Ready to terminate your defined benefit plan?

3 steps that can help in setting your strategy

With nearly 1 in 3 defined benefit (DB) plans currently frozen, employers are eager to reduce volatility and limit their balance sheet exposure. Unfortunately, many DB plans remain significantly underfunded and unable to terminate.

33%
Closed to new entrants or benefit accruals

How can you fix this? With a formal termination strategy.

Consider these three steps to get started.

Regardless of the option chosen, sponsors should continually be looking for ways to manage the risk in their DB plans.

Source: PBGC premium filings, Aug. 2021

STEP 1

Calculate the cost to terminate

The potential cost of terminating your organization's defined benefit plan can determine how long it may take your organization to reach its goal.

Since a lack of funding is one of the top barriers to termination for most defined benefit plans, you'll want to understand the overall cost of your plan. The best way to tackle this is through an actuarial study that calculates and forecasts plan cost based on certain assumptions or variables, including interest rates and funding shortfalls.

Interest rate wild card

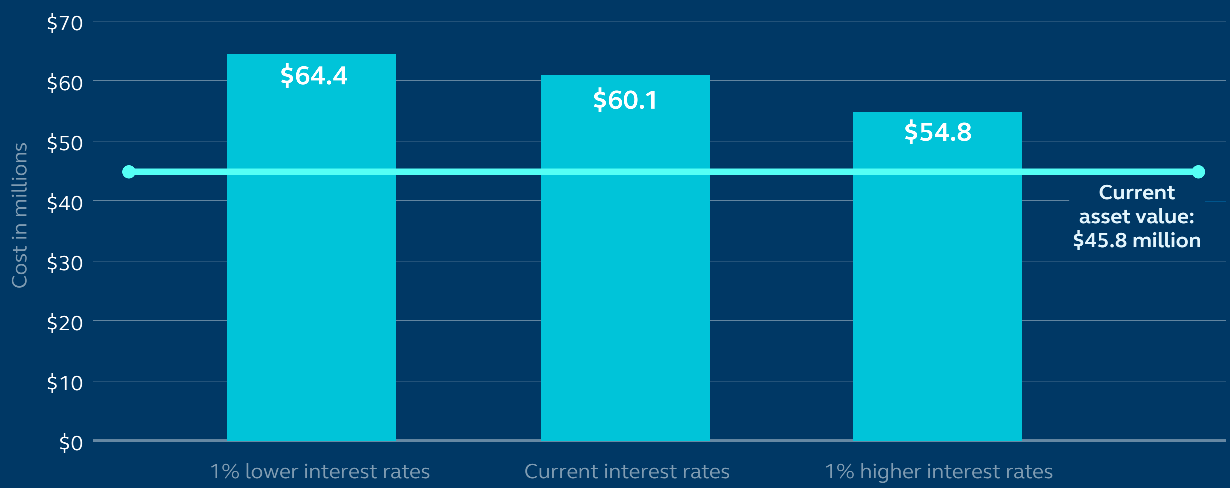
Defined benefit plan costs are impacted by interest rates. As a result, any actuarial study should calculate costs using a variety of interest rate assumptions. In general, higher interest rates result in lower overall liability costs.

Also, interest rates impact liabilities differently depending on the ages and benefits of the participant group.

For every
1% (+/-)
change in interest rates, DB liabilities can shift 10-15% in the opposite direction.

Interest rate impact on termination liability

A drop in interest rates can significantly affect the cost of terminating a DB plan — adding an extra $4.3 million in liabilities in this example.



For illustrative purposes only.

Balancing costs

There's a difference between a fully-funded ongoing plan and being fully funded on a termination basis. You'll generally need to close the gap between your current plan assets and the potential cost to terminate before you can wind down your plan.

Knowing this spread can help you decide whether you can afford to fund the shortfall over one year, five years, or a longer period. Depending on your risk tolerance and your organization's access to capital, you may choose to fund the shortfall through cash contributions, investment earnings, or a combination of the two.

STEP 2

Choose a funding strategy

When you determine your funding goals and strategy, you'll have a clearer picture of the amount and timing of assets needed to terminate the plan.

Once you've identified the funding shortfall and the potential timeline for termination, you're ready to pick a funding strategy that fits your needs. Your actuary can help you weigh the options by using standard assumptions to calculate contributions. While many funding strategies can be considered, these three are typically the most common: minimum, level, and full contribution.

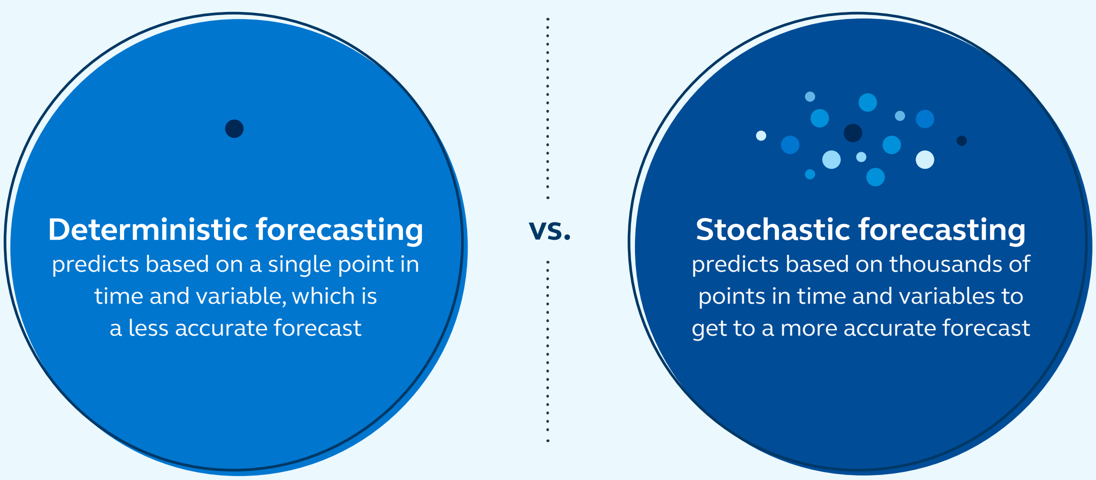
Top 3 strategies for funding a defined benefit plan

MINIMUM CONTRIBUTION	LEVEL CONTRIBUTION	FULL CONTRIBUTION
Employer contributes minimum annual requirement until plan termination year	Employer contributes a level amount annually until the termination year	Employer fully funds the plan
How it works: • In the year assets are distributed (typically 18 to 24 months after the termination date), the employer contributes a final amount. • The timing of final contribution can vary, but many choose to fund over a 3- to 5-year period.	**How it works:** After estimating the cost to terminate the plan, employer identifies a future date to distribute assets (e.g. 5 years from now) and then contributes even amounts over each year until that date is reached.	**How it works:** Employer contributes the minimum required annual contribution for an ongoing plan and hopes investment income can make up the funding shortfall.
Considerations: Likely the most expensive choice. But it offers a short timeframe which can lead to lower overall risk, since risk can rise as the timeframe lengthens.	**Considerations:** Costs may be slightly lower since contributions are made into the plan earlier. This allows for earnings on investment returns within the plan over the time horizon.	**Considerations:** May bring the plan to the termination funding level at a lower out-of-pocket cost, but exposes employer to higher risk. Unfavorable market conditions and/or changes in interest rates from covering the funding shortfall may ultimately result in an overall higher cost.

Economic conditions could also change, increasing or reducing the cost of termination; therefore, it's important to monitor the funded status throughout the time horizon chosen and make adjustments to funding as needed.

Importance of accurate forecasting

To get a better understanding of risks and potential future outcomes, your actuary should run a **stochastic forecast,** which shows thousands of potential future scenarios. This allows you to explore how different capital market and economic outcomes may impact cash contributions, termination funded status, and accounting expenses.



STEP 3

Evaluate your risk management approach

Volatile market conditions along with low interest rates make risk management critical for sponsors of frozen defined benefit plans.

Until the termination date is set, you must operate your DB as an ongoing plan. This means that the funded status and related expenses will continue to be reflected in your balance sheet and income statement. To keep you on track and minimize volatility as you work toward your goal to terminate, review the effectiveness and progress of your risk management strategy on an ongoing basis.

There are two approaches for managing risk:

- **Transferring risk** to another party—either to the employee by offering lump-sum payments or to an insurance company by purchasing an annuity
- **Handling the risk in-house** via investment choices

CHOICE 1

Transfer the risk

Transferring the risk removes a portion of the risk and transfers it to other parties. That may be to plan participants electing lump sum payments or to an insurance company through an annuity purchase. Like any risk management strategy, either option requires careful consideration.

1 Lump sum payment

Participants accept a one-time payment instead of individual annuity options. These lump sums can be paid in cash or rolled over to qualified retirement plans or an individual retirement account (IRA). Generally, the employer has two choices:

Permanent lump sum

This helps employers remove risk gradually as individual lump sums are paid out to employees as they terminate or retire. Risk is retained by the plan until the lump sum payments are actually elected.

Lump sum window

Extends a lump sum option to a specific group of plan participants, such as terminated and vested participants, for a limited time period (typically three to 12 months). The temporary nature allows employers to transfer risk for the targeted group without incurring future additional costs for employees retiring in future years. With this option, it’s important not to discriminate in favor of highly compensated employees.

2 Group annuity purchases

With this option of transferring risk, liabilities and associated assets are shifted out of the plan to an insurance company. The insurer then manages the risk and handles participant payments.

For an annuity purchase, the financial strength of the insurance company is an important factor to consider. When benefit payments move out of qualified plans to insurance companies, participants lose the insurance coverage from the Pension Benefit Guaranty Corporation (PBGC). This means if the insurance company goes out of business, participants' benefits are no longer guaranteed—and the employer could be liable.

Impact of transferring risk on your premiums

Both lump sum payments and an annuity purchase permanently reduce liabilities and can reduce PBGC premiums. However, parting with a potentially significant portion of plan assets should be carefully weighed as it may:

- Reduce funded status, triggering additional cash contributions
- Trigger settlement accounting as a result of recognizing previously unrecognized losses

CHOICE 2

Handle the risk in-house

Taking on the risk yourself means developing an asset allocation that fits your budget, termination timeline and risk tolerance.

Your choice of asset allocation will not only impact the amount of contributions you'll need to fund the defined benefit plan to termination, but also the volatility of contributions from year to year. A well-chosen asset allocation strategy can help protect improvements in funded status as you move toward your termination goal. The financial professional and actuary will work closely with you to identify the approach that best fits your plan.

Conduct an asset liability modeling study

When determining an asset allocation strategy, the financial professional and actuary should prepare an asset liability modeling study. In the study, your DB plan assets and liabilities are modeled simultaneously using either static or dynamic asset allocations. The appropriate allocation for you will depend on your situation and risk tolerance.

Forecasts take into account

What you **have now**

How much you can **contribute** each year

How close you are to reaching your **termination** funding

Two approaches to asset liability modeling

Static asset allocation

Asset allocations with a static mix have a fixed allocation among various asset classes. The defined benefit plan's portfolio is rebalanced to the fixed target allocation on a periodic basis. Static allocations tend to be more appropriate for active DB plans vs. frozen plans with a goal to terminate.

Dynamic asset allocation

Dynamic asset allocation tends to work better for hard-frozen plans because it links the plan's asset allocation to its funded status, which is the most critical factor for a plan to terminate on time. Dynamic asset allocation may also produce a lower cost than static strategies.

While a dynamic strategy will likely mean more stock (equity) exposure when the funded status is low, exposure shrinks as the plan's funded status improves.

Reducing your equity exposure as funded status improves has some potential benefits, including:

- **Locks in gains.** As the funded status improves, allocations to fixed income investments are increased. This is to help protect against the loss of funded status as the plan gets close to full funding.
- **Helps prevent employers from terminating with excess plan assets,** which are subject to taxation.
- **Minimizes cash contributions by closing the funding gap** with better returns and takes advantage of volatility in equity returns or interest rates.

Benefits of dynamic allocation

Static asset allocation strategy

Allocation remains the same, regardless of plan's funded status

60% equities | fixed income 40%

Today
Plan's funded status = 90% funded

60% equities | fixed income 40%

10 years from now
Plan's funded status = 90% funded

Dynamic asset allocation strategy

Allocation shifts as the plan's funded status improves

60% equities | fixed income 40%

Today
Plan's funded status = 90% funded

10% equities | fixed income 90%

5 years from now
Plan's funded status = 98% funded

fixed income 100%

10 years from now
Plan's funded status = 104% funded, ready to terminate

The funded status in this chart is hypothetical and does not guarantee any future returns nor represent the returns of any particular investment. This is for illustrative purposes only.

If you decide dynamic asset allocation is a good fit for your overall termination strategy, it's important to get your actuary and financial professional to work together closely because changes in your plan's funded status will typically trigger changes in the asset allocation.

Ready to get started?

By following these three steps you can not only minimize volatility and risk, you can also build a more realistic termination strategy and timeline.

If you're thinking about terminating your DB plan, our team can help. We handle plan provisions from the very basic to the most complex and we care about your Organization and employees.

Call us at
800-952-3343, option 2
or visit **principal.com**
to get started today.

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