Principal Financial Group

PART II – BEST PRACTICES FOR EXECUTING A TERMINATION STRATEGY

WINDING DOWN YOUR HARD-FROZEN DEFINED BENEFIT PLAN

EXECUTIVE SUMMARY

Once you develop a termination strategy for your hard-frozen defined benefit (DB) plan, it is critical to execute that strategy efficiently to terminate the plan as quickly and cost effectively as possible.

Best practices for efficient management of hard-frozen DB plans leading up to and throughout the termination process should first focus on the protection of benefit security for participants and retirees and then reduction of plan sponsor financial risk.

The objective of this white paper is to describe best practices for executing the termination of a hard-frozen DB plan.

Our analysis centers on working effectively with your financial professional and efficiently integrating your plan's actuary and other retirement plan service provider(s) in the termination process. This team of professionals will help execute a final exit strategy for your hard-frozen plan through DB plan management best practices. Working with a limited number of service providers can improve coordination and accuracy during termination.

Special emphasis within the process is placed on:

- Effective execution of a Dynamic Asset Allocation (DAA) strategy
- Plan sponsor administration of the termination process
- Final risk transfer

OVERVIEW

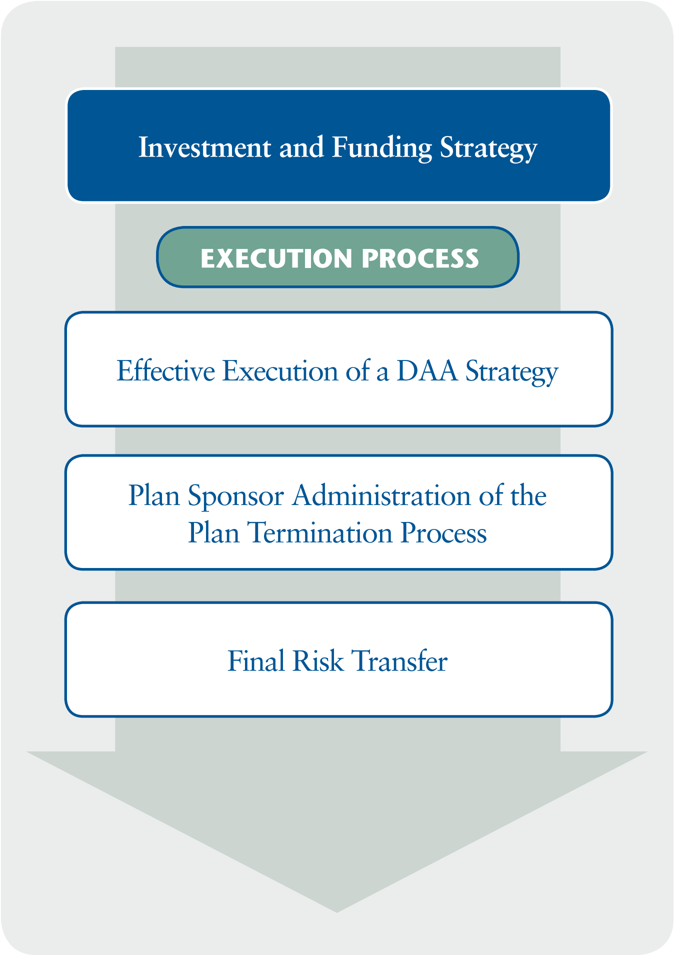
In Part I of this series, Best Practices for Building a Termination Strategy, we described best practices for developing and implementing a strategy for terminating a hard-frozen plan. If those best practices were followed to put an investment and funding strategy in place, the plan sponsor is likely now ready to begin the actual execution of that strategy.

Execution of the termination strategy requires a coordinated effort between the plan sponsor and the financial professional or consultant, actuary, and other retirement plan service providers. A well-executed termination strategy helps assure that the plan is properly administered and will help manage plan sponsor termination costs. It will also protect the plan's funded status while easing the administrative responsibilities of the plan sponsor.

THREE KEY EVENTS IN EXECUTION

Once the plan sponsor has made the decision to put an investment and funding strategy in place, or to modify an existing one, they should continue working with their financial professional or consultant to provide some independent oversight and coordination of the process and plan service providers.

With the investment and funding strategy in place, the execution process can be divided into three key events, with quality, accurate data being an essential component throughout the process.

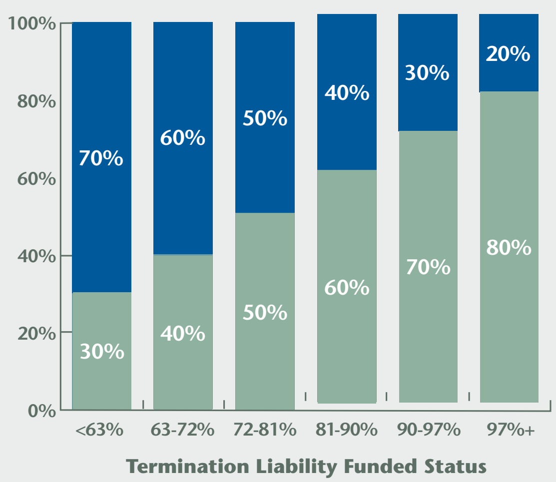


EFFECTIVE EXECUTION OF A DYNAMIC ASSET ALLOCATION STRATEGY

The first phase of a hard-frozen DB plan termination is the execution of an effective asset allocation strategy. Validated by extensive historical testing[1], it is our firm belief that an appropriate Dynamic Asset Allocation (DAA) strategy is **the most effective means** to accomplish this objective for hard-frozen plans. The key goal is a DAA strategy that links the volatility risk of the plan portfolio **to the plan's funded status, gradually reducing risk as the plan approaches its goal of termination sufficiency.**

Our model shows that to generally get the most value out of DAA in terms of the lowest cost to fully fund to termination, development of a customized glide path is essential. This strategy adjusts the asset allocation based on changes to the plan's funded status (the ratio of plan assets to termination liabilities or "termination funding ratio"). As the funded status of the plan improves or as interest rates increase, the glide path generally shifts plan funds from equities into longer duration fixed income investments that match the plan's liabilities.

Sample DAA "Glide Path" Illustration for a Hard-Frozen Plan



For illustrative purposes only.

IT IS THE COMMITMENT to an appropriate DAA process itself, combined with the ability to execute it with real time termination funding ratio data, that ultimately accounts for much of the success of a comprehensive termination strategy.

DAA is a term that describes an investment and funding strategy where the plan's asset allocation is adjusted on a regular basis according to a previously established rule. There are several approaches to DAA construction for the purpose of plan termination, such as asset-liability modeling or cash flow analysis. These various approaches provide a spectrum of sophistication and customization.

After the financial professional and plan sponsor collaborate with an actuary to build a DAA glide path strategy, the commitment to the DAA strategy is formalized **by incorporating it into the investment policy statement.** This helps ensure proper documentation of the decision and its implementation and provides a guiding reference for current and successor plan fiduciaries as the strategy is executed.

The termination funding ratio is a best practice metric for determining asset allocation because it **captures changes in both asset values and the bond rates** used to calculate plan liabilities. The DAA is built to gradually reduce financial risk (de-risk) and lock in funding status gains as they occur. To capture these de-risking opportunities effectively, termination funding ratios should be calculated at least quarterly and more frequently during times of extreme volatility. They must also be based on the appropriate liability. **For hard-frozen plans, this means using a termination liability rather than the Pension Protection Act (PPA) funding target.**

[1] Historical testing by the Principal Financial Group® of frozen DB plans with \$50 to \$60 million in liabilities and duration around 13 years from 1995-2006 and 1996 to 2005.

Coordination among the team working on the termination, including the plan sponsor, pension actuary, financial professional or consultant and other plan service providers, is key to executing a DAA strategy. Understanding where the plan currently resides on the glide path is the first step in taking action toward reallocating investments. The plan actuary should provide this understanding by calculating the termination funding ratio. Market values of assets and the value of termination liabilities at current interest rates should be used to provide a clear snapshot of the plan's funding position. Note that these termination funding ratios are significantly different from those reported under PPA funding rules which are not designed to provide values for this kind of effort.

The updated termination funding ratio is calculated by the actuary and provided to the financial professional or consultant who compares the current plan's asset allocation to the one suggested by the DAA glide path. Typically, the financial professional or consultant then makes any necessary allocation change recommendations based on both the strategic glide path and tactical judgment considering current economic factors. It is important to note that the allocation is not changed automatically. The weighting of asset classes in the portfolio and the duration of the fixed income holdings of the plan are distinct decisions led by the financial professional and ultimately decided upon by the plan sponsor in most instances.

Sponsors of large plans may find it advantageous to have the fixed income portion of the assets actively managed in a customized bond portfolio. This helps provide more precise liability matching than a non-customized bond fund approach and assists the bond portfolio manager in generating targeted returns through intended risk taking within the fixed income portion of the plan.

With assets rebalanced to the appropriate investment risk level for the current termination funding ratio, the DAA process continues with the actuary filing reports and the asset allocation incrementally moving from a traditional to a more conservative portfolio as funded status improves. Reports should be done quarterly, or more frequently, should a change in the situation, such as unexpected market conditions, require it. **By instituting a disciplined process to help reduce plan sponsor financial risk as plan assets and liabilities come into balance, plan sponsors can minimize the chance that unfavorable economic variables will increase the time or contributions needed to terminate.**

Throughout the execution of dynamic asset allocation, plan sponsors should monitor their progress towards plan termination and also evaluate additional risk management opportunities. There may be opportunities in addition to DAA to manage the risk within your plan prior to plan termination. This may be accomplished through a transfer risk management strategy which removes a portion of the risk and transfers it to other parties: either to plan participants electing lump sum payments or to an insurance company through an annuity purchase. [For more information, see Part I, Best Practices for Building a Termination Strategy.]

When plan assets ultimately become sufficient to cover a plan termination, it's important the portfolio be invested in a manner that helps protect the plan's fully funded status. The plan termination process (including government filings, etc.) can take 12 to 18 months between notice of intent and final distribution of assets, during which the plan's funded status is still at risk. It is critical during this period to understand the characteristics of the plan liabilities and the appropriate investments in order to help reduce the risk of new unfunded liabilities arising during the time necessary to administer the termination.

PLAN SPONSOR ADMINISTRATION OF THE PLAN TERMINATION PROCESS

Once there is a termination strategy in place and funding obligations are met, two steps must be followed to file the termination with the Pension Benefit Guaranty Corporation (PBGC):

- **Provide a Notice of Intent to Terminate** to each affected party[2] at least 60 days, but no earlier than 90 days, before a proposed termination date.
- **Provide the PBGC with information to show that the plan has sufficient retirement funds to cover the benefit liabilities.** An enrolled actuary must certify this information.

IT IS ALSO A RECOMMENDED BEST PRACTICE for plan sponsors to file for an **Internal Revenue Service (IRS) Determination Letter** to confirm the qualified status of their plan, particularly if the plan has been amended since the last determination letter. Sponsors should ultimately consult with their legal and tax counsels to determine whether filing for a new determination letter is the best approach for their plan.

WHILE THE PLAN TERMINATION PROCESS IS SOMEWHAT LENGTHY, IT CAN BE BROKEN INTO 3 STEPS.*

1. *Setting proposed termination date*

- Board of directors resolution including details about the termination
- Notice to affected parties of intent to terminate[3]
- Plan fiduciary determination of distribution options available at plan termination
- If remaining assets after benefit obligations are met, plan document should dictate handling of remaining assets

2. *Demonstrating asset sufficiency*

- Certify participant benefits
- Value retirement plan assets and compare to plan liabilities
- Notice of Plan Benefits to participants[4]
- IRS form preparation
- PBGC form preparation

2. *Preparing for final risk transfer*

- Determine distribution date
- Update participant benefit values and projected retirement funds
- Participant distribution elections
- Annuity provider selection
- Recommended IRS Determination Letter
- PBGC filing

[2]Affected parties include plan members, beneficiaries of a deceased member, alternate payees under a qualified domestic relations order, any person designated in writing to receive notice on behalf of an affected party, retirees receiving benefits that haven't been fully guaranteed, and any organization that represents any group of participants or has within the last five years.

*A service provider who maintains plan and participant data can save you time by offering you partially-completed forms and ready-to-use templates.

[3]Notice to Affected Parties of Intent to Terminate is a written notification of proposed plan termination date, impact on benefit accruals/ benefits, identity of insurers, etc. The same notice goes to all affected participants. This notice also states that a written Notice of Plan Benefits will be provided later.

[4]The Notice of Plan Benefits is a written notification including participant-specific benefit information. It includes the benefit amount and information used to determine that benefit.

SETTING THE PROPOSED TERMINATION DATE

The first phase of actually terminating the plan is setting the proposed termination date. This involves several notifications and elections by the plan sponsor including:

- Board of directors resolution (recommended best practice if not required by plan documents),
- The required participant notification,
- Determination of distribution options allowed under the plan, which may include one or more of: annuities, lump sums and plan-to-plan transfers, and
- Determination of plan document requirements regarding handling of assets if any are remaining once participant obligations are met.

Plan sponsors should perform a diligent search for any missing participants, as specific certification regarding such participants is required under PBGC regulations. The plan sponsor must search for participants using a commercial locator within a period of not more than six months before Notice of Intent is provided.

DEMONSTRATING ASSET SUFFICIENCY

The second phase of termination involves demonstrating asset sufficiency. Benefits must be updated to the plan termination date and valued at the proposed distribution date. Assets must be valued and then compared with the benefits or liabilities of the plan to determine sufficiency. The Notice of Plan Benefits, providing participant information such as service and compensation used to determine the benefit amount, the benefit amount and possibly the estimated present value, needs to be provided to participants.

Materials must be filed, such as Form 500 with the PBGC, assuming the plan sponsor wishes to confirm plan qualification, and Forms 5310, 6088 and 8717 with the IRS. There is a waiting period once the applicable forms have been submitted to the PBGC and IRS while each agency has the chance to review the filings. The PBGC does not have to respond, but does have 60 days to raise issues such as noncompliance with their procedures. The IRS review for a plan determination letter may last as long as 12 to 18 months.

PREPARING FOR FINAL RISK TRANSFER

The third phase prepares for the **distribution of retirement assets.** Early in the distribution phase, participants must elect the form of distribution they wish to receive. In addition to the distribution elections, participants must be provided a 45-day advance Notice of Insurer if it has not already been provided. This notice informs participants which insurer will provide annuities.

Distribution of retirement assets can begin when:

- The termination filing has been with the PBGC for 60 days,
- A Notice of Noncompliance has not been issued, and
- If a filing has been made with the IRS, they have issued a favorable determination letter. The distribution period is 120 days after receipt of the IRS determination letter.

The number of insurers capable of providing a single premium guaranteed annuity is limited due to recommended minimum requirements established by the Department of Labor (DOL). The process to select a provider of this annuity contract is outlined in the DOL Interpretive Bulletin 95-1 (the so-called "safest available annuity" rule), Advisory Opinion 2002-14A, and some subsequent court decisions.

You should also keep in mind that historically low interest rates have made annuities less attractive. It is possible that rising rates that would make annuities more attractive may spark a sudden increase in demand for annuities and could result in a period of limited availability to purchase annuities for sponsors wishing to terminate in the future.

It is necessary to perform a thorough review of any service provider involved in the process of terminating a DB plan, such as an annuity provider, including their key business practices.

Teaming with a financial professional can help facilitate the selection of an insurance company to provide annuities. This choice can be made early in the plan termination process or later, but if later, there must be an additional notice sent to plan participants and the PBGC. Establishing a relationship early with a plan service provider capable of working with the plan sponsor and financial professional through the entire process may eliminate the need for an additional review when selecting an annuity provider.

The DOL makes the following recommendations for selecting an annuity provider:

- Plan fiduciaries must act prudently and for the exclusive benefit of the plan participants.
- The fiduciaries should be diligent in their selection process, taking into consideration such things as the financial integrity of the insurer, its history and size (relative to the proposed contract), past investment strategies and decisions of the insurer, current and past business relationship between the employer and insurer, recommendations made by the employer's business peers, the insurer's various exposures, and the relative cost of the annuity contract.
- All steps taken by the plan fiduciaries in the selection of an annuity provider should be documented and kept by the fiduciaries for at least six years.

During the entire plan termination process, ongoing administration of the retirement plan continues as well.

FINAL RISK TRANSFER

The final step of plan termination is the distribution of plan assets to participants, or final risk transfer. Plan liabilities may be settled using two methods, availability of which will be set out in the plan document:

- Payment of the present value of participants' benefits in the form of lump sums which may be rolled over into qualified defined contribution plans or Individual Retirement Accounts (IRAs).
- Purchase of a guaranteed annuity contract from an insurance company.

METHOD ONE: Lump Sum Payments

Many terminating DB plans provide the option of lump sum payments to participants not currently receiving benefits. Plans that do not provide lump sum benefits may be amended prior to terminating to include this distribution option.

The primary benefit of providing lump sum payments is that, under current conditions, it generally costs plan sponsors less than purchasing annuity contracts.

The primary disadvantage of providing lump sum payments is that it includes a higher risk that participants may mismanage their payouts and outlive their retirement funds, as they are not required to roll the proceeds over to another qualified plan or IRA. Participants may be tempted to use the lump sums for something other than retirement, triggering immediate taxes and reducing their retirement security. They may also overestimate the amount they can safely spend each year or invest the funds inappropriately for their age and risk tolerance.

Because of the potential risk to the participant of providing lump sums, it is even more critical fiduciaries work closely with their financial professional and service provider(s) during the payout phase to help ensure adequate attention is given to educating plan participants on key issues such as retirement planning, investment strategies and tax implications.

METHOD TWO: Purchase of Guaranteed Annuity Contract From an Insurance Company

The second method, the purchase of a guaranteed annuity contract from an insurance company, settles any plan remaining liabilities for current pensioners who are receiving ongoing payments from the plan and for whom an annuity was not previously purchased as well as the plan's obligations to participants not electing lump sum payments.

The participant payment options under the annuity will mirror the benefit payments provided through the plan, which could include the option of guaranteed lifetime income. This is a steady income that the participant cannot outlive.

After the annuity purchases have occurred and any lump sums have been paid, administrative responsibilities continue. Upon completion of the participant distributions, PBGC Form 501— Post-Distribution Certification, must be completed and provided to the PBGC within 30 days of distribution. If there are any excess retirement funds, information must also be provided to the IRS about how those funds are handled which is typically defined in the plan document. If the excess funds are returned to the plan sponsor, the plan sponsor must file a Benefit Assurance Form. If at least 25% of the funds transfer to a qualified

IF PROVIDING THE OPTION OF LUMP SUM PAYMENTS, it will be even more critical to offer participants education on the risks in retirement.

replacement plan, IRS Form 5310A must be filed. IRS Form 5330 is completed if an excise tax is paid to the IRS. (If all excess funds revert to the employer, the reversion is subject to a 50% excise tax in addition to the regular tax on income. If at least 25% of the excess is transferred to a qualified replacement plan, the reversion is subject to a 20% excise tax.)

Finally, the final Form 5500 annual report filing must be completed within seven months of distribution, and tax reporting for the plan participant distributions must be completed the following January.

In addition, updates or corrections in participant data can lead to the need for refunds and other administrative responsibilities. The insurer selected to provide the annuity contract may handle these requests without a time limit or charge. Quality data is critical. Otherwise data management concerns could continue for many years after the plan termination. The PBGC reports that almost 30% of plan terminations have data errors.[5]

The benefits of **data management expertise** emphasized during administration of the termination process extend to the annuity purchase process as well. This should start with the annuity provider providing regular estimates of the annuity cost, so the plan sponsor can understand when plan funds may be adequate to make an annuity purchase. It is advantageous to find the point when both interest rates and asset values allow the liability to be transferred. If an annuity provider does not offer regular estimates, the ideal timing could be missed.

The insurer providing the annuity contract should have the capability to transfer participant data in real time, to help ensure all retiree payments and participant communications are sent on schedule.

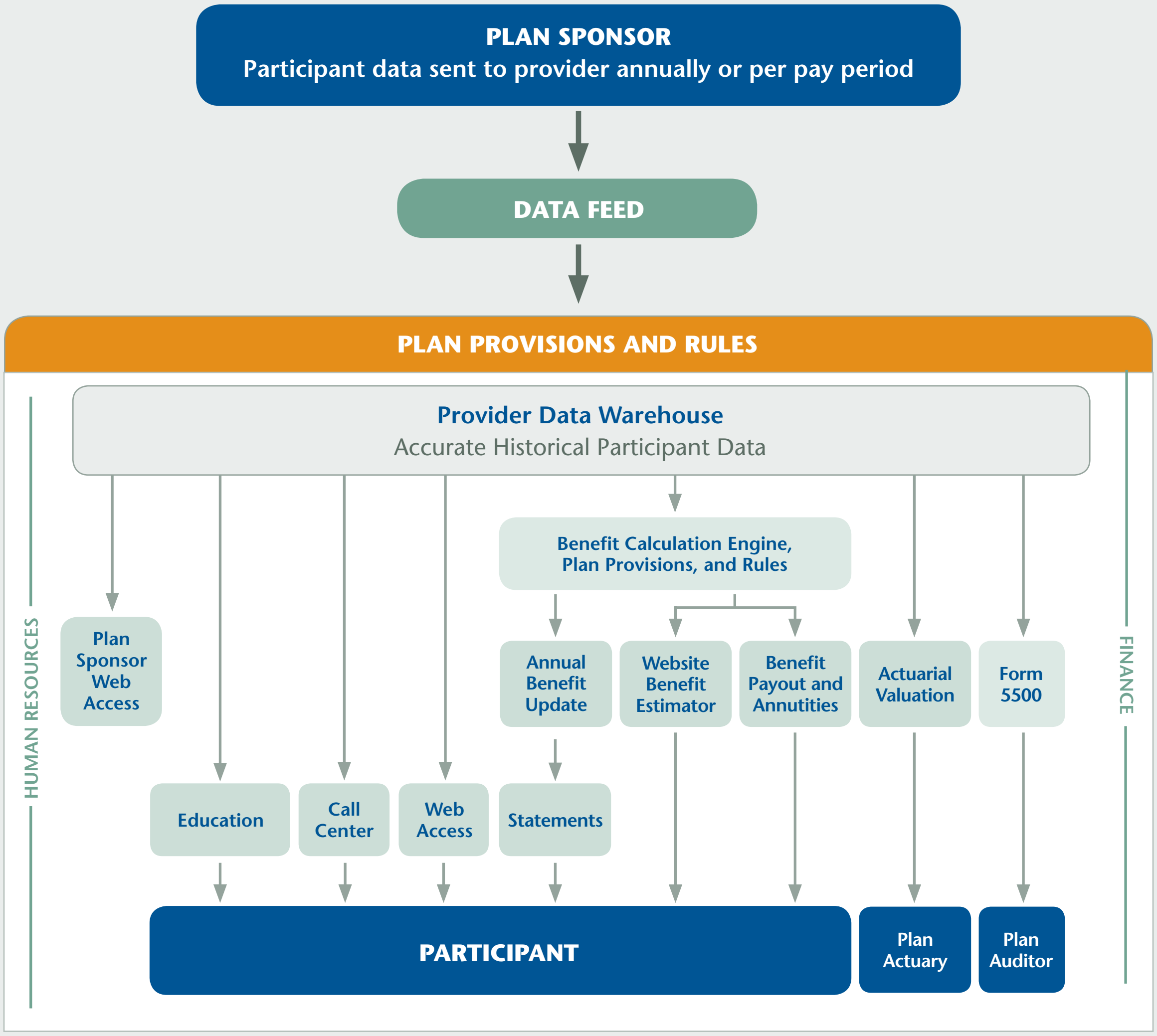
Finally, it is critical to have **dedicated support both for the plan sponsor and participants** during and after the transition to a single premium guaranteed annuity. A dedicated point of contact should be available for the plan sponsor and financial professional to discuss any questions or concerns related to the benefits provided under the annuity contract. Participants should also have access to contacts with expertise concerning the DB plan benefits. It is important that the provider offers that support and has a history of strong customer service. Consistently applied interpretation of the benefit calculations both pre- and post-annuity purchase is essential.

[5] PBGC Premium Filings, February 2013.

MANY PLAN SPONSORS CHOOSE TO WORK WITH A LIMITED NUMBER OF RETIREMENT PLAN SERVICE PROVIDERS THAT OFFER FULL PARTICIPANT DATA MANAGEMENT CAPABILITIES.

This decision can yield several advantages, including:

- Fiduciary benefits with less chance for errors, minimized risk and time saved in the future.
- Streamlined termination process, often resulting in less stress and likely soft-dollar benefits to the plan sponsor.
- Potential for lower fees when service provider manages both participant records data and plan termination services.



CONCLUSION

Termination of a hard-frozen DB plan requires more than just a well-planned investment and funding strategy. The actual execution of the termination strategy and compliance with a multitude of government requirements are just as important to terminating the plan in the most cost effective and timely way.

Working with your financial professional or consultant, actuary, and a limited number of other providers that deliver critical services and following the step-by-step best practices detailed in this paper are keys to effective hard-frozen DB plan management.

WE'LL GIVE YOU AN EDGE®

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