

Back to the Benefits Basics:

DB or Not DB—That Is the Question

by Glenn D. Bowen and Alan H. Perry

Recently, the decision to freeze a defined benefit (DB) plan appears to be a reaction to the plan's recent cost and impact on the company's financial statements, both heightened by wide swings in the equity and bond markets. Now companies are staring at new pension funding and accounting rules, fearing that the situation will only get worse. However, the authors of this article argue that such fear may be misplaced. The new funding rules should allow many sponsors to actually reduce the volatility of required funding costs and accounting impacts. For that matter, this revisited approach—which harkens back to the way pensions were once funded and managed—more closely resembles how companies fund defined contribution (DC) plans.

A sensible funding policy would be to contribute at least the value of our accruals every year, but we were prohibited from doing that in the late 1990s due to the maximum tax-deductible contribution of \$0. So, when things turned down, we were in a worse position than we would have been otherwise.

—*One benefits executive remarking on his past frustrations*

The pressures and frustrations many pension plan sponsors have experienced in the last decade over volatility in the capital markets and the evolution of pension funding and accounting rules have understandably left them confused and, perhaps, unsure on how to manage their defined benefit (DB) plans. Fortunately, now the pension environment is actually improving. The 2007 Milliman Pension Funding Study, which examines the financial reports of 100 large U.S. corporations with DB plans, found that liability increases slowed in 2006 as a result of increases in discount rates. The year's strong investment returns also boosted asset levels, thus driving plans' funded status to almost 100%.

At the same time that plans are less financially stressed, Congress has passed what amounts to a stabilizing force in the industry, the Pension Protection Act of 2006 (PPA). Meanwhile, revised accounting rules have cleared up some of the confusion over the way pensions will be reported on financial statements. All this makes for an opportunity to rethink and reposition DB plans as the attractive employee benefit that they are and as a long-term, strategic advantage to the employers that sponsor them. Like the good-intentioned benefits executive above, many managers and plans have gotten sidetracked in responding to the volatile marketplace and regulatory environment. Often they were pressured to take investment risks as a way to hold down short-term costs and minimize financial statement impacts.

And, even if they wanted to, sometimes managers were constrained from executing what they perceived as the prudent strategy, for example, funding accruals or contributing more into the plan than the legally required minimum.

Given this newly stabilized environment, what is a plan sponsor to do? This article looks at:

- The importance of making the “DB or not DB” decision and what to consider when making it—

specifically whether to maintain or freeze a DB plan

- How plan sponsors may have gotten sidetracked when managing their plans in the face of volatile capital markets and frenetic rules and regulations
- Why sound strategies from 30 or 40 years ago once again make sense
- How to effectively manage a DB plan under PPA, notably, by adopting a disciplined funding policy supported by liability-driven investment (LDI) strategies, which allow assets and liabilities to move more in tandem, thus reducing the strain of managing pension risk
- What's ahead.

DB OR NOT DB

There is a long-term advantage for employers that harness the strengths of DB plans to provide retirement benefits to their employees. For many companies with long-tenured workforces, having a DB plan is a competitive necessity.

Deciding whether to maintain or freeze a DB plan is a strategic choice for any organization; the decision needs to be based on careful cost/benefit analyses, which weigh the following:

- What does the DB plan cost long term, and how does that cost compare with what a defined contribution (DC) plan costs?
- How do employees value a DB plan, say, as compared to a DC plan, where they contribute a larger share and are individually responsible for making investment choices and bearing both investment and longevity risk?
- How does the DB plan affect both long service and newer employees, and how would changes to the DB plan affect both younger and older employees?
- If the long-term cost of the DB plan is deemed to be too high, how can the organization bring the plan's cost down to more acceptable levels by cutting accrual rates, raising normal retirement ages, curtailing early retirement subsidies/incentives, basing benefits on career pay rather than final pay, and the like?

These are the fundamental questions for DB plan sponsors today. In looking for answers, it is instructive to review how pension plans operated a generation ago.

HISTORICAL BUMPER CARS

There was a time when pension funding was more focused on stability than growth. Since the 1970s and early 1980s, however, many plans have gotten caught

in the boom/bust investment markets and the routinely changing and sometimes counterproductive regulations and tax laws. This trauma has sent some plan sponsors down dead ends. Especially during the 1990s, stocks soared and companies found that their pension assets delivered not only the expected investment return, but also enough additional return to cover the cost of accruals. Because they didn't have to contribute to the then-prospering plans, it was easy for employers to forget that pension plans cost money and require attention.

It's a painful irony: Over the last 30 years many plan sponsors made what seemed like perfectly logical choices for their plans at the time, in response to existing pressures. However, the decisions ultimately led them to take more risk with their DB plan than they may have realized. Specifically, plan sponsors focused on obtaining a high level of investment returns from the market while also taking advantage of sometimes-arcaic rules and regulations. In some cases, pension plans were treated as if they were a profit center.

The result of this bumper car pension strategy is shown in the figure on page 32, which depicts the hypothetical fluctuations plans could—and many actually did—experience as they bumped from one investment market to another, and from one fire to the next.

Fast-forwarding to the present, we now have PPA, new accounting standards (with more changes expected in the near future), funded status improvements and emerging demographic trends that will all significantly impact DB pension plans in the upcoming years. While plan sponsors continue to be concerned with the volatility of contribution requirements, accounting expense and balance sheet obligations, they now have several viable alternatives before them.

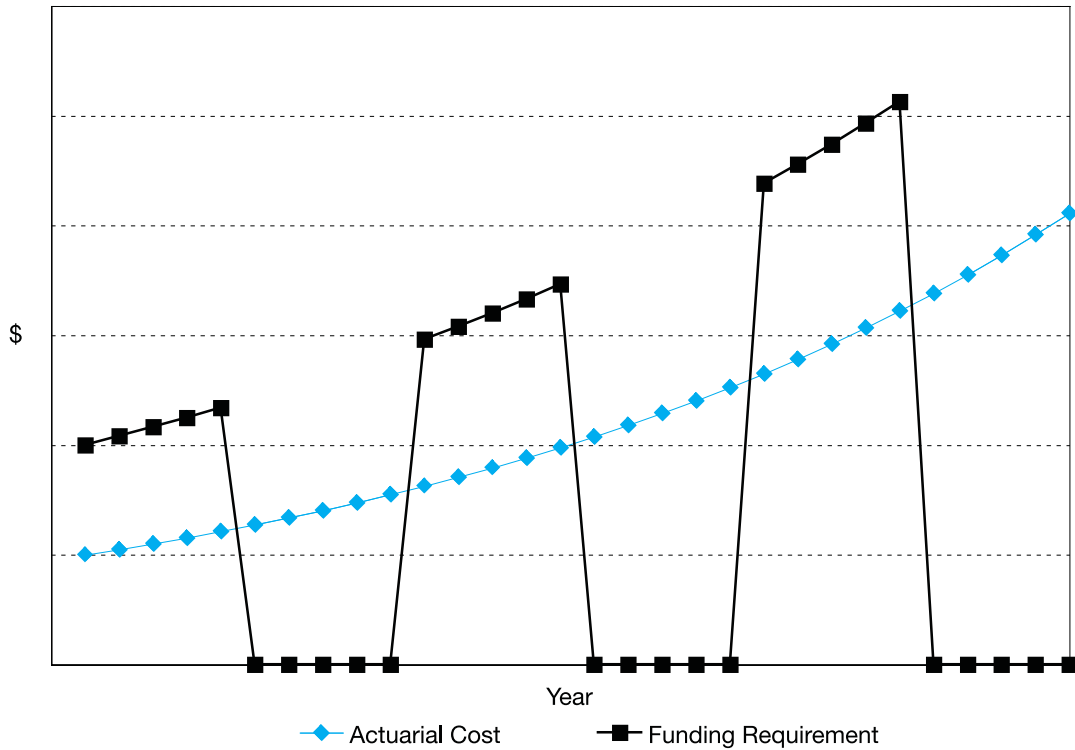
BACK TO FUNDING STABILITY—AND THE PAST

Given that many plans have recently reached improved funded status, there is no better time than the present for sponsors to reassess the expected costs and risks of their DB plans—before drastically changing their benefits policy (e.g., reducing benefit accruals or freezing them altogether).

Most corporate plan sponsors have a significant asset/liability mismatch and high funded status volatility with their plans. To reduce the risk, there is a relatively straightforward approach to managing plan assets that results in far fewer headaches—an approach known as liability-driven investing (LDI). Generally, LDI strategies are designed to manage the dynamic link between assets and liabilities and can

FIGURE

BUMPER CAR PENSION STRATEGY: HYPOTHETICAL FUNDING REQUIREMENT FLUCTUATIONS DUE TO BUMPING FROM ONE INVESTMENT MARKET BOUNCE TO ANOTHER



significantly reduce the impact of market movements on the pension plan—and ultimately on the sponsor’s financial future.

Under PPA, the discounted pension liability is determined by yields on high-quality bonds, not the “expected long-term return” on the plan’s assets, so there is no up-front cost reduction from pursuing a risky investment strategy. The chickens of cost reduction cannot be counted until the eggs of higher returns are actually hatched. A disciplined funding policy, combined with an LDI approach, ensures that the plan sponsor can closely control the plan’s funded status while keeping plan costs closely in line with long-term expectations. Just as with a DC plan, in which employers contribute a preset amount, DB plan sponsors can also develop a funding strategy that allows them to contribute a fixed percentage of pay or fixed dollar amount each year.

This admittedly conservative (but much less painful) approach resembles the way pension plans were managed in the early days. In the 1960s, for example,

actuarial assumptions typically included long-term investment return assumptions that were lower than yields on high-quality bonds. The salary growth assumption was set a few percentage points lower than the assumed investment return. Furthermore, mortality tables were updated periodically and contained margins to allow for future improvements.

The goal then was to have a relatively stable employer contribution (some focused on level dollar, others on level percentage of payroll); and plan assets were typically invested in insurance company contracts (utilizing the insurance company’s general account for most or all of the plan assets) or in trust accounts comprising balanced portfolios of fixed income and publicly traded equities where 50% stocks and 50% bonds would have been viewed as relatively aggressive. This contrasts with most of today’s plans, where investments are commonly weighted 60% stocks to 40% bonds or even tilted more toward equities.

The approach to pension plan management began to change with the enactment of the Employee Retirement

ment Income Security Act of 1974 (ERISA) and its subsequent amendments. Within a few years some employers started to ask, “Why are we contributing more than the ERISA minimum required contribution?” Some started to cut contributions back to that minimum level, especially during the early 1980s with the decline in the stock market and economic recession.

For those employers that continued to fund at the pre-ERISA “recommended” level, the implementation of Financial Accounting Standard 87 (FAS 87), in the late 1980s may have provided another signal that their pension plan was “overfunded.” Many plan sponsors started to accrue negative FAS 87 net periodic pension costs (a.k.a. pension “income”) on their financial statements.

LIABILITY-DRIVEN INVESTMENT (LDI)

As a result of new regulations and accounting pronouncements, plan sponsors are beginning to realize that the most appropriate investment benchmark is one that matches the market-based growth rate of liabilities. As such, many companies are investigating investment strategies that establish a stronger dynamic link between asset values and liabilities in order to preserve the funded status and mitigate pension financial risks. This is the aim of LDI.

With plan liabilities as the investment benchmark, LDI strategies tend to use a higher allocation to long-duration, fixed-income securities, which helps the value of assets to track the changes in the liability over time. Long-duration, fixed-income securities track liabilities more closely because both are valued using prevailing market interest rates. This common factor serves to stabilize the funded status, which in turn stabilizes the contribution requirements and the impact on financial results.

But there is no one-size-fits-all approach—Plan sponsors will arrive at different asset mixes due to differences in benefit formulas, plan demographics, funded status, size of plan relative to size of company, and the company’s ability and willingness to take additional investment risk in the hopes of reducing the long-term cost of the plan. LDI doesn’t imply an all-bond approach either, but it does tell us to get the right bonds into the portfolio, specifically, those bonds that will move in tandem with changes in liabilities. Further, many sponsors will continue to invest a portion of the portfolio in “return-seeking” investments, those that are expected to earn a return higher than the market-based growth rate in the liabilities.

While prevalent in Europe, LDI strategies have not yet been widely embraced by U.S. plan sponsors. However, a growing number report that they’re con-

sidering such a strategy. Surely, human resources executives who are under pressure because plan costs have been too volatile now have a viable option to present to chief financial officers (CFOs) and boardroom executives.

This is an opportune time to stabilize pension plans by employing LDI. Also, consider that well-funded plans can take advantage of their fortunate position and lock in past gains to ensure future stability and plan soundness. While a few extremely well-funded pension plans may be able to help plan sponsors pay the cost of retiree medical benefits, there is generally no tax-efficient way for plan sponsors to recover assets from a plan that is overfunded upon termination. Faced with this asymmetric risk, implementing an LDI strategy to guard against risks to a plan’s funded status may be a very attractive option.

CHANGES AHEAD

That’s not to say all is smooth sailing now: While PPA has calmed the waters on the funding calculations, accounting rules regarding how to compute the annual accounting cost will lag funding rules by perhaps two or three years. Currently, plans can still take credit for an expected higher investment return on a more aggressive portfolio, and have that higher amount drop directly to a firm’s bottom line. However, many expect the U.S. Financial Accounting Standards Board (FASB) to replace the expected return component with the actual return when it completes its Phase II reforms on pension accounting. International accounting standards are expected to converge to the same treatment.

Even as things stand now, however, plan sponsors have the opportunity to enact changes that will ensure greater control over their DB plans—ironically,

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STEPS TO PENSION STABILITY

Here are steps plan sponsors can take—in implementing a funding policy supported by liability-driven investing (LDI)—to reduce the financial volatility associated with pension plan funding.

First, determine the expected long-term cost of the plan under reasonable asset and liability assumptions and then determine whether the current benefit level still makes sense from a cost/benefit perspective. If necessary, modify the plan benefits to reduce the long-term cost to an affordable level. For example, plan sponsors might reduce future accruals, raise normal retirement ages, eliminate early retirement subsidies or change from final pay to career average or a cash balance formula.

Second, develop a contribution policy (e.g., a fixed dollar amount, a level percentage of payroll, or some other cost measure) that satisfies PPA and fits into the overall corporate strategy.

Third (and perhaps more technically), manage the short-term financial risks of the plan, which specifically means to:

- Set the investment benchmark equal to the market-based growth rate of the liabilities—PPA and FAS 158 use a market-based measure of liabilities. Then compare the risk and return of alternative portfolios to this benchmark.
- Measure the magnitude and financial implications of the existing asset-liability mismatch.
- Decrease the mismatch risk by increasing the allocation to fixed income and adjusting the duration to more closely match the duration of the liabilities. Derivatives, such as interest rate swaps and bond futures, can also be useful in this regard and play a key role in many current LDI strategies—But LDI can be implemented without them.
- Consider diversifying the “return-seeking” part of the portfolio into more than just U.S. and non-U.S. stocks. For example, consider real estate, private equity, commodities and hedge funds.
- Consider active management, including portable alpha strategies, as a way to increase returns without significantly increasing risk.

When deciding on the mix between liability-matching assets and “return-seeking” assets (in other words, how much asset-liability mismatch risk to take), the following questions should be critically examined:

- Is there a strong expectation that the mismatch risk will be rewarded?
- Is the sponsor in the financial position to bear the risk?
- Is there a strategic and tax-efficient use for the excess assets?

This course of action is designed to increase the predictability of DB pension plan funding and accounting results, which will ultimately lead to more restful nights for top executives and pension plan managers.

a situation that more closely resembles the funding pattern of DC plans. With PPA providing a wider range of funding contribution limits, plan sponsors can target the value of their accruals (especially because they're less likely to be limited to a zero-dollar maximum deductible contribution).

Although many plan sponsors may have to fund their plans at higher rates than in the past, they also have more flexible funding parameters. Thus, to avoid reliving past experiences with volatility, a plan sponsor can, for example, pay the value of benefits it accrues every year, precisely as a DC plan does. Although it may be expressed differently from one

organization to another, employing an LDI approach provides a disciplined framework in administering a DB plan. LDI can help provide exactly what employees and employers desire—but without the pain, volatility and chaos that pension plans have experienced over the last two decades.

By returning their pension plans to a stable funding strategy, many DB plan sponsors can do right by their employees, leave the plan headaches behind, and begin focusing on new opportunities and initiatives for managing employee benefits and moving ahead in today's competitive global marketplace. Welcome to the new “old” days for DB plans. ◀

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