Sibson Consulting

Spotlight™

Strategic HR Consulting

March 2014

Accounting Implications of Offering a Lump-Sum Window to "De-Risk" a Pension Plan

Many sponsors of defined benefit (DB) plans are interested in "de-risking" their plans to mitigate one or more of the various risks that can lead to unexpected changes in plan cost. One de-risking option involves offering a lump-sum window, which transfers risk from the plan to current terminated vested participants. (The text box on the last page provides background on pension risks and de-risking strategies.)

There are many issues to be considered before embarking on any de-risking strategy. This *Spotlight* focuses on the possible effects on accounting costs of offering a lump-sum window.

The following are among the accounting-related questions that plan sponsors may want to answer before deciding whether to offer a lump-sum window:

- Will the window result in an accounting "settlement"[1] that will trigger the recognition of charges to P&L that otherwise would likely not have been recognized for some time?
- What is the likely impact on near-term future pension expense?
- What factors can be controlled to mitigate negative accounting consequences?

When plan sponsors offer a lump-sum window, plan accounting is affected in several ways. In particular, the plan's assets and liabilities will each change, which will have an impact on both annual expense and the plan's future funded status. Depending on the timing and magnitude of the window, these changes may not be recognized until the next measurement date (*i.e.*, year-end disclosure). However, it may be necessary to undergo settlement accounting in the fiscal year during which a lump-sum window occurs.

Possibility of Settlement Accounting and Re-Measurement of Funded Status

If the total of all lump-sum payouts for a fiscal year exceeds the sum of a plan's service cost and interest cost for that year, settlement accounting will be triggered. Plans that are "frozen" to future accruals typically have a relatively small service cost. As such, the trigger for settlement accounting for these plans is lower, since it is generally only the interest cost.

Sponsors of plans that would face a large settlement charge if they were to offer a lump-sum window to all of the terminated vested population could reduce the charge by offering the window to only a portion of the terminated vested population. The population segment could be based on several factors, including (but not limited to) date of termination or amount of the lump sum. Note, however, that any population segment will need to satisfy non-discrimination requirements.

Because those losses recorded as part of the settlement charge would otherwise have been amortized and reflected as part of the annual expense over many subsequent years, settlement accounting can be viewed as an acceleration of future years' expense to the

[1] Under Generally Accepted Accounting Principles (GAAP), settlement accounting requires the immediate recognition of otherwise deferred losses.

current year — not a recognition of inherently new costs to the plan. Nevertheless, many financial officers of public companies are concerned about the effect this recognition could have on analyst perception of the current year's earnings.

Generally, settlement accounting also triggers a re-measurement of the plan's funded status, which is done at then-current discount rates and asset values. Depending on the year-to-date changes in interest rates and investment returns, this may or may not be favorable to the plan sponsor.

Impact on the Balance Sheet

Generally, the effect of lump-sum windows on the balance sheet are close to neutral because the accounting liability and the lump-sum basis are typically fairly similar. However, there are two key differences that should be considered:

- The accounting liability is determined based on measurements as of the beginning of the fiscal year. In contrast, the basis of lump sums — which is defined in the plan document — is often a slightly earlier period (*i.e.*, a few months prior to the start of the plan year). If interest rates move materially during the period between when the lump-sum basis is determined and when the accounting liability is determined, there may be a disconnect between the valuation liability being removed from the plan and the lump sums that are being paid.

- The lump-sum basis is often static for the entire plan year. If interest rates change materially from when the lump-sum basis is set to when the lump sums are actually paid, the valuation of the corresponding assets may no longer be "in line" with the lump-sum basis. This could lead to either a positive or negative effect on the balance sheet, depending on the directional change in rates.

These differences should be monitored by plan sponsors as their lump-sum window processes unfold. Differences that become material may affect the viability of a window. In some cases, plan sponsors may want to consider using an interest-rate hedge in their asset portfolios to mitigate any unanticipated changes in rates. Of course, the desirability of an interest-rate hedge needs to reflect the plan sponsor's view of short-term interest-rate changes.[2]

Impact on Annual Expense (P&L)

When a lump-sum window is offered, the plan's assets and accounting liabilities are each likely to change by roughly the same amount but there are several other subtle changes that will affect the plan's ongoing accounting costs:

- ***Liability Duration*** The duration of the plan's liabilities (*i.e.*, the liability's sensitivity to interest-rate changes) will likely decrease as a result of a lump-sum window to the extent a portion of the younger population is removed from the plan, leaving a greater portion of the plan's liability associated with benefit payments due in the nearer term. As a result, the liabilities as a whole will be *less* sensitive to future interest-rate changes. Further, lowering the plan's duration will make the plan more weighted towards the short end of the yield curve, which will likely drive down discount rates.

- ***Asset Duration and Allocation*** Consideration should be given to the types of assets that are liquidated to pay the lump sums and the resulting impact on both asset duration (and the coordination with liability duration) and asset allocation. In addition, depending on which assets are used, and whether the allocation is rebalanced following the window, the assumed return on assets may need to be revised.

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[2] Organizations interested in exploring this option should contact Segal Rogerscasey (www.segalrc.com), the investment solutions member of The Segal Group, of which Sibson is also a member.

- ***Amortization of Gains/Losses*** As noted above, settlement accounting is generally an acceleration of gains or losses, which would otherwise have been recognized in future years. Therefore, generally, the outstanding gains or losses will be reduced. But the remaining gains and losses will still be subject to amortization. These future amounts may be affected as follows:

  - First, if the plan sponsor uses the standard "corridor" approach to amortizing gains and losses, only those outstanding gains or losses that are outside of the corridor (typically 10 percent of the greater of assets or liabilities) will be amortized. As the plan's assets and liabilities decrease as a result of the window, this corridor will shrink, therefore accelerating the recognition of gains or losses.

  - Second, if the plan sponsor uses the average future lifetime as the amortization period (as is often used for frozen plans), that period will likely be smaller (due to the exclusion of typically younger terminated vested participants), thus accelerating recognition of gains or losses.

Many of these issues, including the impact from the change in liability duration and the residual effects on the amortization of gains or losses, are directly affected by the change in plan demographics related to the participants who are offered and elect the lump-sum window. Therefore, when selecting a population segment to which a lump-sum window will be offered, care should be given to the effects the window will have on the P&L.

Conclusion

Plan sponsors that are considering offering a lump-sum window to help de-risk their pension plan should consider the less-well-known accounting complexities associated with implementing a lump-sum window.

While not yet included in most plan sponsors' accounting liability and lump-sum calculations, an actuarial task force[3] is expected to recommend using mortality tables with additional longevity improvements, which will likely increase future liability. Therefore, lump sums paid out in the current environment would avoid this potential liability.

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To discuss the advantages and disadvantages of offering a lump-sum window, including the accounting implications, or other pension de-risking strategies, contact your Sibson consultant or the nearest Sibson office. (For a list of Sibson offices, click on the second link in the box at the bottom of the next page.)

Sibson actuaries can analyze the actuarial implications. Employers should rely on their accountants and auditors for authoritative advice on all accounting decisions.

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[3] The Society of Actuaries' Retirement Plans Experience Committee (RPEC) released an exposure draft of the RP-2014 Mortality Tables in February 2014, which can be accessed from the following web page: http://www.soa.org/Research/Experience-Study/Pension/research-2014-mort-tables.aspx. The RPEC requests comments on this exposure draft by May 31, 2014.

Background on Pension Risks and De-Risking Strategies

Typically, there are five major risks that are borne by sponsors of DB plans:

- ***Interest-Rate Risk*** This is the risk associated with a plan's assets and liabilities having different sensitivities to changes in interest rates (thereby changing the plan's funded status as rates move).
- ***Investment Risk*** Investment returns fluctuate greatly from year to year.
- ***Longevity Risk*** Plan participants may live longer than expected.
- ***Inflation Risk*** Inflation may rises faster than assumed.
- ***Funding and Accounting "Rules" Risk*** The "rules" for determining the funding and/or accounting requirements for a DB plan can change.

There are generally two types of de-risking strategies that plan sponsors can use to reduce or eliminate pension risks and, as a result, reduce the volatility of the plans' funding and accounting requirements:

- ***Risk Mitigation*** This involves techniques that reduce risks, such as liability-driven investing or dynamic asset allocation.
- ***Risk Transfer*** This strategy eliminates risk by fully transferring it to a third party, such as an insurance company or to plan participants.

A lump-sum window is a type of risk-transfer strategy that typically provides a limited, one-time offer of a lump-sum distribution to participants (typically, terminated vested participants) instead of receiving an annuity at retirement.* In this case, all risks are transferred directly to participants who choose to receive a lump sum. Unlike other risk-transfer strategies, however, there is no guarantee that the elimination of risk will actually occur because the election to receive a lump sum is voluntary.

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* For an overview of this strategy, see Sibson's May 2012 *Spotlight*, "Opening a Lump-Sum Window to Help 'De-Risk' a Pension Plan": http://www.sibson.com/publications/spotlight/may2012lsw.pdf