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FUNDING STABILIZATION
FINANCIAL IMPLICATIONS AND TRADE-OFFS

MARSH & McLENNAN COMPANIES

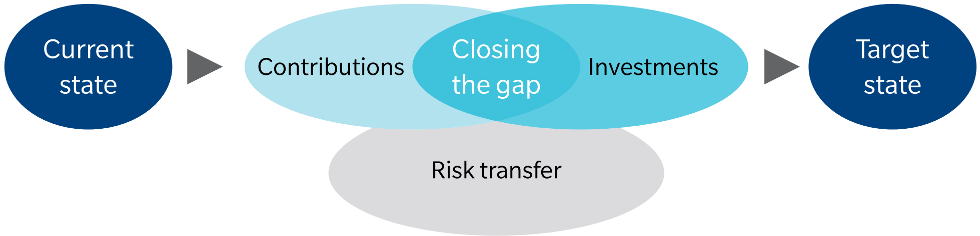
FUNDING STABILIZATION FINANCIAL IMPLICATIONS AND TRADE-OFFS

With funding stabilization legislation a reality, many plan sponsors now have the flexibility to reduce contributions to their plans in the near term. This relief, however, comes at a price – Pension Benefit Guaranty Corporation (PBGC) flat-rate premiums will increase significantly, while variable-rate premiums on unfunded vested benefits will double by 2015, amounting to nearly 2% of the plan's deficit.

While this relief is a welcome change for many sponsors, providing much-needed flexibility to defer pension contributions to meet short-term cash needs of their business, we believe that taking advantage of the relief may not be optimal for some organizations, and options should be evaluated carefully. The new law raises several considerations related to the desired level and predictability of contributions over the next few years as well as potential trade-offs between cash, accounting and PBGC costs. Finally, plan costs and risks should be considered based not only on contribution options but also on investment and risk-transfer approaches.

All of these considerations fit within Mercer's pension risk management framework, as shown below. We believe plan sponsors need to take a holistic view of plan management, incorporating investments, contributions and risk transfers to get from where they are today to their desired target state.

Mercer's Risk Management Framework



CONTRIBUTIONS

Funding relief comes in the form of a 25-year average to determine the interest rate used to discount future benefit payments. This results in a higher rate than current economic conditions allow, thereby lowering plan obligations and contributions. Sponsors need to evaluate whether to reduce contributions in light of this funding relief. For the second half of 2012, this is effectively a decision on whether to pay their originally scheduled contributions or to reduce them, thereby deferring those contributions to future years.

It is important to remember that the legislation has not changed the fundamental economics of investing plan assets to meet future obligations. A plan that is obliged to pay a pension of $1,000 in the future retains the same obligation and will have to contribute and invest to meet this goal over the long term. The new law gives the option to defer but does not ultimately reduce required contributions, unless investment returns are strong enough to fully fund the plan and make up for the higher contributions that would have been required under the old law.

Changes in PBGC premiums make the cost of underfunding and contribution deferral more expensive than before. The annual PBGC levy on unfunded liabilities will move from 0.9% to 1.8% over the next few years. This creates a trade-off to be considered between any savings achieved by contribution deferral and the associated PBGC costs. For sponsors that decide to maintain their pre-stabilization contribution levels, or who have the ability to issue debt at low interest rates to fund their plan, reducing or eliminating PBGC variable premiums through additional funding is a compelling option.

Deferring contributions also results in higher accounting costs resulting from a reduction in the expected-return-on-assets component of pension expense amounts. While the expected-return-on-assets amount is not income in economic or risk-adjusted terms, many sponsors are still focused on this amount, as it affects their net income.

INVESTMENTS

Many sponsors that are concerned about the impact of lower pension-funding requirements on their business will also need to assess their investment policy. Even if a sponsor decides not to change contribution levels, various funding thresholds have changed that may influence the sponsor's risk posture and investment policy. This may result in changes to the composition of a sponsor's portfolio of liability hedging assets and/or the balance between growth and hedging assets and how that changes over time.

In recent years, considerable attention has been paid to liability-driven investment (LDI) strategies, through which plan assets are invested in a way to match the movements in the liabilities. The net effect is to reduce funded status volatility (and by extension, volatility on funding requirements, P&L expense and the balance sheet). A typical LDI strategy often includes two elements:

1. A move to long-duration bonds
2. A reduction in equity allocation, which is often linked to an improvement in funded status

For the increasing number of sponsors implementing LDI strategies, long bonds are considered a low-risk asset, as their values change broadly in line with plan liabilities. However, the 25-year smoothing of the discount rate results in far less liability sensitivity to interest rates over the short term. This means that contribution volatility in the short term with an existing LDI policy could be higher than it would be without an LDI approach in place. However, LDI policies are still effective in reducing volatility of accounting costs and volatility of contribution costs over the longer term when funding stabilization is effectively phased out.

Sponsors that are sensitive specifically to short-term contribution volatility may wish to adapt their existing LDI policies or slow down the transition to LDI over the next few years in order to minimize the volatility of contributions. Other sponsors could see this as an investment opportunity providing some short-term flexibility with hedging interest rate volatility. An evaluation of any changes will depend on sponsors' views of the host of other factors outlined below.

- Funding stabilization does not change the underlying economic risks that would need to be addressed through additional contributions when the relief is effectively phased out. If sponsors reduce their "hedge ratios" in the short term, any change in their deficit resulting from interest rate movements over the next few years will still likely need to be paid for later. Therefore, while short-term contribution volatility may be lessened, or tactical investment opportunities put to work, by changes to a sponsor's LDI strategy, this should be measured in the context of any resulting longer term volatility and potential cost.
- Given the significant reduction in required contributions, short-term contribution volatility may not be a significant enough concern for many sponsors to alter their investment policy materially.
- While short-term modifications to a sponsor's LDI strategy may reduce contribution volatility, the impact on volatility may not be that material. The actual volatility impact should be measured relative to other considerations before any action is taken.
- Unlike contribution costs, accounting requirements are unchanged by the legislation. The pension plan directly affects a sponsor through the balance sheet and income statement that are measured in line with US GAAP rules. For many sponsors, these financial metrics are even more important than cash funding measures, and we often see sponsors develop their investment strategies to reduce the volatility of these key accounting measures. Therefore, while funding reform may offer some near-term opportunities for managing cash, a change in LDI strategy or reduced contribution levels would likely come at the expense of increasing volatility of accounting costs.
- Any significant changes to a sponsor's existing LDI strategy would likely require a corresponding gradual return to the original LDI strategy. This "round trip" strategy would require a high degree of oversight and proactive management, and sponsors will need to determine if the short-term benefits outweigh such governance and resourcing costs.

We anticipate that while some cash-strapped sponsors may change their LDI strategy or transition speed, others may use the shorter-term flexibility to avail themselves of tactical opportunities. Given some of the long-term economic, governance and accounting considerations, many will also stay the course with their existing approach. Regardless of the path chosen, the implications and trade-offs should be evaluated fully so that sponsors are not surprised by unintended risks.

While the composition of the hedge portfolio is an important consideration, given the change in the minimum contribution outlook, sponsors may wish to evaluate their broader risk budget in terms of the balance between growth and hedging assets. For example, for cash-strapped sponsors, a move from growth to hedging assets may be a more effective way to reduce contribution volatility than changing the composition of their hedge portfolio.

Many sponsors have also implemented or are formulating dynamic de-risking strategies. Does this approach still work in the world of funding stabilization? It certainly remains the case that equities in the portfolio produce funded status volatility. Therefore, a strategy to remove equity risk is still relevant under funding stabilization. However, for sponsors that defer contributions as a result of funding stabilization, the lower contribution amounts will likely lengthen the amount of time to hit funded status triggers that drive asset allocation changes. Therefore, it may be prudent for plan sponsors with glide-path strategies to revisit the strategy and determine whether triggers need to be refined to maintain the same pace of risk reduction as originally desired.

RISK TRANSFER

An increasing number of plans are looking to transfer their liability to participants in the form of lump sums. Cashing out participants has the same theoretical risk-mitigation impact as purchasing a portfolio of duration-matched fixed income, but with the added benefits of no default risk, no investment management fees, and lower administrative and PBGC premium costs. We believe that the increase in PBGC premiums makes this strategy even more appealing and suggest that sponsors give this serious consideration. This is particularly true for participants with smaller benefits. Sponsors that are potentially affected by the $400 per participant cap on the variable rate premium may find that cashing out small benefits will result in significant premium savings.

Lump sum cash-outs can result in accounting settlement costs that may be a mitigating factor for many sponsors. Also, for underfunded plans, this would result in a reduction in the funded status and could accelerate contributions relative to the new lower level required by funding stabilization, but contributions may still be lower than originally budgeted before the new law. As with the other considerations, this will require a more in-depth analysis of these options to determine the optimal approach in the new environment.

THE NEED TO COORDINATE

Strategies to fully fund plans involve a combination of contribution policy, investment returns and risk transfers, where appropriate. These levers are inextricably linked in the financial management of pension plans. Mercer believes that contribution decisions must be combined with an evaluation of investment policy and risk transfer opportunities to ensure that opportunities for risk reduction and maximizing returns are not missed.

For example, sponsors may wish to maintain the existing budgeted contribution levels in the short term in order to create a contribution buffer that can be utilized in future years to manage downside contribution volatility. In this respect, sponsors face a choice between reducing imminent contributions and having more flexibility and predictability in future years. Maintaining such a buffer may also be appealing in light of the increased PBGC costs.

In summary, the new law heightens the various trade-offs that need to be resolved by a plan sponsor. The exhibit below illustrates some of these. It is clear that funding stabilization presents many complex issues, and it is crucial for sponsors to work through these in a deliberate and coordinated manner.

Mercer's Risk Management Framework for Plan Sponsors

If your objective is to ...	Contribution policy action:	Investment policy action:	Implications
Minimize contributions	Pay minimum required using the new rules	No change	Higher PBGC premiums and accounting costs
Minimize contribution volatility	Pay more than minimum; potentially old budgeted amount	No change to hedging assets; potentially adapt glide-path triggers	Forego the opportunity to pay lower contributions in the short term, but no adverse consequences relative to the pre-stabilization rules
Minimize short-term contributions and contribution volatility	Pay minimum required	Potentially adapt or delay LDI policy in short term, but modify proactively	Higher PBGC premiums and accounting costs; investment governance challenges
Minimize PBGC premiums	Pay more than minimum; potentially old budgeted amount	No change	Forego the opportunity to pay lower contributions in the short term, but no adverse consequences related to the pre-stabilization rules
Minimize accounting cost impact	Pay old budgeted contribution amount	No change	Forego the opportunity to pay lower contributions in the short term, but no adverse consequences relative to the pre-stabilization rules

Very few sponsors have only one exclusive objective, and many of the objectives above involve different risk management answers. It is therefore critical for plan sponsors to work through these trade-offs deliberately in order to make their decisions in a fully informed way and to ensure that no unintended costs or risks are incurred.

To learn more about pension risk management, please visit Mercer's site Taking Pension Risk Off the Table.

IMPORTANT NOTICES

For further information, please contact
your local Mercer office or visit our website at:
www.mercer.com

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Australia	Netherlands
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Chile	Poland
China	Portugal
Colombia	Saudi Arabia
Czech Republic	Singapore
Denmark	South Korea
Finland	Spain
France	Sweden
Germany	Switzerland
Hong Kong	Taiwan
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Ireland	United Arab Emirates
Italy	United Kingdom
Japan	United States
Malaysia	Venezuela

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