

Strategies to Reduce Single-Employer Defined Benefit Plan Costs

This is the third of our three-part series regarding pension costs for single-employer defined benefit plans. Our leading article detailed the impact of interest rates on rising plan costs while the following article described the impact of PBGC premium increases on pension plans. This final article focuses on alternatives to minimize the level and volatility of these costs.

Despite the strong market performance of recent years, pension plans still face significant financial headwinds. Pension plan liabilities for purposes of determining minimum plan funding requirements will continue to increase unless there is additional legislative relief. In addition, conventional wisdom suggests that the exceptional market returns of the past few years are not expected to continue. Higher PBGC premiums only add to these problems.

It is important for plan sponsors to understand the magnitude and potential volatility of pension costs over the next few years and develop appropriate strategies to manage these costs. Following are a few such strategies to consider.

Borrowing to Fund Pension Plan

Borrowing money to fund an underfunded pension plan may make economic sense when considering the additional cost of rising PBGC variable rate premiums (projected to be approximately 3% of the unfunded liability beginning in 2016), potential tax efficiencies, and reduced annual pension expense and pension liability for organizations required to comply with ASC 715 accounting standards.

Example:

Assume the borrowing cost of a company is 4% per year, pension plan assets earn 7% per year on average, and the company's tax rate is 40%. The company borrows \$1 million with the proceeds contributed to the pension plan.

<u>Pension trust annual return</u>	= 7% of \$1 million	\$ 70,000
<u>Borrowing cost:</u>		
Annual borrowing cost	= 4% of \$1 million	\$ 40,000
Less tax deduction	= 40% of \$40,000	\$(16,000)
Less reduced after tax PBGC premium	= 3% of \$1 million times 60%	\$(18,000)
Net after-tax annual borrowing cost		\$ 6,000
Net Savings	= \$70,000 - \$6,000	\$ 64,000

While the \$70,000 investment return is inside the pension plan and not available for other direct uses, it ultimately results in cash savings through reduced future pension contributions.

The plan also benefits from a one-time tax deduction for the pension contribution equal to 40% of the \$1 million or \$400,000, which can be used in part to pay off the loan.

If the company is subject to ASC 715 accounting standards, the annual pension expense reduction is \$70,000. There would be a \$1 million balance sheet pension liability reduction, although this would be offset by the additional \$1 million loan outside of the plan.

Although the additional \$1 million pension contribution would eventually need to be made anyway in accordance with minimum funding requirements, the substantially higher PBGC variable rate premiums (increased from roughly 1% to 3%) and tax issues make this idea worth considering as a company reviews its debt capacity and alternative uses of cash.

Lump Sum Cashouts

For plans that do not currently offer a lump sum distribution option, consider offering lump sum cashouts to terminated vested participants for a “window” period, or making the feature a permanent part of the plan. With the fixed rate PBGC premium increasing to \$64 per participant in 2016 and then indexed with cost-of-living adjustments thereafter, lump sum cashouts not only save PBGC fixed rate premiums and other administrative costs but also “downsize” the plan, hence reducing future pension cost volatility. This approach could also be considered for existing retirees, although this may not be as desirable for philosophical reasons and possible anti-selection (e.g., retirees in poor health may opt for the lump sum, hence costing the plan more).

Offering a lump sum cashout window in the near term may also make sense due to the likelihood of new mortality standards becoming effective in 2016, which will be based on higher life expectancies and result in larger lump sum payouts of 5% or more.

Consideration should be given to the prospect of potentially rising interest rates. Since higher interest rates would result in smaller lump sum values, it may make sense to wait until interest rates are higher before introducing the lump sum option. However, if lump sums are paid out of the fixed income portion of the pension trust, paying them now would make the direction of future interest rates inconsequential on the plan’s funded position because this portion of the plan liabilities effectively would be immunized from interest rate changes.

Annuity Buyouts for Retirees

Purchasing annuities from insurance carriers for existing retirees is another means to “downsize” the plan. Once the purchase is made, the plan has no further obligation for the affected individuals. This approach reduces future pension cost volatility, as the plan is now smaller, and reduces the fixed rate PBGC premium. However, the near term impact may be higher plan funding requirements and PBGC variable rate premiums because of the extra costs associated with purchasing annuities (i.e. - insurance carrier expense loads, profit margins, and the current interest rate environment).

Summary

Managing pension plan costs in today’s environment poses many challenges for plan sponsors. However, understanding the pattern of these costs over time and considering strategies such as those outlined in this article will help sponsors navigate the uncertainties ahead.