Freezing a DB plan can also mean more complex governance. What do plan sponsors need to know?

Over the last several years, many sponsors of registered DB pension plans have decided that the financial burden of continuing with the same plan design is too heavy. A common response has been to freeze DB accruals in one way or another and replace them with a DC design. By structuring the DC accounts within the existing registered pension plan, the sponsor can keep the existing DB plan alive and avoid the possibility of the pension regulator ordering a plan windup—which can happen if, for example, the sponsor froze the DB and did not continue with accruals under the pension plan (i.e., DC accruals).

While this design strategy is understandable, plan sponsors need to be aware of the new and different considerations that this change brings to the plan’s overall management. The full financial relief that the freeze is expected to bring may not materialize for some time to come. And what may not be immediately apparent is the extent to which the plan has now become more complicated from a governance perspective.

Cold Comfort
There are a number of different ways in which plan sponsors can freeze DB accruals.
**Hard freeze** - The total benefit can be frozen, to the extent that pension legislation will allow it. This is often referred to as a “hard freeze.” In some situations—Quebec and Alberta, for example—the legislator requires earnings to continue to be recognized unless the plan from its inception permitted them to be frozen before termination of employment. The various components of the benefit formula—for instance, pensionable service, pensionable earnings or the benefit rate—would each be frozen at a point in time at the sponsor’s discretion.

**Soft freeze** - In a “soft freeze,” credited service is frozen, but the pensionable earnings in a best or final average earnings formula is allowed to increase in the normal manner over time until the member retires.

**Eligibility freeze** - There may also be an “eligibility freeze,” such as when the eligibility conditions for an ancillary benefit (e.g., subsidized early retirement) are frozen so that only those who currently meet the conditions are eligible. Like hard and soft freezes, such amendments are subject to particular legal and regulatory considerations.

In the end, these freezes result in what is often termed a “legacy DB plan”—which, over time, will start to shrink and will eventually disappear.

**Ice Age**

Unfortunately, a plan sponsor must care about this legacy DB obligation from a financial and governance standpoint for a long time—in most cases, for many decades. Think of the 25-year-old hired two years before the plan sponsor freezes the plan. If she retires at age 65, in 40 years, and enjoys her retirement for another 20, then the sponsor is potentially administering a benefit for 60 years.

One way to shorten the plan’s horizon is to purchase annuities for all DB participants once all active employees with DB benefits have retired, thereby entirely settling the DB liabilities at that point. However, in the example above, this still requires four long decades of managing the legacy DB obligation.

From a financial standpoint, developments are also slow to occur for a legacy DB plan. Figure 1 shows the typical progression of DB plan liabilities after a plan is frozen. For this analysis, we are using an illustrative plan that is meant to represent an average mature Canadian DB plan, not indexed to inflation.

Not only is the horizon very long, it is also interesting to note that it will take a good 25 years before the plan even shrinks in size by at least half. The main reason for that pattern is the maturing of active liabilities. Even with frozen benefit amounts, the liabilities first increase quite significantly as active employees get closer to retirement. This will be particularly significant for a plan with young active members. But, at some point, the tide will turn and the DB liabilities as a whole will start shrinking.

For a legacy plan, if the plan size and the drain on financial resources were important issues on the day it was frozen, they will likely remain valid concerns for a long time. That is one reason why plan sponsors have turned to legacy liability rightsizing (determining the plan’s ideal size compared to the company size) and right-risking (determining which risks the sponsor is willing to be exposed to in the pension plan) using lump-sum payouts and annuity purchase deals with insurers. These strategies help to off-load legacy liabilities from the plan sponsor more quickly than natural attrition.

Since a smaller plan experiences smaller variations in absolute terms than a bigger plan for the same level of volatility (e.g., a 10% variation of a $100 plan is $10, versus $10,000 for a $1 million plan), this would benefit the plan sponsor. If some risks can also be mitigated—for example, by hedging interest rate risk or mortality risk, thus reducing volatility—then the financial pressure that the plan exerts on the sponsor can finally reach a desirable and manageable level.

Figure 2 (page 43) illustrates the progression of DB plan liabilities if all retiree liabilities are settled through an annuity purchase on the day the plan is frozen. The horizon is not shortened, in this case—and the liabilities still increase for more than a decade before starting to shrink—but the plan is immediately much smaller. If a plan sponsor is well prepared and patient, has defined precisely under what suitable conditions actions should be taken and can act swiftly when such conditions arise, rightsizing the plan can also be done in a financially advantageous way.

**On Thin Ice**

After freezing the DB provisions in the plan, there may be a tendency for the sponsor to gradually step back from its previous level of commitment to managing the plan—for example, by wholesale delegation of the DC responsibilities to an insurance company acting as custodian and third-party administrator and by being less attentive to the legacy DB plan. The plan sponsor may feel that the DC is covered by the insurer and the DB is no longer as important, without fully appreciating that the freeze has increased the efforts needed to manage the plan in aggregate. The sponsor needs a strong governance structure and clear responsibilities and processes—now more than ever before.
Essentially, the DB legacy plan has become a combination plan with both DB and DC accruals. The sponsor must now manage the plan from two different perspectives: DB and DC. Often, it is the same employees in the organization who oversee both, perhaps by way of a pension committee. Since there are different risks and challenges involved in each category of benefit, the committee must be able to address both sets of risks, managing and monitoring them in an integrated way. Top this off with the fact that the DB liabilities still have a rather long horizon, and this puts a considerable amount of pressure on those who are responsible for the plan’s well-being.

Managing the DB component - Even though the pension committee may have been managing the DB component for years, things have now changed. Some or all future active members will have no DB accruals, and existing active members may have little or no growth in their benefits. This pattern of change will eventually have a significant impact on plan management, including the investment strategy for the DB assets and the timing of further DB risk-rising actions, such as the purchase of annuities. The committee should continue to review these plan management challenges on an ongoing basis.

At the same time, the management and operational risks that are typical of an ongoing DB plan—including those that are procedural and compliance related—will continue to apply. It is important to take a systematic look at these risks to assess which ones are more or less likely to happen and which will have a minor or significant impact on the plan, and then...
determine if the proper controls are in place to mitigate these risks.

Managing the DC component - The DC component brings some different and equally important governance considerations. While the risk of benefit adequacy in a DC component has been transferred to plan members, who are now responsible for investing their accumulated monies, the area of focus for governing the DC component shifts to member education and communication, as well as to monitoring the investment options. The recently issued CAPSA DC Pension Plan Guideline takes things even further and states that the administrator should consider periodically providing members with their projected balance and resulting estimated benefit at retirement, which goes beyond the current practice of simply making planning tools available for member use.

The arrangement with the service provider that administers the DC accounts—and which often provides the investment options—is important as well. The appointment of the service provider, the assessment of its performance and the terms of the agreement are all crucial to DC risk management. The DC Pension Plan Guideline also focuses on the post-employment, de-accumulation phase of DC plans and reminds plan administrators of the importance of evaluating and monitoring the quality of the service provider’s retirement products and associated member communications, ensuring that conflicts of interest are managed appropriately.

Necessity of delegation - The directors of a company cannot be expected to single-handedly manage a plan of this complexity. They will, of necessity, delegate most—if not all—of their operational duties. Such delegation should be to people with strong abilities who will carry out their powers appropriately and report back to their principals responsibly.

The pension committee can best manage the plan and the activities of its delegates by establishing processes and procedures that are clear and appropriately communicated. Just about every area of pension management is a candidate for these processes and procedures, especially with a legacy DB plan and a dynamic DC plan. The most common areas include records management, member complaints, member communications and education, risk management, delegation and reporting.

If a legacy DB plan is already in place, then plan sponsors need to care for it from a financial and a governance standpoint, despite a possible corporate perspective that the plan’s operation is a declining priority. When managing a legacy DB plan, sponsors need to be well aware of the considerations and ongoing legal, governance and financial risk management challenges that it will bring for the next few decades, and they need to set expectations appropriately with key stakeholders, including the C-suite.

With initial planning and analysis for a legacy DB plan and ongoing monitoring of operational effectiveness, plan sponsors may just be able to survive the freeze. Sheldon Wayne is a senior consulting lawyer and Mathieu Tessier is a senior consulting actuary at Towers Watson. sheldon.wayne@towerswatson.com; mathieu.tessier@towerswatson.com