

As corporate pension executives and multiemployer pension fund trustees consider the impact of the past two years of market volatility on their funds, they face questions about funding relief, investment strategy and management, and what the future holds for defined benefit pension plans. This article lists the principal challenges and provides guidance in meeting them.

Pension Tension: Seven Critical Questions for Fund Trustees, Executives

by Jonathan Waite

©2009 International Foundation of Employee Benefit Plans



The funding status requirements of the Pension Protection Act (PPA) officially began with 2008 plan years, coinciding with the start of one of the most volatile and loss-ridden investment periods in recent history. As a result, pension executives and multiemployer trustees are focused on the impact recent investment volatility has had on pension funding levels moving forward. Several recurring themes and challenges are at the forefront of these discussions, and the following seven questions have been answered to help pension executives and trustees plan accordingly.

1. How will the organization benefit from funding relief provided in December?

The Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) was signed into law in December 2008 providing some modest funding relief for pension plan sponsors and multiemployer pensions. WRERA contained new relief measures and technical corrections to the Pension Protection Act (PPA) of 2006.

The relief for corporate plans will come in two parts:

- First, many plans that were more than 80% funded in 2007 won't have to fund to 100% as previously expected. Instead, certain plans will only need to fund to 92% in 2008 (94% in 2009 and 96% in 2010), thus reducing mandatory contributions.
- Second, if benefit accruals would be frozen in 2009 due to a decline in funded status below 60%, the prior year's funded status may be relied upon if that will enable accruals to continue.

That is the full extent of relief that has already been legislated. Additional relief is in the congressional proposal stage, but as of early October nothing had been passed. Furthermore, it is important to note that not all plans actually received relief. One of the relief provisions above was to ease the transition rule in PPA for plans to fund to 100%; however, this relief specifically excludes plan sponsors that made deficit reduction contributions for 2007. This would include any plan that was under 80% funded in 2007 as well as many plans that were 80-90% funded.

It should also be noted that along with this legislation, the Internal Revenue Service (IRS) has also provided relief in the form of regulation or guidance:

- The first part of the IRS relief was to permit asset valuation methods to be changed for the 2009 year without IRS approval. This means that market value of assets could be used for 2008 and a smoothed value for 2009.
- The second item of IRS relief was to permit a change to the interest rate selection method for the 2009 year without IRS approval and also, for years beginning before final regulations are issued, to permit the spot rate for any of the five months preceding the 2009 valuation date to be used, potentially lowering liabilities significantly.

With regard to multiemployer pension plans, funding relief will come in two parts:

- With the implementation of PPA, trustees must be focused on funded status thresholds and how they can protect the plan from "endangered" or "critical" status. If a plan falls below the 80% funding threshold or projects a funding deficit within six

years it will be categorized as "endangered." If it goes below 65% funded or projected a deficit within three years it would be "critical." For plan years starting October 1, 2008 through September 30, 2009, WRERA provides multiemployer trustees with a permissible election to treat the plan's current status as the plan's status in the preceding plan year. This also provides relief in that funding improvement or rehabilitation plans already in place will not need to be updated as a result of a change in funded status.

- Under PPA, endangered multiemployer plans are required to enact a funding improvement plan that is designed to improve the plan's funding level over the following ten years. Critical plans are required to create a rehabilitation plan that is designed to increase the plan's funded level above critical status within ten years. WRERA has extended each of those time frames to 13 years. Further, seriously endangered plans have also been provided with relief extending their improvement plan periods from 15 to 18 years.

2. What changes are being made to overall investment management strategies?

The enormous losses in pension asset values over the past year and the ongoing volatile investment environment has created the largest set of questions facing pension executives and trustees in recent history. In its simplest form, those overseeing pensions are grappling with "where to go from here" when it comes to the investment strategies being used for the pension plan.

At this point, pension executives and trustees are generally looking to move their attention to the strategic decisions regarding asset management. This means understanding the primary risks facing their plan (interest rate risk and market risk) and the available tools and methods to be used to manage these risks.

On the interest rate side, plan providers are trying to understand the pros and cons of liability-driven investing (LDI) strategies and the viability of tactics used within these strategies. For example, in today's market and given the wide credit

spreads in the current market, the use of Treasury investments and interest rate swaps is not ideal. Plans utilizing these tools during 2008 may have benefited substantially as the credit spreads expanded, but as they contract we will see these implementations result in funding status losses to the plan. Therefore, pension executives and trustees are using corporate bond implementations for hedging interest rate risk, although they need to balance the level of interest hedge with their desire to pursue absolute returns on their portfolio; more interest hedging often means less return opportunity at this point. They also are looking to align themselves with experts that can monitor the hedging tools and alert them to market changes and opportunities for alternative interest rate hedging approaches, which are expected in the next year or two.

Regarding market risk, pension trustees are struggling to stay current with the rapidly changing asset management landscape in addition to their normal jobs. They have a renewed appreciation for the advantages of diversification on the portfolio, style and manager levels, and are revisiting asset/liability analyses to understand the opportunities available to them. Many plans are revising their asset allocations to take advantage of tactical opportunities in the market as well as new and developing asset classes. The attention to the alternative investment space has been driven by the low expected correlations with traditional asset classes and the potential to provide absolute return in the new market scenarios being predicted for the foreseeable future.

Additionally, pension plans are investigating relationships that provide access to best practices and innovative solutions during these turbulent times that will also help them take advantage of short-term events. An example of this occurred in late 2008 during the worst of the market dislocations. During this time, changes in a plan's investment policy regarding rebalancing to target allocations could be extremely beneficial. Many pension plan providers are looking to ensure they will not miss chances such as this as the market turbulence continues.

Continued on next page

3. What about the investment management process needs to change moving forward?

While just about every pension has experienced some level of “pain” over the past year, the extent depends on how the plan is being managed. The expectation is that the investment management process will become even more rigorous, and organizations are therefore preparing to stay competitive by looking at their current process for researching and selecting investment managers. Some issues involve looking at whether or not the neces-

Moving forward, pension plans are, at the very least, learning about other investment models and how they fit into their organizational structure. There is an increased need for oversight, and accommodation of that need is a question many executives and trustees are now concerned with.

sary internal resources are in place, given staff reductions and the increased workload to satisfy due diligence needs. Many organizations that currently use external consultants believe that approach did not perform well during the recent market turmoil as communications were slow and the ability to dynamically respond was limited. Additionally, recent investment scandals led to the questioning of fiduciary roles and where the duty to perform certain fiduciary functions lies.

Moving forward, pension plans are, at the very least, learning about other investment models and how they fit into their organizational structure. There is an increased need for oversight, and accommodation of that need is a question many executives and trustees are now concerned with.

Corporate Defined Benefit Plans

Corporate defined benefit (DB) pension plans face a unique set of circumstances. In addition to the complex investment management decisions confronting all pension plans, corporations with DB plans must deal with the added challenge of operating within the context of a business. With that in mind, the following questions and answers are written specifically for the corporate pension audience.

4. How important is it to align pension finance with overall corporate/organizational finance?

Over the past few years, new legislation and accounting guidelines increased the visibility of pensions within the broader picture of overall corporate finance. Until now, most plan sponsors could relatively easily manage their plans as these plans were fairly well funded and the immediate consequence of the pension's impact on the company's financial statements was limited.

However, the need to effectively align pension finance and corporate finance became critical with the overall economic downturn and the enhanced transparency requirements. The underfunding of pension plans is now highly visible as a significant deficit on the balance sheet and a significant cash drain. This could potentially create additional obstacles with borrowing, credit ratings and business operations and growth plans.

To illustrate the significance of this, consider a recent industry report stating that the S&P 500 companies have over \$425 billion of unrecognized losses on their U.S. pension plans. The report went on to emphasize that this could continue to negatively impact earnings per share for several years as the losses work through income statements.¹

Overall corporate earnings and profitability as well as cash holdings are being reduced as a result of these pension losses. These reductions and the decrease in shareholder equity are getting the attention of analysts and, as a result, finance executives are being required to manage the pension within the broader corporate finance process. It is now more important than ever to clearly understand pension finance and to find

ways to accurately forecast and communicate the pension's impact on corporate finances.

5. With December's relief in place, how are the cash costs impacting businesses?

While plans are now expected to fund to only 92% for 2008, that has provided little help in an environment where businesses have seen reduced revenues and are therefore operating with limited cash.

In a few cases relief has provided contribution costs that are in line with or lower than 2008. However, that does not help if companies have lost revenue and cannot afford even the prior year cost. A more common scenario is that the relief lowered the exorbitant contribution somewhat yet left it well above 2008 levels. This means that companies already strapped for cash are being asked to contribute more than they budgeted for during 2008.

6. What happens if the company does not have the cash to make the required contributions?

This is a very real issue for many organizations as the business environment has negatively impacted revenues and available cash. If additional relief is not provided, some organizations will not have the required cash. In the worst-case scenarios, bankruptcy may be considered and cash available for pension contributions will be determined as part of the proceedings. For these plans as well as those in a marginally better position, there is an option to petition the IRS for a funding waiver. If approved, this could spread the contribution out over several years. This provides only short-term cash flow relief as the waived contribution will eventually have to be made as well as the normal contributions required in the coming years.

7. What is the trend among companies for offering a DB plan as a benefit?

A recent poll conducted by the Pension Management Research Panel showed that 46% of U.S. participants said the recent market conditions have increased the likelihood the organization will take steps to terminate the pension plan as soon as possible. That same poll also revealed that only 54% of U.S. plans are active and open

to new entrants, 34% have closed the pension to new entrants, 10% have closed to new entrants and frozen accruals, and 2% have started the termination process.² Further, followup research reveals that so far in 2009 at least 23 companies have publicly announced the freezing of accruals for their pension plan participants.³

Freezing or closing the plan might not be an option for all pension plan sponsors; however, all financial executives should be setting their retirement benefit strategy now as they develop business plans for the next few years. At the very least, the organization should review the reasons why the organization offers employees a DB plan, what others in their industry or geographic region are doing, and whether the DB plan is a necessary benefit to recruit and retain the best employees.

The benefit effects of any change should be considered along with the organization's financial expectations and how the options may change those projections. As financial executives try to develop strategies for improving funded status while controlling costs, it is extremely beneficial to also have a solid understanding of the long-term direction of the DB plan.

Conclusion

The past year has created a series of

challenges for individuals overseeing pension plans. At the end of 2008, as one of the most volatile investing years in history came to a close, executives and trustees overseeing pension plans were already prepared for worse. Assets decreased drastically and funded levels were subsequently expected to be lower, with contributions expected to be large. While some funding relief to Pension Protection Act (PPA) requirements has been provided by the government, the numbers are still staggering.

As 2009 has progressed, many organizations know they need to begin the process of planning for the future and making strategic and sound decisions today. It will take a number of events over a period of time to ultimately correct some of the problems being faced, but the steps

taken today will have an impact. Individuals responsible for overseeing pensions are evaluating overall processes for optimal plan management and will need to make short- and long-term decisions with a full understanding of the ramifications.

B&C

Endnotes

1. "Pension Review 2009—Fallout from Funded Status Decline Just Beginning," Goldman Sachs (June 2009).

2. "A Market Gone Bad: How Are Pensions Around the World Responding," Pension Management Research Panel (January 2009).

3. According to Pension Rights Center Web site, www.pensionrights.org/pubs/facts/company_list.html.

For information on ordering reprints of this article, call (888) 334-3327, option 4.



Jonathan Waite, FSA, is a director of investment management advice and lead actuary for SEI's Institutional Group, which provides advice on investment strategy, asset allocation, funding policy and plan design. He has more than 22 years of experience working with retirement plans and was with Aon Consulting for nearly 18 years before joining SEI. Waite holds a bachelor of administration degree from Colgate University and is a fellow of the Society of Actuaries and a member of the American Academy of Actuaries.

Reproduced with permission from *Benefits & Compensation Digest*, Volume 46, No. 12, December 2009, pages 36-39 published by the International Foundation of Employee Benefit Plans (www.ifebp.org), Brookfield, Wis. All rights reserved. Statements or opinions expressed in this article are those of the author and do not necessarily represent the views or positions of the International Foundation, its officers, directors or staff. No further transmission or electronic distribution of this material is permitted.