

Retirement plans: What to look for in 2012

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As we are now under way with the 2012 calendar year, it's time to look at the issues we expect to generate heavy interest during the year. For one thing, the federal deficit has attracted a lot of attention lately and will likely continue to do so. The upcoming presidential election is likely to feature plans on reducing deficits, and these plans will undoubtedly reach the world of employee benefits in some fashion. In addition, the economic environment of recent times, both globally and locally, has been unstable to put it kindly. Pressure on employee benefit plan sponsors is coming from a lot of different directions. In this article, we look at a few of the potential headliners that may affect defined benefit and defined contribution plans in 2012.

Defined benefit (DB) plans

Discount rates

First and foremost on the minds of defined benefit sponsors are interest rates. How low can they go? It seems like DB plans have already circled around the limbo stick of interest rates several times and are now faced with rates so low that not even the retirement plan of double-jointed contortionists could slide under without buckling. Bend don't break has been the unfortunate reality for DB sponsor's balance sheets and funding requirements. The rate on the Citigroup Pension Liability Index, a common benchmark used to discount pension liabilities, hit a record low in December of 4.40%.¹ That was the lowest rate reported by the index in its history.

Since 2008, the Federal Reserve has done what it can to keep interest rates low in an effort to offer cheap rates to homeowners and businesses with the hopes of eventually reviving the economy. Federal Reserve Chairman Ben Bernanke said last month that the plan would be to keep rates "exceptionally low" through 2014.² One unfortunate consequence of these actions has been to increase the cost of insurance and annuities to individuals and plan sponsors. This wreaks havoc in the retirement industry. At the individual level, the cost of annuities has dramatically increased. At the same time, the returns under fixed income instruments are potentially inadequate to meet retirement needs. In the DB arena, today's estimates for the values of the liabilities have skyrocketed as interest rates have dropped. If a plan was both fully funded and immunized with investments in a dedicated bond portfolio, the increase in liability wouldn't matter because the underlying asset investment backing the liability promise would increase equally. However, such an investment strategy is the exception not the rule. The inflated liabilities showing up in actuarial reports and financial statements are leading to historically high contribution and expense requirements.

The Milliman Pension Funding Index (PFI), which measures pension requirements for the 100 largest defined benefit pension plans sponsored by publicly traded corporations, expects significant increases in 2012 and 2013 fiscal year contributions. The PFI includes different funding projections, and for the years 2012 and 2013 includes an assumption of \$91 billion annually in order to fill the funding gap.³ This forecast agrees with the results of a recent research project led by the Society of Actuaries, "The Rising Tide of Pension Contributions Post-2008: How Much and When?" The report predicted that the average aggregate contribution to private sector pension plans would increase from \$70 billion per year over the five years in 2004-2008 to about \$90 billion per year over the next 10 years, peaking at \$140 billion in 2016.⁴ Says John Ehrhardt, co-author of the Milliman Pension Study, "It's all about having to cope with low rates right now."

Financial statements

The impact of low interest rates not only leads to higher contribution requirements but also to an increased squeeze on corporate earnings. Under current U.S. GAAP guidelines, large losses in the funded status of a pension plan (whether because of asset returns less than expected or liability increases that are due to lower interest rates) accumulate on the balance sheets through other comprehensive income (OCI). In most cases, these losses are slowly realized through earnings over time. Absent significant increases in asset returns or interest rates over the next few years, corporate earnings for DB plan sponsors will continue to drag from the gradual recognition of the losses that led to the current, historically high underfunded statuses.

Another item to keep an eye on in 2012 is the progress between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on their goal for convergence. The two boards have stated they share a long-term desire to coordinate accounting standards.⁵ The IASB revised its accounting standard for employee benefits (IAS 19) last year, which will require significant changes in reporting requirements in 2013. Of particular importance is the removal of the expected return on assets component of pension cost. That will now be rolled into the net interest charge, which will be calculated by multiplying the net liability or asset by the discount rate. This revised method will likely increase fiscal year pension costs because it replaces the prior calculation of interest on the liability at the discount rate offset by the expected return on plan assets. Most sponsors have been reflecting an expected asset return in excess of the discount rate, in essence assuming asset growth will outpace liability growth. This will no longer be allowed. Also, the annual aggregate gain or loss will be recognized as a change in OCI and will not be subsequently amortized through pension expense in future years. Because of these changes, equity returns will no longer directly generate increased reported profits for sponsors. First, the higher expected return on equities has been removed from the pension cost calculation. Second, the recognition of actual superior equity returns (should they materialize) will also not boost profits because the recycling of asset gains or losses from OCI into profit and loss (P&L) has also been removed. This may urge companies to take a second look at their asset allocations because they no longer benefit in the same way from increased equity risk.

FASB has not yet made similar changes and still allows for differing recognition techniques. It will be interesting to see what progress, if any, is made during 2012. Until that day comes, plan sponsors with U.S.-based defined benefit plans must continue to determine if two sets of plan costs and disclosures may be required.

Funded status and at-risk

One of the new requirements of funding rules under the Pension Protection Act (PPA) requires a determination of whether or not a plan is “at-risk.” A plan is deemed to be at-risk in a given year based upon the funded status from the previous year. If the funded percentage falls below a certain threshold, generally speaking 80%, then the plan may face stricter funding requirements and there may be adverse tax implications for certain executives of the company.

In 2010, most sponsors were in no trouble of being at-risk because the 2009 actuarial valuations benefitted from significant relief that resulted in high funded ratios. Recall that calendar-year sponsors generally calculated liabilities using the October 2008 yield curve, which resulted in an effective discount rate somewhere in the neighborhood of 8.00%. At the same time, sponsors smoothed their asset value to 110% of market value, delaying recognition of the significant 2008 investment losses.

In 2011, some sponsors may have fallen under the at-risk designation because 2010 valuations were likely calculated at a much lower discount rate, generally around 6.70%, or about 120-140 basis points lower than the 2009 valuation. The rates in 2011 and 2012 have fallen even further. It is quite likely that the effective discount rates for calendar-year 2011 and 2012 valuations come in around 6.30% and 5.70%, respectively.

This continued decline in interest rates, coupled with a poor investment year during 2011, is likely to lead to more sponsors missing that 80% threshold. (There is a second threshold of 70% that needs to be missed as well under separate, more “unfavorable” assumptions.) Even if sponsors avoid being at-risk for 2012 or 2013, they should verse themselves in the applicable consequences particularly because the effective discount rate is likely to fall again for 2013 valuations. Recall that most sponsors rely on a 24-month average of corporate bond segment rates to generate the effective discount rate that must be utilized to calculate funding liabilities. For those using a four-month look-back, 16 of the 24 months of rates that will populate the averages for 2013 are already known at this point, and the results aren't pretty. The averages of the three segment rates are 1.87% for Segment 1, 4.89% for Segment 2, and 6.11% for Segment 3. When you extrapolate the latest month's rates through the end of the 24-month period, the expected results are even worse (1.93%, 4.74%, and 5.82%, respectively). That last set of rates would likely produce an effective discount rate near 5.50%. This is 250 basis points lower than the valuation performed just four years earlier.

Many sponsors have already been monitoring the funded status of their plans since the PPA's inception and taking appropriate actions to avoid falling below 80%, which happens to be the same threshold that introduces the first layer of benefit restrictions for a plan. However, not all plans have accelerated forms of payment available (i.e., lump sums) or other potential issues that would have warranted watching of

the 80% target. Further, many sponsors that do care about 80% may not have the wherewithal to do anything about the prospect of falling under it in the near future if contribution requirements become too onerous. The end result is that at-risk determinations could very easily see a spike in occurrences in 2012 and the coming years. For publicly traded companies whose executives participate in nonqualified deferred compensation arrangements, any assets transferred or set aside to a trust while any qualified plan of the employer's control group is deemed at-risk are subject to immediate taxation. Clearly, this may become an important issue.

PBGC activity

American Airlines' recent declaration of bankruptcy could unload almost \$10 billion in unfunded benefits on the Pension Benefit Guaranty Corporation (PBGC), according to the federal agency directed with insuring the pensions of qualified plan participants in the United States.⁶ The PBGC has long been warning of its unstable financial condition and has been seeking increases in authoritative powers from Congress, including the ability to set premium rates for healthy DB plan sponsors based in part on the company's creditworthiness.⁷ Some policymakers, too, want to see increases in premium revenue to buffer the PBGC's deficit. There is much debate as to whether or not these actions would ultimately add value to the goal of protecting retirement benefits. Healthy sponsors may be encouraged out of the system altogether if they find themselves paying the debt of failed sponsors, most of which arose from the steel and airline industries, which actually operated under relaxed funding rules and special exemptions for years. Look for both sides of the debate to continue to play out during the year, with the PBGC arguing for more money, and opponents arguing for more transparency of the PBGC's self-appraisal.

De-risking plans

Given the highlighted areas of concern above, it's likely that plan sponsors will look ever harder at the idea of de-risking their plans in 2012 and onward. The volatility of worldwide markets has been dubbed the "new normal" by many economic minds. Smoothing mechanisms are losing favor in the financial world, and the IASB has already moved toward a more mark-to-market structure, with FASB likely not far behind. Sponsors have already been "encouraged" by the PPA to take on less risk in their pension portfolios, and now the accounting world is joining in on the push. When you further consider the world of pain that comes with benefit restrictions under the PPA and the ramifications of being at-risk, not to mention higher PBGC premiums the more underfunded a plan is, it stands to reason that employers should be very attracted to pension risk management more so than ever.

Liability-driven investment (LDI) strategies have been one popular approach to mitigate risk by reducing the exposure to the most volatile assets in a portfolio, instead concentrating investments in assets that act more like liabilities, namely long bonds. However, the cost of implementing an LDI strategy is high right now because current yields on bonds are so low. Also, there is still a lost opportunity cost with regard to the impact on financial statements, at least with U.S. GAAP anyway.

Full immunization strategies, bond matching, or even annuity purchases to transfer risk are also good ideas but currently "expensive." Alternatively, we expect many sponsors in 2012 to embrace other strategies that maintain substantial equity exposure within the pension portfolio. Simply put, they can't afford not to invest in equities right now. Many sponsors have been interested in the concepts of dynamic hedging, an approach that still allows for significant equity investment with less overall risk. The Milliman Protection Strategy (MPS) is one such platform to accomplish this risk management goal. It offers pension plans more than what simple asset diversification can offer. MPS focuses on capital protection and volatility management. Its risk reduction techniques are very easily added as a futures overlay onto a portfolio with no disruption to the underlying investments. The concept is to sacrifice a small portion of the upside potential while eliminating a greater, more disproportionate amount of the downside.⁸

Dynamic hedging strategies such as MPS can accomplish this because of the asymmetric distribution of stock market returns. Theoretically, the concept should find favor with sponsors because avoiding the worst returns has greater economic and practical value than the small slice of lost value of the most spectacular asset returns. After all, significantly overfunded pension plans present their own set of problems. Thus, it makes sense to strive for middle-of-the-distribution returns and avoidance of the long, fat left tail of poor returns.

Lump sums

Speaking of de-risking strategies, another idea which may gain more traction in 2012 is payment of lump sums from DB plans. 2012 marks the first year that the 417(e) interest rate required to calculate the minimum present value of a DB pension is equal to the interest rate used to calculate its liability for PPA minimum funding purposes (ignoring the 24-month averaging). In the past, the lump sum was based in part

on 30-year treasury rates which often resulted in the payout of lump-sum amounts greater than the corresponding liability funded for in the plan's funding target. With this no longer the case, the settlement of lump sums might be an attractive way to eliminate longevity risk from DB plans. Alas, the buyer must beware. The introduction of lump sums into a plan that otherwise had no accelerated forms of payment could lead to some unwelcome news should the plan ever fall below certain funding thresholds that introduce the sponsor to the world of benefit restrictions. Additionally, the other subtle point to consider is that just because PPA requires the valuing of liabilities using corporate bond rates doesn't mean a sponsor has to equate that to their idea of the true liability on the books. To the extent a sponsor is confident the plan's asset mix will generate long-term returns on average in excess of corporate bond rates, lump-sum settlements are arguably still expensive and represent a lost opportunity cost. As is the case with almost any financial strategy, it's all about the risk appetite.

Defined contribution (DC) plans

July 1, 2012, is a significant date for defined contribution (DC) plan sponsors, including persons who have legal responsibility for managing someone else's money, trustees, and investment committee members. By that date, plan sponsors should have received information from all plan service providers disclosing their status as it relates to the plan, such as an ERISA fiduciary and/or registered investment advisor, their estimated fees, how they are compensated, and the services they provide. The new Department of Labor (DOL) regulations are intended to improve fee disclosure to regulators, plan sponsors, and plan participants. Plan sponsors have a fiduciary responsibility to review, for reasonableness, the compensation of their service providers that is paid from plan assets both directly and indirectly. However, in our experience, some plan sponsors are not aware of the total amount of fees paid from the plan or how they are calculated.

Many plan fiduciaries may not be aware that it is both a fiduciary breach and prohibited transaction to allow the plan to pay more than what is considered reasonable expenses. In practice, how does a fiduciary determine if plan fees are reasonable? If you've taken your plan out to bid within the last three years, you should have current market information and documentation for your due diligence files to support the fees you are paying, or have taken action by going back to your service provider(s) to negotiate lower fees on behalf of plan participants. In lieu of going out to bid, there are other options available: for example you can benchmark your plan. The DOL has developed a fee disclosure worksheets that can be found on their website at: DOL Publications "Understanding Retirement Plan Fees and Expenses"⁹ and "Cost Disclosure Sheet."¹⁰

There is nothing in the regulations to imply a plan must have the lowest fees, just that the plan's fees be reasonable and commensurate with the services provided. Qualitative differences in services may impact fees. For example, quality of service varies with respect to the range of planning and guidance tools available to participants, which may drive up fees. We strongly encourage plan sponsors to develop a diligent process to evaluate fees on an ongoing basis and to document their process. Costly litigation can be avoided by implementing a sound process which shows that you have taken reasonable steps to fulfill your plan fiduciary responsibilities.

What to look for, in summary

The year that just passed saw some extraordinary events take place. Those that are unforeseen are what make predictions impossible, complicating matters and leaving their mark on the global economy and political landscape. The European debt crisis, political revolutions, an earthquake and tsunami in Japan, and the downgrade of U.S. debt, to name just a few, were major events that dictated the direction of economic and regulatory policies. What will 2012 hold? We'll have to wait and see it unfold.

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