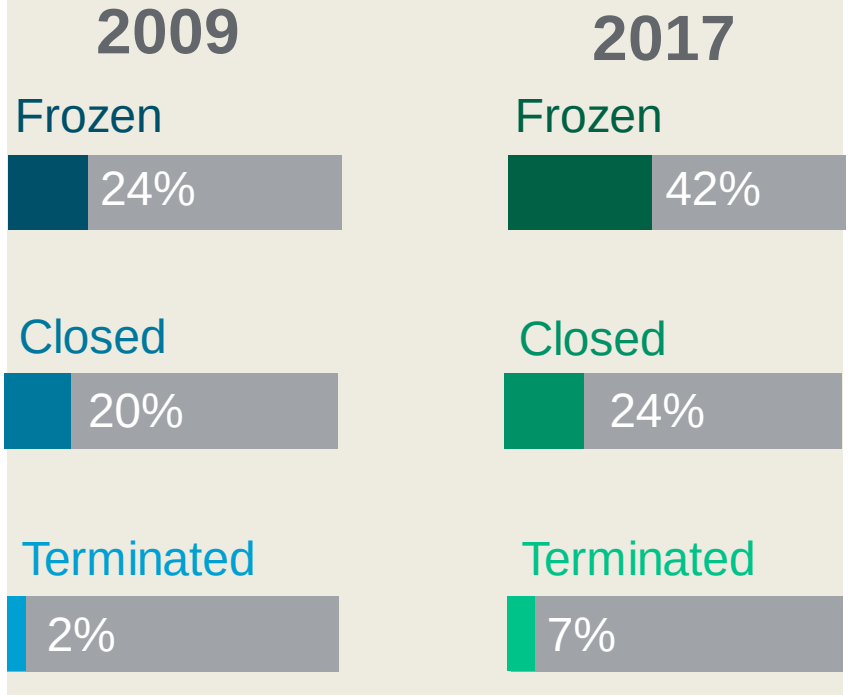
35%

of plan sponsors who have a frozen pension plan, closed their plan to new hires at an earlier date

Certain industry sectors, as well as employers whose **pensions are relatively small** (relative to their market capitalization) and/or well funded, have continued to offer pension plans to **new hires**

There has been an uptick in freezing pension accruals and plan terminations in the past decade or so

Changes in the pension landscape of *Fortune* 500 companies



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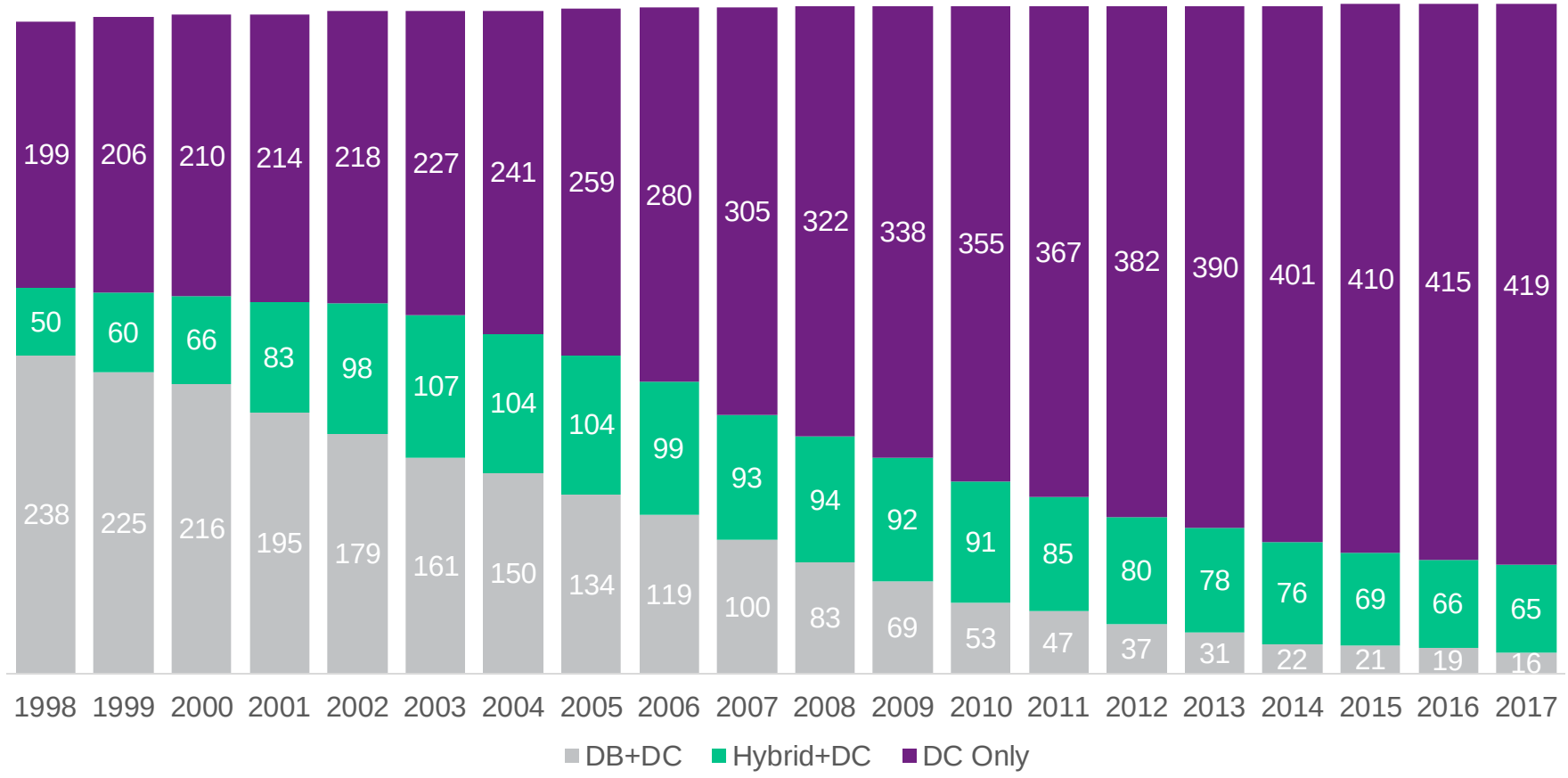
Retirement plan prevalence trend for *Fortune* 500 Companies 1998 – 2017*

For newly hired salaried employees



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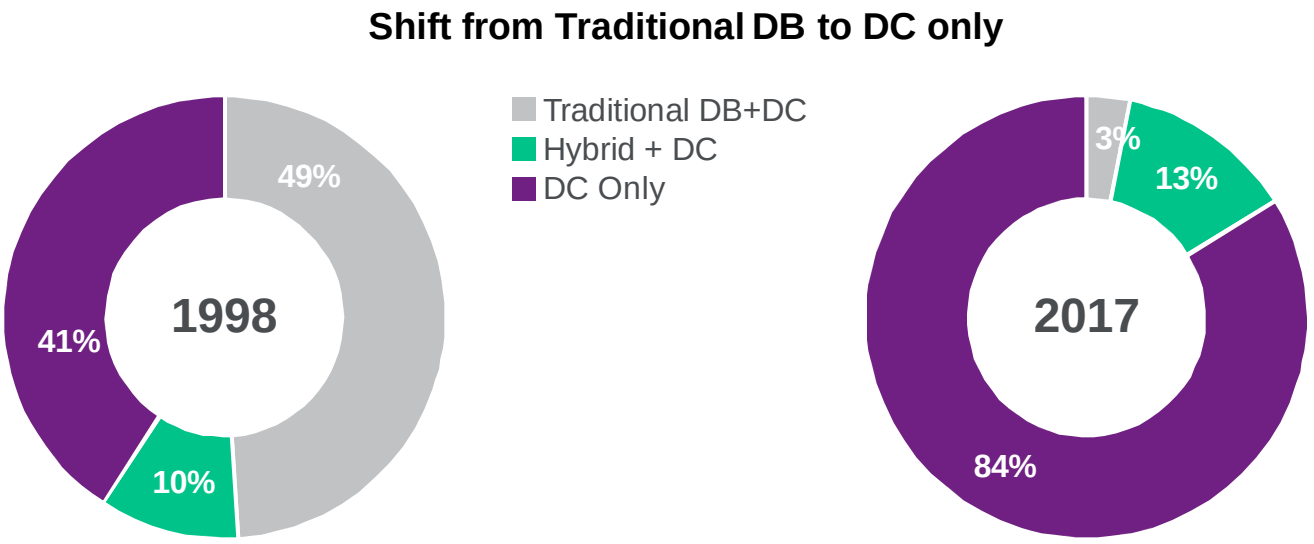
Retirement plan prevalence trend for *Fortune* 500 Companies 1998 vs 2017

For newly hired salaried employees



Cash balance (a type of Hybrid account based plan) is the dominant offering for new hires receiving a pension plan

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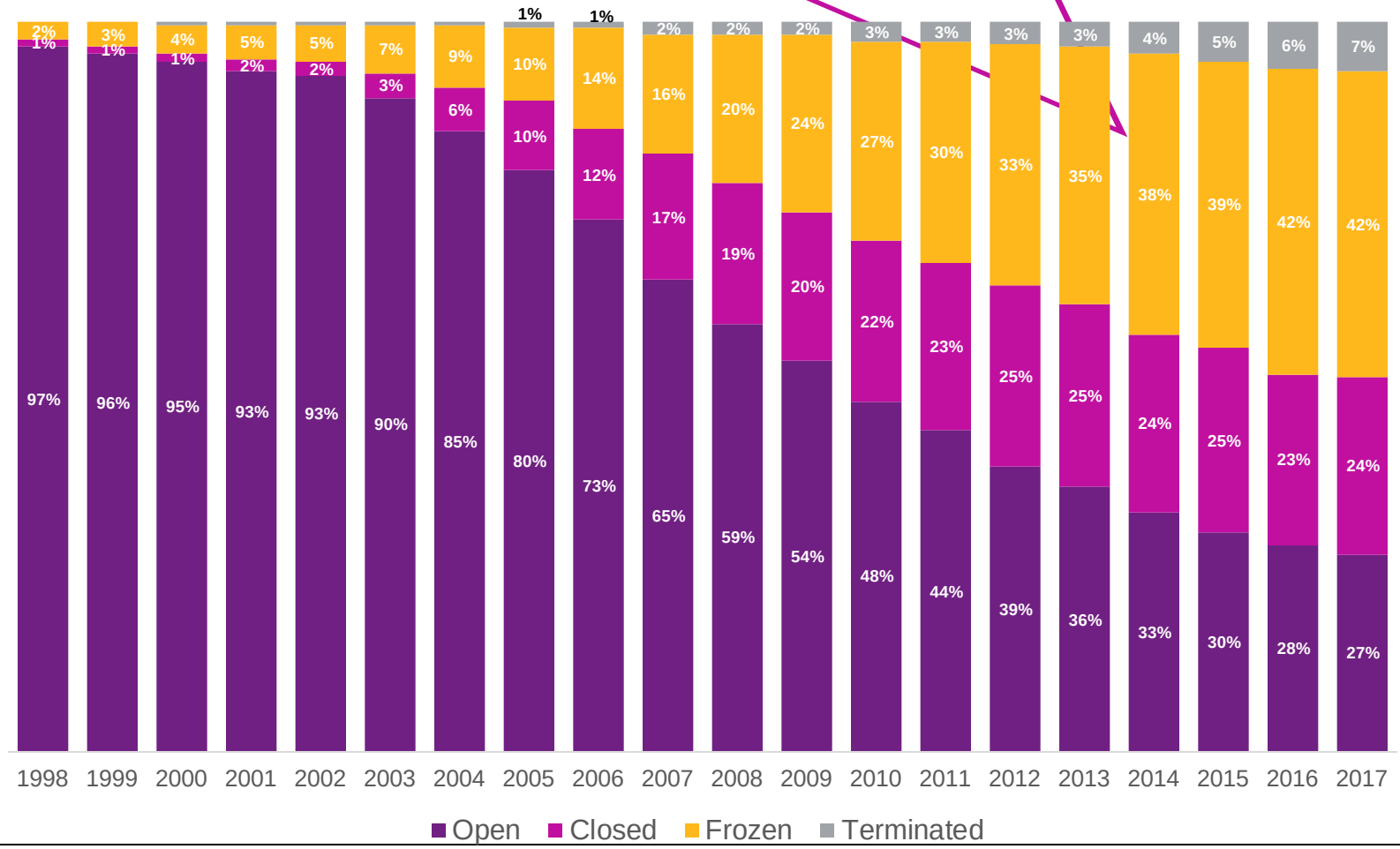
Open, frozen, closed and terminated plans for *Fortune* 500 Companies 1998 – 2017

An uptick in freezing accruals over the past few years, but more than ½ of pension sponsors still have workers actively accruing pensions



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Moving from closing to freezing

	Years from Close to Freeze
Average	5.4 years
90th percentile	10.9 years
75th percentile	7.3 years
50th percentile	4.8 years
25th percentile	2.8 years
10th percentile	1 year

44 companies (or 35% of companies with frozen accruals) **closed their pension plan to new hires** prior to freezing the pension plan

24 companies with previously closed plans froze their accruals since 2012

The **average time to freeze accruals was 5.4 years** from when the entrance plan was closed to newly hired workers

N=44

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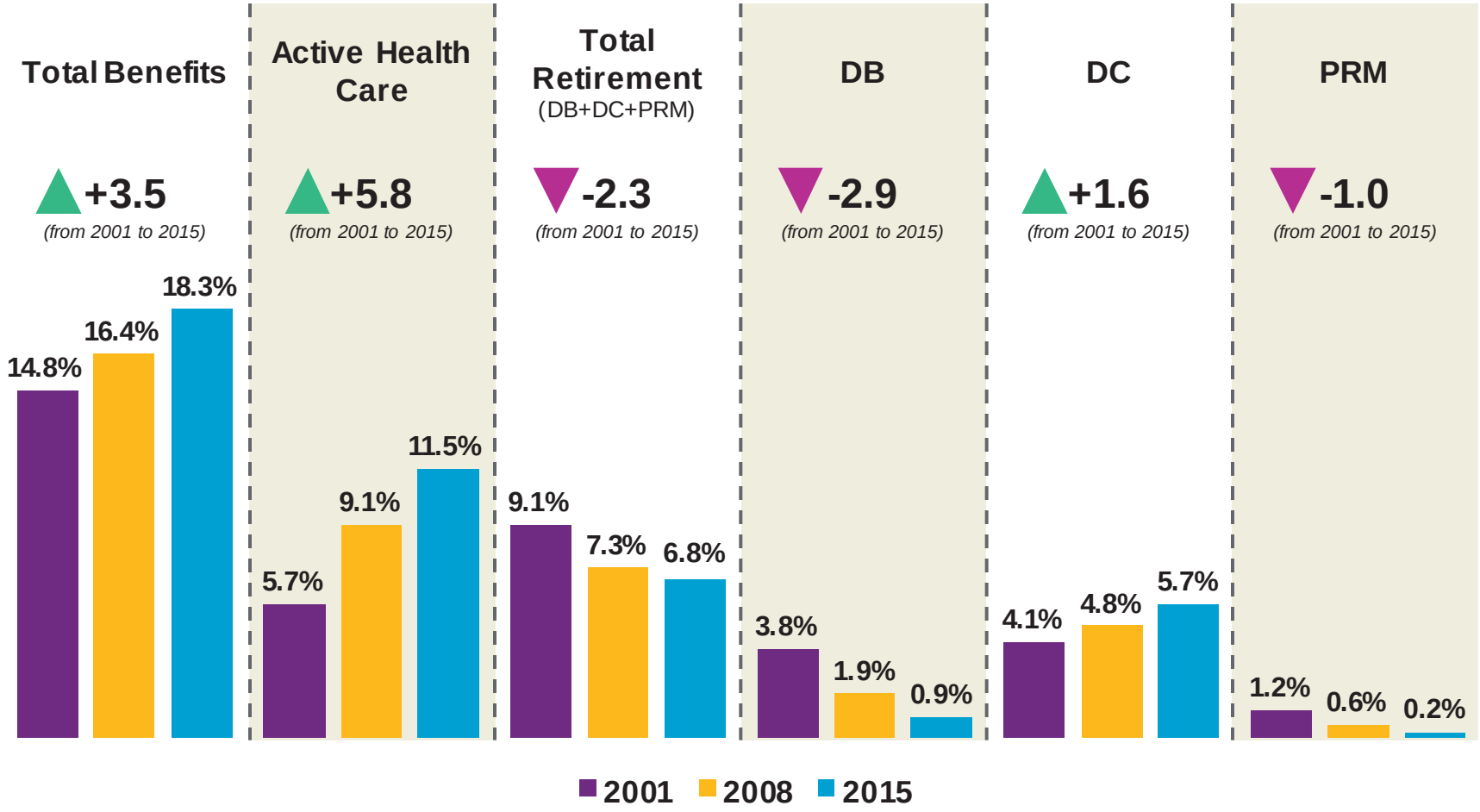
Total employer benefit values as a percentage of pay

All companies – Weighted by Employer size, 2001-2015



n = 1232 for 2001, n = 1422 for 2008 and n = 642 for 2015

Source: Willis Towers Watson Benefits Data Source (BDS)

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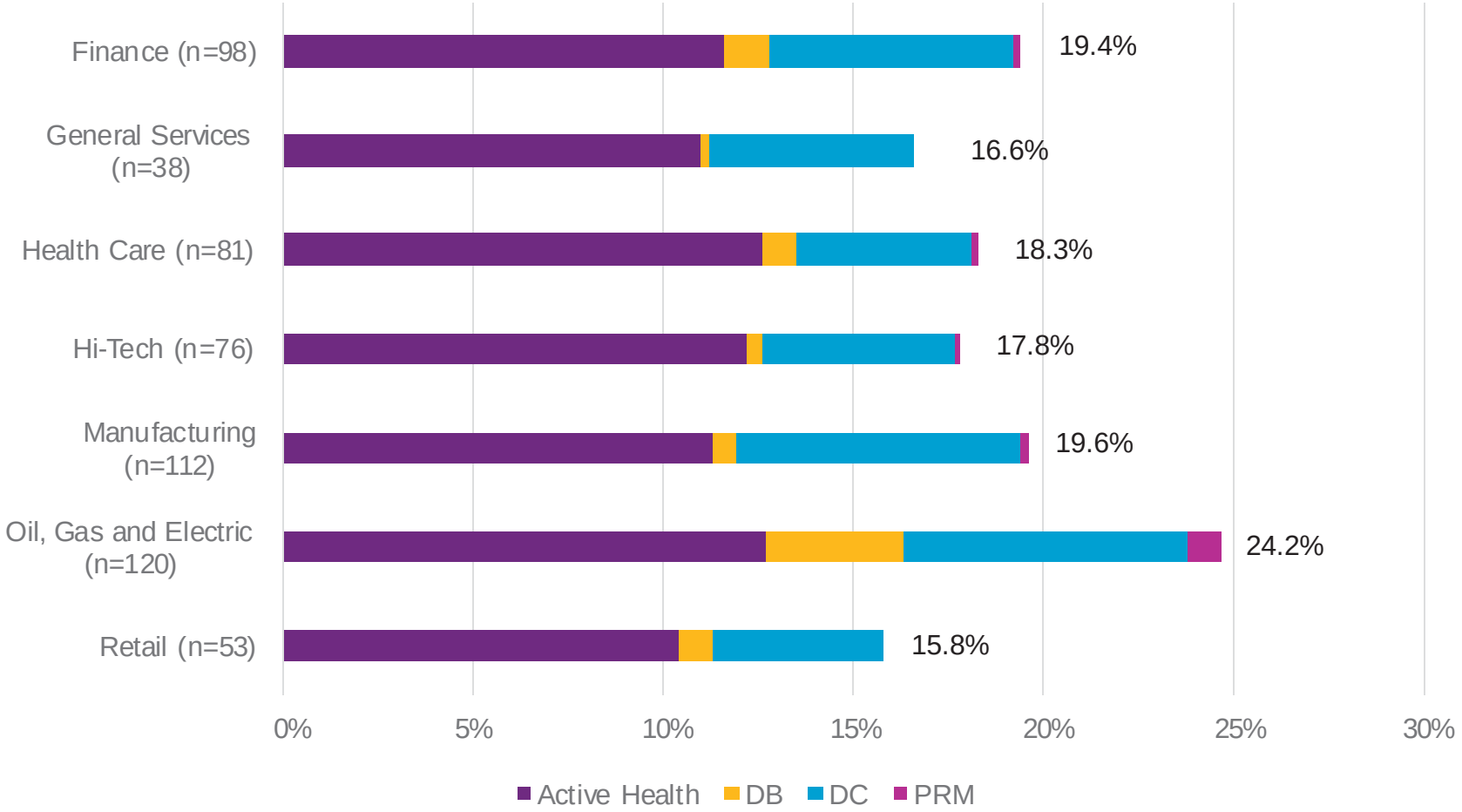
Total employer benefit values as a percentage of pay by industry for 2015 (weighted by employer size)



Source: Willis Towers Watson BDS

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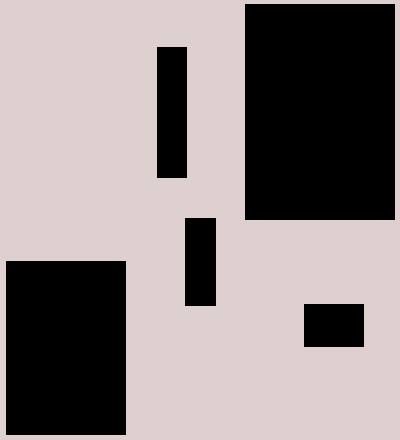
Overview of compliance testing



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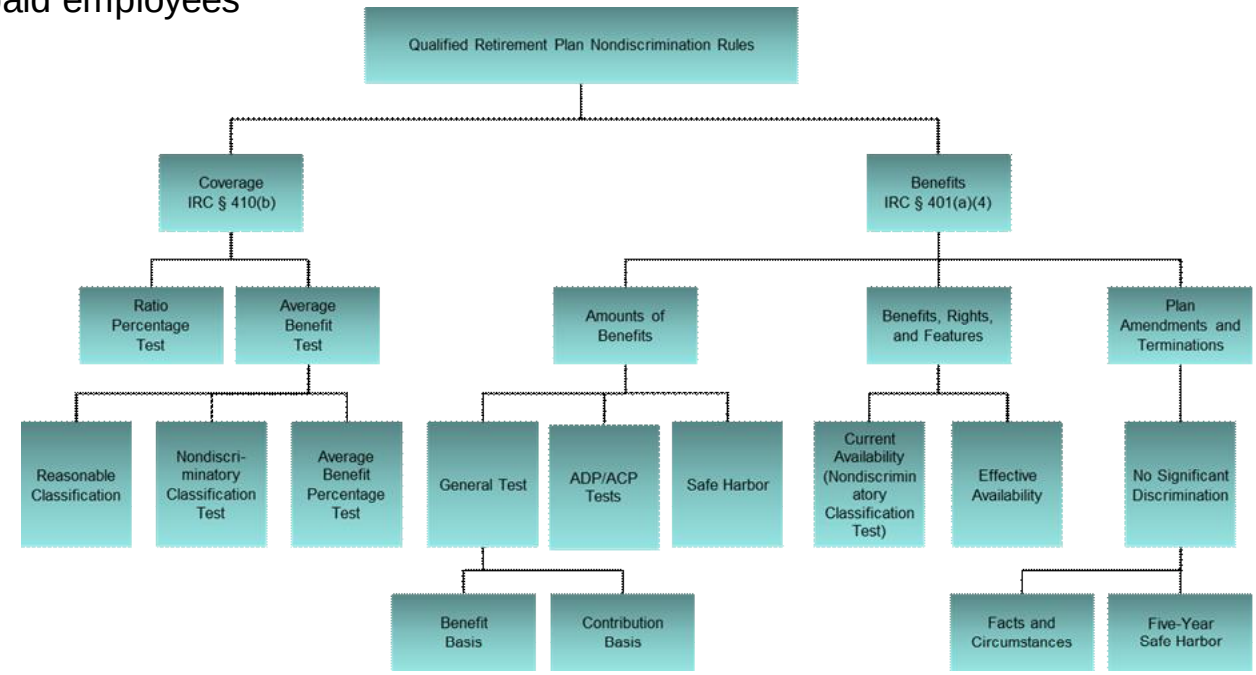
Purpose of nondiscrimination testing

- To prove nondiscrimination, a plan must satisfy these Internal Revenue Code sections
  - §410(b) - Plan must cover a certain percentage of lower paid employees given the percentage of higher paid employees it covers
  - §401(a)(4) - Within the plan, benefits/contributions and other features can't discriminate in favor of higher paid employees



- Rules are complex; important to document that all required testing is complete for total retirement program (defined benefit and defined contribution plans)

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Purpose of nondiscrimination testing

- Intended to ensure qualified plans don't discriminate in favor of "highly compensated employees" (HCEs)
- What does it mean to discriminate in favor of HCEs?
  - Providing better benefits to HCEs, or
  - Covering significantly higher percentage of HCEs
- Must look at total operation of plan
  - Retirement benefit formula
    - Measured as a % of pay, or as dollar amounts
  - Other benefits, rights and features
  - Coverage of plan within controlled group
  - Effects of plan amendments
  - Inclusion of leased employees

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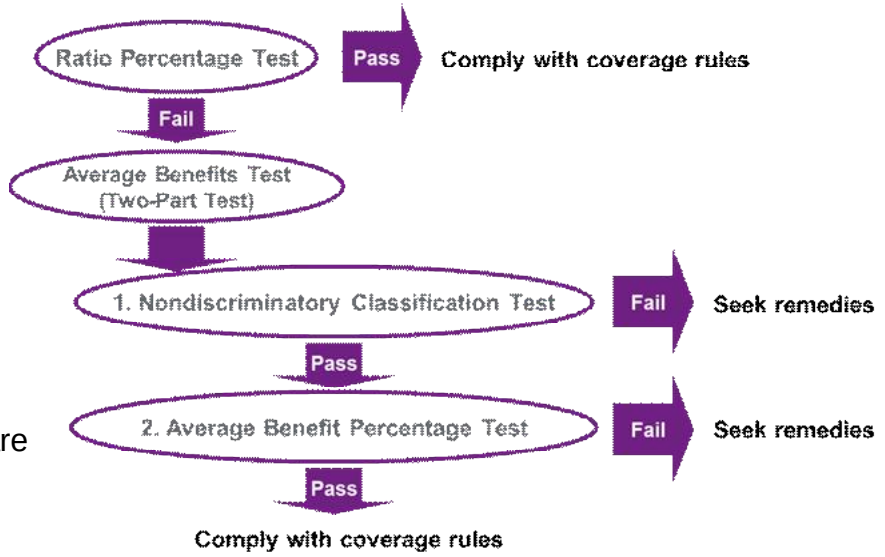
Coverage – IRC Section 410(b)

- Compares those covered by each plan to total controlled group population
- Plan automatically satisfies §410(b) if
  - Collectively bargained
  - Employer has no non-HCEs (NHCEs)
  - Plan is hard frozen
    - Since testing employees "benefiting" under plan
    - Employees receiving pay updates under soft freezes are benefiting
  - Plan has no HCEs
  - Otherwise, must be tested



- Coverage testing ensures plan benefits a reasonable % of NHCEs given % of HCEs it benefits
  - Employees are counted as benefiting if they receive an allocation or a benefit accrual for plan year
  - HCEs and NHCEs benefiting are compared to all HCEs and NHCEs of CG ("testing population")
- To satisfy §410(b), must
  - Satisfy Ratio Test or Average Benefits Test
    - Easier to pass Ratio Test, with strings attached
- A company with a number of plans is likely to have one or more which don't satisfy Ratio Test (without aggregations) even if no discrimination is intended

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Ratio Percentage Test –
Sample plan closed to new entrants on 1/1/2015

Pass if Ratio Percentage ≥ 70%

NHCE Coverage % = $\frac{\text{NHCE } \textit{Benefiting Employees}}{\text{NHCE } \textit{Nonexcludables}}$

HCE Coverage % = $\frac{\text{HCE } \textit{Benefiting Employees}}{\text{HCE } \textit{Nonexcludables}}$

Ratio % = $\frac{\text{NHCE Coverage Percentage}}{\text{HCE Coverage Percentage}}$

NHCE = Non-highly compensated employees
HCE = Highly compensated employees
For 2018, highly compensated employees are those earning more than $120,000 in 2017.

Typically, the number of NHCE's benefiting in the pension plan decreases at a higher rate than HCEs, resulting in a lower ratio percentage test. Additional steps are required for compliance.

1/1/2015

$\frac{800}{800}$ = 100%

$\frac{150}{150}$ = 100%

$\frac{100\%}{100\%}$ = **100%**

>70% = Pass

No issues since all employees are benefitting in the pension plan

1/1/2020

$\frac{500}{800}$ = 63%

$\frac{140}{150}$ = 93%

$\frac{63\%}{93\%}$ = **67%**

<70% = Fail

Newer employees are no longer benefiting in the pension plan (generally NHCE); additional tests required and will eventually fail

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Plan freezes/closed groups – Coverage issues

- Plan amendments may create closed groups
  - Changes in ongoing plan with grandfathered groups retaining prior provisions
  - Conversion to hybrid with a closed group continuing traditional plan formulas
- Closed DB plans alone likely to fail eventually due to
  - Higher NHCE turnover not replaced by new hires in the plan and
  - Shifts of NHCEs into HCE status
- Plan sponsors need to consider
  - Projected length of time the closed plan is expected to pass testing
  - Projected ability to aggregate with existing/new DC plan for some period of time
- If HCEs continue to accrue in closed plan
  - Frequency of testing to monitor ongoing compliance and projected lifespan
  - How changes in the controlled group may increase risk of failure (downsizing / acquisitions)
  - Identify benefit strategy for HCEs to potentially be removed from DB plan
    - Should there be an amendment that will cease HCE accruals automatically?

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Coverage – Permissive aggregation

- Plans can be aggregated or disaggregated for §410(b)
  - Plans that fail on their own might pass if two or more plans were merged, or if one plan were broken into pieces
  - IRS decided that a sponsor should not have to formally rearrange plans to pass §410(b)/§401(a)(4) if it could pass by rearranging them for testing purposes only
  - Plan aggregation may avoid need for ABPT and reduce data that needs to be collected
- Requires a minimum gateway test
  - Each NHCE must have an aggregate allocation rate that meets the following requirements:

Highest HCE Accrual Rate	Required NHCE Accrual Rate
Less than 15%	At least 1/3 of the HCE rate
15%-25%	5%
25%-30%	6%
30-35%	7%
Above 35%	7.5%

  - Depending on DC transition, meeting gateways requirements may be problematic over time

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Defined contribution replacement plans

- When a pension plan is closed or frozen, there is typically a replacement defined contribution plan and/or a defined contribution transition offered to those that are no longer participating in the pension plan
  - Certain contributions can mimic a defined benefit pension accrual to provide greater benefits to those that are closer to retirement age
- Special provisions within a defined contribution plan are subject to coverage testing
  - Example: All employees hired after 1/1/2015 will receive a non-elective defined contribution of 5% of pay
    - Subject to similar coverage testing as pension plan (Ratio Percentage Test)
    - Uniform plan to all future hires generally has no coverage testing issues
  - Example: Pension is frozen; all employees receive a non-elective defined contribution of 1-5% based on age or service
    - Subject to coverage testing for each age group
    - May have issues if HCEs tend to be older or have longer service and receive higher contributions

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Defined contribution transitions

- When a pension plan is frozen, a defined contribution transition can provide greater flexibility in providing benefits to targeted employees formerly in the pension plan
- Transition strategies that do not provide uniform benefits are subject to coverage testing
  - Example: Pension is frozen; all former pension participants receive an additional defined contribution of 5% for the next 5 years
    - Potential issues passing coverage as population ages

	1/1/2015	1/1/2016	1/1/2017	1/1/2018	1/1/2019
Pension NHCE (receiving additional 5% transition beginning in 2015)	800	700	600	500	400
Total NHCE	800	800	800	800	800
Pension HCE (receiving additional 5% transition beginning in 2015)	150	140	130	120	110
Total HCE	150	150	150	150	150
Ratio percentage test	100%	94%	86%	78%	68% (Fail)

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Testing considerations

- IRS issued limited relief and testing exemptions for some closed defined benefit plans
  - 2016 proposed regulations provide additional relief for closed groups but also contain significant restrictions in taking advantage of the relief
  - Because proposed regulations are so restrictive, legislative efforts are still underway to fix this problem in a less restrictive manner
- 401(k) administrators often perform ADP/ACP testing
  - Need to ensure coverage testing is appropriately reviewed
  - Important that when both 401(k) and defined benefit testing is required; vendors coordinate
    - Certain testing requirements must be consistent across the controlled group (such as the determination of HCEs)
- Understand the projected lifetime of testing thresholds
  - Based on the plan demographics and passing thresholds, is there reason for short or long-term concern?

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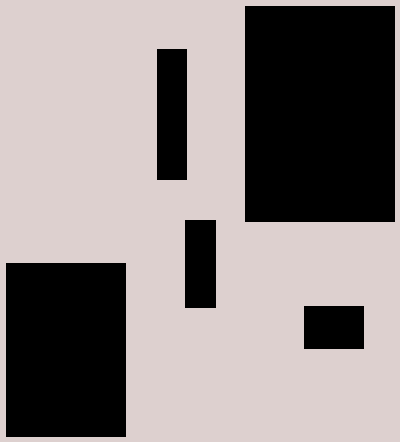
Cost reduction tactics



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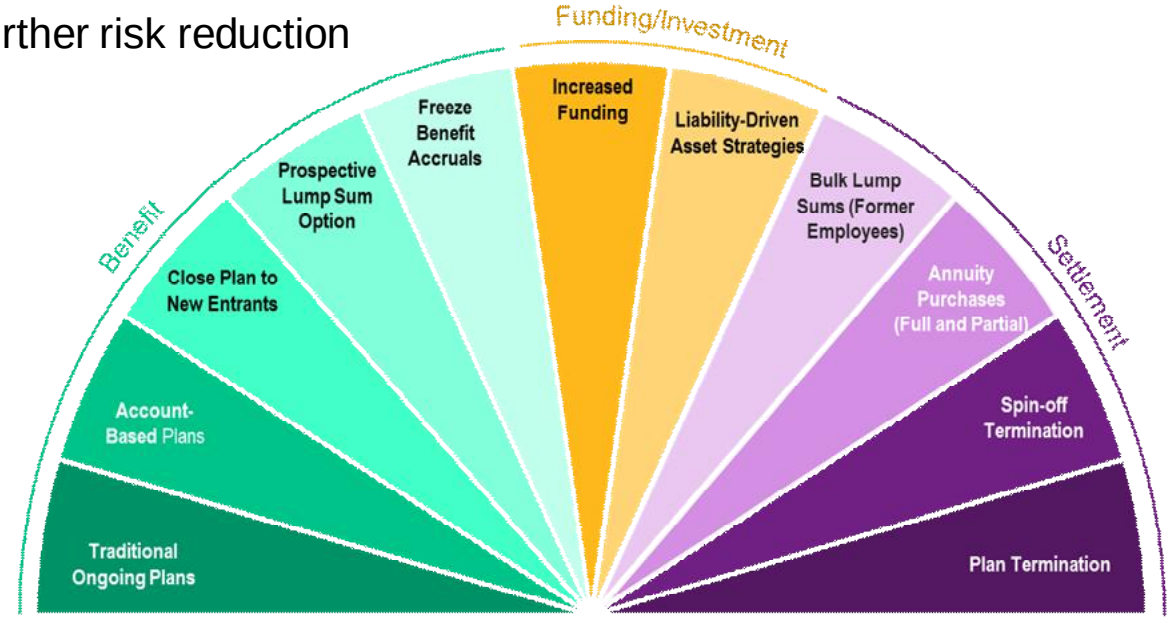
Spectrum of pension de-risking actions

- Closing a plan to new entrants or freezing benefit accruals addresses de-risking through benefit design
- However, the company may continue to have significant exposure to investment, economic and longevity risks
- In recent years, companies have focused on settlement opportunities to continue further risk reduction of their closed or frozen pension plans



Spectrum of Pension De-Risking Actions

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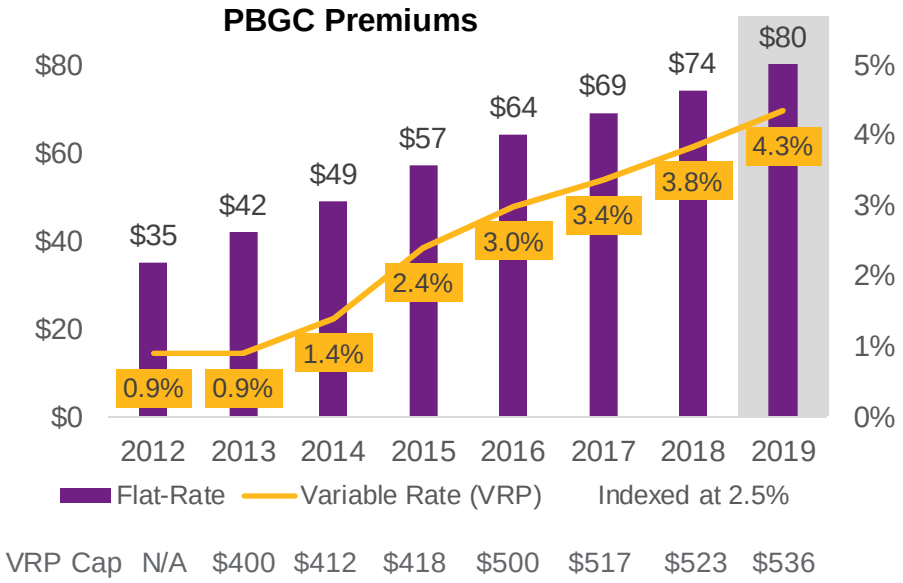
External factors impacting plan position and future costs

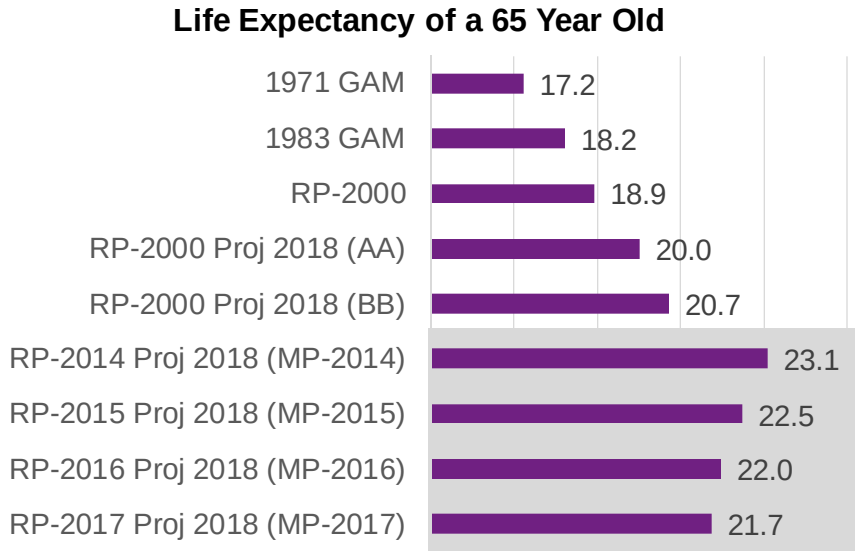
PBGC Premiums

- Third round of increases to premiums in the last 3 years
  - Flat-rate PBGC premiums have increased by over 100%
  - Deficits to be taxed at over 4% by 2019



Mortality

- Updates to mortality tables have increased pension liabilities, but recently, life expectancies have declined and uncertainty remains about the long-term



Based on 50/50 blend of male and female, projected to 2018

Funding Requirements

- Congress continues to set policies that reduce required funding (MAP-21, HATFA)
- Bipartisan Budget Act extends funding relief another 3 years

Tax Reform

- Corporate tax reform may incentivize accelerated funding
- Improved funded status may increase ability to de-risk

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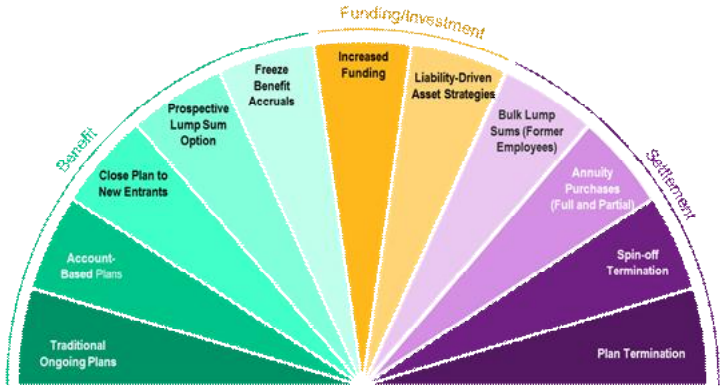
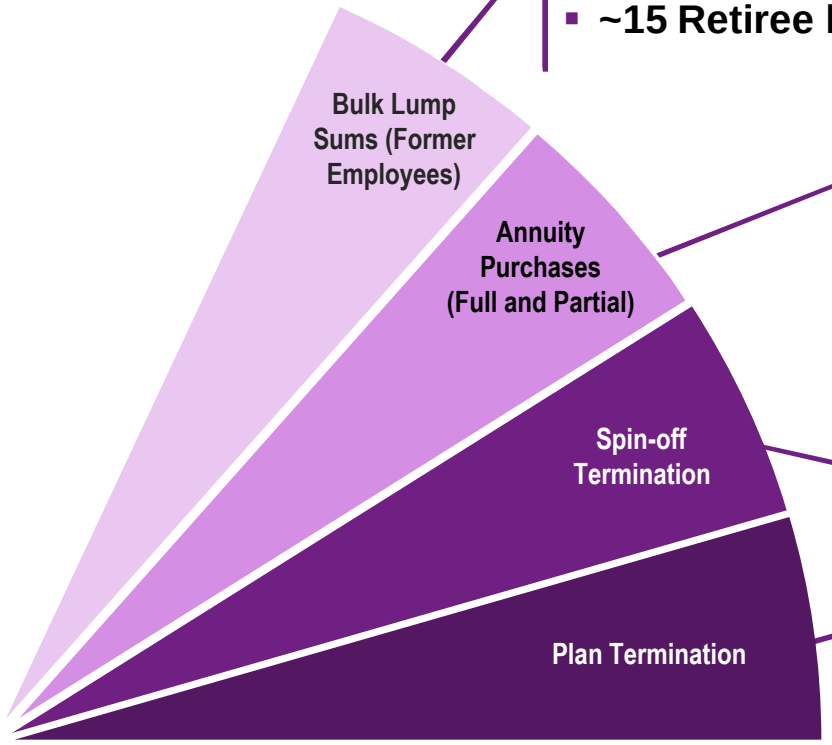
De-risking marketplace update

Settlement activity: 2012 – 2017



Spectrum of Pension De-Risking Actions



- 1,000+ TV lump sum windows (most prevalent tactic)
- ~15 Retiree lump sums (IRS eliminated option)

- ~$100B in Total activity
- ~500 purchases above $10M
- ~120 purchases above $100M
- Over 10 purchases above $1B
- Many sponsors focused on small benefit annuity purchase (SB RAP)

- Preliminary / emerging

- 100+ Plan terminations completed (under $1B in assets)

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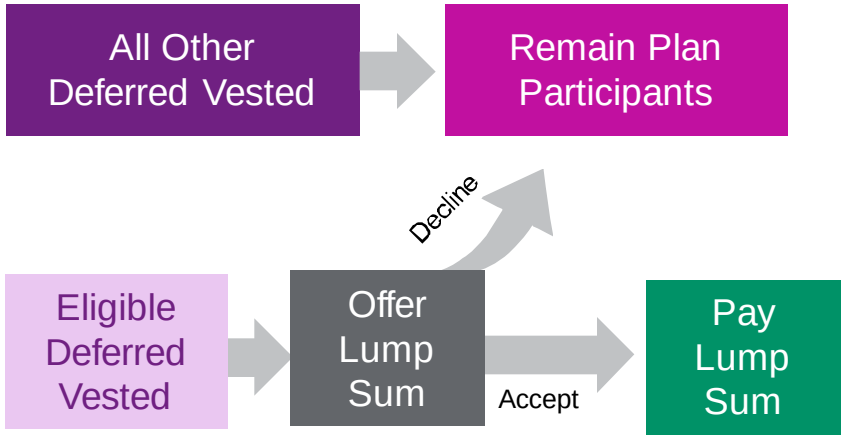
Terminated vested bulk lump sum

Overview

- Offer lump sums to former employees who have a vested pension but have not yet commenced monthly payments
- Eliminates PBGC / admin costs for participants who elect to receive lump sum
- Advantageous to provide lump sums:
  - Provides PBGC / admin savings
  - Lump sum basis (interest and mortality) can be favorable relative to existing obligation
- Size transaction based on risk reduction / financial objectives & constraints
- Potential for significant economic savings

Transaction Summary



Transaction Characteristics – Settlement	
Population:	Former employees
Benefit Threshold:	As desired (can but do not have to limit)
Participant Approval?:	Yes
Execution Timeline:	4-7 Months from “Go” to close

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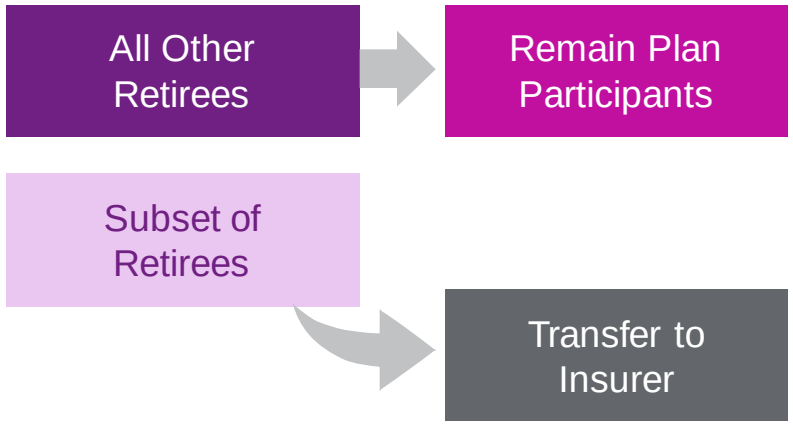
Retiree annuity purchase

Overview

- Purchase annuities for all or a subset of retirees from an insurance carrier (IC)
- Eliminates PBGC / admin costs for annuitized participants
- Advantageous to annuitize retirees with smaller benefit amounts:
  - Maximizes PBGC / admin savings
  - Aligns with current IC interest
- Size of transaction based on risk reduction / financial objectives and constraints
- Potential for significant economic savings

Transaction Summary



Transaction Characteristics – Settlement	
Population Annuitized:	Subset of retirees
Benefit Threshold:	Sponsor defined (e.g., <$250/month)
Participant Approval?:	No
Execution Timeline:	3-5 Months from “Go” to close

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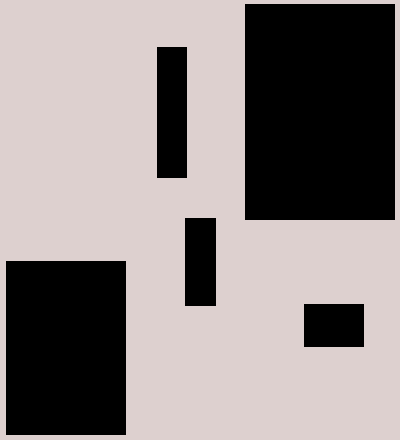
Revisiting your retirement strategy



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Retirement readiness and harmonization

- Maintaining a closed or frozen pension plan creates HR issues in addressing retirement readiness and harmonization
  - Results in population cohorts within the active workforce of “haves” and “have nots” with respect to the pension plan
  - May result in varying levels of retirement readiness and resulting workforce issues depending on the transition and replacement defined contribution plan
- Assessing retirement readiness
  - Increasing trend by plan sponsors to more fully review retirement readiness and educate employees on overall financial wellbeing

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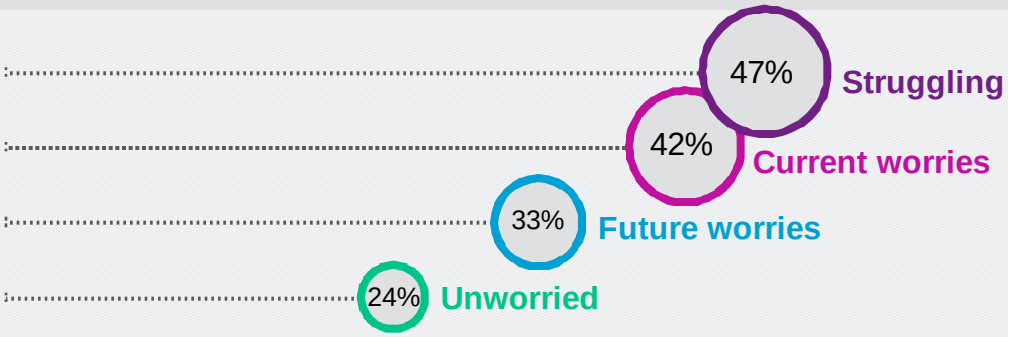
Struggling employees more likely to work into their 70s

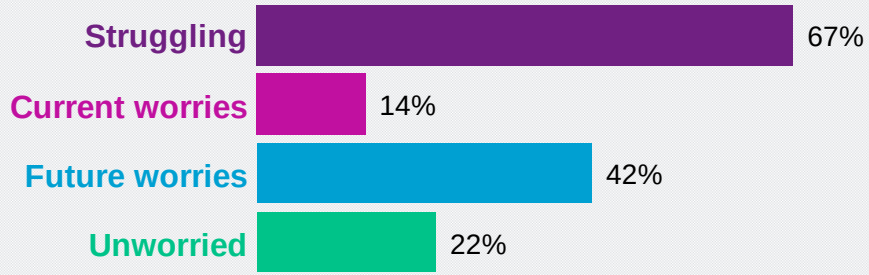
Despite being most likely to want to retire immediately

I feel stuck in my current job and would retire now if I could



Sample: Employees age 50+

At what age do you think you will be able to retire?
Percentage expecting to work to 70 or later



Sample: Employees age 50+

A hidden pensioner problem?

- Struggling employees are nearly twice as likely to be willing to retire as the unworried.
- However, two-thirds of struggling workers don't expect to be able to do so before reaching their 70s.
- Will this translate into a group of discouraged older workers sticking at their jobs out of necessity – acting as a drag on productivity?

Note: Percentage agree or strongly agree.
Source: 2017 Global Benefits Attitudes Survey, United States

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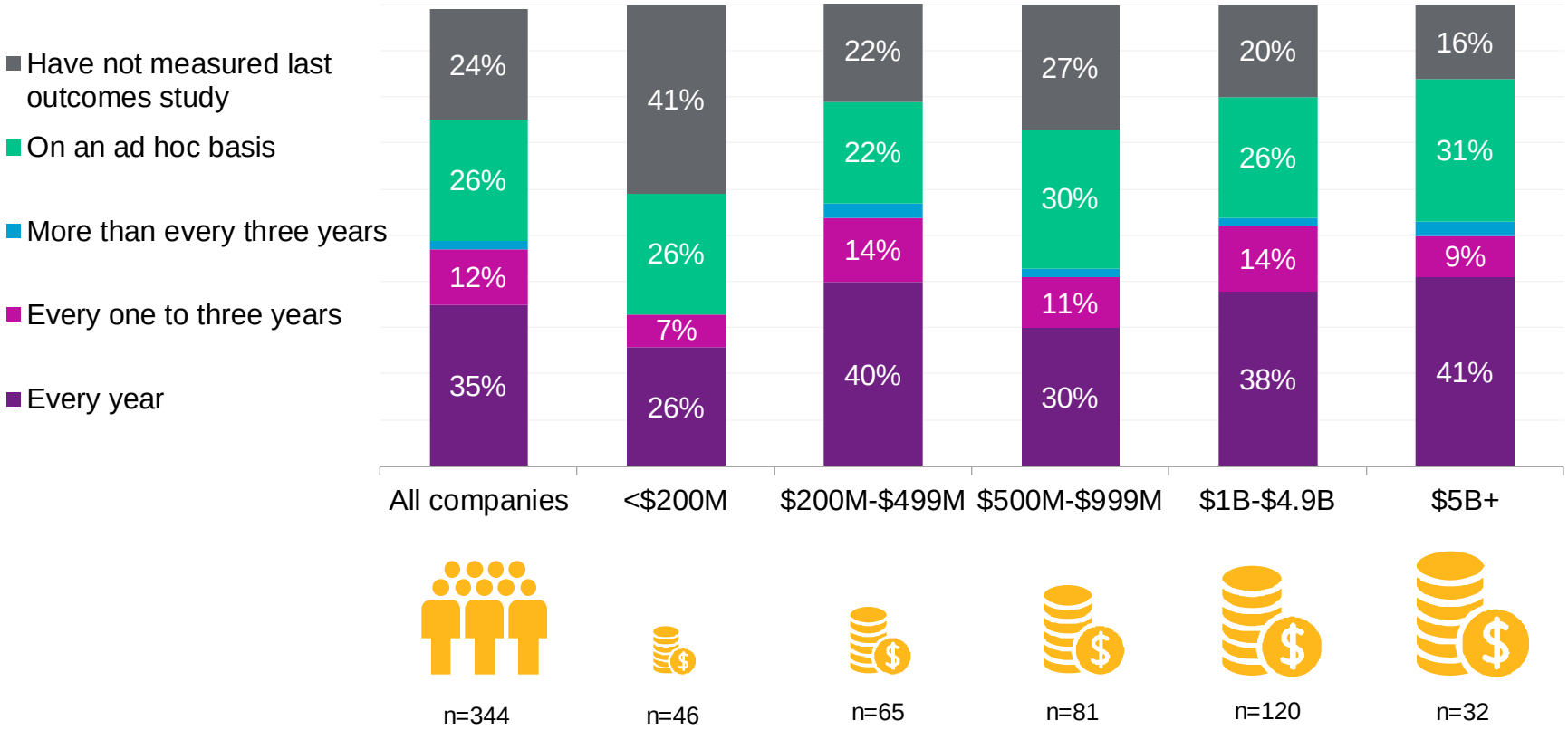
Source: 2017 US Willis Towers Watson Defined Contribution Plan Sponsor Survey

Enhance program effectiveness through measurement: Only one in three measure retirement readiness annually

How often does your organization **measure the retirement readiness** of your plan members (i.e., analyze when your plan members will be able to retire under your plan)?



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Source: 2017 US Willis Towers Watson Defined Contribution Plan Sponsor Survey

Six goals of retirement design

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Source: 2017 US Willis Towers Watson Defined Contribution Plan Sponsor Survey

Questions?

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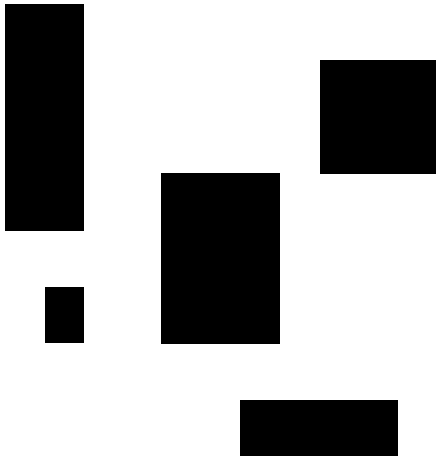

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Source: 2017 US Willis Towers Watson Defined Contribution Plan Sponsor Survey