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Rethinking Risk

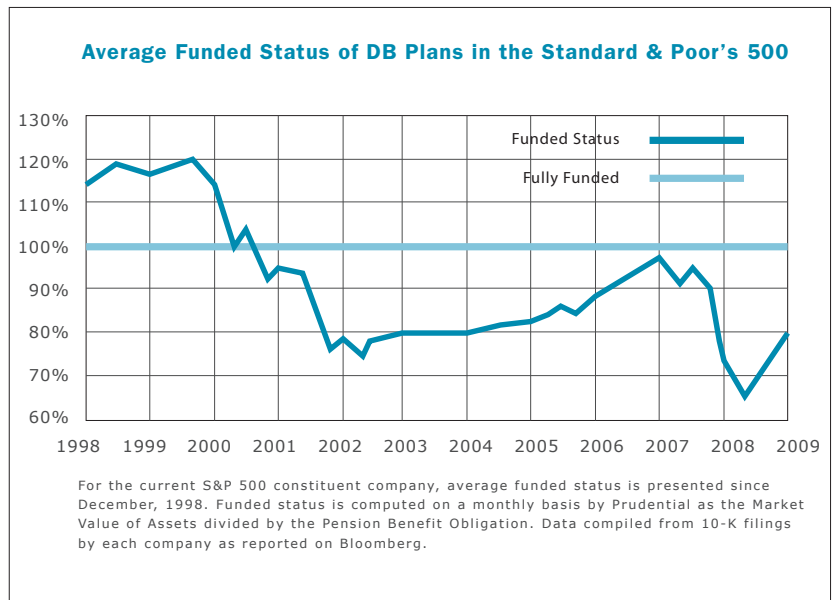
Defined benefit plan management is poised for significant change.

by Dylan J. Tyson

Fundamental shifts within the pension landscape are coming together to alter widely held pension risk management practices. Evolving corporate views of risk and reward, increasingly stringent funding requirements, on-balance sheet pension accounting and emerging product innovations are combining to change the face of defined benefit plan management.

Managing a defined benefit (DB) pension plan is challenging. The pension balance sheet contains myriad risks to be carefully managed. On the asset side, plan sponsors must consider equity risk, credit risk, interest rate risk and liquidity risk. On the liability side, sponsors are faced with interest rate risk, longevity risk, early retirement risk, expense risk and benefit election risk, among others. On top of these more quantifiable risks, pension plan sponsors are subject to less quantifiable regulatory risks, including such areas as plan funding and pension accounting.

High levels of market volatility, significant Pension Protection Act (PPA) funding requirements, changing pension accounting standards and competitive business conditions make the management of a defined benefit plan more difficult than ever. Plan sponsors who previously maintained well-funded pension plans are currently confronted with considerable plan deficits generating substantial contribution requirements and escalating stakeholder concerns. Over the past several years, DB plan sponsors have been forced to contribute billions of dollars to address sharp declines in plan funding. Absent significant market improvement, this cash call is likely to continue for the next few years for



most plan sponsors as PPA regulations are fully phased-in and funding relief measures, enacted for 2009 and 2010 plan years, expire. At the same time, rating agencies and analysts increasingly are focusing on the pension plan's impact on the corporate capital structure where pension deficits diminish shareholder equity and affect a sponsor's financial strength and strategic flexibility.

Between 2002 and 2006, plan sponsors in the Standard & Poor's 500 contributed approximately \$275 billion to shore up their defined benefit plans.

Experiencing a Decade of Downturns

The financial crisis of 2008–2009 had a detrimental impact on DB plans and their corporate sponsors. In a recent Towers Watson–Forbes survey, three of every four plan sponsors reported that their DB plan had a negative impact on the company's cash flow and financial statements¹. But the recent financial crisis wasn't the first time in recent history when plan sponsors suffered significant losses. In fact, 2008–2009 represented the second time in a decade that US sponsors lost more than 35% of their DB plans' funded status to market declines.

While funded status provides a clear indicator of the pension challenge facing US corporations, it does not speak to its relative significance.

To address this question, industry professionals compare the size of a company's pension obligation to the value of that company as a whole. A ready if imperfect measure of the magnitude of pension underfunding compares the corporate sponsor's pension benefit obligation (PBO) to the market capitalization of the corporation itself.

A recent survey of corporate pensions conducted by Mercer categorizes a company's pension obligation as highly material if the pension obligation equals or exceeds 40%, while a significant obligation equals or exceeds 10% of the company's market capitalization. Using these standards, DB obligations are highly material for nearly one of every five companies and significant for one of every two companies and in the S&P 1500.²

Against this backdrop, corporate sponsors have begun to more fully appreciate their role as principal holders of risk. They have begun to recognize that the decision to sponsor a DB plan has slowly become a decision to run an insurance subsidiary complete with asset/liability management challenges, risk management concerns and fiduciary responsibility. This realization has inspired forward-thinking CFOs and treasurers to raise some fundamental questions: Are my DB liabilities becoming a threat to my business and financial health? Will my DB liabilities limit my strategic flexibility and impact my competitiveness? For many, the answer appears to be “yes.”

Rethinking Risk

In the United States, the primary driver of pension risk is asset/liability mismatch. Many plans' strategic asset allocations embrace risk-taking that is disconnected from the pension's ultimate goal—paying benefits. Sponsors of frozen plans—plans in which employees accrue no new benefits and for which the pension obligation is quite well-defined—will commonly invest 50–70% of plan assets in stocks, seeking to outperform an index such as the S&P 500. Meanwhile, the value of plan liabilities is closely connected to the level of interest rates and not to stock market performance.

As a result, fluctuations in the market value of plan assets can diverge widely from the market value of plan liabilities.

This fundamental disconnect has produced breathtaking levels of pension volatility. This mismatch between assets and liabilities represents a risk position that is considered a form of corporate leverage. Leverage arises when the corporate sponsor effectively borrows money from covered employees and purchases equity investments that are meant to earn more than promised benefits—at considerable risk.

Pension strategy and business strategy are closely connected. While pension leverage and its attendant risk are not new, the environment surrounding pension risk-taking has changed substantially. Three key changes in the pension environment stand out: funding, accounting and economic.

Funding: Corporations must fully fund their plans—it's the law.

The Pension Protection Act of 2006 (PPA) has substantially stiffened the requirements surrounding pension funding. As a result, pension volatility and the resultant underfunding becomes a call on corporate cash more swiftly and severely than in the past. Yesterday's plan funding rules were less stringent, allowing plan sponsors to delay significant cash contributions even in the face of disappointing investment results.

Typical DB Plan Risks

Asset	Liability
· Equity	· Interest Rate
· Credit	· Longevity
· Interest Rate	· Early Retirement
· Liquidity	· Expense
	· Benefit Election



¹ Towers Watson – Forbes Insights 2010 Pension Risk Survey, December 2010

² How Does Your Retirement Program Stack Up – 2010, Mercer, June 2010

Accounting: Pensions are not just a footnote anymore.

Once relegated to corporate footnotes, a pension's funded status now appears on the face of the corporate balance sheet. These changes are the result of the first phase of the Financial Accounting Standards Board's (FASB) initiative to reconsider accounting for pension and other benefits as laid out in FASB Accounting Standards Codification (ASC) 715. The second phase of pension accounting reform could be more fundamental. FASB is in the process of reconsidering current pension "smoothing" rules and whether changes in the fair value of assets and liabilities should be immediately recognized across corporate financial statements.

This pension accounting review began with a Securities Exchange Commission recommendation that FASB and the International Accounting Standards Board (IASB) convene a joint project on pension accounting with two primary goals: creating more transparency on surrounding pension funding and improving the consistency of accounting treatment between pension assets and other corporate assets. While the timing and ultimate impact of these changes on US corporations is still uncertain, what is clear is that the process is moving forward and that changes are anticipated to be significant. Certain US companies that compete globally are already anticipating these changes and providing more transparent reporting around their pension accounting.

Economics: DB liabilities do not support risk-taking the way they once did.

Defined benefit plans once had the benefit of a very long time horizon to support pension risk-taking, but the natural maturing of plan populations combined with corporate decisions to de-emphasize defined benefit plans have resulted in a changed DB plan liability. Today's DB liability is shorter and better defined. Increasingly, defined benefit liabilities can be at least partially matched with fixed income assets—greatly reducing pension risk. This liability driven approach is especially attractive because with a shorter liability time horizon, the portfolio does not have sufficient time to heal from a market downturn before benefit payments are due.

De-leveraging the Pension Balance Sheet

Among the host of issues within the pension universe, today's plan sponsor is most concerned with the defined benefit plan's impact on their company's cash flow, income statement and balance sheet.³ The key changes addressed above are reshaping plan sponsors' ability to live with the status quo.

Despite significant underfunding in pension plans nationally, six out of ten plan sponsors are likely to focus on reducing the risks within their pension plan, while only two in ten plan sponsors are contemplating the opposite.⁴ With the majority of plan sponsors on a path to reducing pension leverage, risk reduction comes in two basic forms:

Reducing the level of risk within the plan.

Nearly two out of every three plan sponsors see pursuing better alignment of assets with liabilities (*e.g.*, Buy-ins, which are described below, liability driven investment) as the most likely option for risk reduction within their plan.⁵

Reducing the size of the plan.

With a goal of decreasing risk by decreasing the size of their plans, sponsors are most actively considering offering lump sums to terminated vested participants as PPA cash-out rules are phased-in⁶ and purchasing annuities for some or all pension plan participants. Nearly one in three sponsors believes these actions are somewhat or very likely⁷.

New Options for a New World

Whether the priority is reducing risk within the plan or reducing the size of the plan, new pension risk transfer options are available. In the US, pension risk transfer alternatives take two primary forms:

- Buy-out, which reduces pension risk by reducing the size of the plan; and
- Buy-in, which reduces pension risk of an ongoing plan.

Both Buy-out and Buy-in solutions are available today and can be customized to meet specific sponsor needs.

3 Towers Watson – Forbes Insights 2010 Pension Risk Survey, December 2010

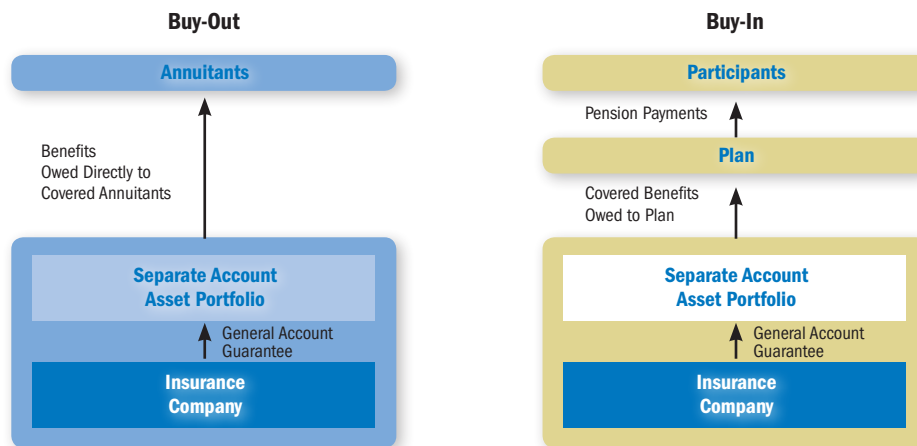
4 Towers Watson – Forbes Insights 2010 Pension Risk Survey, December 2010

5 Towers Watson – Forbes Insights 2010 Pension Risk Survey, December 2010

6 PPA cash-out rules are scheduled to be fully phased-in beginning 2012

7 Towers Watson – Forbes Insights 2010 Pension Risk Survey, December 2010

Comparison of Buy-In and Buy-Out Offerings



Buy-out

Buy-out completely transfers pension risk for covered liabilities to an insurer, who assumes all investment, longevity, benefit option and expense risk. Buy-out can be used to settle the liabilities of an entire plan, or simply a portion of that plan. Buy-out is appropriate for plan sponsors who want to reduce investment risk by settling liabilities of the pension plan, either in part or in whole.

Through Buy-out, a plan sponsor can:

- Eliminate pension volatility by permanently settling pension obligations;
- Avoid ongoing administrative, actuarial and investment management expenses for the settled liability; and
- Eliminate Pension Benefit Guaranty Corporation (PBGC) premiums for participants whose benefits are fully guaranteed.

Because a Buy-out transaction settles a portion of the plan's liability, settlement accounting rules (ASC 715) must be followed. In the current environment this generally results in a one-time loss recognition that is undesirable to many plan sponsors. A Buy-in, as described below, provides similar risk reduction without triggering a settlement, thereby eliminating recognition of the loss.

Buy-in

Buy-in provides a pension asset that perfectly matches pension liability cash flows. Much like Buy-out, the sponsor transfers investment, longevity, benefit option and expense risk, allowing pension plans to transfer risk today. Where Buy-in differs is that the sponsor avoids the immediate accounting recognition that arises under ASC 715 in connection with the settlement of plan liabilities.

Though Buy-in is new to the US, it's a proven commodity in the United Kingdom, where nearly \$8 billion of pension risk has changed hands through Buy-in since 2007⁸. Buy-in is appropriate for plan sponsors who seek to reduce the risk, but not the size of the plan. Buy-in can be customized to cover nearly any pension liability configuration and is designed to help a plan sponsor:

- Reduce pension volatility—funding, accounting and economic;
- Maintain the funded status of the plan, holding required contributions steady; and
- Convert to Buy-out at any time, enabling sponsors to take a phased approach to risk reduction on the schedule of their choice.

Plan sponsors act as fiduciaries when investing in a plan asset as in a Buy-in or settling a plan liability as in a Buy-out. Because contractual

payments are expected to continue for many years, clients are justifiably concerned about fully evaluating the counterparty risk that naturally arises—that is, the risk that the insurance counterparty meets its obligations on a timely basis.

Recent innovation in the US pension risk transfer market centers on providing plan sponsors with increased transaction security. For example, leading insurers now offer insulated separate accounts to safeguard assets in Buy-in and Buy-out transactions. These separate accounts are inaccessible to general creditors, providing an additional layer of protection for plan participants. The Department of Labor (DOL) has indicated that such structural enhancements are appropriate to consider in selecting the safest available annuity provider through DOL interpretive bulletin 95-1.

Toward a More Certain Future


While US plan sponsors contemplate a very different future, they can look to the UK to gain a glimpse of what the future may hold. UK plan sponsors have been systematically reducing their pension leverage, decreasing asset-to-liability mismatch and ultimately implementing pension risk transfer solutions in size. Since January 2007, UK plan sponsors transferred more than \$15 billion in plan obligations⁹. UK plan sponsors are employing pension risk transfer as a means to:

- Achieve contribution certainty;
- Reduce or remove financial statement volatility;
- Reduce the size of their plans relative to the size of their firms;
- Transfer unrewarded risks, particularly longevity;
- Increase focus on their firm's core business; and
- Enhance strategic flexibility.

As US CFOs and treasurers re-assess their pension priorities, they must ask the same fundamental questions that UK plan sponsors have been addressing:

1. What corporate finance objectives am I trying to achieve?
2. What risk reduction and risk transfer strategies are best for my company?

3. Are there tax considerations that inform my decision of when and how to reduce my pension leverage?
4. What impact will these strategies have on my weighted average cost of capital and the stability of financial results going forward?
5. How should I prepare to transact?
6. When should I implement my strategy?

While these questions require careful consideration, CFOs and treasurers who make time today to reexamine the assumptions surrounding their pension plan obligations will be able to confidently chart the right course for their pension and their company. And they will be at an advantage relative to those who don't. 



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Prudential's Portfolio Protected Buy-in and Buy-out offerings, making separate account protection available to all plan sponsors regardless of size. Dylan oversees Prudential's \$29 billion defined benefit annuity block and has gained more than 15 years of Institutional Investment Product experience in a variety of roles at Prudential. (dylan.tyson@prudential.com)