Developments

Recent Developments in Employee Benefits

Defined Benefit Pension Plan Risk

By Ken Hohman, FSA, EA, FCA, MAAA

The word “risk” invokes a range of responses. The timid (or wise, depending on your point of view) think of risk as something to be avoided, or at least mitigated (think George McClellan).[1] The more aggressive see risk as an opportunity and look for a reward to be reaped (think Napoleon Bonaparte). We see risk as something to be analyzed, quantified where possible, and most importantly, understood.

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There are several general categories of risk relating to defined benefit pension plans; these include:

- Actuarial
- Black swan event (unpredictable and random)
- Operational/administrative
- Fiduciary

Where do these risks come from? There are an assortment of sources, including unusual events, flawed processes, human errors, moral hazards, and the ever-present risk of legislative and regulatory intervention.

Risk must also be analyzed in the context of the stakeholders involved. There are four primary stakeholders when one considers a corporate pension plan:

- Plan participants
- Plan sponsor
- Shareholders of the plan sponsor
- Plan fiduciaries

The BIG risks

There are risks that span all or most of the categories of risk and impact all or most of the stakeholders. One such risk is that plan benefits are insufficient to satisfy retirement needs, a fact that—unfortunately—many participants do not understand. Obviously this is a problem for participants, but it also can lead to HR and PR issues for the plan sponsor that could ultimately affect shareholders and fiduciaries. This is, however, a risk that can be easily mitigated. If an employer cannot afford to provide adequate retirement income, or philosophically sees no reason to do so, the employer can provide retirement planning education to its employees.

Other major risks are more complex and more difficult to handle, for example, the risk of inadequate plan funding. With protections from the Pension Benefit Guaranty Corporation, the risk to participants is somewhat softened, but the blame—and ramifications—can fall to the other stakeholders.

Related to inadequate funding is the risk that the plan will negatively affect the corporate financial statements. Clearly this is a concern for the plan sponsor and its shareholders; but poor corporate performance can lead to layoffs, thus affecting plan participants.

Errors (human or otherwise) or worse, malfeasance, pose a risk to pension plans that can contribute to inadequate funding, reduced corporate earnings, and even litigation. There are a number of individuals that can have an impact on the amount of dollars going into or out of a

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pension fund. These individuals are, of course, subject to making mistakes. Additionally, given the large sums of money held in these funds, there is the risk of unethical behavior.

Let's examine how these BIG risks fall within the various risk categories.

Actuarial risks

Actuarial valuations of pension plans are used to both assess appropriate funding levels and to determine the effect of a plan's liabilities on the sponsor's financial statements. The valuation process requires knowledge of the benefits promised, the underlying demographic data of the covered group, and information related to plan assets. It also relies on a number of assumptions related to future expectations. The valuation process also includes the actuarial methods used to allocate future plan funding and expense requirements to future years.

ERISA mandates certain methods and primary assumptions for determining minimum required funding levels. Those methods and assumptions are meant to protect the short-term solvency of the plan; however, that does not necessarily mean they are appropriate for the long-term funding of the program. Therefore, an actuary may develop a range of appropriate funding levels based on a combination of short-term and long-term considerations. Similarly, accounting standard bodies mandate certain methods and assumptions for the disclosure of plan liabilities on corporate financial statements. While it is not surprising, considering the different purposes for funding and financial statements, the ERISA and accounting methods and actuarial assumptions are not the same, which adds to the confusion attached to actuarial valuations.

Assumptions will never exactly match actual experience . . .

An actuary is not a fortune teller—he or she cannot accurately predict the future (proven by my inability to pick a Kentucky Derby winner), so the standard applied to actuaries is that their assumptions and methods must be "reasonable". Assumptions will never exactly match actual experience, but the goal is to have the losses experienced in one year be offset by gains in a future year. We feel it is appropriate for the methods and assumptions employed, particularly for funding purposes, to err on the conservative side of reasonable. It is preferable to all stakeholders to deal with slowly declining contribution levels as opposed to a massive unfunded liability.

Actuarial risk is the risk the actuary selects methods and assumptions that are not reasonable, resulting in inadequate funding and large financial statement liabilities. Actuarial risk can also be the product of the actuary not clearly explaining the risks related to certain assumptions and methods. This risk can be the consequence of misinformation, ineptitude, or even moral hazard (e.g., wanting to provide a funding level desired by the client). To address the risk, the plan sponsor should verify the qualifications and experience of the actuary, as well as his or her ability to communicate effectively.

Black swan risk

As described above, actuarial risk suggests that a bad assumption is made; however, even if the assumption is reasonable, a unique event—a "black swan" event—can result in significant loss. A black swan event is unpredictable, thus, cannot be reasonably assumed. A black swan event is also extreme. The classic example seared in our brains is the collapse of Lehman Brothers, which kicked off the equally unexpected 2008 financial crisis (in spite of the millions of people who, after the fact, claimed to have predicted it).

Corporate financial statements continue to carry forward losses generated in 2008 and 2009, and plan funding levels remain high due to the low interest rates resulting from Fed actions against the financial panic. That said, plan funding levels would be much higher if not for funding relief legislation caused by the crisis.

While we tend to think of black swan events as being primarily economic in nature, there are other events that could dramatically affect pension funds. The elimination of all cancers is something we strive for as a society; however, consider the effect that could have on pension plans. If we suddenly assumed that everyone will live ten years longer, pension liabilities would skyrocket.

It is difficult to effectively plan for black swan risk, but an important element is for the plan sponsor to have advisors—actuarial, investment, legal, and accounting—who can communicate the potential for, and financial effect of, these unique and infrequent occurrences.

Operational and administrative risk

Typically operational and administrative risk is rare in occurrence and small in amount, but it has the potential to be large and devastating. The typical causes of this risk are generally poor procedures and human error, but moral hazards can certainly come into play.

There is a substantial amount of administration that is required for a pension plan: gathering demographic and payroll data, filing government forms, communicating with participants, calculating benefit amounts, and authorizing benefit and expense payments. These operational duties may be handled by the plan sponsor, by an outside administrative firm, or, most likely, a combination of the two. The sponsor should make certain that it has appropriate insurance to cover potential losses due to administrative error and unethical behavior and also verify that any outside administration provider has sufficient coverage.

The sponsor should make certain that it has appropriate insurance to cover potential losses due to administrative error and unethical behavior . . .

The best way to mitigate this risk is to establish detailed procedures for all administrative functions and make sure those procedures are followed.

Fiduciary risk

Fiduciaries are those individuals and entities that exercise any discretionary control over the pension plan. A fiduciary has a duty to perform its function(s) in the best interest of the plan participants.

Generally, the plan sponsor is a fiduciary, and perhaps certain individuals or committees within the company may also qualify as fiduciaries. The plan trustee—either individual(s) or a corporate financial institution—is a fiduciary, and is generally responsible for investment risk. An outside administration firm may also be a fiduciary, although, administrative functions, whether provided internally or externally, do not typically rise to fiduciary status.

While certain entities (e.g., the plan administrator—frequently the plan sponsor—and the plan trustee) are "named" fiduciaries, the determination of fiduciary status is a facts and circumstances test. An individual never has to be referred to as a fiduciary or consent to the title of fiduciary to, in fact, be a fiduciary (and therefore accept the consequent fiduciary liability).

To address fiduciary risk, it is important for the plan sponsor to identify all those who clearly are, or potentially could be, plan fiduciaries. The greatest liability is with individuals (generally employees of the plan sponsor) who face moral hazards resulting from conflicts of interest. For example, is the president of the plan sponsor making decisions as a corporate officer or as a plan trustee? We recommend risk mitigation through appropriate insurance coverage and strong ERISA legal counsel.

Balancing risk and reward

We are continually peppered with stories about great leaders who take bold and aggressive actions and reap rewards while others (the perceived "losers") sit passively and stew over difficult decisions. I contend, however, that leaders must first identify and understand the risks before they can assess whether a risk is worth the reward. Risks associated with pension plans are not always instinctively intuitive for corporate leaders, and the quantification of risk is often more art than science, so some stewing is quite appropriate. Absent this thoughtful understanding, you personally risk the kinds of unpleasant surprises that can result in loss of temper, loss of sleep, and potentially, loss of job.

Questions? Contact your Findley Davies | BPS&M consultant with whom you normally work or contact Ken Hohman via email at ken.hohman@bpsm.com or phone 502-253-4628.

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[1] *An example of George B. McClellan's desire to mitigate risk can be seen in his handling of the Peninsula Campaign, where, as Commander of the Army of the Potomac, he was tricked by the Confederate commander, General Joseph E. Johnston, into thinking that Confederate forces outnumbered his Union forces. McClellan's decision to avoid the risk of defeat by delaying several planned attacks gave the Confederate army ample time to retreat toward the Richmond defenses.*

Kenneth F. Hohman, FSA, EA, FCA, MAAA

Ken has spent 40 years in the retirement industry, 38 as an actuarial consultant with Findley Davies | BPS&M. His expertise is in the design, funding, administration, and regulatory compliance of qualified and nonqualified retirement plans. His clients comprise a variety of employers, including Native American tribes, governmental entities, not-for-profit, and for-profit private employers. He established the firm's ESOP Practice Group and has extensive experience in assessing the feasibility of establishing ESOPs, including repurchase liability studies. He has presented at the annual Enrolled Actuaries Meeting on various employee benefits issues, has written articles on retirement plan topics, and has spoken at various venues, including IRS internal training seminars. Ken is a past president of the American Academy of Actuaries. He is a managing consultant in our Louisville, KY office.

The IRS Paves the Way for More Preapproved Plans

By Sheila Ninneman, J.D.

On June 30, 2017, the Internal Revenue Service (IRS) issued Revenue Procedure 2017-41, which makes significant changes to the IRS' opinion letter program for preapproved retirement plans. On the same day, the IRS issued the 2017 Cumulative List, which lists changes to the qualification requirements that are required to be taken into account in preapproved defined contribution plans that are submitted for opinion letters during the third six-year remedial amendment cycle. The third cycle begins October 2, 2017, and ends on October 1, 2018. Revenue Procedure 2017-41 is effective October 2, 2017.

In our Summer 2016 article, "IRS Puts Brakes on Cyclical Determination Letter Program," we discussed the IRS's termination of the five-year cyclical determination letter program for individually designed plans. Essentially, determination letters for individually designed plans may only be obtained at a plan's inception and termination. Commentators predicted that the end of the cyclical program would encourage plan sponsors to convert their plans, where possible, to preapproved plan formats. In Revenue Procedure 2017-41, the IRS makes that goal explicit.

In keeping with the goal, the IRS states that the new preapproved opinion letter program increases the types of plans eligible for preapproved status, affords greater flexibility in the design of preapproved plans and eliminates the distinction between master and prototype and volume submitter plans. The new opinion letter program involves two types of plans: standardized and nonstandardized preapproved plans.

Other highlights from the Revenue Procedure include:

- A preapproved plan may have either of two formats: an adoption agreement and basic plan document or a single plan document;
- A money purchase pension plan can now be combined with either a 401(k) or profit-sharing plan;
- An ESOP can now include a 401(k) feature, but it must be a nonstandardized plan;
- A cash balance plan may now provide that the rate used to determine an interest credit be based on the actual return on plan assets (not a subset of plan assets), but it must be a nonstandardized plan;
- A nonelecting church plan (plans that do not elect ERISA coverage) may submit an application for an opinion letter; and
- No opinion will be issued as to the tax-exempt status of a preapproved plan's related trust or custodial account.

The IRS invites further comments on how the opinion letter program can be improved and, in particular, comments regarding ways in which individually designed plans that retain legacy benefit formulas can be converted to a preapproved plan format.

Questions? Contact your Findley Davies | BPS&M consultant with whom you normally work or Sheila Ninneman, J.D. at sninneman@findleydavies.com or 216.875.1927, or contact Jason Rothman, J.D. at jrothman@findleydavies.com or 216.875.1907.

Sheila Ninneman, J.D.

Sheila is a senior consultant and a member of the Technical Resources Practice Group at Findley Davies | BPS&M. Prior to joining Findley Davies | BPS&M, Sheila was a member of the employee benefits and executive compensation practice group of a national law firm headquartered in Cleveland.

Sheila advises firm clients on all areas of employee benefits and executive compensation compliance with significant experience in implementing, amending and restating tax-qualified plans, and providing counsel regarding their day-to-day administration. Her experience includes the termination and mergers of tax-qualified plans and advising clients on fiduciary compliance, IRS and DOL plan audits, and correction of operational and documentation errors in submissions under federal correction programs. With respect to welfare benefit plan compliance, Sheila provides employers with advice on matters arising under the ACA, COBRA, HIPAA, as well as wellness plan design. She also assists employers on merger and acquisition employee benefits issues by performing due diligence and providing advice on purchase agreement provisions that affect employee benefits and executive compensation. Her executive compensation experience spans nonqualified plan design, employment agreements, severance agreements and general compliance issues arising under Internal Revenue Code Section 409A.

Sheila is a consultant in our Cleveland, OH office.

Preretirement Death—Who Should Receive the Death Benefit?

By Lisa Tomlin, CPA

Do you know what your retirement plan says or doesn't say about distributions to beneficiaries?

Even with well-written documents, there are still situations that may cause a plan administrator to trip and fall . . .

Retirement plan documents are the rulebooks for determining the amount, form, and timing of benefits for plan participants and their beneficiaries. Even with well-written documents, there are still situations that may cause a plan administrator to trip and fall if not careful.

Paying Beneficiaries

When an employee or former employee dies prior to retirement, do you know who should receive the death benefit, if any?

It sounds simple, pay the benefit to the beneficiary (ies) specifically designated by the employee prior to death. This may be the answer unless the plan provides for an automatic survivor benefit for employees married at the time of death. In this situation, a beneficiary designation that was completed prior to the marriage is invalid, and the employee may not designate another beneficiary without the spouse's written consent. Therefore, even if the employee designated another person as his/her beneficiary prior to marriage, the spouse will be the benefactor of the employee's survivor retirement benefit. One should always refer to the plan document for the definition of "spouse." Defined benefit plans often require that a couple be married for one year, and both defined benefit and defined contribution plans may have other stipulations before someone can be considered a "spouse".

What if the employee is divorced at the time of his or her death, elected his former spouse as the beneficiary prior to the divorce, and the beneficiary election was never changed?

The plan document may provide for the beneficiary designation to become null and void immediately and automatically upon divorce. If, however, the plan does not provide that the beneficiary election become null and void upon divorce (and a Qualified Domestic Relations Order does not provide otherwise), a plan administrator may be obligated to pay the death benefit to the former spouse—even if the divorce decree or the participant's last will and testament specifically says otherwise.

The plan document may provide for a child or children of the participant to receive the death benefit in the event the participant is not married. Does the plan document provide a definition of a "child"? Is a step-child considered a child? Is there an age requirement to be considered a child?

These are questions that a plan administrator must consider before paying a preretirement death benefit to children. If the plan is not clear, then plan administrators should consult with their legal counsel to ensure the benefits are paid appropriately.

Questions? Contact your Findley Davies | BPS&M consultant with whom you normally work or Lisa Tomlin at ltomlin@findleydavies.com or 336-271-2089.

Lisa Tomlin, CPA

Lisa is a senior consultant in the Defined Benefit Administration Practice with more than 20 years of experience in plan administration. Prior to joining Findley Davies | BPS&M, Lisa was with an in-house benefits consulting group for a multi-national corporation, overseeing the plan administration of several large and complex retirement plans. Her experience also includes project management for several data conversions related to plan mergers and divestitures.

Lisa works with clients and their legal counsel, helping to ensure compliance with the provisions of their plan(s) as well as with applicable government regulations. Lisa is a technical resource for the plan administration teams and also works with team members during client conversions helping to set up and implement testing and preparing plan administration requirements.

Lisa has been a member of The North Carolina Association of CPAs since 1993. Lisa is a consultant in our Greensboro, NC office.

CONSULTANTS *in the* LIMELIGHT

Catie Barger has earned the Enrolled Actuary (EA) designation, having met the qualifications and standards established in the regulations of the Joint Board for the Enrolled Actuaries.

Matthew Gilliland has earned his Fellow of the Society of Actuaries (FSA) designation.

Rob Gutmann moderated a discussion at the Thoroughbred ESOP Conference in Lexington, KY on August 9. His topic was "The Three D's of ESOPS: Distributions, Diversification, and Dividends".

Ken Hohman was part of a panel discussion at the Thoroughbred ESOP Conference in Lexington, KY on August 9, 2017. Their topic was "Unique Issues Involved in Personal Service Companies with ESOPs."

Katherine Tange-duPré will moderate the discussion "Creating an Ownership Culture" at the New South & Carolinas Chapters of the ESOP Association Joint Conference, which will take place September 20–21, in Nashville, TN.

John Stone will present " Surviving an ESOP Audit" at the New South & Carolinas Chapters of the ESOP Association Joint Conference, which will take place September 20–21, in Nashville, TN.

The Findley Davies | BPS&M Pension Liability Index

Updated as of July 31, 2017

By Jeffrey Thornton, FSA, EA, MAAA

Interest rates are arguably the primary driver of volatility in pension plan liabilities. Findley Davies | BPS&M has established a set of liabilities and applied the yield curves to those liabilities in order to create the indices used to demonstrate the effect of interest rates on plan liabilities. The Findley Davies | BPS&M Pension Liability Index tracks the percentage change in liabilities for a typical defined benefit plan under the following four interest rate standards, which are in general use:

1. The Full Yield Curve published by the IRS for minimum funding purposes under IRS Code §430.
2. The 24-month Averaged Yield Curve published by the IRS for minimum funding purposes under IRS Code §430.
3. The Adjusted Average Yield Curve reflects the impact of the Moving Ahead for Progress in the 21st Century Act (MAP-21), the Highway and Transportation Funding Act of 2014 (HATFA) (see BPS&M Alerts dated September 16, 2014), and the Bipartisan Budget Act of 2015 (BBA 2015). HATFA and BBA 2015 extended the funding relief, which was introduced by MAP-21 in 2012. Originally, under MAP-21, the funding relief began to diminish in 2013, but has been extended under BBA 2015, such that it now does not begin to diminish until 2021.
4. A Corporate Financial Yield Curve used for financial statement pension liability determinations. Prior to January 1, 2014, this was measured using the Citigroup Pension Discount Curve. As of January 1, 2014, this is measured using the Findley Davies | BPS&M Pension Discount Curve (AA-rated or higher).

The Findley Davies | BPS&M Pension Liability Index uses a hypothetical plan for benchmarking purposes based on "typical" pension plan features. The duration of the liabilities under this hypothetical plan is 15 years. The benchmark period for the Index starts with the effective date of the Pension Protection Act (January 2008), and the graph shows the rise and fall in liabilities due to changes in interest rates relative to that date. All other factors remain constant throughout the

benchmarking period; ergo, the change in liabilities is due solely to the interest rate environment.

The trends demonstrated in the graph will generally hold true for most pension plans, but the magnitude of the percentage changes will vary depending on a given plan's demographics and benefit accrual patterns.

The table shows the percentage changes in the indices over various periods.

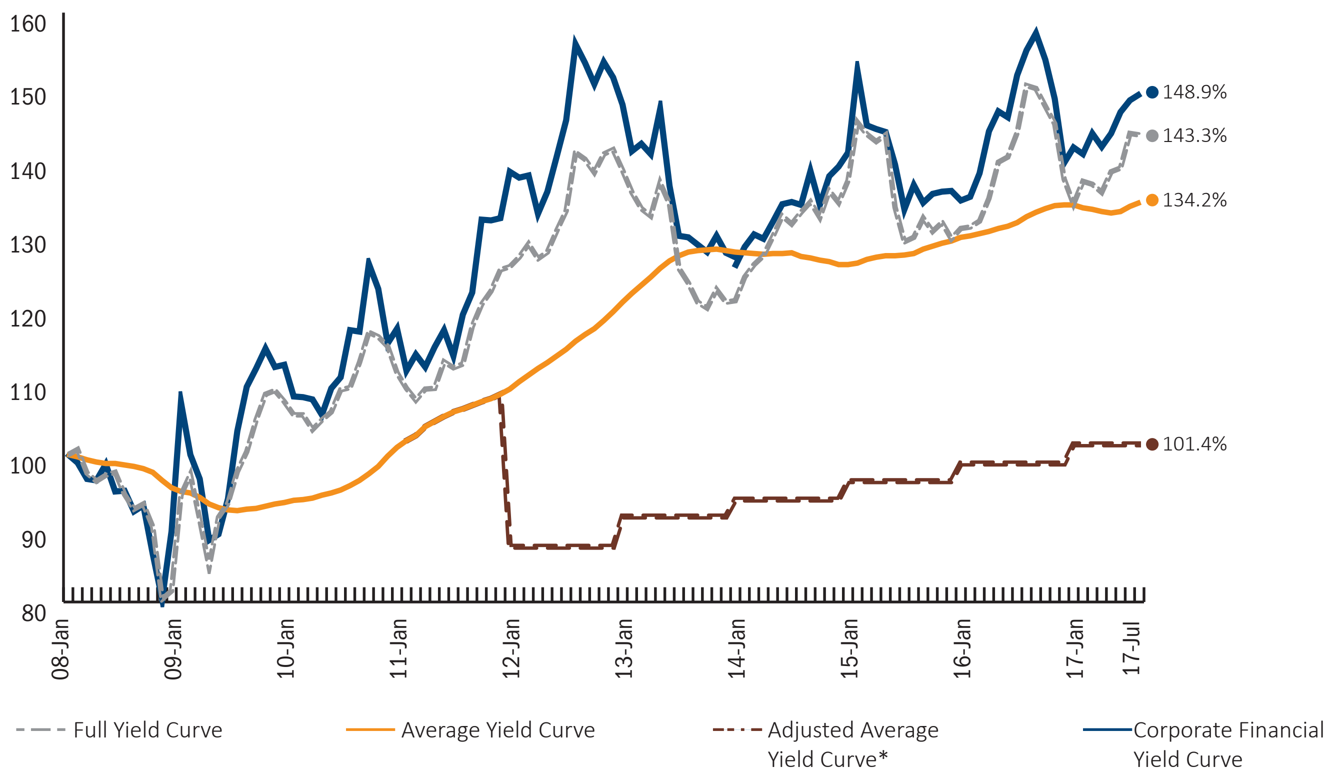
Indices Changes			
Indices	*Since Inception (1/1/08)*	*2017 Year to Date*	*Last 12 months*
Full Yield Curve	+43.3%	+6.9%	-4.5%
Averaged Yield Curve	+34.2%	+0.2%	+1.4%
Adjusted Average Yield Curve*	+1.4%	0.0%	+2.6%
Corporate Financial Yield Curve	+48.9%	+5.1%	-3.9%

The Findley Davies | BPS&M Pension Liability Index is updated regularly. If you have questions or comments concerning the Findley Davies | BPS&M Pension Liability Index, contact your Findley Davies | BPS&M consultant or Jeffrey Thornton at jeffrey.p.thornton@bpsm.com or 502-253-4639.

Jeffrey Thornton, FSA, EA, MAAA

Jeff has more than 10 years of actuarial experience in defined benefit plan administration. He specializes in liability studies and has provided plan-specific analyses for clients of various sizes and diverse industries. Jeff is a consulting actuary in our Louisville, KY office.

Findley Davies | BPS&M Pension Liability Index Since Inception



* Reflects funding relief

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5301 Virginia Way, Suite 400
Brentwood, Tennessee 37027

Developments

Recent Developments in Employee Benefits

If you have questions or comments regarding Developments, you can contact us by mail at 5301 Virginia Way, Suite 400, Brentwood, TN 37027, by phone at 615.665.1640, or by email at developments@bpsm.com. Or visit us on the web at www.bpsm.com.

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