Pension Plan Fix-It Handbook

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Understanding the Basics About Derisking Becomes First Step to Decisionmaking

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Editor's Note: *This is the first of two columns discussing defined benefit plan "derisking." In this month's column, Contributing Editor Mary B. Andersen provides an overview of current conditions that have led to a resurgence in many company DB plan sponsors considering or taking action on derisking. February's column will discuss actual derisking strategies in more detail.*

If you have a DB plan, chances are your company is discussing derisking. This approach for managing DB pension liabilities transfers terminated vested participants' and retiree benefit obligations from company balance sheets when lump-sum payments are made or an insurance company that buys the liabilities continues paying benefits independent of the plan sponsor.

As equities prices and pensions' funded status rise amid low interest rates, most DB plan sponsors are facing a "perfect storm" of circumstances that makes reducing their pension obligations through derisking look more attractive.

Derisking gained significant media attention in 2012 when Verizon and General Motors sold billions of dollars of pension liabilities to insurance companies to manage.

In June 2013 testimony[1] before the ERISA Advisory Council during hearings on private-sector pension derisking, one witness, Penbridge Advisors Co-founder and Principal Steve Keating, cited LIMRA data as his source and said that single-premium group annuity purchases have "…been less than $3 billion annually for the past 20 years, and slightly less than $1 billion in recent years before 2012. [However,] 2012 was the biggest year ever in the U.S … with sales volume of $36 billion."

Here are some basic facts about this strategy that all DB plan sponsors should understand:

What Is Derisking?

Derisking is transfer of risk from the plan — and ultimately the plan sponsor's financial statements — to the participant, in the case of lump-sum distributions, or to insurance companies, in the case of annuity purchases. As a reminder, the decision to derisk is a settlor function not subject to ERISA, but the implementation of the decision is an ERISA fiduciary decision. As with all fiduciary decisions, a carefully thought-out and well-documented process is critical.

Why Has Pension Plan Derisking Garnered So Much Plan Sponsor Attention?

A combination of factors has prompted increased focus on DB plan derisking, including the following.

Financial

- **Improved funded status for DB plans in the latter half of 2013** (plans face negative consequences under federal regulation if they don't maintain funding to cover at least 80 percent of their potential benefit obligations):
    - Actuarial consulting firm Milliman's October reading for its Milliman 100 Pension Funding Index[2] was 91.9 percent;
    - Investment bank BNY Mellon's Institutional Scorecard[3] for "typical" pension funding stood at 91.8 percent;

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Derisking (continued from p. 1)

  - Mercer[4] reported a 91-percent funding ratio for DB plans of S&P 1500 companies it monitors.

- **Historically low interest rates,** even though they are rising slightly, increase pension liabilities and can affect companies' financial statements, especially when company contributions to stabilize funding levels are needed.
- **Potential for market volatility.** A *Business Insurance* white paper[5] on pension plan derisking notes that, for example, "Over just one year, from Dec. 31, 2007, to Dec. 31, 2008, funded status of big pension plans swung from a $60 billion aggregate surplus to a deficit of more than $400 billion."
- **Full phase-in of new Pension Protection Act lump-sum interest rates.** Historically, lump-sum interest rates were based on 30-year U.S. Treasury bond rates. Starting in 2008, lump-sum rates became based on a mix of Treasury and corporate bond rates. In 2012, the corporate bond yield curve was first used to calculate lump-sum payouts to retirees. The corporate bond yield curve rate is generally higher than the Treasury rate; higher interest rates result in lower lump-sum payments.
- **Increased U.S. Pension Benefit Guaranty Corp. premiums** (rising from $35 per participant to $42 in 2013, and to $49 in 2014).

Business

- **Pension obligations can represent a significant portion of a company's market valuation**, and fluctuations in pension funding can affect the company's financial statements. For example, Dan Ammann, General Motors senior vice president and chief financial officer, in announcing the carmaker's major derisking action in 2012, said, "These actions represent a major step toward our objective of derisking our pension plans and will further strengthen our balance sheet and give us more financial flexibility going forward." GM's actions are expected to result in a $26 billion reduction in the U.S. salaried employee plan's pension obligation.
- **Pension costs can be volatile.** Plan sponsors have no control over interest rates and market conditions.
- **Many DB plans have been closed or frozen,** and are of little value to new or prospective employees. Plan sponsors are viewing derisking as an opportunity to help stabilize or cut pension costs, if possible.
- **Ultimately, many companies are acknowledging** that managing this risk is not their core business.

Derisking Strategies

Derisking can involve both plan design and asset strategies. Plan design strategies can include converting a traditional DB plan to a cash balance plan. These are also known as "hybrid" plans, and are DB plans with benefits more characteristic of a defined contribution plan. A cash balance plan offers the promised benefit in terms of a stated account balance, according to the U.S. Department of Labor's website. Other plan-design changes available include closing the plan to new entrants, freezing the plan; or, ultimately, terminating the plan.

Changes made to pension assets strategy generally are thought of as either internal (those in which assets are managed to limit risk but remain within the plan) or external (when assets leave the plan). Each method is complex and requires careful evaluation in light of a plan's particular demographics.

Internal derisking

This focuses on plan investment strategies, including liability-driven investing. The goal of LDI is to match the plan's investments with its liabilities; as participants age and approach retirement, assets should be invested in instruments that will provide the necessary benefit payment amounts. In the past, techniques included bond immunization and the use of a laddered bond investment approach.

Another method, which has gained more traction in Europe than in the United States, is the use of a group annuity contract, purchased and held by the plan. Periodic annuity payments by the insurance company to the plan are used to pay benefits.

External derisking

Such strategies include offering lump-sum payments to deferred vested participants and, in some cases, to participants receiving monthly payments; purchasing annuities for certain segments of the plan population (for example, retirees), with the resulting benefit paid by the insurance company from which the annuity was purchased; and DB plan termination, as the ultimate derisking strategy.

The Derisking Decision

As mentioned, derisking is a settlor function not subject to ERISA, but implementing the decision is an ERISA fiduciary activity.

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Derisking (continued from p. 2)

Pension consulting firm Towers Watson reports that almost 75 percent of respondents in a 2013 derisking survey[6] "either have implemented, are planning to, or are considering developing a formal 'journey' plan to de-risk their DB plan. A journey plan details actions a plan sponsor will take to de-risk its pension plan once certain trigger points have been reached. Forty-two percent of respondents had a journey plan in place before this year, while 8 [percent] implemented a plan this year."

Mercer reports in the Mercer and CFO Magazine Pension Risk Survey (2013) "Evolving Pension Risk Strategies - The Journey to Risk Transfer and Outcomes-Based Objectives"[7] that 67 percent of respondents are either very likely or somewhat likely to consider offering lump-sum distributions to terminated vested participants who haven't started receiving benefits; 48 percent plan on transferring risk to third parties by purchasing annuities and 33 percent will terminate one or more of their DB plans.

It All Starts with a Derisking Game Plan

There are many components to derisking, and plan sponsors should assemble a team of experts, both internal and external, to examine the issues and explore derisking options. Key areas of examination include:

- **Cash flow** - the Towers Watson survey indicated that the company's cash-flow needs are critical to any derisking strategy. Have you modeled how your pension obligations will affect your cash-flow needs under various market and interest-rate scenarios?
- **Funding status** - PPA ties the ability of offering lump-sum distributions to the plan's funding status. Will you be able to offer lump sums?
- **Plan demographics** - evaluate liabilities associated with an aging workforce and legacy plans; frozen or closed plans may help with employee retention but will be of no value to new hires. Frozen or closed plans still have funding and other ERISA reporting and disclosure obligations. Will offering lump-sum distributions to terminated vested participants reduce your financial obligations to an acceptable level? Will group annuity purchases for large segments of employees be the only suitable approach, from a corporate financial perspective?
- **Investment policy** - plan sponsors are increasingly focusing on matching liabilities with investments, rather than investing for the best possible return. Will that be enough for your organization?
- **Risk tolerance** - what is your company's risk tolerance? A 2013 MetLife study ranked responses to 18 risks looking for consistency between the importance plan sponsors assigned these risks and the plans' success in managing risks. (See study at www.metlife.com/pensionrisk.) Where does your company fit on the matrix?

Choosing a Course of Action

No matter what course of action for derisking a plan sponsor chooses, a detailed implementation plan must be carefully constructed. As part of this, it can't be emphasized enough that making a settlor decision is a fiduciary function. Documented due diligence at each phase is required; derisking is an activity that already has resulted in litigation by affected participants, and that trend is likely to continue.

Footnotes

[1]http://www.dol.gov/ebsa/pdf/penbridgeadvisors060513.pdf
[2]http://us.milliman.com/Solutions/Products/Pension-Funding-Index/
[3]http://us.bnymellonam.com/core/investment_managers_and_distribution/bny_mellon_pension_services/institutional_scorecard/institutional_scorecard.html
[4]http://www.mercer.com/press-releases/1558445
[5]http://www.businessinsurance.com/assets/PDF/CB89092610.PDF
[6]http://www.towerswatson.com/en/Press/2013/11/more-us-companies-formalizing-plans-to-derisk-defined-benefit-pension-plans
[7]http://secure.cfo.com/research/index.cfm/download/14685346