

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

Defined Benefit Plans Excel in Depressed Financial Markets – Spring 2020

Recent events dramatically illustrate why defined benefit pension plans (DB Plans) are the least cost alternative for retirement benefits funding. Although the Fair Market Value (FMV) of a plan's assets may have decreased by 25% or more, there may be little or no impact on DB plans' funding costs:

- Unfunded liabilities are at their least for valuation dates on or before February 1, 2020

Comparatively favorable funding and financial reporting results will occur at valuation lookback dates as late as February 1, 2020 for plan years beginning in late 2019 and early 2020. Increased unfunded liabilities resulting from depressed Fair Market Values (FMVs) will occur at valuation lookback dates after February 1, 2020 only if the financial markets have not rebounded to their early 2020 levels, and are not offset through asset averaging techniques that smooth FMV variations as part of the funding method.

- Life annuity payments directly from DB Plan assets smooth the effects of market fluctuations

Each \$1,000,000 of plan assets on January 1st declines to a FMV of \$750,000 by April 1, 2020 with a 25% market value decline. Each \$10,000 of monthly life annuity benefit payments on January 1st reduces plan assets by \$10,000. The same \$10,000 of monthly life annuity payments distributed on April 1st will reduce plan assets by roughly \$12,500 in terms of January 1st dollars. The \$2,500 realized asset loss at April 1st will quickly recover with favorable financial markets.

- Lump Sum Distributions and single premium life annuity purchases amplify market losses

DB Plans can limit distributions to life annuity benefits paid directly from plan assets on a self-administered basis to avoid Lump Sum Distributions (LSDs) and Single Premium Life Annuity (SPLA) contract purchases. The following comparison illustrates the full effects of the recent market decline for a \$559 monthly single life annuity beginning at male age 65 with no COLAs in terms of January 1st FMVs.

<u>Payment Method</u>	<u>Asset Reduction at Date</u>		<u>Plan Liability</u>	<u>Reserves Released</u>	<u>Net Asset Loss in January 1 Dollars</u>
	<u>January 1</u>	<u>April 1</u>			
Annuity from plan	\$ 559	\$ 745	\$74,510 ³	\$5,000 ⁴	\$ 69,510 ⁵
LSD from plan	\$100,000 ¹	\$125,000	\$ -0-	\$ -0-	\$125,000 ⁶
SPLA contract	\$112,579 ²	\$150,239	\$ -0-	\$ -0-	\$150,239 ⁶

Notes:

1. The LSD equivalent for a \$559 monthly benefit is based on recent IRS mandated valuation assumptions under the Minimum Present Value Segment (interest) Rates published monthly.
2. See the immediateannuities.com website published during March 2020 for average SPLA costs.
3. Plan Liability is the plan's projected single sum cost to fund life annuity payments based on a historically reasonable, annual long-term valuation discount rate of 6.0% for a self-administered managed fund.
4. Reserves Released is the amount the plan could be expected to retain to reduce its funding costs upon the death of the annuitant depending on plan experience. The life insurance company retains the remaining life annuity reserves when a retiree passes away under a SPLA.

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5. Net asset losses and gains in a plan are spread over the remaining lifetime of the annuitant.
6. The Net Asset Loss can never be recovered when favorable financial markets return because those are realized net losses. The 25% realized loss materializes only if expenditures occur.

- DB Plan investments are outside the reach of panicky participant investment churning

Panicky plan participants tend to churn their participant directed investment accounts with unfavorable investment news. Average Section 401(k) and IRA account balances at all ages declined 25% or more after January 1, 2020, see Motley Fool's March 12th article on the Internet. Financially naive employees believe they can outperform the financial markets through lunch hour investment selections while professional investment advisors discourage investment changes. Employees sometimes fall for SPLA purchases that may pay little more than interest and eventually forfeit to the life insurance company.

- DB Plans usually limit participant withdrawal rights before retirement age

Well designed DB Plans restrict benefit payment options to life annuities paid directly from plan assets with ancillary benefits limited to the minimum required surviving spousal life annuity death benefits. Participants can not access accrued benefit values before retirement. Section 401(k) and IRA-type arrangements can permit participant loans, hardship withdrawals, disability withdrawals, pre-age 65 in-service withdrawals, and other options that "leak" account balances leaving insufficient assets to pay retirement benefits. Workers will deplete accounts not sheltered in a DB Plan to meet living expenses.

- Employees nearing retirement ages with DB Plan coverage can retire

DOL estimated median household annual income at \$78,635 with median expenditures at \$61,224 during 2018. The Pension Rights Center estimates Social Security replaces about \$30,000 of this amount for married couples in retirement. Estimates of average Section 401(k) and IRA-type account balances vary widely with only about 44% of workers covered by any type of defined contribution plan. The Employee Benefits Research Institute estimated Average Section 401(k) balances among workers in their age 60s with more than 30 years of service exceeded \$280,000 during August 2017. This amount will pay about \$24,000 per year under a 6.0% annual investment return assumption over a 20 year remaining joint life expectancy. This means that, at best, replacement income totals about \$54,000 of working life annual income in retirement for the relatively few workers having large defined contribution plan accounts. Most workers nearing retirement ages know they can not retire with an acceptable standard of living, so will cling to jobs better filled by younger, better qualified and more productive employees.

- A silver lining for DB Plans

Net funding costs will be reduced by increased DB Plan tax deferral advantages resulting from increased taxation on business owners and higher-paid wage earners to fund the current and future governmental stimulus programs. Both private and public sector employers will be forced to pay higher investment returns on equity and fixed income investments to attract investors as the U.S. economy recovers. The premature withdrawals and investment losses in account balance plans that add to the growing cohort of current and future indigent retirees will underscore the advantages of DB Plans as defined contribution plans struggle to recover their 2020 losses. Employers, employees, and governmental officials will recognize the exit from DB Plans as a colossal blunder. Employers will promote DB Plans to attract quality employees as the U.S. economy recovers.

Please call or e-mail any questions or comments.