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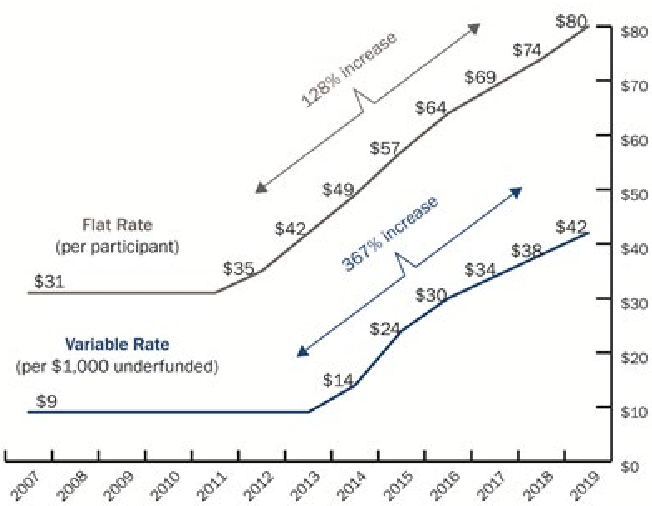
Managing PBGC Premiums: There Is More Than One Lever

By Matthew Klein

Pension Benefit Guaranty Corp (PBGC) premiums have been getting a lot of press lately, and for many plan sponsors, the minimum funding requirement is no longer the most important number that plan sponsors discuss with their actuaries every year. Instead, plan sponsors have shifted their focus to managing their PBGC premium. As you can see on the chart, by the year 2019, variable rate premiums will be **367 percent higher** than they were in 2013. This tremendous increase is driven by multiple law changes this decade.



The Economics of PBGC Premiums

In general, PBGC premiums insure that a participant's benefits earned during their working career will be paid if their company cannot pay benefits. For a healthy employer, PBGC premiums are essentially a tax paid to a quasi-government agency. Unlike plan contributions, this money does not go into the plan's trust and does not pay benefits. Unless a plan sponsor goes bankrupt, neither the employer—nor their plan participants—receive anything of value from these payments.

High Premiums and the Usual Response

Our prolonged historically low interest rate environment has created a perfect storm for PBGC premiums. The inverse relationship between interest rates and liabilities has pushed pension liabilities to all-time highs. As a result, many plans are significantly underfunded. Even plans that have no minimum funding requirements can have large PBGC premium payments due to the differences in assumptions used for calculating minimum funding requirements vs. PBGC premiums.)

As illustrated in the graph to the left, the PBGC variable rate premium, which is an amount that each plan sponsor pays based on the underfunded status of its plan, has ballooned to unthinkable levels compared to just five years ago. Up until 2013, the variable rate premium was 0.9 percent ($9 per $1,000) of the underfunded amount. In 2017, that rate has jumped to 3.4 percent, and it is expected to be 4.2 percent in 2019.

As with any tax, prudent management seeks to minimize the amount of tax paid. To accomplish this, the standard actuary's response has been to instruct the plan sponsor to increase contributions to the pension fund. While this is certainly a reasonable suggestion, many plan sponsors may want to preserve available cash for use in their business.

Plan sponsors, there are other options! The remainder of this article discusses the PBGC premium circumstances common to many plan sponsors, and two techniques that are particularly effective in reducing PBGC premiums.

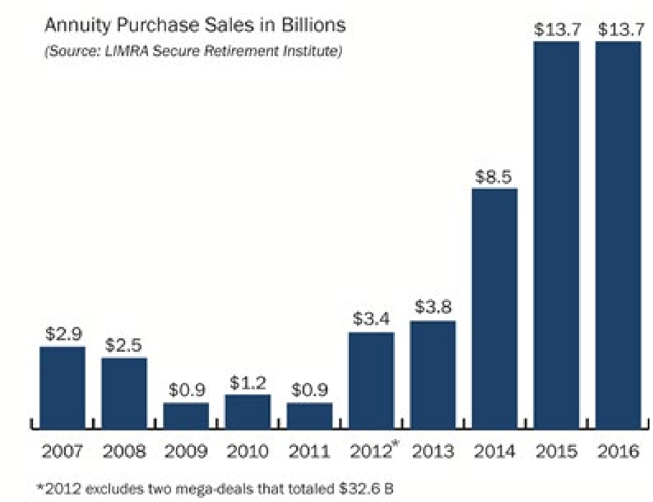
Start with Understanding the Premium Cap

The variable rate premium cap is a maximum amount that a plan sponsor of a significantly underfunded plan has to pay. The cap for 2017 is $517 per person; which means for a 1,000-life DB plan, the maximum PBGC variable premium is $517,000. As noted in the above chart, there is also a flat-rate premium, which is simply a price-per-participant calculation. For 2017, the flat-rate premium amount is $69 per person. Therefore, the PBGC premium for a 1,000-life plan at the premium cap would total $586,000. For this 1,000-life plan, each participant who can be removed from the plan will save the sponsor $586 in premiums for **each year** the plan remains at the cap.

The following are two effective levers for reducing headcounts and PBGC premiums that a plan sponsor should strongly consider.

Annuity Purchases

With an annuity purchase, generally your goal is to transfer the benefits to be paid to your retiree population (or a subset of that population) to an insurance carrier. I often describe this as going from self-insurance, where the plan sponsor is responsible for the mortality and investment risk, to being fully insured. Compared to an organization's accounting liability, there will likely be a premium to be paid (in both insurance and economic terms) for an insurance company to take on these benefit obligations and associated risks; however, and this is especially true for plans that are at the premium cap, the PBGC savings can more than offset this cost.



As can be seen from the above graph, annuity purchases have significantly increased in popularity in the past three years despite the low interest rate environment. Annuity purchases are easy to implement because they do not require participant consent, and from the retiree's perspective, the only noticeable change is the name of the entity sending the check.

Lump Sum Windows

Offering a lump sum window is often the most successful strategy. This is a targeted campaign for participants who are no longer active with the company, but have not yet started their benefit because they haven't reached retirement age. Via a plan amendment, a temporary window is opened to allow the targeted participants the opportunity to exchange their future monthly annuity for a one-time lump sum payment. This payment is eligible for rollover into an IRA or other qualified plan, or the participant can take a cash distribution (subject to taxes). After the payment is made, the plan sponsor is relieved of any further responsibility.

Lump sum windows are the most popular form of active de-risking because the amount of money coming out of the plan is usually less than or equal to the plan sponsor's accounting liability. This means the window can be executed without worsening the funded status of the plan as measured for accounting purposes. For plan sponsors reporting under international standards (IAS), there is additional justification for implementing a full window compared to US GAAP. In our experience, the cost of implementing a window is more than recouped by the plan sponsor in just the first year of PBGC premium savings.

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Having described these two techniques and their significant advantages, it may sound like every plan sponsor should implement one or both if they haven't already; however, these de-risking techniques can cause additional required cash contributions, often much larger than PBGC premium savings. Thus, a plan sponsor should discuss all financial impacts with its actuary before implementing any strategy to reduce PBGC premiums. Findley has been educating clients and executing strategies such as these mentioned here for years. For more information, you can access our thought leadership and recorded webinars on terminated vested buyouts, plan termination, and many other de-risking options.