De-Risking Goes Mainstream

Employers have spent much of the past two decades looking for ways to de-risk their defined benefit (DB) pension plans, both to minimize their plan's impact on their organization's financial statements and to allow management to focus more tightly on core business activities. Today, they show few signs of slowing down. A new CFO Research survey conducted in collaboration with Mercer asked plan sponsors which of seven investment-related actions their plans were likely to take over the next two years to manage risk. All seven options were selected by at least 50% of the executives surveyed. Topping the list: increasing allocations to fixed-income investments, cited by 67% of the respondents (up from 53% in 2017); employing

CFO

MERCER
MAKE TOMORROW, TODAY

dynamic de-risking or "glidepath" strategies, cited by 60% (up from 52% two years earlier); and making greater use of options or related strategies for tail risk management, cited by 56%. (This is the first year this tactic was listed as an option in the biennial survey.)

Meanwhile, 76% of the executives polled said it was likely their organizations would take some form of lump-sum-based risk-transfer action in 2019 or 2020, in which at least some plan participants would be offered a lump-sum buyout of their pension benefit.

"The risks inherent in retaining pension obligations, such as interest rates, capital markets, and participant longevity, are not within the control of an employer," observes Jim Danley, North American treasurer for French multinational manufacturer Schneider Electric SE. "Transferring these risks creates a win-win for both the company through risk reduction and for plan participants through improved benefit security." (Schneider has three DB plans in the U.S., each of which has been frozen at some point over the past decade.)

Many of the earliest efforts at de-risking centered around liability-driven investment (LDI) strategies, often to good result. For example, Mercer reports that

76% of the executives polled said it was likely their organizations would take some form of lump-sum-based risk-transfer action in 2019 or 2020.

outsourced chief investment officer (OCIO) clients using its LDI offering have a higher average funded status than the average for all defined benefit plans sponsored by companies in the S&P 1500, and that their portfolios on average have outperformed the S&P 1500 by 13% since 2008.

Over the past few years, however, plan sponsors have become notably more proactive about de-risking and increasingly open to exploring a new and broader range of tactics, including dynamic de-risking or "glidepath" strategies, lump-sum cashout options for plan participants, and the transfer of their pension plan's obligations to an insurance company.

Schneider exemplifies those organizations that have been active in employing a wide range of de-risking strategies. Among the tools it has used are various term-vested lump-sum payment windows and retiree annuity purchases. Together, these have resulted in the transfer of more than 50% of the company's U.S. pension obligations since 2012. Today, about 60% of its DB assets are managed using an LDI and glidepath approach, while the remainder are managed using a static portfolio allocation with risk mitigated via an interest-rate overlay program. The company is currently moving to an all-LDI strategy.

Danley says Schneider has been "very satisfied with its de-risking strategies to date. We have continued to reduce our pension plan volatility and the impact on our corporate financial statements. In addition, we've been able to reduce administrative expenses and significantly decrease the complexity of running our plans."

Grocery retailer Kroger Co. has also used LDI strategies, an approach it embraced when it began freezing its three DB plans — a multi-year process that will be completed by Jan. 1, 2020. "Our liability-driven investment strategy has helped us become somewhat immune to changes in interest rates and how that could affect our plans' funded status," says Mike Schlotman, Kroger's chief financial officer. "Now, with a lot of our investments tied to the bond market, when interest rates go up or down our liabilities go up or down in synch. As a result, our funded status has been in a very, very tight range, which means we haven't been facing unexpected future contributions of cash, or variable-rate premiums from the PBGC."

Results like these have likely prompted many other plan sponsors to closely consider de-risking strategies.

Broadly speaking, plan sponsors intent on de-risking have three levers on which to pull: funding strategies, risk-focused investment strategies, and risk-transfer strategies.

Plan sponsors intent on de-risking have **three levers on which to pull:** funding strategy, investment strategy, and risk-transfer strategy.

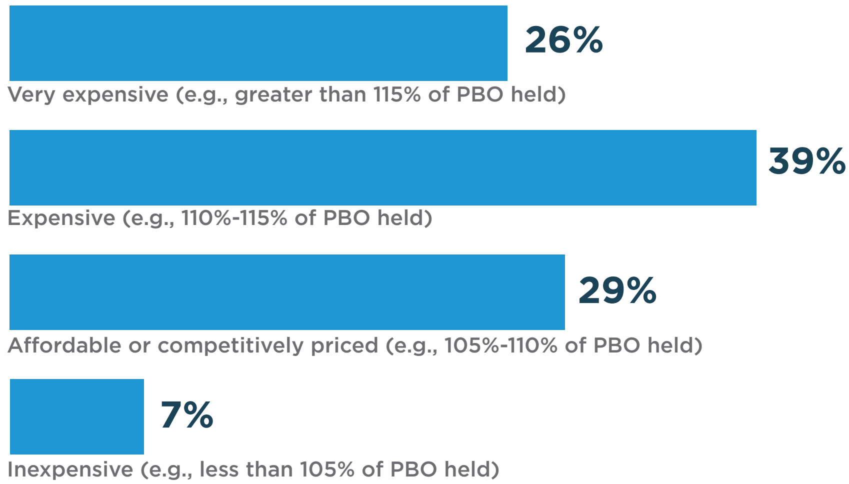
Funding strategies: Pension Benefit Guaranty Corporation (PBGC) insurance premiums remain a key driver of pension funding strategies for many employers. Improving a plan's funded level can reduce its PBGC premiums and reduce its impact on the sponsor's balance sheet. In the 2019 CFO Research survey, 85% of survey respondents had recently increased plan contributions to reduce the future cost of PBGC premiums or were considering doing so, up from 73% in 2017 and 57% in 2015.

In addition to boosting funding to minimize PBGC premiums, many sponsors recently chose to voluntarily pre-fund their plans beyond minimum requirements in response to the Tax Cuts and Jobs Act of 2017, realizing that lower corporate tax rates would make tax deductions on future contributions less valuable. In the CFO Research survey, 80% of the respondents from taxable organizations say their companies made at least some contribution to their plan above the required minimum as a direct response to the law, including nearly 32% who made a significant additional contribution. The additional contributions may have allowed some sponsors to explore other risk-reduction tactics that may not have made economic sense in the past.

Risk-focused investment strategies: Risk-focused investment strategies, such as dynamic de-risking, appeal to some plan sponsors because they reduce the likelihood of unexpected cash contributions to their plans. With dynamic de-risking, the sponsor maps out a glidepath that specifies how a plan's asset allocation strategy will change as its funded status improves. The ultimate goal is to have assets and liabilities tightly matched once the plan reaches its maximum funding level, making it easier to maintain going forward — or to terminate the plan if that is the desired outcome. In the 2019 survey, just over 50% of the respondents say their organizations have a dynamic de-risking strategy in place, and another 34% say they are considering one.

To be sure, plan sponsors have plenty of other investment-related risk-management strategies available to them. Thirty-seven percent of respondents say their organizations recently increased allocations to fixed-income investments, 30% adjusted the duration of their fixed-income investments to hedge plan liabilities, 28% made greater use of derivatives to hedge interest-rate risk, and 23% made greater use of options or related strategies to manage tail risk.

What is your perception of the cost of an annuity buyout for retirees in your pension plan, relative to the pension benefit obligations held on your balance sheet?



Percentages do not add to 100% due to rounding.

Risk-transfer strategies:

Risk-transfer strategies seek to move pension risk from the plan sponsor to another party. One of the most straightforward approaches involves offering plan participants a lump-sum of money in exchange for their standard pension benefit, with the lump-sum approximately equal to the net present value of that benefit. This strategy settles the pension obligation from the balance sheet including ongoing PBGC and operational costs. The most common variant is a cashout for participants who are vested in the plan, are not retired, and are no longer employed by the organization. Plan sponsors are also completing cashouts for active participants of frozen plans, which can be offered to actives over age 62 from within the plan, or to any active participant through a spin-off transaction. In addition to cashouts for active employees, the Internal Revenue Service recently reopened the option for cashouts to retirees, which may be of interest to plan sponsors, especially in 2019 where the interest rate environment is favorable to cashouts.

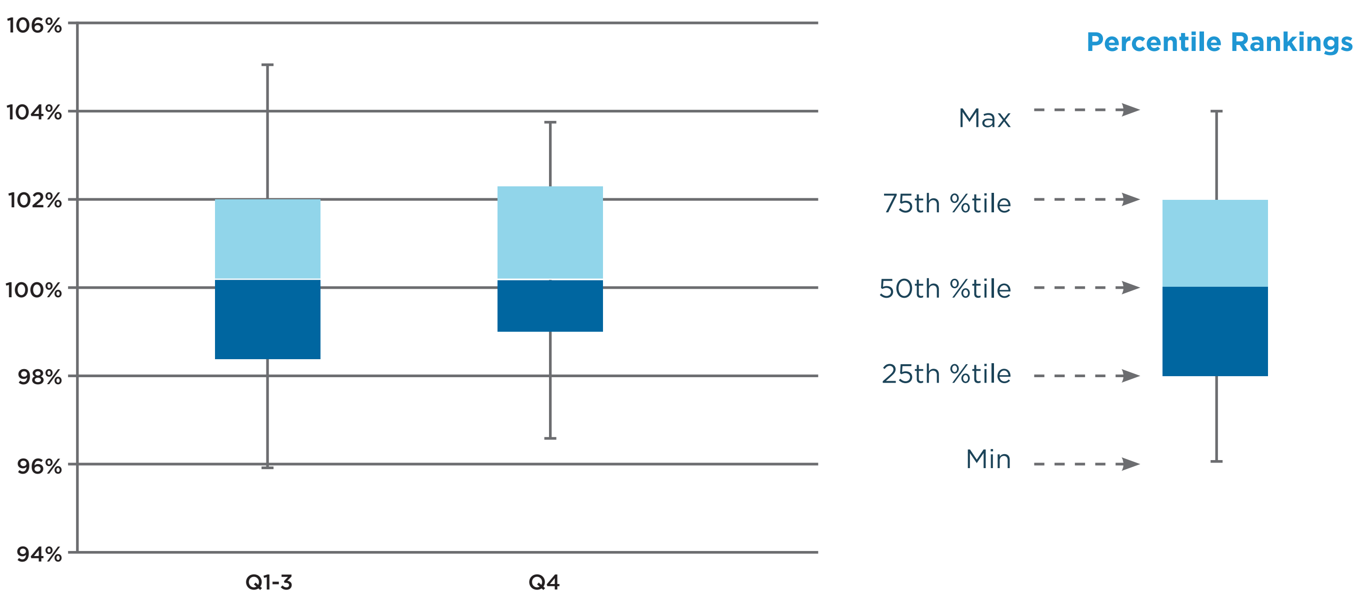
In the new survey, 83% of senior finance executives say their organizations have offered at least one lump-sum "window" to certain participants, have amended their plan to make a permanent lump-sum feature available when employees retire or are otherwise terminated, or have done both, up from 69% in 2017.

Eighty-six percent of sponsors who have offered a one-time lump-sum payment to plan participants say their organizations were satisfied or very satisfied with the outcome.

Meanwhile, 76% of sponsors say they consider it likely their organization will take some form of lump-sum-based risk-transfer action in 2019 or 2020, up from 55% in 2017. With interest rates reaching five-year highs in late 2018 and subsequently retreating a bit in early 2019, cashouts in 2019 may be particularly cost-effective for plans that use rates from the end of 2018 in their calculations.

Yet another option available to plan sponsors is to transfer some or all of their retiree obligation to an insurer through the purchase of an annuity. Under this

Premium vs. Market Liabilities Distribution by Quarter



approach, the associated liabilities disappear completely from the plan's books, and retiree payouts become the responsibility of the insurance company that issued the annuity. In years past, many plan sponsors assumed that annuity purchases were too expensive to make economic sense. That's still a common — but often unfounded — perception. In the latest survey, for example, 65% of respondents say they think an annuity buyout for retirees would be expensive (e.g., 110% to 115% of the pension benefit obligation held) or very expensive (greater than 115% of the PBO), while 29% think pricing between 105% and 110% of the PBO would be "affordable or competitively priced." In fact, Mercer's experience is that retiree-only annuity purchases typically cost between 98% and 103% of market liability, implying that a majority of respondents may be viewing the annuity cost as higher than it really is.

(**NB:** The above charts outline the results of Mercer's retiree buyouts, shown as a comparison to a standardized market liability.)

That said, a significant number of plan sponsors have warmed to the idea of annuity buyouts. Seventy percent of survey respondents say they're likely to transfer some or all of their retiree obligation from their DB plan through the purchase of an annuity in 2019 or 2020, up from 56% who were planning to do that two years ago.

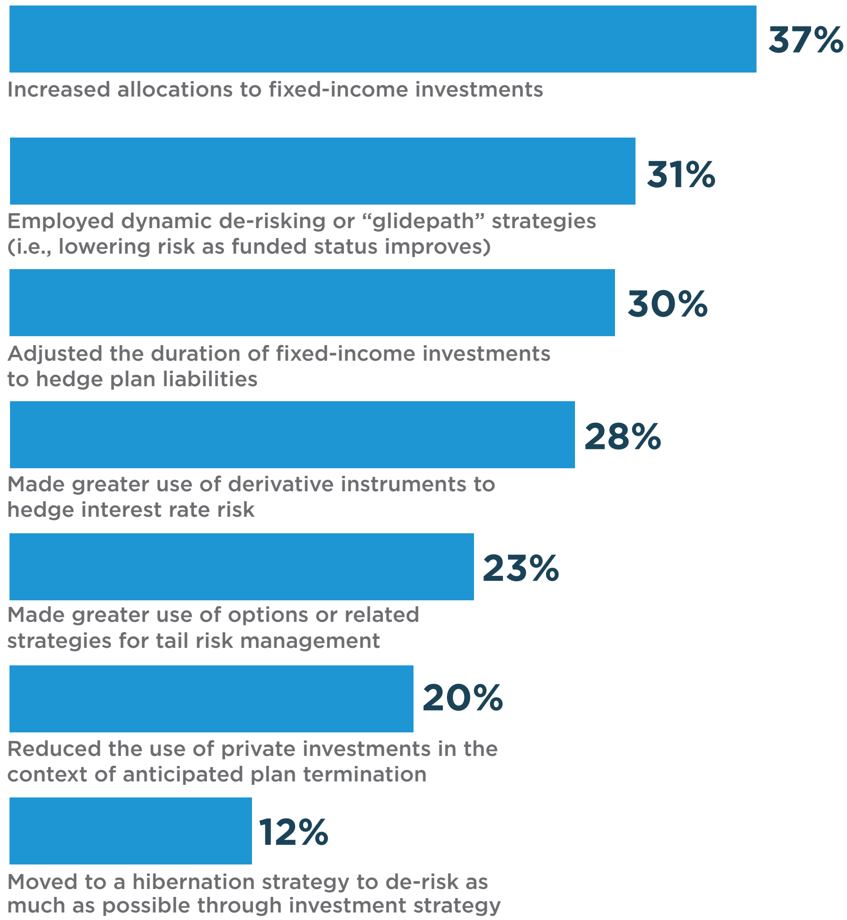
Among organizations that have not transferred liability through a retiree annuity purchase, 36% say it was because of the current funded status of their plan; 29% cite concerns about low interest rates; 27% say they worry about cash funding implications; and 26% blame adverse accounting implications or concerns about the impact on participants. Only 24% attribute it to concerns about the price of an annuity. While a retiree annuity purchase won't be right for all organizations, it remains for many a clear way to reduce plan size and risk.

While any of the de-risking strategies discussed here can be effective in isolation, it is important in practice to consider them in concert, both to maximize their utility and to avoid unintended consequences. (It would be possible, for example, to undo the benefit of de-risking by making additional contributions and not rebalancing the LDI portfolio.) Among the many organizations that made extra contributions to their plan as a result of the new corporate tax rates recently, nearly 45% went on to execute a pension risk-transfer strategy as a result; 31% took steps toward terminating a plan; and 26% migrated toward a lower-risk investment strategy.

"Pension risk transfers are one part of an overall pension risk strategy and should be integrated with funding policy and investment policy," says Danley of Schneider Electric. He adds that plan administration and data quality should not be overlooked either, as "risk transfers are much more difficult without accurate and reliable data and strong administrative support."

As noted earlier, organizations that have succeeded in reducing the size of their retiree liabilities are now in many cases looking to get out of the pension business altogether. Danley says outside support can be critical when working toward a plan termination. He suggests that sponsors bring in experts in various disciplines, including

Has your organization implemented any of the following investment-related actions for managing risk in its DB plan?



Multiple responses allowed

investments, regulatory compliance, and law. And because the selection of an insurance carrier is a fiduciary decision in a buyout transaction, he adds that choosing a strong annuity provider is critical, too.

With so much attention focused on plan liabilities and reducing risk in the investment portfolio, Mercer offers a final reminder to plan sponsors that they not forget about the growth segment of their investment portfolios. At a high level, the firm says, sponsors will want to ensure that their portfolios are well-diversified and resistant to potential shocks. Allocations to real assets, private equity and debt, hedge funds, and other alternative asset classes may help diversify common risk factors such as equity market volatility and inflation sensitivity.