CFO Insights
De-risking pensions: Can it be done?

There was a time when companies' typical approach to providing retirement benefits was to maintain open and accruing pension plans. To offset the company's ongoing costs associated with their pension plans, many focused on increasing investment returns of pension assets rather than on mitigating risk. But with pension deficits at near record highs for the largest 100 U.S. public company funds – $498 billion[1] – and market uncertainty almost a norm, such a laissez-faire approach is largely obsolete.

In fact, in the Q4 2011 *CFO Signals* survey, more than 95% of CFOs said they were actively using retirement risk reduction techniques.[2] While there is a broad range of such approaches, the majority of large companies surveyed appeared to have moved toward the middle of the continuum by coordinating the management of retirement assets and liabilities as well as limiting existing and future retirement liabilities through revised plan design (such as closing the plan to new hires or freezing future benefit accruals).

Still, in the face of increasing benefits costs and continued market volatility, many CFOs are wondering if such actions are enough. And those questions have become more pointed given that several large companies, including Ford Motor Co., General Motors, and Verizon, have recently undertaken efforts to de-risk their balance sheets through strategies that include settling pension liabilities due to former employees by offering voluntary lump sum payments or transferring defined benefit (DB) risk to a third-party insurer. While these strategies will play out over the next several years, many large-company CFOs are closely following these new approaches and wondering if now might be the time to follow suit.

In this issue of *CFO Insights*, we'll discuss some of the options CFOs have to manage the risks inherent in their DB plans and outline the factors to consider before adopting similar de-risking strategies.

Risk reduction techniques

The risks inherent in DB plans are well known to CFOs, and the last decade has brought a parade of bad news from unprecedented market volatility to sustained declines in interest rates. In addition, the regulatory environment has brought changes to both the accounting and funding of pension plans with FAS 158, IAS 19, the Pension Protection Act of 2006, and the recent MAP-21 legislation.[3] Indeed, the main constant has been change, leading to increased volatility for corporate earnings, balance sheets, and free cash flow as well as increased analyst and investor scrutiny of the legacy liabilities carried by many organizations.

Little wonder that in recent years, numerous companies have taken steps to reduce the risk associated with their DB plans. In general, their options fall into three buckets:

1. **DB plan redesign:** To reduce liability growth and risk, many companies have restructured their DB plans and moved existing and newly hired employees to defined contribution plans. In the Q4 2011 *CFO Signals* survey, in fact, plan closures were cited by 43% of respondents, while plan freezes were reported by 23% of CFOs.[4] The value, of course, is that such redesigns may reduce or cancel future benefit accruals in the DB plan. The problem, however, is that while changing plan design may reduce the pace of liability growth, it does not stem the risk exposure from legacy pension benefits.

2. **Financing and investment policy:** The most-cited risk management strategy in the Q4 2011 *CFO Signals* survey was liability-driven investment (LDI), with 52% of the CFOs surveyed indicating the use of some form of LDI-based approach.[5] Such approaches may include reducing equity price risk by lowering exposure to equities or reducing interest rate risk (asset liability mismatch) through long bond funds or synthetics. Companies hope that these portfolio modifications will result in a greater asset-liability match as interest rates fluctuate. However, with interest rates at historic lows, many CFOs question whether this is the time to be purchasing expensive longer duration bonds.

   Beyond traditional LDI, a myriad of new investment approaches are emerging, with strategies, such as annuity buy-ins, designed to provide a more precise liability hedge, avoid immediate income statement impacts, and maintain investment control for the company. In addition, insurance companies continue to innovate in this space as they deliver new variations of traditional LDI strategies to provide DB plan sponsors with additional tools to hedge pension liabilities.

3. **Liability management:** When we surveyed large company CFOs last year about their risk reduction strategies (see 4Q2011 *CFO Signals*), only a small proportion of companies had moved to more active liability management. But the options on that end of the risk management continuum are expected to experience substantial growth, particularly if the measures taken by Ford — which in April announced its intention to offer 90,000 white-collar retirees and former employees the option of taking their pension as a lump sum[6] — or General Motors — which also offered a lump sum and simultaneously entered into an agreement with Prudential Insurance Company of America to purchase a group annuity transferring to the insurer the responsibility for pension obligations covering GM's remaining eligible U.S salaried retirees[7] — are effective. Since then, a number of other large employers have announced optional lump sum offers to former employees who have not yet retired, and Verizon recently contracted directly with Prudential to settle $7.5 billion in retiree pension obligations through the purchase of a group annuity.[8]

Relief & regulation: Changes in the pension landscape

CFOs should carefully consider the legislative and regulatory landscape as they explore pension de-risking strategies. In particular:

1. **Moving Ahead for Progress in the 21st Century Act (MAP–21).** Part of the two-year omnibus highway transportation bill (H.R. 4348) signed into law by President Barack Obama last July. Allows employers to use a smoothed discount rate to determine cash contribution levels (as opposed to a current market rate). In the current environment, that produces a higher discount rate, which will allow companies to contribute less cash to their DB plans over the next couple years. For 2012, for example, the smoothed discount rates had to be within 10% of the average of benchmark bond rates for the 25-year-preceding period. This change also improves the funded status of the plan and can ease benefit restrictions for many plan sponsors and allow them to look at additional de-risking strategies.

2. **Pension Benefit Guaranty Corporation premiums.** MAP-21 also increased the premiums that companies pay to the PBGC — basically the insurance agency that insures pension benefits for employees if a company were to go bankrupt. Those premiums will rise 20% per year for 2013 and 2014. So when a company is considering whether or not to offer lump sums to terminated invested employees, CFOs should factor in that the payments that will be made on their behalf will rise significantly in the next few years.

3. **IAS 19.** Potential changes in U.S. GAAP that could accompany convergence with International Financial Reporting Standards could have a significant impact on the way that U.S. companies account for pensions. While the status and timeline of U.S. GAAP and IFRS convergence remains unresolved, the pension accounting changes made to International Accounting Standard 19 in 2011 eliminate smoothing opportunities that U.S. GAAP provides for pension sponsors. In addition, the revised IAS19 changes the way the investment return on assets is reflected in the annual pension expense, which may further encourage companies to look at alternative investment strategies focused more on de-risking rather than generating higher returns. In the meantime, it would behoove prudent CFOs, when they put together short-to-near term, or short-to-midterm, roadmaps for their pension plans, to take the impact of potential pension accounting changes into account.

These strategies can significantly reduce risk in the near term and also produce longer term administrative simplification for the companies. But significant risk reduction will likely come at some near-term cost to the plan sponsors. In October, General Motors, for example, announced that it expects to make total cash contributions of approximately $2.6 billion to its plan and record an approximately $2.9 billion pre-tax charge in the fourth quarter as a special item to reduce its retirement obligations by about $29 billion.[9]

Multiple considerations for CFOs

Before adopting any de-risking strategy, however, CFOs should consider the following factors:

Economic considerations: An important consideration for each company to assess is its perspective on interest rates. Many finance executives have been expecting U.S. rates to rise, but these increases have not materialized. And given the Federal Reserve's stance on maintaining a low interest rate environment through mid-2015 — coupled with greater demand for longer duration corporate bonds — companies should take the time to analyze the impact of potential economic scenarios on their balance sheet, profit and loss statement, and free cash flow. Such scenario analysis, including the risk and return trade-off of alternative strategies to the current state, can allow finance to better assess its risk tolerance and help determine if action should be undertaken promptly or to at least prepare longer term de-risking strategies that align with their views on interest rates and investment returns.

While evaluating the implications of various interest rate and investment return scenarios, companies should consider the overall financial implications of any de-risking strategy. With significant increases coming for Pension Benefit Guaranty Corporation (PBGC) premiums and the heavy hard and soft costs (e.g. vendor fees and senior management attention) of administering these plans, companies should weigh whether the near-term costs of de-risking can be offset by longer term savings.

Cash considerations: Some de-risking strategies require the pension plan to maintain a certain minimum funded status or may otherwise require cash infusions to implement the chosen de-risking approach. As such, companies should gain a clear understanding of the cash requirements of implementing and sustaining their desired approaches. While many companies are sitting on record levels of cash, capital investment needs continue to grow and may require companies to look for creative ways to fund their pension plans either internally or externally. But regardless of where the cash comes from, it is important to understand that simply funding the plan may actually increase the overall risk profile of the plan if the assets and liabilities remain misaligned. Consequently, any funding strategy should be coupled with a broad de-risking assessment to help maintain the improved funded status.

Regulatory considerations: One reason for the increased interest in lump-sum payment programs is a change in Internal Revenue Service (IRS) rules that made lump-sum payments economically more palatable for companies. Lump sums used to be expensive as a cash-out vehicle, but as of last January, many plans are allowed to calculate the lump sums on a similar basis as the plan liabilities themselves.[10] Looking forward, companies should anticipate regulatory changes to the mortality tables that the IRS prescribes as a minimum basis for lump sums. These tables will likely be updated in a way that increases lump sums, and companies should consider that as they evaluate their timing and approaches. Other regulatory considerations include a significant rise in PBGC insurance premiums as well as pending IFRS convergence rules on pension accounting (see sidebar: Relief & regulation: Changes in the pension landscape).

Talent considerations: Finally, another element to consider is talent. Many CFOs agree that their companies should pay attention to the role retirement benefits play in attracting and retaining employees. For companies that continue to offer DB plans, it can be prudent to measure the ROI gained from a talent perspective with certain employee segments. For companies that have already frozen their DB plans, alternative employee benefit programs may be necessary to attract or retain talent. As companies evaluate alternatives to their DB plans, they should try to understand the longer term implications on their active workforce, including the ability for employees to retire at appropriate ages and how future workforce management actions may be executed without the flexibility of a DB plan.

Four questions for your pension manager

Having an understanding of the economic, cash, regulatory, and talent considerations associated with DB plans can provide CFOs with the big picture framework for evaluating a de-risking strategy. Deciding what is right for your company, however, may require an in-depth evaluation of the different strategies for both your employees and your financial statements. And a good place to start is by asking your treasurer, pension manager, or pension consultant the following questions:

1. **What is the current asset allocation in our pension plan, and what is the risk associated with that allocation?** Pension investment portfolios typically consist of return-generating assets and interest-rate hedging assets. The mix of these assets can dictate how the portfolio performs under various economic scenarios. Many companies have revisited their investment strategies and are paying more attention to the hedge ratio and the asset liability mismatch so that the allocation aligns with their risk tolerance.

2. **How should we evaluate the new risk reduction products that financial service companies are offering?** In addition to the annuity buy-outs in the news, some companies have looked at annuity "buy-in" strategies, where instead of actually transferring the liability and assets to the insurance company, the pension plan basically invests in annuity contracts, offering a hedge against future risks. Other products include insured LDI strategies or derivative overlay strategies. Deciding which is right for your company requires thoughtful analysis that considers the pension plan's impact on the business, the company's risk tolerance, and a clear understanding of these emerging products. Given the interest of insurance companies and other financial institutions in tapping into the billions of dollars of corporate pension assets, there may be some advantages to being an early adopter of these emerging approaches despite the current interest rate environment.

3. **Should we consider new measures such as offering voluntary lump sums or transferring DB risk to an insurer?** There are several factors to consider. What is the potential additional cost of such a strategy? Which employee tranches should our company target? How will my current and former employees react? What are the potential benefits of employing such a strategy (e.g. reduced future PBGC premiums)? Analyzing each of these factors can help support the business case for or against such a strategy.

4. **Should we consider outsourcing the investment management of our plan?** This may be considered "investment outsourcing," but one option companies can explore is retaining an outside advisor who takes responsibility for investment decisions (such as investment manager selection) as co-fiduciary to the plan, in contrast with traditional investment consultants who provide advice. There are many qualified new entrants in the marketplace.

What's your road map?

Going forward, finance executives can expect continued volatility in their DB plans. But by evaluating their plan options as well as future economic considerations, and working with their internal and external pension advisors, they can develop a roadmap to help with de-risking over time. No pension plan may ever be risk free. But by developing a proactive strategy over a long-term time horizon, the company can focus on taking pension risk off the table and focusing on its core business.

Endnotes

1 The Milliman Pension Funding index as of October 2012 showed that the largest 100 U.S. public companies pension funds had a funding deficit of $498 billion. http://www.milliman.com/news-events/press/pdfs/pfi-november-2012.pdf

2 *CFO Signals*, Deloitte CFO Program, see 4Q2011, January 2012. http://www.deloitte.com/view/en_US/us/Insights/browse-by-role/Chief-Financial-Officer-CFO/CFO-Signals/5c801d135ef84310VgnVCM1000001a56f00aRCRD.htm?id=us_pr_cfo_signals_011712

3 FAS 158 refers to the Financial Accounting Standards Board's Statement 158: Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R) (http://www.fasb.org/summary/stsum158.shtml); IAS 19 refers to International Accounting Standard 19/Employee Benefits (http://www.iasplus.com/en/standards/standard17); the Pension Protection Act of 2006 was signed into law on August 17, 2006 (http://www.gpo.gov/fdsys/pkg/PLAW-109publ280/pdf/PLAW-109publ280.pdf); and MAP-21 legislation refers to the Moving Ahead for Progress in the 21st Century legislation, which contained a provision for pension relief. http://www.fhwa.dot.gov/map21/

4 *CFO Signals*, Deloitte CFO Program, see 4Q2011.

5 *CFO Signals*, Deloitte CFO Program, see 4Q2011.

6 Ford Motor Company, 8K, SEC filing, April 27, 2012; http://corporate.ford.com/our-company/investors/reports-financial-information/us-sec-edgar-filings?releaseId=1244753690043

7 General Motors, 8K, SEC filing, June 1, 2012; http://www.gm.com/company/investors/sec-filings.html

8 Verizon Communications Inc., 10Q, SEC filing, October 17,2012; http://eol.edgarexplorer.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?SessionID=zVjfFuRtw-kwYa-&ID=8879581

9 General Motors, 8K, SEC filing, October 31, 2012; http://www.gm.com/company/investors/sec-filings.html

10 Pension Rights Center, "Interest rates for lump sums;" http://www.pensionrights.org/issues/legislation/interest-rates-lump-sums

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