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Developing a Strategy for Moving from Pension to 401(k) Benefits

By Amy Kennedy and Kathy Soper

Budgeting for next year's cost of employer-provided benefits can seem daunting, especially when an organization sponsors both a defined benefit pension plan and a 401(k) defined contribution plan. Is it time to consider moving away from the defined benefit pension plan to avoid the volatility and risk? If so, plan sponsors should develop a well-thought-out process for analyzing the alternatives and impact to both employer costs and participant benefits. The overall strategy and objectives should be reviewed.

Each year, an actuary provides projections for the defined benefit pension plan and the amount required to fund seems to be ever-increasing. It feels like there's no end in sight. Becoming fully funded seems to be a dream instead of a reality. Even in years when the assets in the plan had double-digit returns, there was either a new mortality table that needed to be adopted or the required interest rates dropped – all increasing the plan's liability. This can be very difficult to manage going forward.

While it is challenging to deliver an equivalent benefit in a defined contribution plan at the same level of contribution, defined contribution plans provide a predictable level of employer contribution each year. If plan sponsors are considering a transition to a replacement 401(k) plan, an analysis should be conducted to:

- Determine the level of benefit desired for employees
- Set a budget that provides the desired level of benefit when considering a defined benefit pension plan freeze

Performing the Analysis

When performing this type of analysis, we encourage companies to start by thinking of both the defined benefit pension and defined contribution plans together as a total retirement benefit. This allows the plan sponsor to contemplate its philosophy and develop a strategy related to short- and long-term goals for the retirement program.

Establish Guidelines

Plan sponsors should start with a well-defined and proven process, taking the time to establish guidelines and understand the financial strategy. Begin by discussing the organization's philosophy and define objectives for the retirement program to guide decision-making. These guidelines should include how the plan sponsor feels about management/budgeting of retirement plan costs, willingness to take on risk, providing benefits based on the organization's ability to fund – discretionary vs. mandatory, the level of employees' retirement benefits, and the competitiveness of benefits.

Determine Affordability

By evaluating all the current retirement plans and the projected cost and benefits, organizations will better understand the current and projected state of the plans and be able to determine the affordability of current plans over the long-term. The evaluation also allows them to discuss acceptable benefit levels and a cost strategy. A thorough analysis of the current and projected costs should include an outline of the current state of the program, including five-year projections under three scenarios for the defined benefit pension plan:

- Ongoing plan
- Closed to new entrants
- Frozen accruals

In addition, the termination liability estimate under agreed upon assumptions should be calculated.

Determine Competitive Position

The guidelines and budgets are then coordinated with competitive market benchmarking to identify relevant alternatives to evaluate. Benchmarking the retirement plan benefits with competitive norms relative to the market allows the organization to measure the competitive position of benefits and expenses compared to industry/geographic region/employer size based on revenue or number of employees. The benchmarking helps the plan sponsor make informed decisions on the:

- Form of benefit to be provided
- Desired level of benefit for new hires/newly eligible participants
- Impact on total compensation and the benefits package
- Desired contribution allocation structure – pro-rata on pay, position-based, or based on age and/or length of service

Evaluate Alternate Strategies

Potential plan design alternatives including utilizing the current defined contribution plan should be developed based on previous discussions related to the organization's philosophy, objectives and strategic direction for the retirement program. Alternative strategies can be assessed to determine the final strategic direction of the retirement program, such as modifying the current level of pension benefits or reduction/elimination of the defined benefit pension plan by freezing pension benefit accruals for all participants and moving toward a defined contribution plan only strategy.

Other strategies such as grandfathering selected participants or providing participants a "choice" between defined benefit and enhanced defined contribution benefits should be considered. If providing enhanced defined contribution benefits, determination of how the benefit will be provided – either with matching contributions and/or non-elective contributions in a fixed amount, performance-based, or based on a tiered age and/or service allocation – should be evaluated as well.

Modeling different plan designs that include variations of both defined benefit pension and defined contribution structures helps the plan sponsor compare costs and benefits. Based on the guidelines set upfront, these plan designs reflect the organization's philosophical principles for providing these benefits to employees. The results of this analysis and each alternative are compared to the current plan(s) to show the overall impact on the employer-provided cost and level of employee benefit. Be prepared to study supplemental alternatives at this point because the first set may provoke additional thoughts or refinements.

Plan sponsors must be aware of compliance testing restrictions and be sure that any alternative considered will satisfy compliance rules — there is no point in studying an alternative that cannot be adopted due to nondiscrimination or coverage issues.

Making and Implementing the Decision

When all alternatives are reviewed, a final recommendation that ultimately links the retirement strategy with the philosophy and desired objectives is presented. Any potential transition issues or challenges should be outlined and a communication strategy should be developed. Establishing a formal communication plan is very important.

Develop and Document the Retirement Plan Strategy and Implementation Plan

The end result of the review should include a proposed retirement plan strategy to be presented to the board of directors. The proposed strategy should document the findings and conclusions of the review process and identify the steps necessary to carry out the recommendations within the strategy.

Change Management: Communicating to Employees

After the decision is made to change retirement benefits, communication to those impacted is key. This is the perfect time to remind employees of the retirement program and its overall value. In addition to government-required notices, you should also consider proactively sending out an individualized statement outlining the changes and providing the impact on participant's benefits. It is important to make sure the changes are communicated clearly and that each participant understands the changes. Sometimes plan sponsors will hold group or one-on-one meetings with those impacted.

In Perspective

A change in the retirement program is a significant decision that affects the organization and its employees significantly. A thoughtful approach to a change like this can lead to better alignment of the overall program with organizational philosophy and goals, while still providing employees with competitive benefits.

If you have any questions regarding your options with transitioning from pension to 401(k) benefits, please contact Amy Kennedy at *amy.kennedy@findley.com* or Kathy Soper at *kathy.soper@findley.com*.