What's Up with Pension Costs?

Where we stand today

In 2014, we began a 3 part series plus follow up articles on Defined Benefit Plan Costs. These articles covered various law changes that have impacted both single employer and multiemployer defined benefit plan costs and strategies to deal with these costs.

A review of the below articles will help plan sponsors navigate the current environment.

- *The Impact of Interest Rates on Single-Employer Defined Benefit Plan Costs*
- *The Effect of PBGC Premium Increases on Single-Employer Defined Benefit Plan Costs*
- *Strategies to Reduce Single-Employer Defined Benefit Plan Costs*
- *Additional Pension Funding Relief is Here!*
- *Multiemployer Pension Changes*
- *The Bipartisan Budget Act of 2015*
- *Time to Offer a Lump Sum Window in your Corporate Pension Plan?*
- *IRS Proposed New Mortality Rates*

As we look back on the law changes that have occurred, pension plan investment performance, and interest rate movements, what is the present financial condition of defined benefit plans, and why is it so?

Background

The impact of the 2008 stock market collapse and subsequent Federal Reserve policies which drove down interest rates resulted in pension plans that had been well funded or adequately funded to become poorly funded. For single employer plans, lower interest rates increase actuarial liabilities for both financial accounting purposes and pension funding purposes.

According to a recent article by Willis Towers Watson[1] the aggregate funded status for corporate plans in their index showed little change over the past three years, with a funded ratio of about 81% as of December 31, 2016. A recent Milliman article[2] shows that the average funded status of multiemployer plans as of December 31, 2016 is 77%; before the 2008 market collapse, the average funded ratio for multiemployer plans was 85%.

The S&P 500 Index lost 37% in 2008. Since that time it has returned 194% through December 31, 2016 for an average annual return of 14.5%. The Bloomberg Barclays US Aggregate Bond Index has returned 36% since 2008 for an average annual return of

[1] WTW Pension 100: Year-end 2016 Disclosures of Funding, Discount Rates, Asset Allocations and Contributions
[2] Milliman Multiemployer Pension Funding Study - Spring 2017

3.9%. While international equity markets have not performed as well during this period, they represent a much smaller portion of the average pension fund portfolio.

Given the market returns since 2008 and pension funding requirements, intuitively one might think that pension plans on average would be in much better financial condition than we are seeing.   There are a number of reasons as to why this has not occurred.

Multiemployer Plans

For multiemployer plans, the economic downturn directly affected the level of work in the trade industries, which translated into lower pension contributions. At the same time, these plans have become more mature as the ratio of retiree liabilities to active employee liabilities has increased, so diminished contributions have been absorbed by funding benefits for participants who are no longer in the workforce. 2008 investment losses were allowed to be recognized over a 10 year period instead of the maximum 5 year period, and many multiemployer plans are still feeling the effects of these losses for one more year. While law changes enacted over the past several years that were designed to force plans in poorer financial condition to either increase contributions or lower benefits have helped, very poorly funded plans may find themselves in a hole that will be very difficult or even impossible to overcome.

Higher PBGC premiums were implemented to shore up the financial condition of the Pension Benefit Guaranty Corporation as a result of these issues, but these higher premiums exacerbate the problem for some of these plans. Lastly, updates to the mortality tables used to measure liabilities have been made for many plans based on recent studies that have shown longer life expectancies, hence increasing liabilities.

Single Employer Plans

For single employer plans, law changes implemented since 2008 have temporarily lowered minimum funding requirements in order to alleviate the burden of higher required contributions after the economic downturn. However, corporate bond interest rates that are used to measure liabilities have not increased to a significant degree thus far, and these law changes have effectively *"kicked the can down the road"* by allowing plan sponsors to fund less than the current market rates would suggest.

While the Federal Reserve has increased short term interest rates and is expected to continue to do so, this does not directly translate into higher long term corporate bond rates. In fact, pension funding liabilities may continue to increase as lower historical interest rates are phased into the minimum funding contribution calculation. PBGC premiums have skyrocketed for single employer plans over the past few years, which have further deteriorated plan assets for sponsors who pay those premiums out of the pension trust. Lastly, mortality table changes have been made for financial reporting accounting purposes, and for 2018 new mortality tables will be required for pension funding and lump sum distributions based on longer life expectancies, which translates to higher costs.

Conclusion

While there are many reasons why pension plan funded statuses have not improved as expected, what should plan sponsors do now to shore up these plans?

For multiemployer plans, the law changes made to shore up the financial condition of plans currently or projected to be in poorer shape have forced Trustees to implement lower benefits or increase contributions. Beyond that, it is important to review the long term investment return assumption for the plan to ensure it is not overly conservative or aggressive in order for the plan to be funded in a proper manner. Benefit and contribution changes should be based on a best estimate projection of the workforce, benefits and contributions.

For single employer plans, consideration should be given to offering a lump sum window to terminated vested participants in 2017 (see articles *"Time to Offer a Lump Sum Window in your Corporate Pension Plan?" and "IRS Proposed New Mortality Rates").*

For ongoing plans where participants continue to earn future benefits, it is important to develop both a short term and long term funding strategy rather than simply contributing the minimum required contribution each year. For frozen plans, a funding and plan termination strategy should be developed, which should factor in the potential risk of overfunding the plan.