The "1-2-3s" of Pension Derisking: Three Tactics for Financial Stability

by **Zorast Wadia** | *Milliman* and **Heidi tenBroek** | *Milliman*

The year 2020 provided no shortage of volatility for corporations around the globe. From the continuing low-interest-rate environment to the operational and economic disruption caused by the COVID-19 pandemic, executives have been faced with enormous challenges. As the C-Suite seeks balance sheet stability, it's no wonder that some of the largest U.S. corporations have renewed their interest in pension derisking. Based on the data collected for the Milliman *2020 Corporate Pension Funding Study,* approximately two-thirds of the nation's 100 largest corporate defined benefit (DB) pension plans (known as the *Milliman 100)* are *frozen*—closed to new entrants and/or having ceased benefit accruals.[1]

A plan freeze is one of the more drastic tactics for executives considering pension derisking, and it often just stops the bleeding while not sufficiently removing risk from a pension plan. At the same time, even while employers may be attempting to rein in their costs, these pension plans also provide critically important human resources (HR) tools in the form of talent recruitment and orderly retirement. Thirteen of the companies on *Fortune* magazine's list of the "30 Best Workplaces to Retire From" offer DB pension plans.[2] Because so many employers have moved to defined contribution (DC) plans, a company offering a pension could have a crucial differentiator when it comes to hiring. Furthermore, a pension can be a strong driver of retention—but only if employees are aware of the plan and its value. (For employers that have a pension plan, it's vital to communicate its benefits to employees.) DB plans also provide benefits to employers that are exclusive to these plans, such as workforce management to enhance the streamlining and retention of employees.

With three once-in-a-lifetime financial crises within the past 20 years, it's not surprising that employers may be looking for stability in this new normal. While there are a number of pension derisking tactics, they are not all created equal. Terminations, freezes and lump-sum payouts may too often be first choices when there are innovative strategies that could allow companies to maintain what's most useful about DB pension plans while also providing financial stability. This article explores three different tactics Fortune 100 companies may

AT A GLANCE

- Facing a low-interest-rate environment and economic volatility, many large U.S. corporations have renewed their interest in pension derisking.
- Employers may want to consider some innovative options rather than proceeding with terminations, freezes and lump-sum payouts.
- Asset-liability matching and transferring pension risk to an insurer are among the derisking options companies may consider.
- The most potential for innovative and effective derisking is through changes in plan design, including implementing a cash balance plan or variable annuity plan.

consider for analyzing risk, derisking pensions and increasing financial stability. They are intended as starting points for companies thinking about the wide range of derisking options.

Asset-Liability Management

Asset-liability management (ALM) strategies for derisking have been widely developed and deployed. They include asset allocation adjustments, use of liability-driven investment (LDI) techniques, immunization, glide paths and more. The majority of companies in the Milliman 100, for example, have already begun derisking their plans, often using LDI glide paths. Generally, LDI strategies are designed to manage the dynamic link between assets and liabilities, shifting more assets into fixed income positions as the plan's funded percentage gradually improves. These strategies can significantly reduce the impact of market movements on pension plans. A disciplined funding policy, combined with an LDI approach, ensures that a plan sponsor can closely control a plan's funded status while keeping plan costs in line with long-term expectations.

The use of LDI among plan sponsors has been trending for 15 years and continued in 2019, with the Milliman *Corporate Pension Funding Study* showing that, as of the end of fiscal year (FY) 2019, roughly 33% of pension fund assets were allocated to equities, while 49% were allocated to fixed income and 18% were allocated to other investments. While less than a handful of firms maintain up to 80% positions in equities, the overwhelming majority of companies in the Milliman 100 have decreased their equity allocations since 2005, as can be seen in Figure 1. By the end of the 2014 fiscal year, 86 companies in the Milliman 100 had fixed income allocations greater than 40%—And they have maintained those levels since.[3]

All the evidence indicates that use of LDI techniques continues to be a useful and flexible way for plan sponsors to significantly decrease the risks in their DB pension plans.

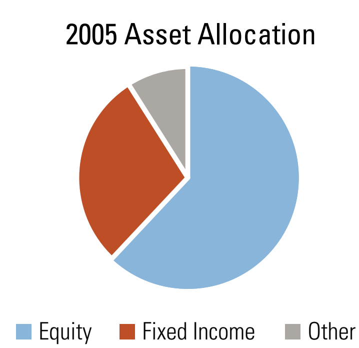
Pension Risk Transfers

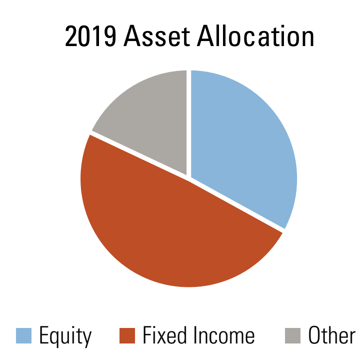
If a plan sponsor has already taken the step of freezing its plan, a number of pension risk transfer options are available to consider. Lump-sum window offers made to terminated vested participants, which may now also be offered to some retirees as well, have one primary goal in mind: getting participants and their associated long-term liabilities out of the plan. Because of interest rate volatility and various interest rate arbitrage opportunities, the lump-sum payout continues to be the low-hanging fruit of derisking efforts. In addition, reducing the size of the plan by implementing a lump-sum window would create current and future Pension Benefit Guaranty Corporation (PBGC) premium savings, which have the potential to grow should an employer's variable rate premium component be limited by a per participant dollar cap.

But beyond lump-sum window offers, a number of third-party transfer strategies are available as well, including annuity purchases for blocks of participants, leading to partial or whole plan termination. According to the Milliman *Pension Buyout Index,* for employers looking to transfer pension risk to an insurer, the average estimated retiree buyout cost in February was 102.1% of accounting liabilities. Among the most competitive insurers, the average estimated retiree buyout cost was 99.3% of accounting liabilities. Termination is, of course, the most severe step that a plan sponsor can take. It is generally for the sponsor with zero risk tolerance—one that is willing and able to pay up immediately to offload all pension risk.

Looking at the Milliman 100 plans over the past few years, plan sponsors continued to be active making these

FIGURE 1





types of transfers in the 2019 fiscal year, although volume as measured among the Milliman 100 companies was down relative to the 2018 fiscal year. Pension assets and liabilities were either transferred to insurance companies or paid out to participants in significant volumes. Examples of companies and their total transactions include GE ($2.7 billion), Lockheed Martin Corporation ($1.9 billion), PepsiCo ($1.3 billion) and Ford Motor Company ($1.3 billion).[4]

Clearly, transferring pension risk to an insurer can be an effective way to reduce a plan's balance sheet footprint. But this generally also has an adverse effect on the plan's funded status since assets paid to transfer accrued pension liabilities are higher than the corresponding actuarial liabilities that are extinguished from the plan. Derisking comes at a financial cost, and third-party risk transfer strategies to insurance companies, such as annuity purchases and plan termination, are often the costliest of available options. Pension plan termination also eliminates the HR tools that are part of the DNA of a DB plan.

Plan Design

Perhaps the most potential for innovative and effective derisking is in the many options available for working with plan designs. Derisking through a change in plan design—as opposed to termination, third-party pension risk transfer or ALM—can be valuable for employers from an HR and recruiting perspective while lowering the potential effects of market volatility.

Cash Balance Plans

In today's developing retirement crisis, as people are retiring with inadequate funds in their DC plans, more employer HR groups are beginning to take another look at DB pension structures to maximize employee attraction and retention. A cash balance plan may successfully redefine a more desired level of risk sharing between employer and employee. Cash balance plans are DB plans with some of the features of a DC plan, basing the benefit on a stated account balance subject to market forces. Cash balance plan benefits are also generally based on more inexpensive unit accrual types of formulas or career average earnings as opposed to final average earnings.

In a typical cash balance plan, an individual's employee account is funded by the employer each year (say at the rate of 5% of compensation) along with an interest rate that is either fixed or variable, linked to an index such as the ten-year Treasury. Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised to participants. Thus, the investment risks are borne solely by the employer. However, the plan's return burden is relative to the plan's interest rate accrual (e.g., Treasury rates) and is not as onerous as in traditional final average pay plan designs.

Variable Annuity Plans

Another type of plan design is the variable annuity plan, in which there is a higher level of risk sharing between the employer and employee relative to a cash balance plan. The variable annuity plan automatically increases or decreases benefits based on market fluctuations, maintaining the plan's funded status. By keeping assets and liabilities in balance, companies are able to lower their financial risk while maintaining lifelong income for employees, though the monthly benefit does change based on market returns.

The draw of a variable annuity plan is that it has something to offer for both employers and employees. Exactly when will you die? That is an impossible question for an individual to answer. An individual cannot know exactly how long they need to make their savings last, so inevitably they will either reduce their spending in retirement more than necessary or run out of money. Mortality risk is much easier to manage when it is pooled in a DB plan. From an HR perspective, this lifelong benefit can be especially effective for talent attraction and retention during times of economic turmoil when employees are craving more security.

Beyond the HR advantages, remaining fully funded is a key distinction of variable annuity plans compared to other plan design strategies. Not only does this minimize annual contribution requirements for the employer, but it also eliminates other peripheral costs such as PBGC variable rate insurance premiums. These costs are a growing concern for employers because they have increased markedly in recent years and are subject to annual cost-of-living increases, creating additional financial burdens for a plan sponsor. Interest rate risk is also essentially limited in this type of design, given that it typically stays fully funded in all kinds of market conditions.

In a variable annuity plan, the risk of investment return is shared with employees. These plans may represent a lower level of benefits to participants because they are based on a career average earnings formula relative to a final average earnings formula, but they offer other benefits such as postretirement inflation protection. Figure 2 compares the benefit accrual trends of a traditional DB benefit, a basic variable annuity plan and a modified variable annuity plan (sustainable income plan). The two variable annuity plans greatly outperform the traditional DB benefit for the participant after the age of 73.

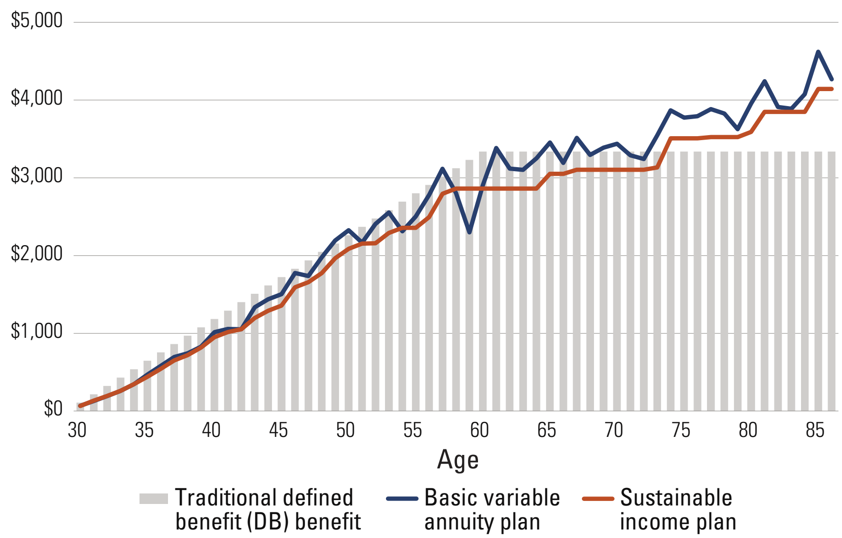
For employers, a variable annuity plan offers stable and predictable contributions even in times of market volatility. For employees, it offers the security of lifelong income. Balancing the risks, instead of simply shifting them to the other side or to an insurer, may be a win-win tactic for sponsors.

Conclusion

Plan sponsors concerned with derisking their DB pension plans have a number of available tools beyond plan termination. Individual companies may want to look at recent plan design innovations to find ways to pool longevity risk between sponsors and participants. The bottom line is that employers in need of lowering their pension costs, including PBGC insurance premiums, while also wanting to maintain a pension plan to attract and retain employees, should know there are many options that exist within the pension derisking spectrum.

FIGURE 2

Benefits Comparison



AUTHORS

Zorast Wadia, CFA, FSA, EA, MAAA, is a principal and consulting actuary with Milliman in New York. He has been working in the retirement benefits field for more than 20 years and has expertise in actuarial valuations for qualified and nonqualified plans. He also has expertise in the areas of pension plan compliance, design and risk management.

Heidi tenBroek is a principal and communication consultant with Milliman where she focuses on conveying today's complex benefit issues to meet specific employer and employee needs. For more than 20 years, clients have relied on her technical knowledge and strategic advice. Her areas of expertise include health care communication, retirement communication and employee research.

Endnotes

1. Z. Wadia, A. H. Perry and C. J. Clark, (April 2020). *2020 Corporate Pension Funding Study.* Milliman White Paper.

2. "30 Best Workplaces to Retire From." *Forbes.* Retrieved on November 8, 2020 from https://fortune.com/best-workplaces-for-retirement/.

3. Ibid.

4. Ibid.

pdf/421