Invest or Contribute to Solve a Retirement Funding Shortfall?

Marty Menin (left) and Russ Proctor

Many defined benefit (DB) plans were closed to new entrants and/or frozen after the market crash in 2001 and the financial crisis in 2008. Due to many reports of the demise of DB plans, advisers might think all these plans would be terminated by now. However, many are still in existence and are—despite significant market returns during the past few years—still underfunded. As plan sponsors struggle with the volatility of their plan's funded status and the increasing expenses required to maintain them, they are looking for assistance. PLANADVISER spoke with **Russ Proctor** and **Marty Menin**, directors with Pacific Life in their Retirement Solutions Division, about the challenges defined benefit clients face, how some of them mirror challenges faced by defined contribution (DC) plans, and the solutions retirement plan advisers can consider to help resolve these issues.

PLANADVISER: First, why is funded status volatility a problem for frozen defined benefit [DB] plans?

Marty Menin: Volatility is somewhat accepted for an ongoing plan that is still accruing benefits for the company's employees. However, once the plan is frozen and employees are not earning any additional benefit, the volatility is just a financial irritation to the company. Add to that volatility the increasing administrative expenses, including Pension Benefit Guaranty Corporation [PBGC] premiums, and now it's more costly than ever to maintain these frozen DB plans.

PA: Many companies have not fully funded their plans hoping to earn their way out of this underfunding problem. Advisers know that doesn't work when saving in your 401(k) plan, but how has that worked on the DB side?

Russ Proctor: Yes, that's a good comparison. Just hoping your 401(k) plan earns its way into the retirement income that you need is not going to work, without putting some money in, and for the DB plan, this really has not worked out very well either.

At the end of 2008, the average large plan was 78.3% funded.[1] The total funding shortfall for all of these plans was about $250 billion. At that time, the S&P 500® index was at 826 and the 10-year Treasury was 2.25%.

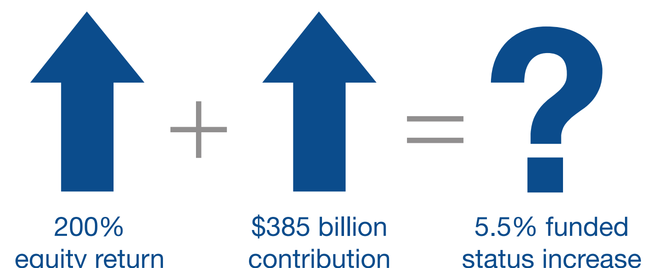
Move forward to May 31, 2017, the 10-year Treasury is about the same at 2.21% and the S&P 500® index has increased almost 200% to 2,412. On top of that, the Milliman 100 companies have contributed more than $385 billion to these pension plans during this time, more than the under-funding that was there back in 2008.

One would think the plans would be in a surplus position with that level of contributions and the approximate annual 12.8% market returns. Sadly, the funded status is still well short of 100% and stands at only 83.8%, an increase of only 5.5% during that time frame.[2]

PA: How is it possible that these plans are still that far underfunded given the increase in equities and that level of contributions?

Marty: Not all of those Milliman 100 plans are closed and frozen. Thus, some of those contributions are being used to fund the increases in the accrued benefits. Also, not all of the assets are invested in equities. Most sponsors would find it too risky to be 100% in equities in their pension plan similar to how an individual approaching retirement might not want to be 100% in equities. Therefore, not all of their assets are increasing at that historical rate of 12.8% per year. Other assets may be invested in a fixed income or traditional "Best Efforts" LDI [liability-driven investment] strategy designed

RESULTS SINCE 2008



For illustrative purposes only.

Reprinted from PLANADVISER July-August 2017. ©1989-2017 Strategic Insight. All Rights Reserved.
No reproduction or redistribution without prior authorization. For information, call (203) 595-3276 or email reprints@planadviser.com

to move in the direction of the liability when interest rates change but not close the funding shortfall.

Russ: Speaking of interest rates, even though the 10-year Treasury is a common interest-rate benchmark, the pension liabilities for GAAP accounting are based on corporate bond rates (e.g., Citigroup Pension Discount Curve). These bond rates have decreased about 2% from 5.87% at 12/31/08 to 3.77% at 5/31/17. This 2% reduction in the liability discount rate would result in an increase in pension liability of 20% to 30%. The fixed income or LDI assets should increase as interest rates decrease to offset this increase in liability. However, a best-efforts LDI strategy cannot guarantee that assets will increase the same as the liability when the discount rate changes.

Finally, the increasing ongoing administrative expense of maintaining the DB plan is eating away at the funded status.

PA: What are the risks for sponsors and advisers as they continue to try to earn their way out of an underfunding situation?

Russ: If what they have done for the last eight years isn't working, following the same strategy and hoping that something different will happen is sure to be a problem. They should be asking these questions:

- Do they expect the next eight years to provide the same or better equity returns of almost 13% per year? A market correction could have a huge negative impact on funded status.
- Will interest rates finally increase enough to lower the plans' liabilities? Many have been predicting an increase in rates for the last eight years, but we are still at a 10-year Treasury below 2.50%.
- Is it time to implement a strategy to get the plan fully funded in a timeframe that fits the organization they're working with to move the liability off the balance sheet?

PA: What are other ways advisers can help plan sponsors decide when or whether or not to fully fund their pension plans?

Marty: In 2019, PBGC variable premium levels are going to be about 4.4% of the unfunded liability. This is a cost that can be completely avoided simply by fully funding the plan. Even if the company needed to borrow the money to fund the plan, they may find the interest cost will be less than the PBGC variable premiums.

Another incentive to fund now is the potential reduction in corporate tax rates. Many plans are looking at accelerating contributions to take advantage of the tax deduction while the corporate tax rate is higher, versus what might be a 15% or 20% tax rate in the future.

[1]*Milliman 100 Pension Funding Index, December 2008.*
[2]*Milliman 100 Pension Funding Index, May 2017.*

PA: If a plan sponsor funds its plans to 100%, how can it make sure the plan does not end up at 80% again, like what happened in 2008?

Russ: It can take six to 18 months to completely terminate a plan and transfer that liability off the company's balance sheet. So, it's important for the company to remove as much risk from the plan as it can during that process so that funded status can be maintained.

Plans can consider an Insured LDI solution to guarantee the assets move with the liability and protect the funded status.

They can also consider purchasing a Buy-in annuity solution. That really locks in all the costs of those future annuities and transfers the risk to the insurance company without triggering settlement accounting.

Finally, they can purchase a Buy-out annuity for a subset of the participants, usually those with the smallest benefits. That will remove that liability, shrink the size of the plan, and eliminate all future administrative costs related to those transferred participants.

PA: For advisers without DB plan specialization, is there enough information and support for them to help their clients with DB plans?

Russ: Absolutely. Even though an adviser may not be a DB expert, think of the DB plan as an individual saving for retirement: "I need to help them solve their retirement funding shortfall." Advisers can reach out to other pension consultants, insurance companies, and the plan's actuary to gather the necessary information to identify the funding shortfall and develop a plan to meet the company's funding goal.

Marty: Be the adviser who says, "We are going to develop a plan to get you to 100% funded, and we're going to protect that funded status along the way." If you can solve these problems for your clients, you can become their trusted adviser. This could easily lead to a growth in other business opportunities—including additional defined contribution, nonqualified plan, or even personal wealth clients.

Pacific Life refers to Pacific Life Insurance Company. Insurance products are issued by Pacific Life in all states except in New York. Guarantees are backed by the financial strength and claims-paying ability of the issuing insurance company. Pacific Life is a product provider. It is not a fiduciary and therefore does not give advice or make recommendations regarding insurance or investment products. Pacific Life, its affiliates, its distributors, and respective representatives do not provide any employer-sponsored qualified plan administrative services or impartial advice about investments and do not act in a fiduciary capacity for any plan.

Reprinted from PLANADVISER July-August 2017. ©1989-2017 Strategic Insight. All Rights Reserved.
No reproduction or redistribution without prior authorization. For information, call (203) 595-3276 or email reprints@planadviser.com