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SECURING RETIREMENT OUTCOMES

TIME TO ACT ON PENSION RISK

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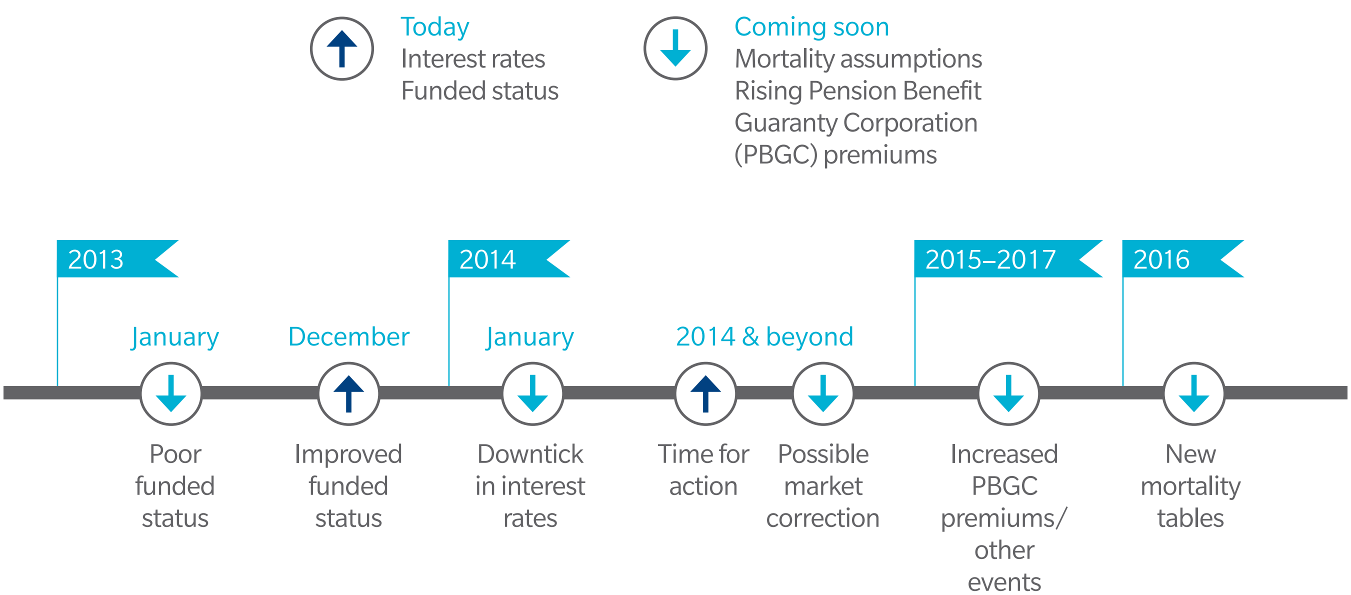
MARSH & McLENNAN COMPANIES

Improved funded status creates risk management opportunities — but the open window may soon close.

After five years of volatile economic conditions, pension plan sponsors may be wondering if they will ever get back to the halcyon days of a fully funded position that many of them enjoyed in 2007 and early 2008.[1] From late 2008 onwards, sponsors have faced a steep climb, as depressed equities hampered pension plan assets while declining interest rates drove significant increases in plan liabilities. US corporate pensions hit a low point at the end of July 2012, with plans sponsored by S&P 1500 organizations at only 69.5% funded, equating to an aggregate deficit of $689 billion.[2] These deficits caused many plan sponsors to defer action on pension risk management strategies — as well as required plan funding — as they waited for rising interest rates and recovering equity markets to bring plans back onto solid ground.

CONVERGENCE OF GOOD NEWS ... BUT FOR HOW LONG?

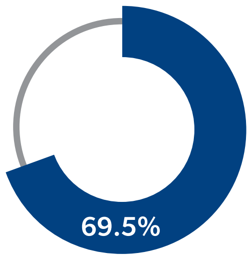


[1] The aggregated funded status estimation was 104.3% as of end of December 2007. Source: Mercer. *S&P 1500 Funded Status Report* (published monthly).

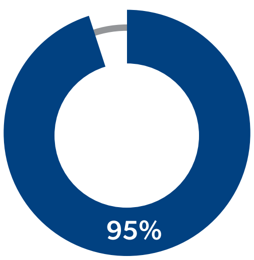
[2] Mercer. *S&P 1500 Funded Status Report*.

FUNDED STATUS ROSE SHARPLY

In July 2012, DB plans sponsored by S&P 1500 organizations were at only 69.5% funded.

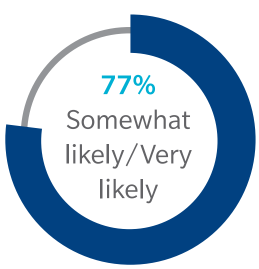


In December 2013, DB plans sponsored by S&P 1500 organizations were at nearly 95% funded.*



* Mercer estimates

HOW LIKELY IS YOUR COMPANY TO EMPLOY DYNAMIC DE-RISKING STRATEGIES IN THE NEXT TWO YEARS?



Source: *CFO Research and Mercer, 2013*

In 2013, plan sponsors began to see a light at the end of the tunnel as double-digit equity returns and rising interest rates resulted in significant improvements in funded status for most pension plans. In fact, Mercer estimates that as of December 31, 2013, the aggregate funded status of defined benefit (DB) plans sponsored by companies in the S&P 1500 was at nearly 95%, with 31% of plans over 100% funded.

The current environment offers plan sponsors an opportunity to explore risk management strategies that strike the right balance between cost and risk reduction. But this opportunity may be short-lived as companies face new uncertainties:

- How would changing interest rates or a moderate-to-severe market correction affect assets and liabilities?
- Will Congress look to further increase Pension Benefit Guaranty Corporation's (PBGC's) premiums, on top of the significant increases incorporated into MAP-21 legislation in 2012 and the budget deal signed in late 2013?
- To what extent will new statutory mortality tables increase participant lump sums, and how will these increases affect plan funding and the bottom line?
- Are plan sponsors prepared for the complex legal, administrative, and compliance issues in this new environment?

Pension risk management has entered a dynamic new era and the most successful plan sponsors will feature collaborative teams from HR and finance. These teams will have to be prepared for a range of potential opportunities; they will review (and overhaul as needed) governance structures, and develop and execute clear, proactive, and flexible plans. Of course, success will come much easier to those that have clearly communicated their course of action to both internal and external stakeholders. This paper lays out some of the options that sponsors should consider over the next 12 to 24 months to capitalize on the recent funded status improvements, while mitigating the potential headwinds on the horizon.

RISK MANAGEMENT CONSIDERATIONS

TAKING THE 'GLIDE PATH' TO THE NEXT LEVEL

Perhaps the most common approach to managing balance sheet volatility has been the "glide path." This approach aims to reduce risk levels as the fully funded target is approached. As companies reach full funding levels, many employers will be able to see that strategy make a soft landing and may choose to buy out past-service liabilities, either partially or completely.

Plan sponsors may wish to consider the following for glide path strategies:

THE MYTH OF THE PERFECT HEDGE.[3] For obligations that are retained by the plan sponsor, there is no such thing as a perfect hedge to the associated assets. Credit spreads and interest rate levels can change dramatically over time and interact in different ways along the yield curve. Liability-driven investment portfolio management requires a proactive blend of know-how and enabling governance to manage through these conditions. This becomes particularly important as you get further down the glide path, where plans are trying to maintain a high-interest-rate hedge. "Set it and forget it" hedging strategies are generally not going to result in optimal outcomes for the plan sponsor.

THE NEW FRONTIER OF GLIDE-PATH TRIGGERS.[4] Though most glide paths have triggers based on funded status, we see more and more companies interested in pursuing a two-pronged approach for which funded status remains a primary driver but that also incorporates interest rate triggers. This approach would help plan sponsors "lock in" interest rate increases when they occur. Also, sponsors looking to terminate the pension plan use time-based triggers to integrate their changes in asset allocation with the eventual purchase of annuities from a third-party insurer.

THE CASE FOR DERIVATIVES.[5] Pension plans generally use physical bonds to achieve the hedge. However, physical securities may not be sufficient to manage interest rate risk or may be an inefficient use of capital, and Mercer anticipates that more plan sponsors will use interest rate derivatives in 2014.

DON'T FORGET ABOUT THE GROWTH ASSETS. De-risking glide paths are intended to reduce risk as funded status improves and generally result in a reduction in the allocation to growth assets. The expected return for the assets will then typically fall as well. But in many cases, sponsors can reduce risk without necessarily reducing returns through optimizing the growth portfolio by adding new asset classes and investments other than equities. A diversified growth portfolio can have an expected risk level as much as one-third lower than an equity-only portfolio.

CASE STUDIES

Glide-Path Management

Our client — a global multi-national company — implemented a glide path in a number of its plans in 2013. The glide path was monitored and executed on a daily basis, resulting in three triggers being hit over the year — opportunities that may have been missed with a less frequent monitoring approach. The end result was a phased move from short bonds to liability-matching bonds, thus achieving a key goal to reduce income statement volatility.

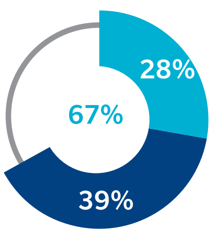
Mercer Pension Buyout Index

Our client regularly monitors buyout pricing and the investment board receives a dashboard with key financial metrics along with clear go/no-go decision points. This increased scrutiny provides all stakeholders with clarity around the decision to proceed when the price is right.

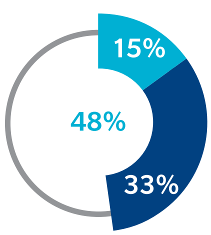
[3] Mercer. *Best Ideas for the Liability Hedge Portfolio*, 2013.
[4] Mercer. *Growth Portfolio Along a De-risking Glide Path*, 2013.
[5] Mercer. *DB Pensions — Where To Go From Here?*, 2013.

RISK MANAGEMENT SURVEY: HOW LIKELY IS YOUR COMPANY TO UNDERTAKE THE FOLLOWING RISK-MANAGEMENT INITIATIVES IN ITS DB PLAN IN THE NEXT TWO YEARS?

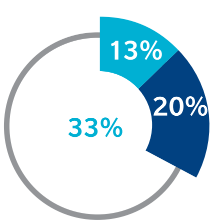
Lump-sum distribution for former employees who have not yet retired (either as a one-time window or as an ongoing feature)



Purchase annuities to transfer liabilities to a third party



Terminate one or more DB plans



- Very likely
- Somewhat likely/will consider

Source: *Mercer and CFO Magazine Pension Risk Survey (2013), Evolving Pension Risk Strategies — The Journey to Risk Transfer and Outcomes-Based Objectives*

CONSIDER CASHOUT STRATEGIES[6]

Finance executives show a growing interest in transferring portions of their DB portfolios to third parties, such as insurance companies, in the form of annuities or lump-sum cashouts to plan participants. A recent Mercer survey revealed that more than two-thirds (69%) of plan sponsors are somewhat or very likely to offer lump-sum distributions to current employees at some point in the future. Additionally, 67% said they are somewhat or very likely to offer cashouts to former employees. Cashouts can often be the first step on a risk management journey. Plan sponsors have a fair amount of flexibility in developing cashout programs by determining which groups could be offered cashouts, fixing the maximum amounts for the lump sum, and choosing the frequency of setting interest rates for the cashout offering.

With PBGC premiums rising dramatically in 2015 and thereafter — coupled with liability increases from new IRS-mandated mortality tables — 2014 looks to be a good time to explore a cashout of terminated vested participants. In our experience, the economic benefits of lower PBGC premiums and other administrative- and investment-related costs, along with transferring the longevity risks, will typically outweigh the cost of executing on a cashout program. Furthermore, risk management could be substantially improved as these liabilities often have long durations and are subject to significant interest rate risk.

CONSIDER RETIREE BUYOUTS

In addition to cashouts, many sponsors are considering retiree buyouts as a risk management alternative. This is because the expenses, mortality risk, and other costs of self-insurance can now equal or even exceed the cost of insuring the liability through a third party. Our 2013 survey indicated that 48% of plan sponsors are somewhat or very likely to transfer liability to a third party via an annuity purchase in the next two years. This option is most attractive to sponsors interested in reducing the size of their obligations, especially given that self-insurance still leaves residual liability, credit, and asset risk on the balance sheet. The relative value of a retiree buyout to self-insuring varies based on a number of factors: interest rates, credit markets, insurer capacity, reserving requirements, and opportunity costs.

The cost of an annuity purchase for a typical retiree group may be virtually the same as the cost of keeping these retirees in the plan. The Mercer US Pension Buyout Index tracks these costs on a monthly basis, and the December update indicated that the cost of purchasing annuities for a sample retiree group from an insurer was 108.5% of a typical balance sheet liability. By comparison, the economic cost of holding liabilities in the plan was estimated to be 108.6%, which includes an allowance for future retention costs (administrative, PBGC premiums, and investment expenses) as well as a reserve for future improvements in life expectancy. Transferring these retiree liabilities to an insurer removes volatility from the balance sheet and income statement.

[6] Brennan S. "Out in Front: Preparing for the Next Phase of Pensions Risk Management," Fall (2013).

ACCELERATING CONTRIBUTIONS

The funding relief provided under MAP-21 allows for plans to fund at lower levels. However, many sponsors are making discretionary contributions to improve the funded status, especially for plans that are on a de-risking glide path but have a funded status that is much lower than the first trigger point. Accelerating contributions has the added benefit of reducing the PBGC variable rate premiums that are linked to the size of the deficit. This gives an effective “free” return of nearly 2% to these assets under the current rules, and closer to 3% under the new rules as they phase in. Furthermore, under US GAAP accounting rules, sponsors are able to take credit for the expected return on these assets to help lower their P&L expense.

IF NOT NOW, WHEN?

OPEN WINDOW MAY SOON CLOSE

Five years ago, there was little difference between pension plans, as practically all were hit hard by the economic downturn and most were following the same investment strategy. More recently, plans have separated into those that are proactive in their decision-making and have adopted risk management changes, and those that are maintaining the same investment strategy.

For companies that have not acted on their DB plans, 2014 may present the last significant chance for some time to enhance risk management strategies. Like a roller-coaster ride, the high points can pass quickly before the train heads back downhill. The fleeting nature of many recent opportunities has highlighted the need for action. If plan sponsors execute, and do so effectively, they can create material financial value for their plans. Others will remain on the sidelines, waiting for the next opportunity to act.

For plan sponsors who are concerned with the level of risk posed by their plans, now is a good time to act and develop a strategy that incorporates a glide path, cashout, or annuity buyout. Sponsors will also need to determine the appropriate implementation approach and follow an integrated governance structure to ensure that they meet the program’s objectives. Many plan sponsors, especially those with limited internal resources, have decided to delegate these functions and focus on their core business. Mercer expects this trend to continue, with companies increasingly turning to third parties to monitor the glide path, trade executions, manager selection, contracting, and oversight.

LESSONS FROM EXPERIENCE

Engage Internal and External Stakeholders

Early on, finance and HR will need to agree on which actions are viable for achieving corporate pension risk objectives.

Plan, but Remain Flexible

Any risk management timeline should indicate when events might occur, but actual execution will depend on market conditions, corporate financial position, and many other elements.

Monitor Frequently

Most plan sponsors used to assess plan asset values quarterly and liability values annually. Now internal and external stakeholders need this information daily. The broader tool kit requires an expanded set of monitored metrics, including cash flow and earnings, interest rates, relative value of credit bonds versus government bonds, and lump sum/annuity costs versus accounting liabilities.

Budget for Costs and Time

Intensive data preparation is necessary to achieve pension risk transfers. This often takes many months — sometimes years — and consumes significant resources.

Coordinate Investments with Risk Transfer

Both lump sums and annuity buyouts have unique investment planning requirements, from adhering to the regulatory timing and basis for lump-sum interest rates to managing portfolios consistent with insurer pricing of annuities.

MORE INFORMATION

Mercer advises on and implements comprehensive, leading-edge solutions to create sustainable retirement programs. We partner successfully with Fortune 1500 companies to help them meet past commitments and plan for future needs, achieve business and fiduciary objectives, manage investment and retirement risks and their financial impact on business, and create and strengthen retirement plans that engage the workforce.

For more on Mercer's capabilities and pressing issues in investments and retirement planning, visit www.mercer.com/pensionrisk.

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