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THE NEW ERA OF DEFINED BENEFIT PLAN RISK

By Sheva Levy and Chris Lipski

If you are a plan sponsor looking for ways to manage the risks and maximize the return on investment associated with your defined benefit (DB) plan you are not alone. Sponsors of DB plans are being forced to focus on their plans as never before. A confluence of events–market downturn, aging workforce and changing legislation/regulation–has meant the status quo no longer applies to companies' DB plans.

Risks–whether financial, compliance or employee related–may cause serious reputational and financial harm from inefficiencies, litigation or penalties. The responsibility to assess these risks resides in many places throughout an organization, but these efforts must be centrally coordinated–often under the guidance of human resources (HR).

The issue of underfunding

A Watson Wyatt Worldwide analysis of 450 Fortune 1000 companies found that a total loss of $445 billion in pension funds wiped out a 2007 surplus of $78 billion, leaving these companies with a combined $366 billion deficit on year-end 2008 financial statements.[1]

In spite of a partial equities market recovery in 2009, the U.S. stock market dropped by nearly six percent (on a market-cap-weighted basis) during the first eight months of 2010. Combined with a continuing–if not slightly worsened–discount rate environment on investment-quality corporate bonds, the funded status of the typical U.S. corporate pension plan remained at a historically low 71 percent.[2]

With employees hearing more and more bad news each day from many sources, the last thing employers can afford to do is have any sort of slip-up associated with their DB plans, whether it is actual or perceived.

With all of the risks associated with DB plans, many plan sponsors are

Needs and Risks Committee in the United States and the Pension Advisory Task Force in Canada

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contemplating a change to DC plans. In this case the investment risk is shifted to the employees. However, the frozen DB plans still carry large legacy costs and administrative burdens.

Employers with a paternalistic mindset may still prefer to provide benefits using a DB vehicle. However, they are finding that employees do not fully understand DB plans as the value to them is difficult to see. DB plans continue to be an excellent retention tool if properly understood by participants, and the employers must educate participants on the value of the benefits that they are receiving.

With proper oversight, DB plan risks can be monitored and contained. Once the framework has been put in place to manage these plans, they can satisfy and motivate the workforce while still achieving stated business objectives. Employers with more nimble control environments and motivated employees will be best positioned for growth as the economy resumes its long-awaited recovery.

Changes due to the Pension Protection Act

Prior to 2006, IRS rules related to funding of qualified pension plans were a patchwork of rules that have evolved since ERISA was passed in 1974. The Pension Protection Act of 2006 (PPA) presented changes to the rules governing the funding of qualified DB plans effective Jan. 1, 2008. These rules were intended to make sure that qualified plans are properly funded so that benefits promised to employees are paid and the PBGC can better manage its responsibility for severely underfunded plans.

In addition to the accelerated funding requirements for underfunded plans, PPA also imposed potential benefit payment and accrual restrictions that can create difficult employee relation situations. While PPA intended to simplify the funding rules, it has added new layers of complexity. Minimum funding requirements, benefit restrictions and limitations on funding of nonqualified arrangements create a juggling act for plan sponsors. More focus will have to be placed on working with a plan's actuary to forecast funded status and make sure funding strategy meets business objectives.

The new funding requirements, along with the declining assets associated with these qualified plans due to poor market performance, have triggered significant additional short and mid term financial and administrative costs for plan sponsors. Although the Worker, Retiree, and Employer Record Act of 2008 (WRERA) and the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act (PRA) provide some measure of relief, they do not provide the full extent of relief that some plan sponsors had hoped for.

The Sarbanes-Oxley impact

Now that organizations have had some time to absorb the impact of

Section 404 of Sarbanes-Oxley (SOX), the focus has been switched to processes that may not have been as closely considered during the initial implementation waves. The identification by external auditors of "significant deficiencies" or "material weaknesses" related to pension and OPEB processes has become more prevalent as auditors express their concerns surrounding the controls and procedures associated with compiling required financial information.

Large organizations with complex reporting structures find it difficult to document these processes. These organizations may sponsor multiple plans with varied plan provisions. It is likely these organizations have outsourced the plan administration, often with multiple vendors, and therefore rely on these administrators to transfer census data to the plan's actuary. However, the plan sponsors may find that they are left holding little in the form of evidence of controls or even the source data itself. The sponsor must balance oversight of the administration process in a way that still realizes efficiencies gained from outsourcing.

There are a number of critical action items that companies can undertake to ensure greater control over data integrity. There must be sufficient coordination between payroll and HRIS so the appropriate data, such as pensionable earnings and service history for active employees, are maintained for use in actuarial valuations. Many employers still face issues with the maintenance of census data for plan participants that are no longer actively employed. Often these groups account for a larger portion of plan obligations than the active population and require just as much, if not more, oversight.

There are additional complexities for global organizations that have financial results rolling up from many foreign entities. Foreign entities may be reporting results under local statutory or accounting standards. Oversight is needed to ensure that consolidated U.S. results reflect the appropriate accounting basis. Given all of these factors, there is clearly a need to strengthen internal controls around the entire reporting process related to pensions and OPEBs.

Regulatory compliance

The Employee Plans Team Audit (EPTA) program became a permanent IRS program on Oct. 1, 2003. EPTA is a broad-scope examination of employee benefit plans with 2,500 or more participants. An IRS report on the top 10 issues found in EPTA audits noted a "lack of sufficient internal controls to ensure that data provided to third party record keepers/plan administrators is accurate. Often the audit reveals that reports and testing prepared by third parties have inaccurate data, such as dates of hire or termination, ages of employees, amount of compensation, etc. Thus the plan administrator is improperly calculating such things as vesting or

employer matching allocations." The report also noted that "large corporations with decentralized payroll systems may have problems administering the plan if there are no internal controls to ensure plan provisions are properly applied." Findings from an EPTA audit could affect the qualified status of pension plans. Even plans not subject to EPTA audits still can become disqualified if administration issues are identified.

Frequently, companies lack the internal resources for self-review to identify control issues; even if internal resources are available, the labor-intensive nature of the work makes it very difficult for any one group to identify all systemic issues. In addition to qualified status or internal control deficiencies, lack of control generally represents inefficiencies in administration of the plan and translates into unnecessary costs to an organization. During these cost conscious times in, there are clear benefits to properly assessing the controls environment associated with DB plan processes.

Vendor and risk management

Most large organizations today outsource a portion of their HR functions to a third-party administrator, the primary drivers being cost reduction and re-focusing of resources on functions core to operational goals. After the contract is signed organizations may fail to actively manage the vendor relationship. They are often faced with poor service, uncertainty on whether the vendor is performing according to the agreed service levels or the possibility of overbilling problems.

While it may seem that the risk itself is outsourced, the company should consider nothing is off the table. Activities must be carefully reviewed and documented to capture business improvement opportunities.

Regular monitoring steps include:

- Reviewing contract terms and invoices to identify potential billing errors
- Assessing vendor's performance against key performance indicators
- Assessing the current contract against leading practices
- Analyzing services in the contract compared to services actually performed to identify any contractual services that are not being provided
- Assessing regulatory compliance of vendors

When managed correctly, these relationships have great potential to

reduce risks and maintain predictable costs.

The impact of FAS 158

Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (FAS 158), first became effective as of the end of the fiscal year ending after Dec. 15, 2006. Amounts that were previously deferred and recognized over time through the annual expense instead had to be recognized immediately as "Other Comprehensive Income/Loss." This caused large changes for some organizations.

FAS 158 consolidated guidance from various Financial Accounting Standards Board (FASB) sources on the process used to select assumptions for the actuarial valuation process. This has generated more focus on the actuarial valuation and reporting process. Auditors are now looking more closely at the processes and documentation associated with the discount rate setting process to assess its appropriateness for a particular plan, rather than simply comparing the assumption to general market benchmarks.

The plan sponsor bears responsibility for selection of the assumptions and is usually done with the assistance of an actuary. The actuary bears responsibility of the assumptions application to develop the projected costs. The actuary is not required to opine on reasonableness of prescribed assumptions. Therefore, plan sponsors need to be ready to demonstrate that processes used in the assumption-setting process are both appropriate given the particular plan's facts and circumstances and also the market conditions relevant as of the plan's measurement date.

FAS 158 included illustrations related to the creation of a deferred tax asset/liability associated with pension and OPEB liabilities. Although some organizations already followed this practice, such illustrations were not included in previous accounting standards associated with pensions and OPEBs. Therefore, additional focus on DB plans' relationship to the tax provision and FASB Interpretation No. 48 (FIN 48) considerations was triggered.

Investment disclosure and management

In December 2008, the FASB issued FASB Staff Position No. 132(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets containing new disclosure requirements related to pension plan asset. These requirements first applied on a prospective basis for fiscal years ending after Dec. 15, 2009. Frequently the plan sponsor's treasury department's trust and investments group handles decisions associated with plan assets. Now more communication and coordination is required between those producing the financial statements and the treasury

function to make sure that the information is readily available for disclosure purposes.

In addition to disclosure and reporting, plan sponsors have begun to focus more on the investment process. Prudence in this area has always been procedural. However, the big issue now is whether investment strategy should be aimed at liability matching with an emphasis on fixed income. If not, it will be necessary to determine what the proper level of equity investments should be based on that liability. An understanding of the various investment classes is needed to set the assumed long-term rate of return on assets used to calculate the annual expense.

Health Care Reform

In addition to the myriad of complexities that Health Care Reform (HCR) has introduced for employers, there are specific considerations related to the valuation of OPEB plans. Sponsors must consider the impact today on their plan obligations of changes yet to be implemented such as excise taxes on benefits over a given threshold and changes to trend rate assumptions in light of the impact of HCR on the healthcare industry.

HCR also presents cost savings opportunities such as the Early Retiree Reinsurance Program (ERRP). Under this program, plan sponsors are able to submit for reimbursement certain expenses associated with claims for retired participants receiving medical benefits who are not yet eligible for Medicare. Although the cost savings generated may be significant, the ERRP carries administrative requirements that are complex. A strategic decision is required as to the value of participating in this program.

The new era of fiduciary responsibility

In addition, plan sponsors could be held personally responsible for breach of fiduciary responsibility for actions associated with the administration of DB plans. ERISA fiduciaries in the corporate environment may include senior executives (often CFO/finance department), the board of directors, vice president of HR and benefit plan committee members. Examples of types of activities that create ERISA fiduciary status are managing plan assets, selecting or directing plan investments, selecting third party service providers, deciding claims appeals, interpreting the plan provisions or oversight of any persons with these responsibilities.

ERISA's fiduciary rules are not intuitive or obvious. An ERISA fiduciary can be held liable for violating ERISA's fiduciary rules even if the violation was accidental. In certain circumstances, a fiduciary can also be held liable for breaches of a co-fiduciary. A fiduciary found guilty of a breach of fiduciary duties under ERISA may face potential consequences such as personal liability to reimburse the plan for any losses, punitive damages and even civil and criminal penalties. However, many times ERISA fiduciaries are

not even aware that they may be in such a position.

There are some simple steps plan sponsors can take to try to minimize the risks associated with fiduciary responsibility:

- Review the plan's administrative operations to identify any cracks in the system. Lawsuits have been premised on preventable administrative mistakes, so take the time to prevent a small problem from becoming a big problem.

- Determine who the plan's fiduciaries are. Although a plan is required to specify a fiduciary, ERISA applies a functional definition: anyone exercising discretion over plan assets is a fiduciary. If the plan has allocated or permitted this discretion to extend to parties not observing fiduciary safeguards, this could be a problem for all.

- Determine who bears the financial burden in the event of a fiduciary breach. The plan document or a service provider agreement may indemnify parties performing fiduciary functions. Explore options for shifting this risk through insurance, limitations on indemnification or reversing indemnification provisions to place the risk on the party in error.

- Consider modifying the plan's administrative procedures to treat complaints of administrative error as claims for benefits. Requiring administrative exhaustion of these claims could secure a more lenient standard of review, or avoid litigation entirely, if the claim can be resolved at the administrative level.

Changes ahead

More changes are brewing. The Securities and Exchange Commission (SEC) issued its road map for the adoption of International Financial Reporting Standards (IFRS) in the United States. Absent any considerations by the International Accounting Standards Board related to convergence, IFRS will introduce significant changes to accounting for pensions and OPEBs. Plan sponsors need to start considering these changes prior to implementation to make sure they have processes in place to create necessary financial disclosures as of transition date.

The IRS has yet to issues guidance regarding some of the practical considerations related to the PRA. Additionally, PRA includes some strings related to items such as extraordinary dividends that may require individuals in a pension oversight role to familiarize themselves with aspects of their organizations that were previously outside their area of focus.

The new role of HR

DB plans clearly no longer fit simply under the realm of HR. DB plans touch many aspects of the organization and have evolved into an area of high focus for boards of directors and compensation committees, investors and employees. Organizations need to identify an internal resource that is able to coordinate the various considerations and stay informed on the continuing changes related to DB plans. As the HR function evolves, the responsibility for overseeing all touch points would likely reside there.

The appointment of a "DB controls manager" may be the answer for some organizations. This person should be familiar with the corporate structure and act as a liaison between HR and the other corporate functions. Preferably, he would have an audit background or an understanding of the audit function. This type of background would bring an added focus on the process and documentation needed to bring the DB processes to a point where they can stand up to scrutiny of an audit–whether it is conducted by external auditors or an EPTA audit.

Familiarity with the corporate systems would also be a prerequisite to help the resource understand the flow of entries in financial information system and census data throughout the organization. In this role, the DB controls manager would be an enabler and facilitator to design and implement controls which would then be performed by the HR team and other relevant functions.

It is the intent that the DB controls manager role would be distinct from the existing HR roles. Keeping the role separate would create an independent party who will be able to focus the overall process while the remaining HR staff would focus on the day-to-day oversight.

The DB controls manager would initially have to work to make sure that all of the processes meet current expectations. However, as changes take place, ongoing monitoring of the controls would be needed to make sure that they are updated appropriately.

Given the breadth of subject matter involved, the DB controls manager will need to rely on advisors with deep finance, accounting, actuarial and tax knowledge to keep updated on developments that have great bearing on the company's decision-making process. These advisors will need to help the DB controls manager understand the various issues. The role will need to work to maintain a consultative arrangement with advisors, and not strictly a compliance relationship, to ensure that the corporation does not encounter any unpleasant surprises with the DB plan processes.

Employee communications and education

DB plans are not easily understood by employees, particularly the younger

workforce. With such significant investments required for maintenance and oversight of these plans, sponsors need to make sure that their investment is valued in the eyes of employees.

If there is any silver lining to be realized from this economic downturn it is that employees are more motivated to pay closer attention to their personal financial situation. Consequently, programs such as financial planning and education can help employees understand and better utilize the features of all their benefits programs. They, in turn, develop a better appreciation for the combined value of their total reward program, including their DB plan. By providing the communication and education about benefits such as the DB plan, employees can learn to plan around them. Greater attention to the financial acumen of employees not only improves productivity, it also enhances recruitment and retention efforts down the road.

By properly combining streamlined, low-risk DB plan operations with appreciative and incented employees, plan sponsors can maximize the return on their investment and make their organization a market leader and an employer of choice into the future.

Sheva Levy, ASA, is a senior manager in the Performance & Reward group of Ernst & Young LLP's National Tax Department in Cleveland, Ohio. She can be reached at sheva.levy@ey.com.

Christopher Lipski, JD, is leader of the U.S. Human Resource Risk Management service line in Ernst & Young LLP's Performance & Reward practice in Atlanta, Ga. He can be reached at chris.lipski@ey.com.

Footnote

[1] Watson Wyatt Worldwide. Available here

[2] BNY Mellon Press Release. Available here