Managing your Frozen Pension Plan: A New Paradigm

Recent changes in funding requirements and financial reporting have brought increased attention to frozen pension plans. Coupled with recent market turmoil, there is increased interest in finding better ways to move these single employer and multiple employer qualified plans to full funding.

Managing the Frozen Pension Plan as a Financial Obligation

When a pension plan is frozen, the future growth of the plan’s benefits stops. However, the plan sponsor must still fulfill the commitment for the benefits already promised. This is accomplished by (1) moving the plan to a fully funded status and (2) deciding how to execute the benefit commitments that may extend beyond the life of the organization. The frozen pension plan is no longer a human resource tool, but a financial obligation which must be aggressively addressed to insure that:

• participant benefits will be paid in full, which is in the best interest of all concerned: plan participants, the employer, the PBGC, and the country.
• the cost to the sponsor is minimized, which is in the interest of current employees and the sponsor as it provides more funds for other enhanced benefits or increased sponsor assets to deploy in advancing business objectives.

Shifting the organization’s thinking about the pension plan requires the plan sponsor to make a fresh look at their:

• management of the plan,
• outside advisors,
• timeframes for decision-making,
• strategy,
• policies affecting the plan, and,
• process.

In this document, we review strategies for moving a frozen pension plan to full funding so that all obligations can be met.

The New Financial Paradigm

There are two types of frozen pension plans, often referred to as “soft freeze” plans versus “hard freeze” plans. The soft freeze (a.k.a., “closed plan”) continues service-related accruals for at least a portion of the active participants, but no new participants are permitted in the plan. The hard freeze (“frozen plan”) provides no service-related accruals to active participants – new or existing.

When a plan is frozen it moves from being an HR tool to a financial obligation much like long-term debt. But this debt is very peculiar, in that its coupon and par payment are really benefit payments, and the government requires the organization to pre-fund these payments (on a tax qualified basis) under rules that don’t look anything like long-term debt.

And, as we begin to think of the frozen plan as a financial obligation, our description of it should shift as well. The primary point of discussion will be around the amount of unfunded obligation, i.e., liabilities less assets, where the obligation has three components: the amount in pay status, the amount in deferred pay status, and the continuing increase in obligation coming from service related benefit accruals. Note that from this perspective active plans are not so different from frozen plans – only differing in the relative size of the three components. Managing an active plan versus a frozen plan differs only in the treatment of the obligations that are continuing to grow from service-related benefit accruals – often not a significant obligation relative to the rest.
Look at the Management of the Plan

The new paradigm requires the plan sponsor to review the financial management of the plan. Does the management team have adequate representation by individuals with a financial perspective? Does the management team structure and process allow for quick response to effectively manage the unfunded obligation? Do the advisors to the management team have a financial perspective that focuses on the unfunded obligation as opposed to an assets-only or obligations-only perspective? Are the policies affecting the unfunded obligation coordinated in meeting sponsor objectives to the extent not in conflict with the general fiduciary obligation to the plan participants and beneficiaries? Does the management team have documented objectives for managing the plan? Does the management team have a documented strategy and accompanying tactics for managing the frozen plan? Does the management team have a strong process to ensure its effectiveness?

Adopt a Documented Strategy

There are a number of reasons why a documented strategy is recommended. First, it offers a common point of reference on which stakeholders can agree. A documented strategy leads to much clearer choices than not. For example, if you were to ask a pension management team without a documented strategy what will happen if their plan were to become fully funded within one month, they may not know how to, or have a procedure in place to, respond to such a situation. If the management team established a strategy, developed a policy for monitoring the funded status of the plan, and has determined in advance that, for example, the allocation to long duration bonds should be increased when the funded status increases, and that a sub-committee of two people is designated to execute the policy, something will happen. That is the reason for having a documented strategy.

Develop a Frozen Plan Strategy Framework

The basic strategy framework is the same for all frozen plans but the details of the strategy, or the tactics, will need to be determined by your advisors through modeling your plan’s unique characteristics. Here is a description of an appropriate strategy framework for managing a frozen pension plan:

• Use existing equity exposures, or equity like exposures, in addition to contributions to help eliminate the unfunded obligation.
• As the unfunded obligation is reduced, de-risk the plan by moving to more and more bonds, or bond-like exposures, that match the behavior of the plan’s liabilities. (If you choose not to transfer annuity obligations to a third party, this is your ultimate strategy.)
• When your plan is close to full funding, investigate the cost of fulfilling the benefit obligations. The cost of meeting annuity obligations will be the cost of transferring the obligations to an insurance company and the cost of meeting lump sum obligations will follow the rules of your plan. Once these are determined you will have a good estimate of any final contribution requirement needed for full funding.
• Once you near the point that full funding can be reached with an acceptable final contribution amount, set the IRS “termination date,” prepare and send filings to the IRS and the PBGC. Once you are cleared to distribute benefits, determine final amounts to settle the obligations and liquidate plan investments to cash.
• Then make the final contribution needed to settle all liabilities.
• And finally, distribute lump sums and annuities to participants.

Optimize the Tactics to Support your Optimum Strategy

Above, we described the strategy framework that is effective for managing frozen plans. Your advisors must further develop the strategy by identifying the tactics that will provide you with the optimum strategy; they will be unique to your plan and your objectives. An analysis will be required to answer all the tactical aspects of the strategy.
The tactics can be identified by reviewing the four policies that affect your plan:

- **Investment policy**, which governs the selection, implementation and monitoring of a strategic and prudent asset allocation. This includes:
  - What is the best initial investment mix?
  - What type of bonds, or bond-like instruments, will best match liabilities?
  - When and how much should the asset allocation be changed as plan funding improves?
  - What equities, or equity-like exposures, will best match liabilities?

- **Funding Policy**, which governs the determination of the amount and timing of contributions and analysis of available methods used by your actuary. This includes:
  - What funding methods should your actuary employ?
  - What trade-off of risk versus reward is garnered for various levels of contributions?

- **Benefit Policy**, which governs the administration of the plan, determination of benefits and compliance with legal requirements. This includes:
  - Should the plan be amended to offer unlimited lump sums?
  - Are there administrative or compliance issues that should be addressed to better estimate plan obligations?

- **Financial Policy**, which governs the recognition of the plan in the organization’s financials and the organization’s risk capacity for the plan. This includes:
  - How big is the risk of the plan to the sponsor?
  - What are the appropriate metrics for measuring risk?
  - What is the appropriate measure for settlement purposes?

**Develop a Strong Process for Adopting, Implementing, and Monitoring Strategy**

So what are the critical steps in the process of developing, implementing, and monitoring your strategy? The ideal approach is based on eight key steps as follows:

1. **Provide background and educate the management team.** Your advisors need to provide some education about the need to manage the unfunded obligation in addition to the assets, what investments are likely to help in accomplishing that, and how the policies that affect the management of the plan affect managing the unfunded obligation.

2. **Develop documented objectives for the pension plan.** Your advisors need to lead your management team through a discussion leading to documented objectives. The primary objective is to fully fund and defease plan obligations at the lowest cost under a range of circumstances. Secondary objectives are constraints that need to be considered in developing a strategy. For example, an objective of defeasing all plan obligations in five years is really a constraint on the process.

3. **Develop a good understanding of the liabilities and assets of the plan.** Your advisors need to research your plan document and federal law and regulations to determine what the nature of liabilities will be when the plan is likely to be fully funded. What portion of liabilities will be in each of the three categories (see above) and what type of investment will be the best match with these liabilities taking into account investment type, sector, maturity, and so forth.

4. **Investigate alternative strategies.** Your advisors will need to do some analysis using the information they have acquired from you and their views of the markets to develop efficient strategies from which you can adopt an optimum strategy. Efficient strategies are those that for a given expected cost have the lowest worst case cost. The optimum strategy for your plan is the strategy that has best combination of expected cost and worst case cost for your organization.
5. Adopt a strategy and implement. After your advisors recommend a strategy, your management team will need to make a decision to adopt, or perhaps adopt, after some further discussion and changes. Once adopted, your advisors will help you implement the new strategy.

6. Monitor the strategy. After initial implementation, and quarterly thereafter, your advisors should be providing updates on the progress of the strategy with at least an annual review of market conditions to determine if a modification in strategy is warranted. As the market moves to extremes, opportunities may arise that were not considered likely at the inception of the strategy. Monitoring allows for review and adjustment to these circumstances.

7. Bring the plan into compliance and clean up participant data. The time needed to prepare plan data for ultimate distribution can be lengthy. You need to start a process to clean up the data now for three reasons. First, your strategy will not be very good if you don’t have good data from which to calculate liabilities and conduct analysis. Second, you don’t want to have surprises in your liability amounts when you go to annuity providers for quotes. You may find increased liabilities which you hadn’t accounted for. Third, data problems need to be fixed before you go to an insurance company to finalize the purchase or the process may be delayed for months.

8. Transferring the total benefit obligation. Your final step is the distribution of all benefits and the transfer of any remaining obligations to a third party such as an insurance company. This process can be lengthy, from 6 to 24 months, and requires notices to the PBGC and IRS followed by unstated or stated approval from these agencies.
About Aon’s Corporate Risk Services Group

Aon’s Corporate Risk Services (CRS) Group is part of Aon Investment Consulting. CRS leads national and/or global assignments to assist clients with the identification, measurement and reduction of broad corporate risks.

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Aon Consulting’s Ready 2012 Initiative

Aon has developed a consulting process that reflects the new financial paradigm and assists plan sponsors in addressing the complete process associated with managing frozen pension plans called Ready 2012. Our “Ready 2012” consultants can help you to develop and implement the optimal strategy for your frozen plan by reflecting your specific and individual plan funded status and restrictions as well as your individual corporate risk measures and metrics, timing, and policies. Sponsors considering a freeze of their current ongoing plan(s) can also utilize Aon resources to address other important aspects, including regulatory compliance and employee communication.

If you would like assistance in developing the optimal frozen plan strategy for your company, please contact Aon Consulting’s Ready 2012 consultants:

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