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next steps in

pension risk management

June 2021

Introduction

When it comes to managing pension risk, companies and their executives seem to have ravenously consumed the expanding menu of options at their disposal...and they seem hungry for more.

Against an ever-evolving and, over recent years, challenging market and regulatory landscape, defined benefit plan sponsors are considering and acting on nearly all forms of pension risk management. In a new survey of 201 senior executives by CFO Research in collaboration with Mercer, over 90% of respondents report following a deliberate, multi-year strategy to manage their plans, thinking holistically about both asset and liability management.

But even the best laid plans need to be adaptable to incorporate both market conditions and changes in policy that impact one or both sides of the asset-liability equation. The tools available to plan sponsors fall into three categories: funding policy, risk transfer activity, and investment strategy.

2020 proved to be a perfect test case across all three categories as the fallout from COVID caused disruption in financial markets, weakened corporate balance sheets, and ultimately, funding relief. According to the survey, over 75% of sponsors' businesses were at least moderately impacted by the events of the past year, and most of them are looking for what's next.

The survey and related in-depth interviews with individual CFOs also revealed some interesting findings about how executives are thinking about and acting on the funding, risk transfer, and investment tools available as they look to effectively manage both their businesses and their DB plans.

Key points

- Reported DB pension funded ratios in the survey as a whole skewed lower than previous years. On the bright side, the 2021 market conditions have been favorable to funded statuses, creating new opportunities.
- Plan sponsors are open to many investment and funding options to satisfy their fiduciary opportunities.
- Most companies plan to take advantage of expanded DB pension plan funding options offered by new legislation.
- DB pension plan sponsors need to know whether their asset managers are taking advantage of the tools available for reducing risk and meeting funding benchmarks.
- Most companies are dynamically managing risk in their DB plans, and have access to timely asset and liability information, but do not have the confidence those actions can be implemented in a timely or efficient manner.
- Nine out of 10 companies have offered lump-sum payments to transfer risk to DB plan participants, and the vast majority of them are likely to offer additional lump-sum payments in the next two years.
- Seven out of 10 companies have (or are considering) purchasing an annuity for a portion of participants including retirees.

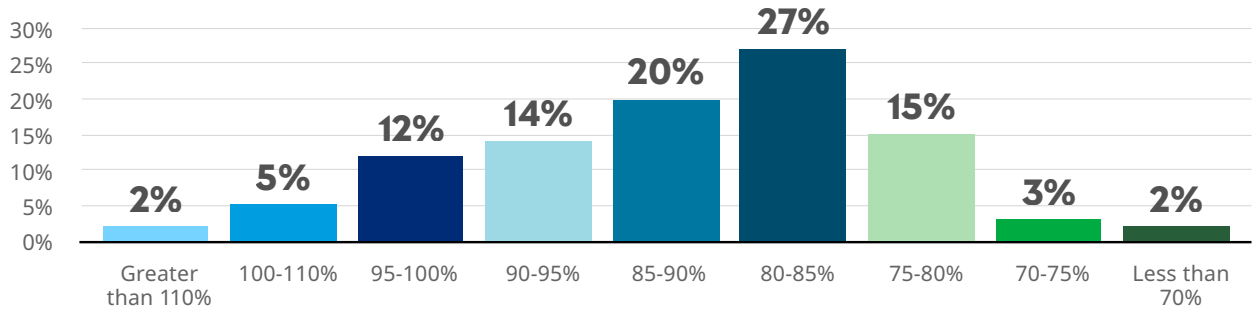
Expanding funding options

Under the American Rescue Plan Act (ARPA), companies have more funding options for their defined-benefit pension plans. For most DB plans, the legislation lowers the minimum contribution amounts required from companies. The contribution amounts are also insulated from market fluctuations, meaning that companies can better predict future contributions over the next several years. For the CFO, the funding relief offers flexibility to explore other funding goals, such as building to a future funded percentage where their DB plan could be terminated. Or, for companies with DB plans that are already well-funded, CFOs could find opportunities to shift part of the annual allocation to other areas of priority in the company.

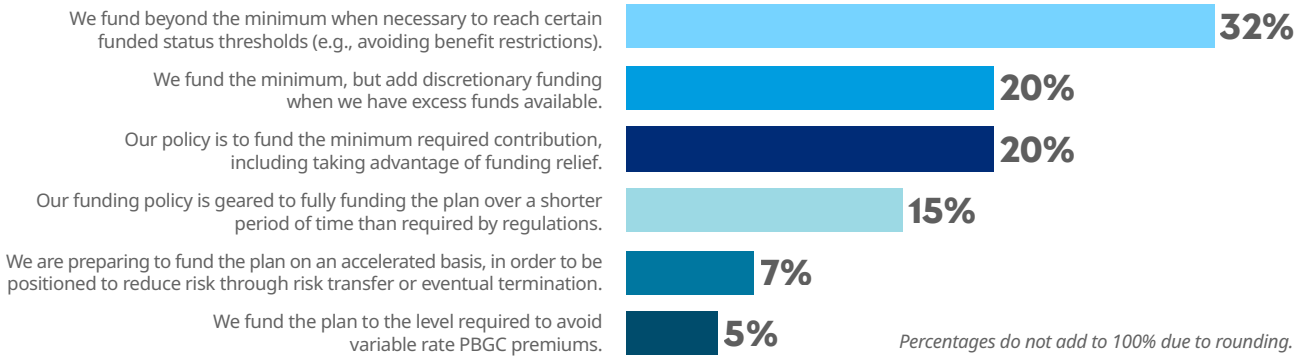
The CFO Research survey of 201 executives showed companies are primed to make changes to their DB plans and they're planning to take advantage of the funding relief legislation. To avoid potential pitfalls, plan sponsors will have to consider their long-term objectives before adopting new funding strategies. Fully adopting pension funding relief will delay contribution requirements, and offer flexibility to save cash for several years, but that may come with an increase in Pension Benefit Guaranty Corporation (PBGC) fees – which in part are based on the funding level of the plan – and may lead to significantly larger contributions over the long-term. On the other hand, if the strategy targets a specific funding level – like plan termination -- the funding could be more volatile as market conditions change. We expect most employers will take a balanced review of the business case considerations of funding relief with long term objectives in mind, while others may be eager to immediately take advantage of the opportunity to contribute less. All in all, the flexibility offered with relief is welcomed by plan sponsors.

The funded ratios reported by the surveyed executives skewed lower than prior survey results. Through the first quarter of 2021 we have seen equities at new highs, and increases in interest rates that improved most plans' funded status. Most companies on the whole still have more work to do in shoring up their DB plans, and the funding relief in the new legislation may have an impact on the pace and time horizon of getting there. The largest percentage of the survey respondents, 26%, reported their DB plans have current funded ratios (plan assets divided by projected benefit obligation) of 80% to 85%, with 19% in the 85% to 95% range and 15% in the 75% to 80% range. Nearly three quarters of the respondents, 73%, fell into ranges between 75% and 95%. During 2020, we saw the funded status of a typical plan decrease by 10% through March, and end the year down 3%, and then increase 10% through the first quarter of 2021. This illustrates the inherent volatility in a typical plan, and the challenge that many plan sponsors are focused on addressing.

What is the current funded ratio on an accounting basis (i.e., PBO/plan assets) of your organization's largest DB plan?



Which of the following statements best characterizes your organization's approach to funding its pension plan?



Percentages do not add to 100% due to rounding.

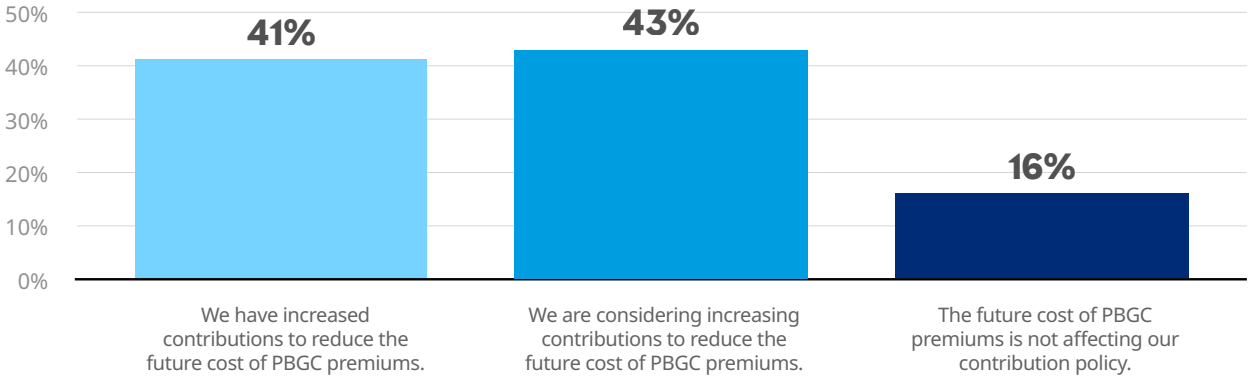
What motivates companies to fund their plans? According to the survey, the most popular funding approach—cited by 32% of the respondents-- is to fund to a threshold to avoid PBGC filings or participant notices. Tied for second-most popular, both at 20%, were: 1. Fund the minimum required contribution and take advantage of funding relief, and 2. Fund the minimum, but add discretionary funding when excess funds are available. As a slight departure from prior survey's results, only 15% say they are geared to fully fund the plan over a shorter time period than the regulations stipulate. This is down from 29% in 2019 and points to higher needs for cash in other parts of the business.

The survey also indicated that most of the reasons for modifying pension funding policy have to do with risk transfer goals. And eight out of 10 of the surveyed executives said they had either increased or were considering increasing contributions to avoid PBGC premiums. Taken as whole, the top motivating factors described by the surveyed executives indicate more of a short-term outlook on funding, probably by the financial challenges of 2020 presented by COVID-19.

For Ralph Balestriere, CFO of Red Wing Shoe Co., interviewed as part of the survey project, the motivating factors for increasing the funded ratios for the three qualified DB plans at his company were mainly to hit an 80% level mandated by the funds' charter and then to ultimately reach 100% so the company could exit the plans, which are all frozen to new entrants. Red Wing Shoe is a privately held footwear company based in Minnesota. The funded ratios for the three plans rose to 100%, 100% and 78%, up from about 70% for all three in 2010. "We were in tough shape," Balestriere says.

Whether by the fund charter or avoiding PBGC premiums, CFOs have many options for funding policy for their plans. The new funding relief delivered by ARPA will give flexibility to meet their needs.

To what extent are future PBGC premium costs affecting your organization's contribution policy?



Transferring risk

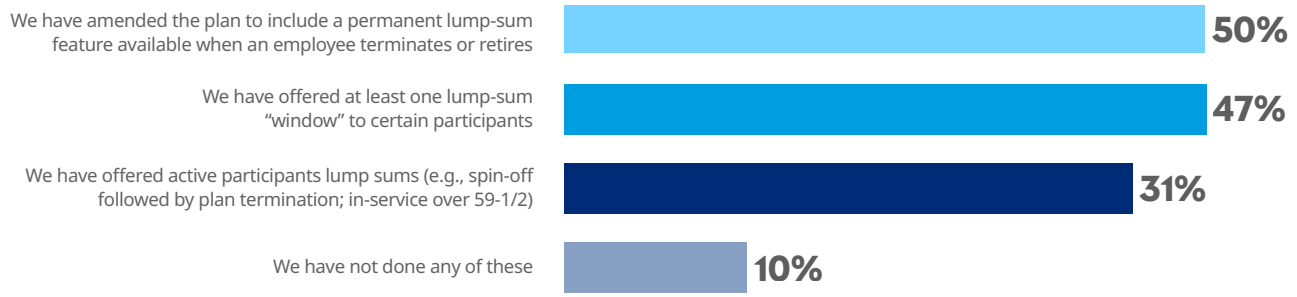
Plan sponsors continue to reduce their contribution and funded status volatility risk by transferring liability to an insurer or another party. How are companies transferring risk? The vast majority of the surveyed executives—90%--said they had offered lump-sum features to DB plan participants to transfer risk within the last 10 years.

The lump-sum risk-based transfer option is popular as a future option as well, with 77% of the respondents likely to offer additional lump-sum options within the next two years. Purchasing annuities from insurers to transfer retiree obligations from the DB plans is also popular, with 66% of the survey respondents saying they've performed or are considering the option in the next two years.

As for future plan terminations, 28% foresee their organization terminating their DB plan in the next three to five years, while nearly as many--26%--say they won't terminate their plan. Plan sponsor long-term objectives are spread amongst those who plan to retain their plan over the longer term, versus those who are moving towards termination, with others in the middle who may not be focused on full termination but are actively de-risking and downsizing.

Has your organization undertaken any of the following lump-sum-based risk-transfer activities in the last 10 years?

*(Respondents were allowed to choose **multiple** responses)*



The company has done three annuity risk transfers for a limited number of plan participants to gradually reduce the DB plans. Interestingly, the "premium" of the annuity purchase price over the balance sheet obligation has dropped each time, from 5% of five years ago to about 2.5% for the second purchase to 0% for the most recent purchase, last year.

For Balestriere, the CFO at Red Wing, his company exited its first DB plan two years ago with an annuity buyout with an insurance company. Red Wing paid 108% of the plan's liabilities on the deal, which covered the roughly 2,000 participants still in the plan at that point. Prior to that, Red Wing had offered a lump-sum buyout that was accepted by about 100 plan participants. The company has another DB plan currently well-funded that it plans to exit within the year.

Bruce Swain, CFO of Crawford & Company, a publicly traded insurance claims adjusting company, says his company has offered one-time lump-sum payments every other year for the last six years to DB plan participants with smaller benefit values: those who weren't receiving pension payments yet but who had vested benefits in the plan. Similarly, the company has done three annuity risk transfers for a limited number of plan participants to gradually reduce the DB plans.

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In one area, the survey respondents were probably overly optimistic in their self-assessment: How they rated the quality of their pensions plan participant data. If conditions should turn favorable for a plan termination, 93% described their data as "pristine" or "in good shape." However, finance executives may be unfamiliar with the niceties of finalizing benefits and tracking down former employees with speed and finding out where they live, whether they're still alive, whether divorce or other court judgements have changed their beneficiaries' status, and whom to pay if they've died. Pension risk transfer accelerates the time horizon for these activities, forcing most companies to admit that the "pristine" pension date may be a fairy tale.

Has your organization completed (or is considering) a project to transfer some or all of the retiree obligation from its DB plan to an insurer, through the purchase of an annuity?

Making smart investing choices

Pension investing is unique. "Success" for a pension investment strategy means that the plan moves toward fully funded, which is not necessarily the same as asset growth, although they are certainly related.

In order to help create a successful investment program, sponsors must apply principles of not only traditional portfolio management, such as maximizing the risk-adjusted return, but also shift their paradigm to orient toward a liability-aware framework, that is to say, investing assets in the context of plan liabilities. In this framework, there are three key themes executives surveyed are focused on: governance, dynamic de-risking, and innovative asset strategies.

Governance

Unlike most traditional institutional pools of capital, DB assets are earmarked for a particular use and the strategy for investing those assets needs to be measured in the context of the underlying benefit liability that the assets secure. This asset versus liability relationship and risk adds a level of complexity which almost 40% of respondents feel unequipped to handle internally.

Making good governance decisions in a board meeting is a different skill than executing the plan strategy with speed and efficiency. Most companies are more confident in their ability in the former skill than the latter. Most of the

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executives were dissatisfied on two fronts: 63% said they struggle to find the time and expertise to oversee the pension investment strategy and 68% said they struggle to execute changes required by their investment strategy in a timely fashion.

(Re)introducing: the outsourced chief investment officer (OCIO). The answer most have turned to is professional investment management – in fact almost 90% of survey respondents indicated they use some degree of professional oversight. While traditional advisory investment consultants are still prevalent, the trend is very clearly toward using OCIOs. A partial or full OCIO model increased in survey results by 50%, while advisory consultants dropped commensurately.

OCIOs themselves have needed to transform to meet the growing needs of these plans, as helping to set an investment strategy is no longer enough. Technology and access to real-time data has become crucial to pension investing. As markets move with more speed and volatility than we've ever seen before, the ability to capitalize on fleeting opportunities to lock in funded status gains is becoming the gold standard in the industry, brought on by the adoption of de-risking glide paths.

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De-risking glide paths

The mechanism by which plans are looking to lock in these ephemeral funded status gains is a dynamic de-risking strategy, also commonly known as a glide path. Glide paths have certain funded status triggers that signal changes in asset allocations to align the sensitivity of assets and liabilities to discount rate changes to achieve the goal of maintaining 100% funding through different market scenarios.

More than nine out of 10 of surveyed executives said they have implemented a glide path or are considering one.

Balestriere, the CFO at Red Wing Shoe, says his company implemented a de-risking strategy for its DB plans that included shifting away from a 70% equities/30% fixed income investing allocation in 2010 to a 40/60 allocation and, as a plan reaches a potential annuitization, 20/80.

The company is very happy with its de-risking strategy. "We've been thrilled with it; it's done well," Balestriere says. "We're happy with the fact that we sleep better at night, knowing that we've taken a lot of the risk out of it."

Swain, the CFO at Crawford, says his company adopted a liability-driven investing (LDI) plan starting in 2009. The strategy was to systematically migrate out of return-seeking assets, such as equities, into liability hedging assets. Now, more than 75% of the company's DB plan assets are in fixed-income investments that are matched to its liabilities from a duration standpoint.

"As interest rates rise and fall, those assets and liabilities will move in lockstep," Swain says. "So that takes a lot of the risk off of the table."

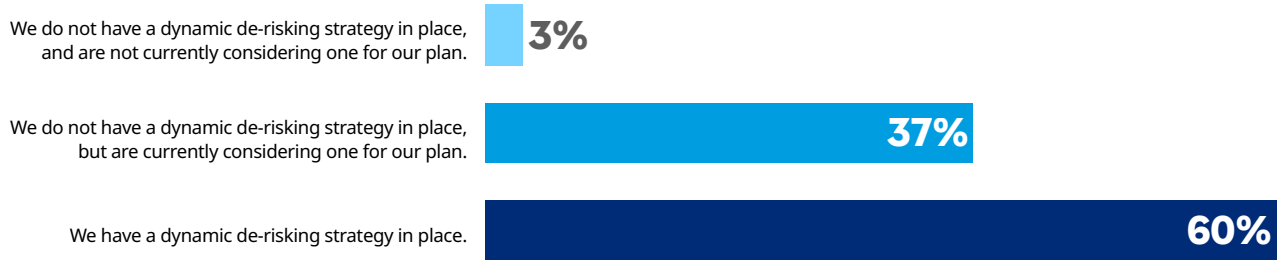
However, just because you bought the boat doesn't mean you know how to sail, especially when the seas gets choppy. While the widespread adoption of glide paths is encouraging, it also means that sponsors are now discovering how critical it is to have th e ability to monitor and execute on triggers in real-time. While 95% of executives feel they have access to information needed to make timely decisions about the plan, most still struggle to implement it in a timely manner.

The COVID pandemic-fueled market sell-off and subsequent recovery within a matter of weeks was a prime example of how significantly funded status can change in a short amount of time. Plans that were not able to de-risk quickly may have missed opportunities to lock in significant gains.

This concept of dynamism in de-risking is underscored further by the fact many plans are actively making or plan to make changes. Most of the executives—54%--changed their glide-path triggers in 2020. Looking ahead, the survey showed 78% of plan sponsors are likely or very likely to adjust the durations of their fixed income investments and 43% are very likely to increase fixed income allocations in the next two years.)

This underlines the fact that dynamic de-risking is not a set-and-forget process. New information, like global pandemics or changes in company's cash needs, can affect investment strategy and the widespread acceptance of glide paths indicates this trend seems here to stay for the foreseeable future.

Many plan sponsors have implemented a dynamic de-risking strategy, or "glide-path," for their pension plans to reduce risk as funded status improves or interest rates rise. Which of the following applies to your plan?



Innovative Asset Strategies

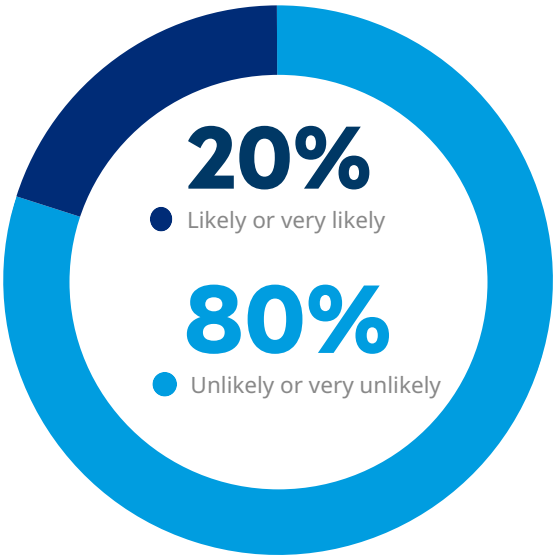
The final aspect of pension investment strategy is, ironically, the assets. In this area, we again see a trend toward risk management, particularly using more sophisticated strategies. This shift is likely tied to the increased use of an OCIO model where professional investors are helping educate executives on the role these strategies can play in their pension portfolios. To do this, companies represented in the survey implemented a wide range of investment changes over the last two years and they're considering changes over the next two.

The fact that executives seem to be equally trying all the various strategies our survey inquired about underscores the observation that they are eagerly consuming all varieties of risk management. However, when we look at the most significant trends over the past four years, changes focused on more innovative ways to manage interest rate and equity risk relative to traditional risk assets.

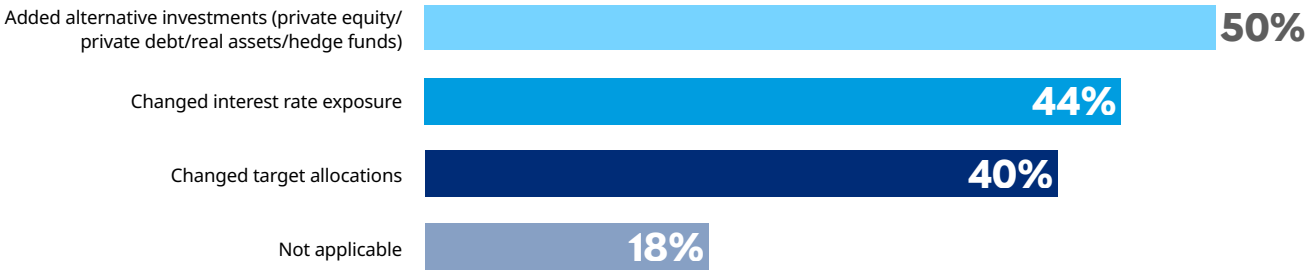
For example, 30% of respondents say they have increased their use of derivatives, both for interest rate hedging as well as tail risk management (equity options). Since the Financial Crisis, derivatives have often been considered a four-letter-word. However, when used appropriately in a risk management—not speculative—context, they can be used to extend the duration of fixed income investments to better align with and hedge liability duration. Similarly, other derivative instruments are structured to pay out when equity markets do poorly, helping manage tail risk.

The other most-cited investment change in 2020 was adding alternative investments—such as private equity, private debt, hedge funds and real assets—a shift cited by half the respondents. Historically, plan sponsors have shied away from alternative investments as the liquidity restrictions and fiduciary risk were too high. But, in a world where interest rates remain at historical lows and equity markets are expensive, a high rate of return that is minimally correlated with traditional, liquid equities is very attractive. Integration into portfolios appears to be gradual, with the majority using private assets selectively, although 39% have them as a core part of their asset mix.

How likely do you think it is that your organization will take some form of lump-sum-based risk transfer action in 2021 or 2022?



Which investment strategies, if any, did you change in response to the pandemic?



Putting it all together

To end where we began, pension investing is unique. Investment strategies employed by executives are focused on de-risking both at the top level (allocation to hedging vs. growth assets via glide paths) and within assets (inclusion of innovative strategies like derivatives and private equity allocations). These strategies create a strong foundation for risk management. Moving forward, sponsors will look increasingly toward their governance model to help incorporate the new standard of timely dynamism and execution.

Conclusion

As companies review taking advantage of recent DB plan funding relief legislation, they need to make sure their funding strategies are sound in the context of business objectives. The generally low funded ratios and short-term funding motivations revealed by the survey also indicate that CFOs have their work cut out for them in adopting and executing effective, long-term investment and risk-transfer strategies. Companies also need to make sure their DB plan asset managers are taking full advantage of the available tools and strategies, and the broader range of opportunities made possible by the new legislation.

Choosing the right OCIO

What should a CFO look for in an OCIO (Outsourced Chief Investment Officer) for a DB pension plan? Bruce Swain, CFO of Crawford & Company, says it's important to him that the OCIO is a fiduciary of the DB plan "so they're riding in the front seat with me from a risk perspective." Crawford is a publicly traded insurance claims adjusting company based in Atlanta with more than 9,000 employees.

"I wanted someone who would execute our LDI (liability driven investing) plan and live that every day and manage our plan assets in relation to our liabilities every day," Swain says. "Do our investment advisors lay in the top decile of alpha generators? I doubt it. That's not what I wanted them to do. I wanted them to manage our assets vis-à-vis our liabilities on the glide path that we put in place and help us on that systematic risk reduction. And that's what they did."

Experience is also important, of course, as is checking references. And make sure that the OCIO will fit with the unique attributes of your DB plan and the strategy for it, Swain says.

"I think it's really important before you make a decision like that to understand what your goals are, what do you hope to achieve, and what's your end state. And with that in mind, the strategy and the people that are going to help you implement the strategy," he says.