Mapping and Managing a Defined Benefit Plan's Journey

The evolution of pensions in the U.S., for many DB plans, has included a transition from an open plan to one that is closed or frozen. From there, plan sponsors generally embark on a journey toward one of two states: hibernation (long-term sustainability) or termination — in some cases mixing elements of both. Right now, termination appears to be the most popular option: 71% of senior finance executives polled in a new survey by CFO Research in collaboration with Mercer say their organization is considering terminating their DB plan within the next 10 years. On the other hand, 51% say they are likely to move to a hibernation

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strategy in the next two years — which in many cases could be a long-term plan for sustainable retention or perhaps a prelude to an eventual termination. In either case some level of de-risking will be core to direction.

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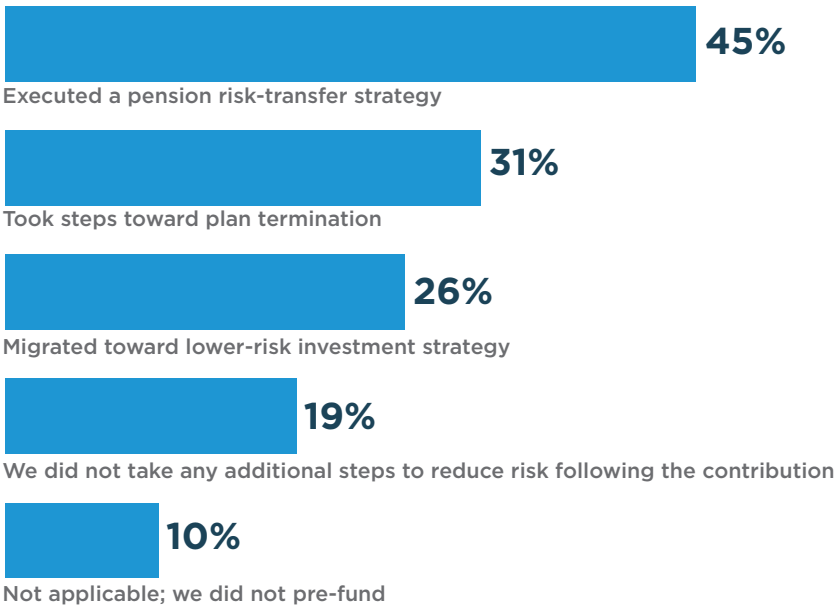
Regardless of the ultimate goal, plan sponsors need a multi-year roadmap to help them reach their destination as efficiently as possible. That roadmap should spell out the plan's de-risking strategy, describing what the plan will be doing to minimize its impact on the sponsor's financial results until it reaches a funded status that makes hibernation possible or termination desirable. A growing number of sponsors are already approaching that funded-status milestone, but they remain a distinct minority. Twenty-three percent of survey respondents say their plans have a funded ratio of 100% or higher, up from 13% just two years ago.

In developing a roadmap, we see three key areas — three key foundational building blocks — where plan sponsors will want to focus their attention: strategy, readiness, and execution.

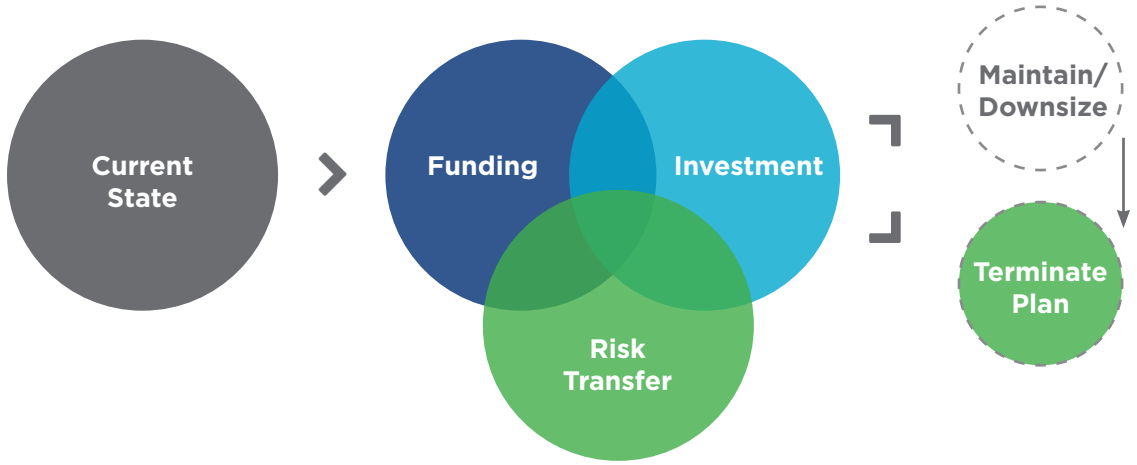
Strategy. The key objective here is to map out the ultimate destination for the plan and the funding, investment, and risk-transfer policies that will guide direction. An important part of this undertaking is ensuring that the plan uses the appropriate de-risking strategies at the right time. As described in our companion report, "De-Risking Goes Mainstream," the de-risking options available today are numerous, and are being deployed on a broad front. In our survey, 71% of senior finance executives say their organizations recently made a funding contribution to their DB plan above the minimum required, partially in response to the Tax Cuts and Jobs Act of 2017, knowing that lower corporate tax rates would make tax deductions on future contributions less valuable. Then, as a result of that decision, many took further action to reduce the risk in their plan: 26% changed their investment strategy, 45% executed a risk-transfer strategy, and 31% took steps toward plan termination.

At the same time, 20% of survey respondents say their organizations reduced their use of

To the extent you made additional contributions to your plan in response to the Tax Cuts and Jobs Act of 2017, what action did you take as a result?



Building a DB Plan Journey



SET THE DESTINATION

- Plan termination
- Long-term sustainability
- Maintain plan and downsize opportunistically over time

MANAGE THE SIZE

- Vested terminated cashout
- Active cashout
- Retiree buyout
- Full plan termination

MANAGE THE RISK

- De-risking glide path
- Diversified growth portfolio
- Custom hedging strategies
- Dynamic governance models

private investments to improve liquidity in the context of anticipated plan termination, and 12% moved to a hibernation strategy. Over the next two years, 55% of survey respondents say their organizations are likely to reduce the use of private investments. And, as noted, 51% say they're likely to pursue a hibernation strategy.

Understanding the costs of various de-risking strategies is also an important part of setting a plan's overall strategy. Many plan sponsors — 65% in our latest survey — believe that buying annuities to settle obligations to participants is expensive. In practice, this may not be the case. Increased competition from new entrants to the insurance market has driven down pricing in many cases, and alternative payment strategies — such as transfers of in-kind assets — can help make annuity purchases more attractive. In most cases, Mercer finds plan sponsors are able to settle liabilities with insurers at a price that is near or below their long-term economic cost of carrying the liability.

French multinational manufacturer Schneider Electric has executed a number of term-vested, lump-sum payment windows, and retiree annuity purchases since 2012, and is among the many organizations that have found annuity purchases to be fiscally prudent. "Several years ago, it was the belief of our company that the cost to transfer risk was appreciably higher than the accounting liability," says Jim Danley, North American treasurer for Schneider Electric. "Having carefully monitored the annuity buyout market pricing for the past several years, we have gained insight on what now represents fair transfer pricing. The timing of our placements has been based on this trend, and the actual costs were within our expected range."

Kroger Co., a large U.S. supermarket chain, also has found annuitization to be an effective tool. As it has sought to de-risk its three DB plans, it has annuitized thousands of plan participants who had relatively low account balances. That focus on low-balance accounts, says Kroger Chief Financial Officer Mike Schlotman, helped the company execute the annuitization program at what he called a "modest cost."

Readiness. Once the de-risking strategy has been set, it's time to begin preparing for its execution. This involves making sure the plan's data is ready for whatever steps will be taken next, and that the appropriate governance structure is in place to support the process. This is also the time to consider all the fundamental elements of the strategy. If the sponsor will be buying an annuity to assume plan liabilities, for example, it will want to confirm annuity pricing and explore potential alternative payment options, such as in-kind transfers of assets.

Plan sponsors who will be executing on de-risking activities will need complete and accurate data to support the process. Plan administrators should carefully examine data-readiness and make sure all plan governing bodies understand the level of data cleanup that may ultimately be needed. "Plan administration and data quality should not be overlooked," says Danley from Schneider Electric. "Risk transfers are much more difficult without accurate and reliable data and strong administrative support. And good data and thorough administration lead to more insurer interest in the transaction and sharper prices."

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Right now, finance executives appear to be highly confident on this front: 95% of survey respondents say their plan's data is either pristine (meaning they would be able to execute a plan termination immediately) or in good shape (meaning they would be able to execute a termination in a matter of weeks at low cost). That's up from 85% in 2017.

While that is encouraging, Mercer's experience indicates it may not be consistent with real-world conditions. It cites this example: A retiree is receiving a joint and survivor annuity that will be payable to a beneficiary upon the participant's death. The sponsor has the beneficiary's date of birth on file but no name, gender, or Social Security number. The CFO may assume this is good data since the beneficiary's date of birth is available. But one of the most common problems with data used to buy annuities is inaccurate or missing beneficiary information. Missing the other required beneficiary data elements can slow the annuity purchase process or potentially

exclude that plan participant from the transaction.

Winning buy-in from stakeholders also can be critical to ensuring favorable outcomes for the DB journey and when implementing de-risking strategies along the way. Schlotman notes that Kroger's de-risking initiative will culminate at the end of this year with all of its interested and eligible employees saving in a 401(k) plan rather than accruing new benefits in a DB plan. Before executing the plan, Kroger first brought all of the company's senior officers together to show them exactly how they would be impacted. "We showed them where they would be in the old DB plan, where they would be in the new 401(k) plan if they maxed out their contributions and worked to a certain age, and what their combined benefit ultimately would be," Schlotman says. The company then went through a similar exercise with its division presidents. "We wanted those top 40 or so people to understand what we were doing and to be disciples for it — and for investing in the 401(k) plan at the maximum level," he says. "We also wanted to explain the competitive world we're in and why this move made sense." Once all this was done, the company undertook an extensive communications plan to roll out the changes to its workforce.

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Execution. Successfully navigating a plan's journey depends to a large degree on being able to execute that strategy smartly and efficiently. For many plan sponsors, that means working with capable partners. More isn't always better.

A majority of plan sponsors have already consolidated their service providers to some degree, allowing for more streamlined plan management. Where sponsors are still using multiple service providers, it makes sense for them to assess whether further efficiencies might yet be achieved. Currently, 62% of sponsors use a single provider for all DB services, or use the same provider for at least two DB services, such as actuarial, administrative, or investment services.

Employee communication and education is also key to the success of the overall program. As sponsors execute their plan journeys and implement de-risking strategies, clear communication will help promote good participant decisions and drive more successful outcomes.

Finally, as employers increasingly move away from offering DB plans and make defined contribution (DC) plans like 401(k)s their primary retirement offering, the importance of getting those DC plans right becomes more critical. As they move forward on their DB plan journey, plan sponsors also will want to make sure they have the right governance controls in place to keep up with an increasingly complex DC regulatory environment, and the increased scrutiny that's surfaced around DC fee transparency and reasonableness. They also may wish to consider enhancing their overall retirement and financial wellness programs to help drive positive outcomes for employees.

For most organizations, their DB plan's journey, whatever the ultimate goal, will be a long one. Creating a roadmap can help them avoid wrong turns along the way.