A Pension Sponsor's Readiness Guide to Plan Termination

Market volatility demonstrates need for pension plan termination strategy

Do you understand your defined benefit (DB) pension plan's current financial situation and how that relates to your option to either maintain or terminate your plan? Your plan's improved funding status is now face-to-face with market volatility, geopolitical uncertainty and hints of a recession. If you've been contemplating de-risking your defined benefit pension plan, the time may be right to develop a successful pension risk transfer strategy.

Making the decision to terminate a pension plan is no simple matter

A decision to terminate can affect employees and stakeholders, and includes many moving parts such as regulatory, budgetary and timing considerations.

This guide covers how to prepare for the plan termination process once a pension plan sponsor is seriously considering this action. It outlines the decisions and considerations necessary to terminate a plan, focusing on standard terminations for single-employer pension plans.

Our goal is to provide pension plan sponsors and their finance and human resources teams with a guide to best practices for a successful plan termination — one that is predictable and smooth and meets the highest standards of efficiency, quality and communication with employees.

Types of pension plan terminations and pension plan freezing

A pension plan termination eliminates plan liabilities by distributing plan assets through a combination of lump sum payouts and annuity purchases. There are several types of terminations. Distress and involuntary terminations follow different procedures than standard terminations.

Many pension plans are frozen — either "hard" or "soft" frozen (for which the rationale and steps are beyond the scope of this paper). A soft freeze occurs when no new participants/employees enter the plan, but a portion of the plan's existing participants continue to accrue benefits. A hard freeze occurs when all benefit accruals have stopped. There are exceptions, but once a plan is hard frozen, the goal is usually to terminate the plan, and readiness planning is appropriate, even if the plan termination is several years away. **Types of pension terminations:**

- **Standard terminations** are voluntary.
- **Distress terminations** are for organizations that are in bankruptcy or near bankruptcy.
- **Involuntary terminations,** or Pension Benefit Guaranty Corporation (PBGC) initiated terminations, occur when the PBGC forces a plan to terminate. Involuntary terminations usually occur when a plan sponsor is in financial difficulty and presents a risk to the PBGC insurance program.

First things first

So, what should pension plan sponsors know up front? The list below is a good place to start for a bird's eye view of the planning process.

Readiness Checklist

- **Start planning now.** The formal plan termination process takes time. It can take 12 months or longer with multiple reporting requirements to participants and to governmental agencies.
- **Designate the project team.** It's important to have key players in place with defined roles and specified deliverables to ensure a well-coordinated process from beginning to successful completion.
- **Consider final changes for pension benefits and design the prospective retirement program.** A plan document amendment is usually needed to terminate a plan, and decisions need to be made about replacement benefits, if any.
- **Be informed about the financial impact.** Plan sponsors need to know where they stand financially, and how the termination will affect their financial status.
- **Determine the investment strategy.** Protect the plan's funded level as the termination process proceeds.
- **Review the data.** What is the quality of participant data? Depending upon the answer, data collection and issue resolution can be minimal or require significant time and effort.
- **Prepare to communicate.** The plan termination process is complex, significant, and subject to rigid legal deadlines. The most significant aspect for many companies, however, is employee communication.

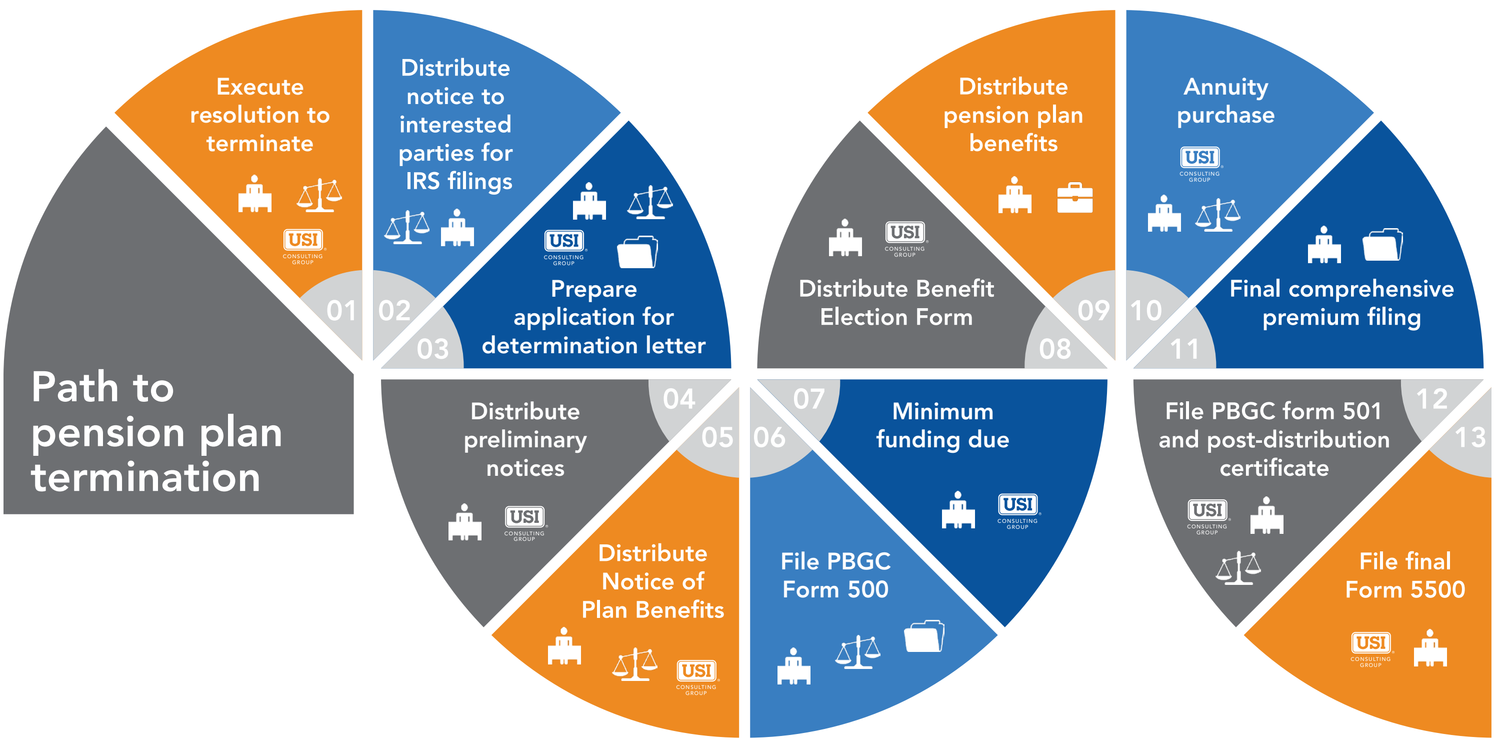
As noted in the readiness checklist, the formal plan termination process has many legally mandated and interrelated steps that require accurate historical data, significant communications with plan participants and reporting and disclosure to agencies such as the Internal Revenue Service (IRS) and the PBGC.

As sponsors move closer to full funding on a plan termination basis, their strategy should include a focus on these criteria, **including those governing investments**, **data** and **the plan advisors that will play a role in the termination process.**

Path to pension plan termination

When contemplating plan termination, pension plan sponsors need to understand the complexity of the termination process. Our experts make the process as predictable and smooth as possible, preparing sponsors for the following:

Financial	Plan Design	Data	Employee Communication
▪ Additional cash needed ▪ Financial statement impact including settlement charge ▪ Investment strategy ▪ Engage annuity consultant	▪ Allow lump sums ▪ Consider recent legislation ▪ Design replacement benefits	▪ Quality of data ▪ Obtain current addresses ▪ Search for missing participants ▪ Qualified Domestic Relations Orders	▪ Technical communication of termination ▪ Include any benefits enhancements and other communications/PR considerations



Who is Responsible/Involved?

Employer | Attorney | Trustee | PBGC | USI Consulting Group

Start planning now

Everyone is familiar with the phrase, "Timing is everything." A more pertinent adage is, "Planning affects readiness, which in turn affects timing and financial considerations."

Readiness planning may begin a few months before plan termination starts or five or more years prior to plan termination. It is considered a best practice to begin the readiness planning period as soon as the plan sponsor is seriously considering termination. Once started, the deadlines of many of the plan termination steps are set, so a month or two before beginning the formal plan termination, verify that all details have been addressed prior to starting down the plan termination path.

Although not legally required, we generally recommend that the plan sponsor requests and receives a favorable IRS determination letter. A determination letter:

- Documents that any issues with the IRS (other than operational) have been resolved
- Preserves the deductibility of contributions by the plan sponsor
- Allows distributions to active participants
- Ensures the favorable tax treatment of distributions from a qualified plan
- Documents that distributions rolled over to an IRA are permitted
- Satisfies the requirement by some trustees in order for them to distribute benefits

Unfortunately, it often takes the IRS six to nine months (or more) to issue the determination letter. Such a lengthy process can:

- Increase the ultimate cost of the plan termination
- Frustrate participants who want their distributions
- Complicate the plan sponsor's administration and accounting
- Increase the risk of adverse changes in interest rates and/or investment performance
- Cause unplanned under- or over-funding

Some plan sponsors file for the determination letter but distribute benefits prior to its receipt. The plan sponsor's decision on whether or not to file for a determination letter in the first place or to distribute benefits prior to receipt of a requested determination letter should be made in consultation with the plan's legal counsel.

Designate the project team

The complexities of the plan termination process demand an experienced and defined project team. Therefore, it is imperative to get the right team members in place. To ensure success, all team members must be prepared and equipped to deliver on the details. They should understand their project roles and responsibilities and have concrete, specific, deliverables aligned to target dates.

Many sponsors outsource parts of the project to ensure that all compliance requirements are met and key project team members can continue to focus on the business. Due to the complexity of plan terminations, project fees may be significant when outsourcing is utilized.

The plan sponsor should establish a relationship with an annuity consultant, who will solicit the annuity bids and who usually acts as a fiduciary to the plan. The annuity consultant will document that a selected insurance company meets the Department of Labor's (DOL) definition of "safest annuity provider." This will require the assistance of the plan's outside consultants and attorneys.

The sponsor should also plan for the extra administrative resources needed to manage the plan termination, taking into account the required participant notifications, participant election processing, extra phone calls, etc.

The trustee will typically be involved in the investment of trust assets, liquidation to cash, and final distribution of benefits. The trustee will need to know when distributions and annuity purchases are expected in order to know when to raise cash, process a large volume of lump sum payments, and transfer premiums for the annuity purchase.

> **Get the right team members in place.** To ensure success, all team member must be prepared and equipped to deliver on the details.

Plans with more than 1,050 participants, and one in three plans with fewer than 1,050 participants, are audited by the PBGC after distribution of benefits. The sponsor's entire team must maintain organized documentation throughout the plan termination process to be ready for a PBGC audit. Documentation of the plan termination work must be maintained for six years following distribution.

Who should be on the project team?

Project team members typically include:

- **Plan sponsor/plan administrator** (director of HR and CFO or their representatives)
- Communications professional
- Actuary
- Benefits administrator
- Attorney
- Investment advisor
- Trustee
- Annuity consultant
- Potential annuity providers

Be informed about financial impact

A plan's funded status and financial reporting requirements will affect readiness for termination. Pension plan sponsors should consider the following points in readiness planning:

- **Is additional cash needed?** The plan actuary should evaluate the unfunded liability on a plan termination basis, not on the IRS funded ratio basis or accounting basis. The IRS funded ratios reflect funding relief and significantly understate the plan termination liability. The accounting liability basis usually understates the plan termination liability as well. Any additional contributions needed to fund the plan termination liability are generally deductible, with some exceptions for small plans.
- **Determine the period over which to fund the shortfall.** Sponsors should develop a schedule to fund the plan over a period of time. Is it a short-term period, such as one or two years? Five to seven years? Or is it a longer period, like 10 years? As interest rates for calculating the plan termination liability and investment returns fluctuate, the shortfall that needs to be funded will fluctuate and create a moving target. The funded status should be monitored periodically as conditions change.
- **Is borrowing to fund the plan feasible or desirable?** Low interest rates may make borrowing desirable, which produces fixed and predictable payments. If interest rates are low, plan liabilities are higher than during periods when interest rates are high. Sponsors should weigh the extra cash cost of achieving predictable payments against the possibility that waiting longer may result in positive future market conditions that help close the funding gap.
- **Financial statement impact/settlement cost can be significant.** When a plan has a significant accumulated unrecognized accounting loss, primarily due to very low interest rates and/or low net investment experience, financial accounting for a plan termination can be a substantial consideration. At the time benefits are distributed, all unrecognized actuarial losses become a one-time settlement charge. Making additional contributions does not reduce this loss or its recognition in earnings at the time plan benefits are distributed. That one-time charge to earnings could be as high as 50 percent to 100 percent of the value of plan assets. Sponsors should educate themselves and their stakeholders on this accounting impact.

A true story: Assess all assets

A coal mining company decided to terminate its pension plan due to its pending liquidation. Assets had always been invested in a group annuity contract. Based on reported value, the plan was well funded on a plan termination basis. Pension plan participants were offered the choice of an annuity or a lump sum. At the end of the plan termination process, most participants elected the lump sum.

The contract provided for a market value adjustment (charge), which was about 40 percent of prior reported value; therefore, the company had to contribute a large final amount to fully fund all benefits.

Insight: Early in the planning stage of the plan termination, all assets should be reviewed for liquidity and net value. Intangible assets, real estate, hedge funds, group annuity contracts, etc. should be assessed to be sure there are no surprises.

Determine the investment strategy

It's important to consult with the plan's investment adviser to ensure the plan's funded level is protected as the termination process progresses.

The investment policy of an ongoing plan might provide for an investment mix of 65 percent equity and 35 percent bonds, while another plan may have a 50-50 split. The time horizon for an ongoing plan is very long (usually decades). If, however, the desire is to terminate the plan in five to seven years, sponsors may want to change the investment policy and employ liability-driven investing or bond matching techniques, which could lead to a lower percentage of equities and a higher percentage of bonds. A glide path investment policy would gradually increase the percentage of plan assets invested in bonds as the funded ratio increases.

Once the plan termination begins, the remaining life of the plan lowers to around 12 months. At that point, continuing to invest in equities becomes a much bigger gamble. Surprisingly, in most cases investing in cash is also a risk, as liabilities are still subject to changes in interest rates. A 1 percent decrease in long-term bond yield could increase liabilities 12 percent to 16 percent, depending on the duration of the liabilities. So, investing in long-term bonds of a similar duration to the plan's liabilities means less risk than investing in cash and minimizes the risk of unfunded liabilities increasing.

Another consideration is whether there are any nonliquid assets (hedge funds, real estate, intangibles). If these assets cannot be liquidated, the plan termination may need to be delayed. While working to close the funding gap, sponsors should also avoid overfunding the plan due to excise taxes on any surplus that is distributed to the sponsor. For for-profit entities, there is a 50 percent excise tax on any excess assets that revert to the plan sponsor upon plan termination. For-profit sponsors can reduce the excise tax if a portion of the surplus is given to the plan participants, but there is still some excise tax on the reversion of excess assets to the plan sponsor. Not-for-profit organizations may or may not be subject to the excise tax with the maximum excise tax being 20% of the reversion. Sponsors should work closely with their actuary or legal counsel when facing potential excise taxes.

Even with the best planning, sometimes overfunding still occurs during the plan termination process. Plan sponsors should plan for what to do with excess assets if the plan becomes overfunded. **Check out our article highlighting seven possibilities** to consider depending whether or not the plan document permits a reversion.

A true story: Interest rate risk

A nursing home in financial difficulty decided to terminate its pension plan. It needed to minimize any additional funding risk of the plan termination. The actuary made detailed calculations to determine the exact amount of underfunding as of the proposed termination date, and additional funds were contributed to fully fund the plan. To avoid having to make further contributions, the plan sponsor thought that investing in CDs would keep the plan fully funded. During the 15-month plan termination process, interest rates decreased significantly. Even though assets incurred no losses, plan liabilities had increased more than 20 percent by the time benefits were to be distributed. Obtaining the additional required contributions became extremely difficult.

Insight: Investing in cash or CDs may appear to be the safest choice, but the real funding risk is the potential underfunding at the distribution date, as required funding fluctuates with changes in market interest rates. Investing in high quality bonds with durations similar to the plan liability minimizes the potential underfunding due to declining interest rates. Sponsors should focus on protecting the plan's funded level rather than protecting principal in the portfolio.

Consider final changes for pension benefits and design the prospective retirement program

Next, it's time to prepare the termination amendment and consider any replacement benefits. It will be critical to ask the right questions and develop appropriate steps along the way. The team should be equipped to consider crucial questions, such as:

- Are any plan provision changes desirable?
  For example, it may cost less to offer participants the choice of a lump sum distribution rather than provide a lifetime group annuity benefit. It is not unusual for participants to elect a lump sum distribution if they are given a choice. Spousal consent is required for a lump sum election, except for small payments.

  If unlimited lump sums were provided under the plan prior to plan termination, lump sums can be paid during the termination process.

- Are any compliance amendments needed?
  Plan sponsors may need to amend the plan to comply with recent legislation, new regulations, or other guidance provided by the IRS, DOL, or the PBGC. These amendments should be made before formal action to terminate the plan.
- What is the objective of the termination? Perhaps the organization believes in providing retirement benefits but cannot afford the unpredictability associated with the current DB pension plan. Is a defined contribution (DC) plan, such as a 401(k), being created—or enhanced—to deliver the level of retirement benefits appropriate for the company?
- What do we want employees to think, feel, or do about this benefit change? Direct, succinct communication is a must to ensure employees understand why the change is necessary and to value the replacement benefits. Personalized communications help answer employees' age-old question: "What's in it for me?"
- How can we make this process easier on employees?
  Many plan sponsors streamline the process for rolling over pension benefits into an existing DC plan, such as a 401(k). Sponsors need to review any DC plan provisions regarding rollovers to be sure that the plan can accept rollovers from the pension plan during the plan termination. They should also check with the benefits administrator about the easiest way for employees to process their rollovers.

Review the data

Depending on the circumstances, the amount of time for data collection can be minimal or could require a number of months to conduct. Either way, sponsors need to produce all historical data to calculate the benefits payable to each participant, whether currently or formerly employed.

During the plan termination, all historical data used in the calculation of benefits payable to all active and vested terminated participants is required to be included in various notices. That data may not be readily available for vested terminated employees who left employment many years ago, or for benefits that have been frozen for a long period of time.

The diagram on the following page will help you assess the condition of pension plan participant data and understand the steps to take.

Data readiness evaluation

Collecting data and resolving all issues can be a significant undertaking during the plan termination process. Review and address data issues early in the planning process.

START HERE

Are accrued benefits accurate and final?

NO — If not, accurate accrued benefits should be calculated before starting the formal termination.

YES

Is the underlying participant data available for all participants?
(includes salary history, service, etc.)

NO — If not, can it be obtained? The PBGC understands some old data (prior to mergers for example) might not be available, but it's best to document that an attempt has been made to obtain this information to avoid a post distribution audit problem.

Usually the IRS requires that participants who have not had a break in service become fully vested, depending upon the plan's language.

YES

Has a review of all the Qualified Domestic Relations Orders (QDROs) been conducted?

NO — The review needs to occur to ensure all benefits are properly allocated.

YES

Are addresses up to date for all participants?

NO — Use a locator service to obtain addresses for missing participants and alternate payees due to any QDROs.

Annuities can be purchased for missing participants, but a bona fide effort to locate missing participants must be made and documented before the plan termination begins.

YES

PLAN TERMINATION READY

Prepare to communicate

Communication with employees is critical, especially with the change a plan termination brings. Significant benefit election decisions must be made during legally constrained periods of time, and proactive communication from the outset is wise. Early education regarding changes to the retirement program, the process and upcoming benefit elections helps set expectations, elevates pension plan participants' understanding of their upcoming decisions, enables participants to seek financial advice and helps reduce peak periods of questions during the limited benefit election period. As a fiduciary, the plan sponsor should be sure that participants are well-informed about these significant financial decisions.

When developing a communication plan, it is essential to include:

- Timing
- Targets (participants, employees, etc.)
- Messages
- Who will deliver communications
- How communications will be delivered

It's important that the project team develops, agrees to and precisely executes this communication plan for maximum efficiency and success.

Best practices for employee communications

- **Inform employees of the termination of their pension plan.** Of course, there are legal requirements—formal notice of plan termination must be provided between 60 and 90 days before the proposed termination date. Plan what information to provide and how to provide it.
- **Provide a platform for employees to ask questions and receive answers.** Employees must be able to make informed decisions in a short period of time. With a multigenerational workforce and a wide range of communication preferences, consider using multiple platforms to provide answers in a timely manner throughout the plan termination process.
- **Provide notice at least 45 days (15 days for small plans) before the freeze date.** If a plan is not already frozen, we recommend freezing a plan when it terminates so that if the termination is later voided, whether voluntarily or involuntarily, benefit accruals will not be reactivated.
- **Communicate any new or enhanced replacement program, such as a 401(k), 403(b) or variable benefit plan, when the formal termination notice is provided**. This affects the organization's total compensation strategy, and offers an opportunity to educate employees about other benefits the company provides. (Legally, sponsors are required to inform participants about their distribution options and rights between 30 and 180 days before distribution begins.)
- **Consider communication needs related to other plan sponsor issues.** For example, a union plan will need the union's agreement in order to terminate. Considerations may include union issues, workforce reduction, community issues or public relations.

A true story: Assess all assets

A manufacturing company that provided a pension plan to its employees was anticipating being acquired by a larger, financially stronger company that provided retirement benefits through a defined contribution plan. Early in the merger discussions, the manufacturing company decided to terminate its pension plan to simplify the transition to the acquirer's retirement plans. Employees were provided formal notice of the pension termination but, because the merger discussions were confidential, no explanation for the change or description of the replacement retirement program was provided. Employees immediately expressed disappointment and anger that the pension was being taken away with no explanation and no replacement plan. Employee morale suffered. When the merger was called off, the employer had to scramble to put together a successor program, leaving many employees disenchanted with the employer.

Insight: An employer should carefully consider the timing of communication and what replacement program will be established early in the planning process. When the plan termination is formally communicated, a full description of the replacement plan should be made, communicating as many details as possible about the new program. Communicating termination when the details are still unknown is not advisable.

In perspective

A pension plan sponsor seeking to terminate its plan should first review and understand the implications of the plan termination and then develop a detailed readiness plan and project plan to prepare for the termination process. Establishing timelines with target dates, required deliverables, the responsible team members and managing the project plan are the keys to success.

Our team has assisted hundreds of organizations through the plan termination process, and we offer these key insights to ensure pension sponsors are ready to execute a process that is wise, efficient and ultimately successful.

It's important to remember that:

- Financial data, communications and business objectives, as well as market conditions affect any decision about readiness for plan termination.
- Having complete data is advisable before starting the formal termination process.
- Once the decision is made that the plan is ready to start the formal plan termination process, it typically takes 12 months (or longer).
- The plan sponsor is subject to funding risk until the distribution of all trust assets is complete. Certain investment strategies can help minimize the volatility of your funded status.
- Proactive communication with pension plan participants helps to ensure that all compliance and fiduciary requirements are met and to minimize peak periods of questions from participants.
- Plan termination is a process involving federal regulators, insurance companies, benefit calculations and communication with every participant.
- Understanding staff resources is essential to successfully execute the termination.
- The devil is in the details.
- Having an experienced team of expert advisors is key.
- Proactive readiness planning can minimize and/or remove obstacles or hurdles along the way.

HOW USI CONSULTING GROUP (USICG) CAN HELP

When executed properly, a pension plan termination eliminates plan liabilities by distributing plan assets through a series of lump sum windows or annuities. There are various issues to consider when developing an optimal approach to plan termination. Our program is designed to relieve pension plan sponsors of the risk, expense and fiduciary responsibility associated with maintaining their plan.

USICG's team of experienced actuaries focus on helping pension plan sponsors identify and evaluate opportunities and challenges so they are prepared to adequately address the pension de-risking process. To learn more, please reach out to us at **information@usicg.com**.

Connect with us today | **information@usicg.com** | 860.633.5283 | **usicg.com** |