H. C. FOSTER & COMPANY
Retirement and Welfare Plan Actuaries
P.O. Box 99, Belle Rive, Illinois 62810 ■ (618) 244-1850
hcfoster@mvn.net ■ www.hcfoster.com ■ Deliveries to 8252 North Program Lane

Managing Unfunded Liabilities – Summer 2016

A pension plan's Unfunded Accrued Liability (UAL) is the excess of its benefit settlement liabilities over plan assets at Fair Market Value (FMV) if settled at one time. This Newsletter clarifies the meaning of an UAL, and presents a way for most employers to dramatically reduce UALs.

A plan's UAL is a nonevent for most ongoing plans:

- Ongoing plans that do not provide a Lump Sum Distribution (LSD) payment option for LSDs exceeding $5,000 may never materialize an UAL due at one time. Life annuity benefit payments directly from a pension trust fund extend over many years to smooth variations in FMVs, then revert unused plan reserves to the plan upon the deaths of vested terminated employees and retirees in payment status. Lenders and others concerned about UALs usually overestimate their impact.

- Additional PBGC Premiums may be payable for UALs under PBGC's assumptions; but, the added premium is reduced by investment gains on plan assets held for terminated and retired participants.

- For minimum funding purposes under IRS' unrealistically high "funding relief" mandated valuation interest rate assumptions, many plans show valuation assets exceeding the present value of accrued benefits to imply no UAL. This has been very misleading to employers since 2006 under PPA '06.

- For plans paying LSDs, IRS' unrealistically low Minimum Present Value Segment (Interest) Rates (MPVSRs) create excessive LSD present values that likely exceed a plan's FMV of assets. Terminated and retiring participants will likely elect LSDs during low-interest rate periods due to their excessive present values to severely reduce plan assets in years of payments.

- Terminating plans that must settle all their benefit liabilities at one time for LSD payments can easily have an UAL that must be funded. Primary business owners and Highly Compensated Employees can usually waive sufficient accrued benefits to fund non-owners' LSDs in a small plan.

- Non-LSD benefit settlements funded through single premium life annuity contracts secured through commercial life insurance companies may be more costly than LSD present values, and will forever remove an ongoing plan's opportunities to recover FMVs through positive investment returns and mortality gains to breach the true "derisking" concept. Many plans tied to insurance company investment contracts may never reduce their UALs due to implicit investment and administrative charges. The employer's explicit self-administration of investment selection and management with benefits paid directly from a pension trust fund can easily maximize investment returns to prevent an unnecessary accrued benefit freeze or plan termination that matures an UAL.

Many plan sponsors overlook an outstanding opportunity to reduce their UALs through discretionary Profit Sharing Plan (PSP) provisions under Floor-offset Plan (FOP) arrangements. Under a FOP, the employer funded account balances in a PSP reduce a defined benefit plan's (DBP's) UAL by replacing the equivalent annuity values by the PSP accounts with the balance of the benefits paid from the DBP. A discretionary PSP provision can be added to existing Section 401(k) provisions, or a new PSP can be adopted without Section 401(k) provisions to maintain simplicity. Employer contributions to an existing PSP can be applied prospectively under a DBP amended to add FOP provisions. Section 401(k) provisions are technically a subset of a PSP.

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The IRS regulations for hybrid plans finalized in 2014 permit an 8.5% valuation interest rate assumption to convert a participant's PSP account balance under a FOP arrangement to its life annuity equivalent, referred to as the DC Plan Annuity. The 8.5% interest rate assumption provides a much less costly annuity than do the lower IRS mandated minimum funding and much lower IRS mandated LSD interest rate assumptions. Each $1 of PSP contributions reduces the DBP contribution by considerably more than $1 as demonstrated below where Target Normal Cost (TNC) is the present value of the plan year's accrued benefit increase. The past service liability is the Funding Target (FT).

Minimum Funding Example – employee age 48 with age 65 Normal Retirement Age (NRA) under typical minimum funding assumptions applied in recent months having an Effective Interest Rate (EIR) of 6.32% with minimum funding mortality.

A.	PSP contribution at 3.0%, .03 times $23,272 (last annual compensation)	$ 698
B.	Accumulated value of A. at age 65 at 8.5% annual interest with no mortality	$2,794
C.	Equivalent DC Plan Annuity of B. under Plan Assumptions and 8.5% annual interest	$ 330
D.	Annual accrued benefit increase for plan year ending 12/31/15 under DBP	$ 484
E.	TNC for D. without FOP	$1,826
F.	Annual accrued benefit increase for minimum funding under FOP, D. less C.	$ 154
G.	TNC for F. under FOP	$ 581
H.	Reduction in TNC under FOP, E. less G.	$1,245
I.	Net TNC cost with 3.0% PSP contribution, A. less H.	($ 547)

The FOP cost reducing effects are summarized as follows:

- Under the minimum funding assumptions, the PSP contribution of $698 replaces $1,245 of DBP cost for a return of $1.78 per $1 of PSP to decrease the TNC and FT. Under LSD MPVSR interest rates having an EIR of 3.87% and LSD mortality, the PSP contribution of $698 replaces $2,198 of DBP cost for a return of $3.15 per $1 of PSP contribution to better represent the actual funding requirement for LSDs and magnify the FOP cost savings.

- To the extent the PSP produces more or less than 8.5% investment returns each year, the difference reflects as a gain or loss in the DBP's FT amortized over seven (7) years to smooth FMV variations.

- The reduction in the TNC is much more for older, higher paid business owners closer to NRA, so it is advantageous for them to option out of the 3.0% PSP contributions when prohibited discrimination is avoided. This reduces taxation to pay for social programs and interest on the National Debt.

- Younger employees will usually receive greater benefits in the PSP than under the DBP formula, and can have negative TNCs that immediately reduce the FT, but not the TNC. PSP account balances for all plan participants build to reduce a DBP's Accrued Liability. A portion of the investment risk transfers to plan participants, and the DBP retains gains from favorable investment and mortality experience at less net funding cost.

- Net pension costs can be recovered in future years through reductions in employees' Form W-2 direct compensations; and, a private pension plan avoids the currently proposed government-run defined contribution plan arrangements held by life insurance companies adding to ACA costs.

Please e-mail any questions or comments.

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