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A road map for effectively managing a frozen pension plan

For some plan sponsors, the desired result is to eventually remove the plan — and its associated liability — from the company's books. But the cost of immediately terminating a pension plan is often higher than most companies can cover with current assets.

For others, a well-managed frozen pension plan can provide predictable expense levels — or even pension income — to help boost a company's earnings. In these cases, plan sponsors may opt to maintain their plan over a longer time horizon.

An aging workforce, low interest rates, uncertain investment returns, and elevated PBGC premiums have put significant financial pressures on pension plan sponsors. To cope, more organizations are choosing to freeze their plans — either closing them to new entrants or discontinuing accruals for some or all of their employees.

While freezing a plan limits the future growth of its liability and may help alleviate some risk, a frozen plan still requires significant attention and resources. Plan sponsors may be required to continue making cash contributions to meet the plan's target liability, and the same market fluctuations and interest rate risks that affected the active plan will continue for the frozen plan.

In addition, the need remains for accounting, reporting, compliance, fiduciary and investment oversight, as well as participant administration and communications. These responsibilities can strain resources — particularly if the organization has already introduced another retirement savings program, such as a defined contribution plan, and has to cover the costs of those enhanced benefits.

Plan sponsors of frozen plans generally fall into one of two broad categories — opportunistic or deliberate — depending on their risk philosophy and financial constraints. While some opportunistic sponsors may be successful in reaching their goals without thoughtful planning, the preferred strategy is to work actively toward a more predictable end.

This paper provides a four-step road map for deliberate sponsors who want to implement an effective strategy for managing their frozen pension plan — with the goal of either terminating the plan or managing costs and risks over a longer time horizon. Of course, you should always consult with your company's legal, tax, actuarial and investment advisors before implementing any changes.

Intended for plan sponsor and consultant use.

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Frozen plan management strategy

Creating a strategy for assets to outperform liabilities and managing plan costs and risks over the desired time horizon

STEP 1
Evaluate goals
- Time horizon
- Cash constraints
- Earnings implications

STEP 2
Understand the liability and other key pension metrics
- Balance sheet
- ERISA funding liability
- Termination liability

STEP 3
Implement an asset/liability investment approach
- Limit contribution volatility
- Manage toward funding target

STEP 4
Implement and track revised investment strategy
- Track funded progress
- Periodic re-optimization and de-risking

STEP 1:
Evaluate goals

Prior to the Pension Protection Act (PPA) of 2006, many plan sponsors focused solely on maximizing investment return in order to reduce future contributions. However, once a plan is frozen, the priorities typically change, and so should the approach to investment management. With a frozen plan, the following considerations should be reviewed:

- Time horizon for maintaining the plan.
- Desired contribution level and pension expense budgets.
- Acceptable levels of balance sheet, cash contribution and pension expense volatility.

Since more than one objective often applies, the goals should be prioritized and the trade-offs evaluated. The type of freeze also affects whether the plan can phase out sooner rather than later. For example, if a "soft freeze" has been implemented in order to limit the impact to employees, the growth in the plan's liability will not be curtailed in the same manner as a "hard freeze," and the time frame for maintaining the plan will be extended.

STEP 2:
Understand the liability and other key pension metrics

While funding and accounting reforms sought to simplify pension rules and improve the accuracy of measuring pension plan costs, there are still many methods that can be used to determine a plan's funded position.

Plan sponsors who want to maintain their frozen plans may decide to focus on managing balance sheet and expense volatility, which are measured on an annual basis. However, for sponsors who want to terminate their plan, the numbers published in valuation reports and company financials may underestimate the plan's termination liability. This is because insurance companies, in quoting annuity purchase rates, will generally use lower discount rates and include a margin for profit, which are not considered in funding and accounting measurements.

Sponsors need to understand the level of funding they are targeting, and on what measures those levels are being calculated.

Level of plan freeze affects duration and asset management decisions

Soft freeze *(Longer-liability duration)*			**Hard freeze** *(Shorter-liability duration)*
Plan is maintained for current employees but is not available to new employees	Future plan accruals are reduced for current employees	Selected employees are grandfathered into the plan; all others cease future plan accruals	No plan accruals for current or future employees

STEP 3:
Implement an asset/liability investment approach

An asset/liability approach can serve as an effective method for meeting cost and risk objectives, reaching the plan's target liability and preparing the plan for termination, if that is the objective.

Asset/liability modeling (ALM) not only considers a plan's objective of achieving total return in the asset allocation process — it also incorporates the impact of the plan's liabilities on various pension metrics. Results can enable the plan sponsor, with the investment manager, to identify the investment strategy with the greatest likelihood of meeting the plan's financial and risk management goals. ALM can also help sponsors identify how to limit contributions and avoid the risk of overfunding — since excess funds cannot easily be removed from the plan without incurring significant excise taxes.

For many frozen plans, a dynamic de-risking glidepath will be more effective than a static asset allocation. Glidepaths are rules-based investment approaches that define the target asset allocation as a function of the funded status of the plan, prescribing de-risking steps as a plan's funded status improves at various trigger points. Glidepaths are a useful tool for managing risk through a pension lifecycle, particularly for avoiding excessive risk-taking after a plan has seen significant funded status improvement, to avoid both significant backsliding and the risk of having a trapped pension surplus.

STEP 4:
Implement and track revised investment strategy

Prior to freezing a pension plan, some plan sponsors may measure the success of their program solely on asset performance relative to a portfolio benchmark or peer group universe. However, after a plan is frozen, most sponsors introduce new objectives based on the plan's funded status and the long-term objective of either reducing costs and volatility or terminating the plan. These new objectives, risk standards and resulting asset allocation decisions should be updated in the plan's investment policy statement (IPS), along with criteria for tracking and replacing investments.

If a glidepath is selected, funded status thresholds would be identified, which, when reached, would trigger asset allocation changes to help reduce program risk, increase liability hedging, and help lock in funded status improvements. As part of a liability-hedging strategy, it may also be appropriate to use a custom liability benchmark to track the fit to the plan's liability rather than to a standard benchmark. These types of more sophisticated liability-aware investment strategies require close monitoring and expertise to implement effectively.

These opportunities to actively seek to reduce the plan's risk over time should be built into the plan freeze strategy and tracked as market conditions change.

Consider the case study that starts on the next page.

Hypothetical case study:
Asset/liability analysis shapes investment strategy

Evaluate goals

This hypothetical plan sponsor identified three goals for the plan, based on timing, cost level and risk profile.

Timing: Terminate the plan within a five-year time horizon

For this plan sponsor, five years was a critical end date since employees with knowledge of the plan's administration were scheduled to retire at that time.

Cost level: Make a $2.5 million cash contribution annually for five years

In the plan design analysis, the strategy of freezing the defined benefit plan and increasing the defined contribution plan was estimated to save the company about $10 million to $15 million over a five-year period. A $2.5 million annual contribution would keep the defined benefit plan cost-neutral in the short term and produce net savings once it was terminated.

Risk profile: Reduce balance sheet volatility

The pension plan represents a significant portion of the company's balance sheet; sharp declines in the plan's funded status could affect key financial ratios, credit ratings and debt covenants.

Understand the liability and other key pension metrics

The plan is currently 84% funded on an accounting basis and is estimated to be 78% funded on a plan termination basis. Also of note is the interest rate sensitivity of the plan's assets and liabilities, as measured by duration. The fixed-income portion of the plan's portfolio has a duration of four years while the plan's liability has a duration of 10 years. Since the plan's liability is more sensitive to changes in interest rates than the underlying investments, this exposes the plan to funded status deterioration in a declining interest rate environment.

Current state	$ Millions	Funded status	Duration
Market value of assets	$90	N/A	1 year
ERISA funding target liability	$90	100%	10 years
Balance sheet liability	$107	84%	
Estimated termination target	$115	78%	

The case study presented is hypothetical and does not reflect an actual client. It should not be considered an offer, solicitation or endorsement.

Asset class	Current asset mix	Modified asset mix
U.S. equities	75%	25%
International equities	0%	5%
Fixed-income	25%	70%
Fixed-income duration	4 years	10 years
Approximate percentage of liability hedged	10% multiplied by funded status	70% multiplied by funded status
Expected return	7.00%	5.50%

For illustrative purposes only. This case study is not intended to portray an actual plan, nor is it representative of an actual plan sponsor. This hypothetical illustration does not reflect the performance of any specific investment. Actual rates of return cannot be predicted and will fluctuate. Your results may be more or less.

Use asset/liability modeling to identify an optimal investment strategy

An ALM analysis was performed to evaluate the current asset mix against the organization's objectives. A modified asset mix that increased the percentage and duration of the fixed-income allocation and restructured the equity components was also evaluated against these objectives.

The analysis shows that, post freeze, the modified asset mix would increase the likelihood of reaching the plan's objectives as follows:

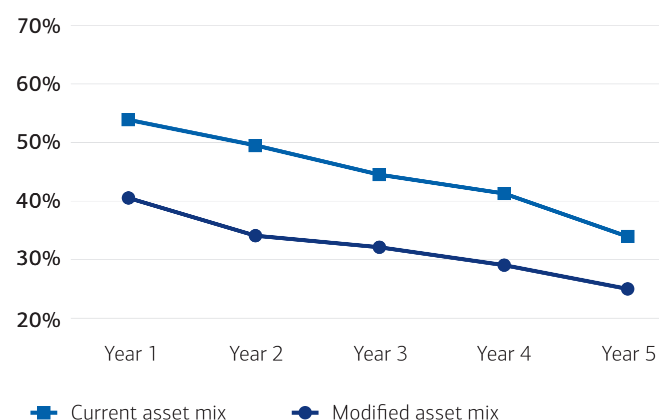
Objective #1: Terminate the plan within a five-year time horizon

Under the current asset mix — and assuming that the company contributes $2.5 million annually to the plan — the company has a 75% chance of reaching its termination target by year five. By modifying the asset mix, the company is more likely to reach its goal; the plan has an 88% chance of reaching its termination target by year five. There is a trade-off, however, for the more predictable outcome. Under the current mix, there is a small chance that the higher equity exposure could enable the plan sponsor to terminate the plan early and save on the remainder of the contribution budget. The higher equity allocation, of course, comes with more volatility, which affects the other two objectives.

Objective #2: Meet cost/affordability threshold

Under the current asset mix, the plan could be required to fund more than its $2.5 million annual budget more than 25% of the time. Under the modified asset mix, the risk of additional required contributions is reduced.

Probability of exceeding $2.5 million annual contribution target



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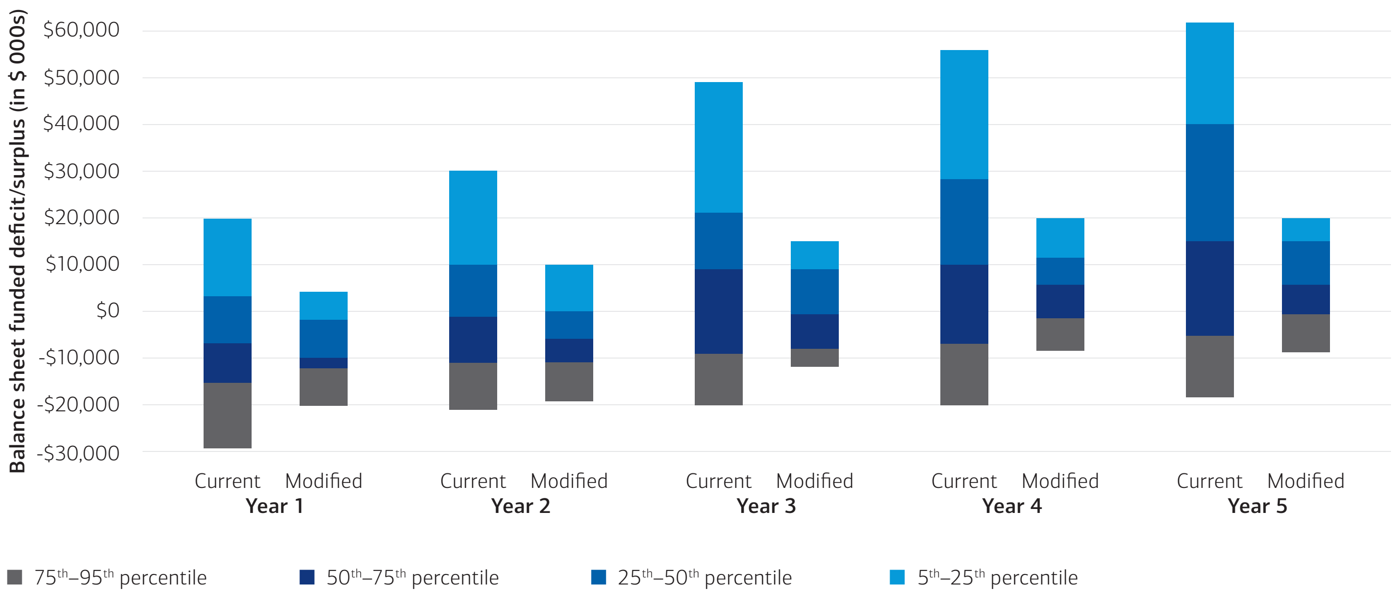
Funding relief, most recently embodied by the American Rescue Plan Act (ARPA) and the Infrastructure and Jobs Act (IIJA), makes contribution requirements lower and less likely to apply at all. However, there is still risk that asset losses can trigger funded status declines that would result in additional contribution requirements.

Objective #3: Reduce balance sheet volatility

Changes to the accounting regulations have created more emphasis on funded status volatility and its impact on the company's balance sheet. The chart below shows the reduced volatility that comes with the modified asset mix, as measured by funded status.

As a result of this detailed ALM analysis, the plan's asset allocation can be modified to increase the probability of success, based on the stated objectives. Dynamic de-risking glidepath strategies should be considered as well for frozen plans. These approaches often improve results on a risk-adjusted basis relative to what static allocations can achieve.

Modified asset mix may reduce balance sheet volatility



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Termination options: Lump-sum distributions versus insurance annuities

When a plan sponsor terminates a pension plan, removing the obligation from the company's books, liabilities are generally settled through a combination of one-time lump sum payments directly to participants and annuity purchases from an insurance company. While an annuity option must be offered to participants by law, employers can also offer the option to take the value of their benefit as a lump sum, with no immediate tax implications if it is rolled over into another qualified retirement program, such as the organization's 401(k) plan or a personal IRA. Through an effective education and transition campaign, the organization can guide its employees to make prudent investment decisions and actively manage for their retirement.

Annuities	Lump-sum distributions
By law, an annuity must be offered as a distribution option to participants.	Optional, but generally the more popular choice for nonretirees.
The cost of transferring benefits to an insurance company can come with significant premiums for the employer, particularly for deferred benefits.	A prescribed basis for determining the minimum value of lump sums is defined under IRC 417(e), which protects plan participants.
Plans and plan participants assume a risk that the insurance company could dissolve (the guarantee of an annuity is subject to the claims-paying ability of the issuer).	With proper education, participants can consider whether to roll over their distribution to an IRA or, if applicable, to their defined contribution plan.
Participants continue to benefit from a predictable, fixed income retirement stream.	An effective communication program can also help employees invest the distribution as they see fit — empowering them to take charge of their financial future.

Could you benefit from assistance with frozen plan management?

Bank of America can assist you in managing your frozen plan — helping mitigate the impact to your organization's balance sheet and lessen the strain on company resources. We can undertake an asset/liability analysis to identify an optimal investment strategy. And we can assist you in achieving your plan termination goals and exploring cost-effective alternatives to help your employees save for retirement. We welcome the opportunity to work with you.

For more information, please contact your Bank of America representative or visit go.bofa.com/retirementplans.

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