

Pension Plans After the Meltdown

Originally published by Towers Perrin.

If you have responsibility for overseeing your company's pension plan, chances are that you have plenty on your mind these days. The combination of greatly reduced plan asset values and increased liabilities as a result of the meltdown in global financial markets is enough to give any CFO sleepless nights.

The damage has been sudden and, in many ways, shocking, although actual results of pension plan performance vary significantly from one company to the next. In February, the funding level for the Towers Watson benchmark pension plan fell to 60.2%, the lowest recorded since the data series began in December 1998 (see *Exhibit 1*).

Little Relief From PPA Pension Funding Rules

Now it's time to pay up. Large employers are facing tens of millions of dollars in required contributions this year and probably next year as well to comply with the funding requirements set by the Pension Protection Act (PPA) of 2006. Relief from the Worker, Retiree and Employer Recovery Act (WRERA) of 2008 was modest. And while recent guidance from the IRS might allow sponsors of calendar-year plans a one-time election to use interest rates from their peak months in determining the 2009 contribution requirements, this relief is not likely to continue for 2010.

“Companies that sponsor ‘at risk’ plans face significant penalties for funding any nonqualified deferred compensation.”

Exhibit 01. PBO Funded Ratio for Benchmark Plan



■ 60/40 Average Duration Fixed Income (FI)

These developments could not come at a more unwelcome time for plan sponsors, given the squeeze on revenue and cash flow from the recession. Financial institutions and companies in some other industries are also facing demands to raise capital. Meanwhile, many employers are wondering how they can best deploy available capital to pay for ongoing reward programs needed to attract and retain talent.

Possible Benefit Restrictions

New regulatory restraints are also coming into play for pension plan sponsors. Companies that fail to meet key funded status thresholds must comply with restrictions on lump sum payouts and other benefits. For calendar-year plans, the benefit restrictions can take effect as early as April 1, although for many companies the effective date will be when the actuarial valuation is completed (not later than October 1, 2009).

Companies whose funding levels fall below 75% in 2009 may be considered “at risk” for 2010 and have higher required contribution levels. They must also pay higher variable premiums to the Pension Benefit Guaranty Corporation. In addition, companies that sponsor at-risk plans face significant penalties for funding any nonqualified deferred compensation — potentially undermining executive reward programs.

The impact of the 2008 events in capital markets on a typical pension plan with 60% of its assets in equities and 40% in fixed income is shown in *Exhibit 2*.

Shifting Benchmarks

The benefit restrictions that can be triggered under PPA requirements place employers on new and unfamiliar terrain that will shift from one year to the next, adding to the importance of having a forward-looking framework for pension plan financial management. Companies need to take action now to avoid the benefit restrictions or prepare for their onset. Plans funded at 80% or above will be able to use any credit balance to offset cash contribution requirements in the following year, while those below 80% will not.

In a survey of participants in a recent Towers Watson Webcast, about 35% indicated that they expected to be subject to lump sum restrictions in 2009 unless they increased plan funding levels. Of these companies, about two-thirds said they planned to make contributions to avoid the restrictions.

Other options that are available to mitigate the impact of capital market results on benefit restrictions include:

- adopting asset smoothing as allowed under WRERA
- moving from a 24-month average interest basis for calculating liabilities to a one-month average

“Plan sponsors and their investment advisors face a number of thorny issues even when plans gained from LDI strategies.”

Exhibit 02. Impact of the Bear market on Sample Pension Plan

Situation on January 1, 2008

PPA funded status: 92%

2008 contribution requirement: \$42 million (7% of payroll)

2009 expected contribution: \$44 million

2009 expected expense: \$37 million (6% of payroll)

No anticipated benefit restrictions

Situation on January 1, 2009

PPA funded status: 70%

2009 contribution requirement: \$92 million

2009 expense: \$47 million

Partial lump sum restrictions under PPA apply; amendments prohibited unless fully funded

Source: Towers Watson analysis

- revising other assumptions used to calculate plan liabilities, consistent with changing expectations of future experience in light of the economic environment (such as later retirement expectations)
- credit balance forfeitures, some of which might be mandatory
- for calendar-year plans, electing to use the average interest rate from October 2008 or November 2008
- posting a surety bond that would be counted as an asset for 2010.

Managing Cash Flow

These can be powerful steps to manage cash flow and benefits in the post-PPA world. Asset smoothing, for example, increases the PPA funded ratio of our sample pension plan from 70% to 77%. Although this is not enough to avoid benefit restrictions, it reduces the 2009 contribution requirement from \$92 million to \$62 million — almost a third. Moving from a 24-month average interest rate to a one-month average for calculating liabilities increases the interest rate used under PPA by about 40 basis points and pushes the funded ratio on January 1, 2009 from 77% to 80%. This is enough to avoid benefit restrictions until April 1, 2010, at the earliest, and reduce contributions by another \$6 million.

At the same time, these techniques must be applied keeping in mind potential traps in the funding rules that could require plan sponsors to forfeit credit balances and thus make much larger contributions.

Towers Watson worked with one large employer that was facing a requirement to forfeit \$222 million of its accumulated credit balance from prior years in order to be at least 80% funded and avoid benefit restrictions. Smoothing the value of plan assets under WRERA delayed recognition of a large amount of losses in 2008 and raised the reported funding level to above 95%, enabling the company to keep its entire credit balance of \$428 million.

Rethinking Plan Design

Other actions that can help cash flow and manage cost include changes in benefit design. These run a familiar gamut from a plan freeze (temporary or permanent), to closing the plan to new or current participants, to suspending 401(k) matches. Financially sound companies whose stock may be undervalued may also wish to consider contributing stock or property, provided there is fiduciary compliance.

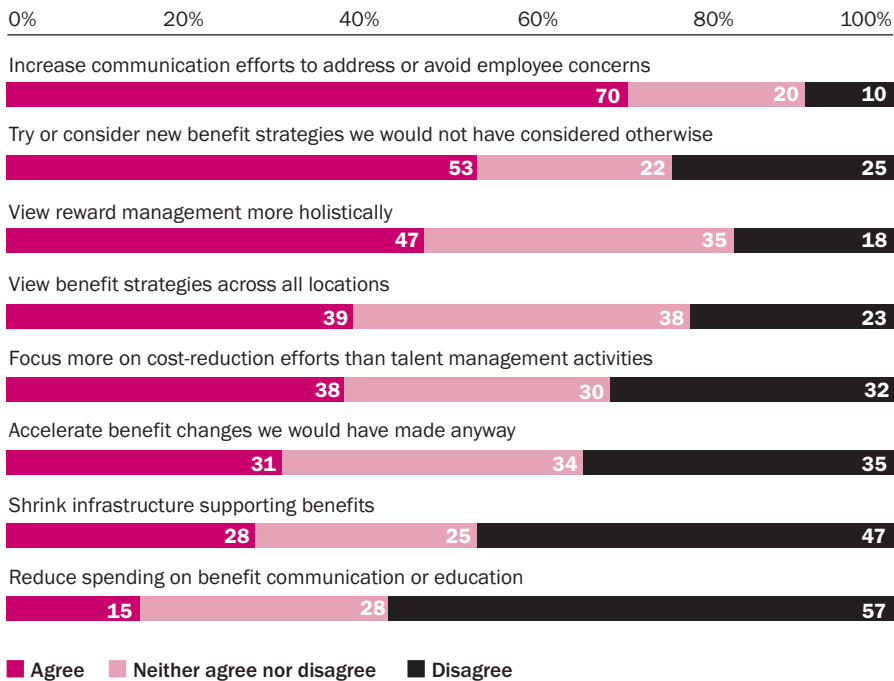
More exotic approaches may also be worth evaluating, such as amending the plan to advance accruals or increasing pension plan benefits while reducing other benefits that require immediate cash flow. For example, a company could provide enhanced pension benefits in lieu of severance benefits. There's also some evidence, given the burden of the new PPA rules and the losses many employees have experienced with their 401(k) plans, that interest is reviving in cash balance plans at companies that don't have one.

A February survey by Towers Watson of 770 North American companies (*Benefits in Crisis: Weathering Economic Climate Change*) sheds some light on companies' current and likely actions in the midst of this crisis. According to the survey, 44% of the respondents have closed their defined benefit (DB) plans to new participants, and another 10% are considering doing so. By contrast, just 12% have suspended or eliminated accruals for current participants, and fully three-quarters have no plans to do so. Most of these plan closures and freezes occurred prior to the current financial crisis.

There has been more activity with respect to defined contribution (DC) plans. About 15% are considering suspending their 401(k) matches, and while only a handful (4%) have done so already, more companies have suspended their 401(k) matches since the onset of the crisis than have frozen their DB pension plans. A larger number indicated they are stepping up their communications with employees, either to help guide investment choices or increase investment education (see *Exhibit 3*).

“Pension plans face tactical questions about the structure and viability of their long-term investment strategy.”

Exhibit 03. Actions Employers Are Taking in Response to the Recession



Source: Benefits in Crisis — Weathering Economic Climate Change (U.S.)

Investment Implications For Pension Plan Managers

Plan sponsors and their investment advisors who are actively managing pension plans face a number of thorny issues, even in situations where plans achieved gains in 2008 from liability-driven investment (LDI) strategies based on Treasury bonds or swaps rather than corporate bonds.

At the end of 2008, the spread, or difference, between the yield on the Moody’s double-A index and the yield on a 10-year Treasury bond remained at historic levels (see *Exhibit 4* on page 5). Looking ahead, if spreads narrow on a reduction in corporate bond yields, then this would likely mean lower discount rates and imply a greater liability for pension plan obligations. However, if spreads narrow on an increase in Treasury bond yields or swap rates, there would be no implied change in liabilities, but typical long-duration strategies would suffer significant losses, giving back gains recognized in 2008.

Thus, while yields on corporate bonds may look attractive, and while yields on Treasuries have reached surprisingly low levels, pension plans face tactical questions about the structure and viability of their long-term investment strategy, as well as liability hedging strategies they have put in place. In addition, many plans have suffered as fund managers relied on mortgage-backed and other types of asset-backed securities, which became illiquid and difficult to price. Between illiquidity and the lack of safe havens for investment managers, many plans continue to underperform passive indices.

What should a plan sponsor do? Rebalance now? Replace underperforming fund managers? Change the strategic allocation? Among the participants in our recent Webcast, roughly two-thirds (63%) anticipated no change in their asset allocation. Most of the remainder said they were becoming more conservative, and only a few said they were becoming more aggressive.

At a minimum, companies should start rebuilding their investment strategy. Possible steps range from revisiting the strategic allocation to implementing strong, detailed and rigorous procedures to monitor and control plan performance.

“Many companies are using the economic crisis as a catalyst to rethink their overall approach to benefits.”

Your plan may have experienced fixed-income returns far below benchmarks because it was overweighted in mortgage-backed securities and relied heavily on unsuccessful investment strategies focused on certain industries or companies. In that case, you would be well served to take a critical look at individual fixed-income manager performance, as well as at investment manager mandates, to assure that risk management allows sufficient diversification of investment styles.

No Time Like the Future

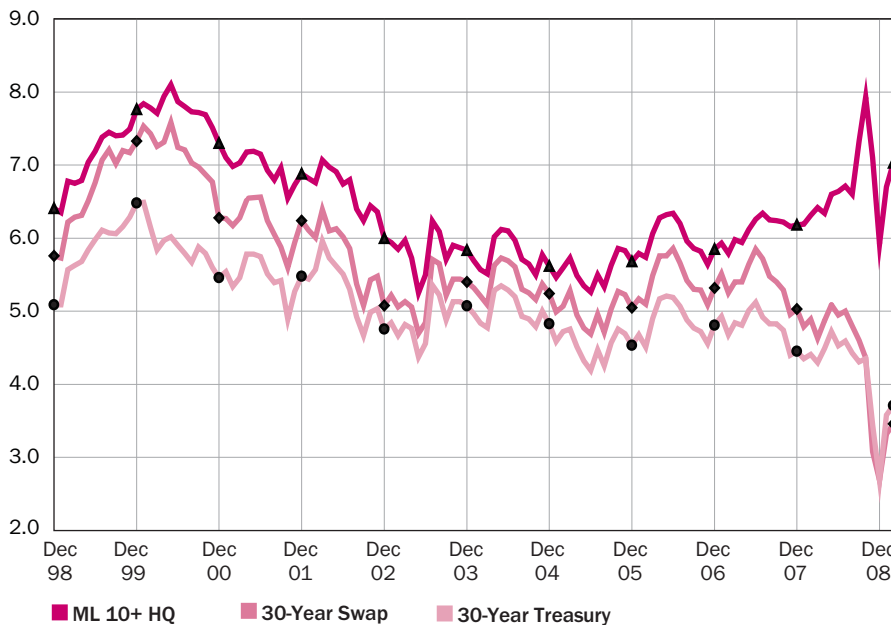
Broadly, our Benefits in Crisis survey confirms that most companies are staying the course in the benefit arena right now, with very few taking precipitous action in terms of dramatic reductions or outright elimination of current plans. However, many are using the economic crisis as a catalyst to rethink their overall approach to benefits. Nearly half (48%) of the organizations indicated that they plan to try new benefit strategies they would not otherwise have considered, and nearly a third (30%) said they will accelerate changes already planned.

Unfortunately, the survey also found that employees are exacerbating the impact of the recession on their retirement savings by contributing less to their plans, withdrawing more and reallocating to lower-growth assets. And, in perhaps the most compelling finding, more than half of the employer respondents indicated that their employees are postponing retirement (see *Exhibit 5* on page 6). This pattern, if it holds, will have a significant impact on the composition and cost of employer workforces, as well as on talent management and reward programs.

“Companies are not willing to sacrifice talent management in the face of cost pressures.”

Obviously, any design changes require serious consideration of both the financial impact and the potential impact on workforce attitudes, which in turn can influence a company’s ability to engage employees and keep them contributing to the organization in ways that will position the company to grow when the economy recovers. While more than three-quarters of the survey respondents indicated their actions to date had had either a positive or neutral impact on employee engagement or productivity, there is also compelling evidence that companies are not willing to

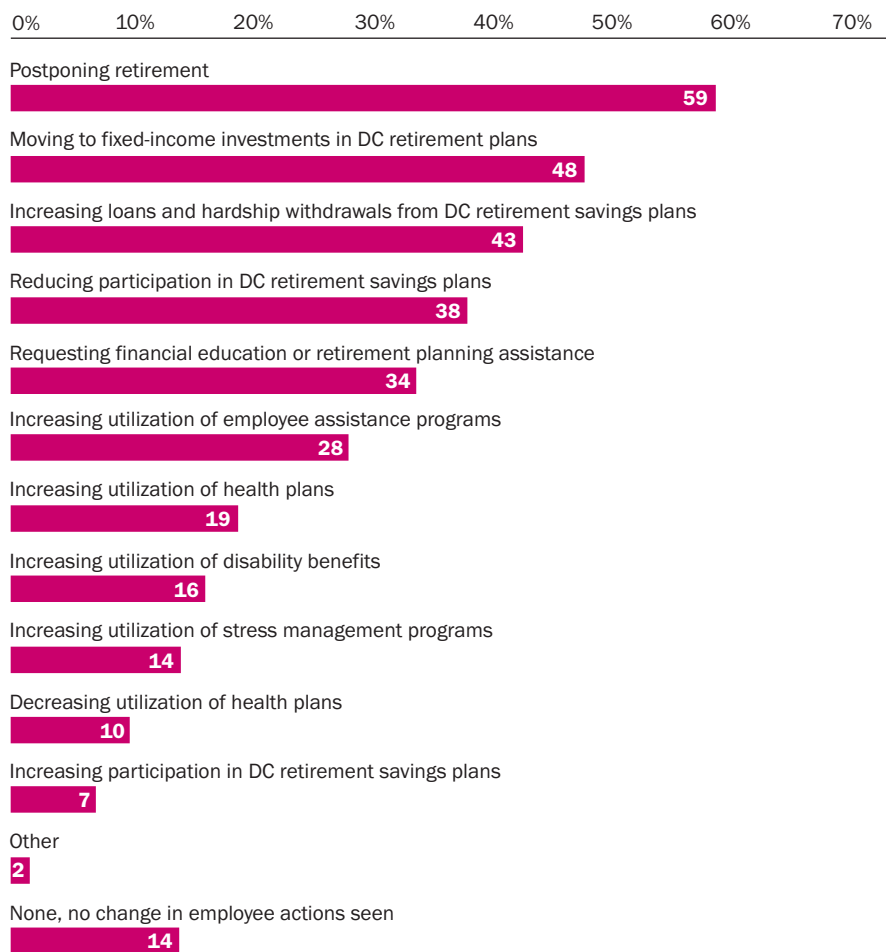
Exhibit 04. Key Bond Yields (at end of month)



sacrifice talent management in the face of cost pressures. This came through in the fact that virtually as many companies were emphasizing talent management over cost reduction as were taking the opposite tack. This is also consistent with a recent Towers Watson white paper that examined what employers are doing to balance cost-reduction efforts with ongoing talent management programs despite additional financial strains.

Employers need to take stock of the damage and carefully plan out their future path. And, while doing so, they should realize that their pension plans often provide financial opportunities as well as challenges.

Exhibit 05. Actions Respondents Believe Employees Are Taking in Response to the Recession



Source: Benefits in Crisis — Weathering Economic Climate Change (U.S.)

About Towers Watson

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.

Originally published by Towers Perrin.
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