THE DISAPPEARING DB PENSION PLAN. The use of defined benefit pension plans continues to decline as sponsors look to de-risk pension strategies. Governing a defined benefit (DB) pension plan and its investment strategy has always been challenging. Over the past decade it's also become increasingly complex, not to mention costly, spurring many plan sponsors to reevaluate their pension plan approaches. A new survey of 155 U.S. senior finance executives conducted by CFO Research, in collaboration with Mercer, found that 77% of those DB plan sponsors expect to change how their plan is managed over the next two years. That was up from 60% the last time the survey was conducted in 2017. (Mercer and CFO Research have been conducting a DB risk management survey on a biennial basis since 2011.) Meanwhile, 63% conceded their organizations were struggling to find the time and expertise to fully meet their obligations relating to oversight of their DB plan investment strategy. Historically high equity prices are causing some plan sponsors to question whether the stock market is due for a downturn that will impact pension strategy. In fact, 35% of respondents identified expected market returns as the factor most likely to prompt them to modify their pension funding policies and practices over the next two years.

De-Risking Paths. Many employers have spent much of past two decades looking for ways to dial down the risks presented by their DB plans. They aim both to minimize the plan's impact on their organization's financial statements and to relieve management of duties that take their focus away from core business activities. For some, the "nuclear option" is increasingly popular. The survey found that 71% of plan sponsors were considering terminating their plans over the next 10 years, up from 59% in 2017 and 47% in 2015. Broadly speaking, those intent on de-risking have three levers to pull: funding strategy, investment strategy, and risk-transfer strategy. Which are they using?

Funding strategy. The Pension Benefit Guarantee Corporation (PBGC) insurance premiums remain a key driver of pension funding strategies for many employers. Improving a plan's funded level can reduce its PBGC premiums. In the 2019 Mercer/CFO survey, 85% of survey respondents said they recently increased contributions to reduce the future cost of PBGC premiums or were considering doing so, up from 73% in 2017 and 57% in 2015. Other recent increases in contributions were motivated by the Tax Cut and Jobs Act of 2017, which not only lowered taxes but also raised the cost of financing pensions (for taxable corporations). Seven in 10 respondents said their organizations made a contribution beyond the minimum as a direct result of changes in corporate tax law. They included 29% that made a significant additional contribution.

Investment strategy. Strategies such as dynamic de-risking appeal to some plan sponsors because they may obviate the need to come up with additional cash for their plans. In dynamic de-risking, the sponsor maps out a "glide path" that specifies how a plan's asset allocation strategy will change as its funded status improves. The goal is to have assets and liabilities tightly matched once the plan reaches its maximum funding level. Doing so makes it easier to maintain the plan going forward or terminate it, if that is the desired outcome. In the 2019 survey, just slightly more than half of respondents said their organizations had a dynamic de-risking strategy in place, and 34% said they were considering one. Other investment-related risk-management strategies are available. For example, 37% of respondents said their organizations recently increased allocations to fixed-income investments, 30% adjusted the duration of their fixed-income investments to hedge plan liabilities, 28% made greater use of derivatives to hedge interest-rate risk, and 23% made greater use of options or related methods to manage tail risk.

Risk-transfer strategy. One of the most straightforward approaches for moving pension risk from the plan sponsor to another party (or to the employee) involves offering plan participants a lump sum in exchange for their standard pension benefit. In the 2019 survey, 57% of senior finance executives (compared with 33% in 2017) said their organizations have amended their plans to make a permanent lump-sum feature available when employees retire or are otherwise terminated. And 40% said they have offered at least one window during which certain participants could get a lump-sum payment. Greater enthusiasm for this method is evident - 76% of sponsors that have offered a one-time lump-sum payment to some or all plan participants said their organizations were satisfied or very satisfied with the outcome. Another risk-transfer option is to offload retiree obligations to an insurer through the purchase of an annuity. Many plan sponsors assumed that annuity purchases were too expensive to make economic sense. That's still a common perception; in the latest survey, 39% of respondents said they think an annuity buyout for retirees would be expensive (e.g., 110% to 115% of the pension benefit obligation held) or very expensive (greater than 115% of the PBO). Despite that prejudice, more plan sponsors may be warming to the idea. The proportion of surveyed organizations that have completed or were considering an annuity purchase for some or all retiree obligations remained flat over 2017 (55%). A greater proportion (70%) said they're likely to transfer some or all of their retiree obligation from their DB plan through the purchase of an annuity in this year or next. That's up from 56% that were planning to do so two years ago.

The End State. Every defined benefit plan in the U.S. is facing one of three end-states: sustainability, hibernation, or termination. Right now, termination appears to be the most popular option. Regardless of the ultimate goal, plan sponsors will need to pay attention to data, transaction costs, and plan management.

Data. Right now, plan sponsors are highly confident in their plan data. Nearly all (95%) of the survey respondents said their plan's data were 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). That was up from 85% in 2017.

Transaction Costs. Many plan sponsors (65%) believed that buying annuities to cash out plan participants was expensive. In practice, this may not be the case. Sponsors contemplating an annuity purchase should be planning now for what the actual costs may be and exploring alternative payment strategies that may make de-risking via an annuity more attractive.

Plan Management. A majority of plan sponsors have already consolidated their service providers to some degree, allowing for more streamlined plan management. Currently, 62% of sponsors use a single provider for all DB services or use the same provider for at least two DB services.

Chris Schmidt, Issue 2019-06 CFO, Chief Financial Officers (CFO), June 28, 2019.

https://www.cfo.com/retirement-plans/2019/06/the-disappearing-db-pension-plan/