

PENSION MANAGEMENT RESEARCH PANEL

The Pension Tension: 7 Critical Questions Weighing on the Minds of Financial Executives (August 2009)

The **Pension Management Research Panel** is an independent panel of more than 350 executives whose organizations are dealing with the critical issue of managing defined benefit pension plans, while simultaneously running their organization profitably. The panel has been designed to provide value to its members by pursuing best practices for the management of defined benefit plans by periodically organizing and facilitating discussions, surveying participants and conducting research on emerging issues. In recent months, as part of a series of regionalized roundtables on the management of pension plans, the panel hosted events in a variety of U.S. cities. The intimate roundtables were focused on discussing the impact recent investment volatility has had on the management of pensions and the issues on which pension executives are focused. Throughout the events, several recurring themes and challenges were brought to the forefront of the discussions. As a response, the following seven questions have been answered to help financial executives better manage their defined benefit pension plans;

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. The WRERA contained new relief measures and technical corrections to the Pension Protection Act (PPA) of 2006. The relief will come in two parts:

- First, many plans that were more than 80 percent funded in 2007 won't have to fund to 100 percent as previously expected. Instead, certain plans will only need to fund to 92 percent in 2008 (94 percent in 2009 and 96 percent in 2010), thus reducing mandatory contributions.
- Second, if benefit accruals would be frozen in 2009 due to a decline in funded status below 60 percent, 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 at this time nothing has 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 percent; however this relief specifically excludes plan sponsors that made deficit reduction contributions for 2007. This would include any plan that was under 80percent funded in 2007 as well as many plans that were 80-90 percent 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 is issued, to permit the spot rate for any of the five months preceding the 2009 valuation date to be used; potentially lowering liabilities significantly.

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

While plans are now only expected to fund to 92 percent 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.

3. 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 only provides 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.

4. What is the trend among companies for offering a defined benefit plan as a benefit?

A recent poll conducted by the panel showed that 46 percent of US 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 percent of US plans are active and open to new entrants, 34 percent have closed the pension to new entrants, 10 percent have closed to new entrants and frozen accruals and 2 percent have started the termination process¹. Further, follow-up research reveals that so far in 2009 at least 23 companies have publicly announced the freezing of accruals for their pension plan participants².

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 defined benefit plan, what others in their industry or geographic region are doing and whether or not 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.

5. What changes are pension plan sponsors making to their 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 financial executives in recent history. In its simplest form, sponsors are grappling with "where to go from here" when it comes to the investment strategies being used for the pension plan.

¹ "A Market Gone Bad: How Are Pensions Around the World Responding" Pension Management Research Panel (Jan. 2009)

² According to Pension Rights Center website http://www.pensionrights.org/pubs/facts/company_list.html

At this point, plan sponsors 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, sponsors 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, sponsors are now 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, plan sponsors are struggling to keep up with the rapidly changing pension asset management landscape in addition to their normal jobs. Sponsors 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, sponsors 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 sponsors are looking to ensure they will not miss chances such as this as the market turbulence continues.

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

While just about every pension executive has experienced some level of "pain" over the past year, the extent depends on how their 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 selection of investment managers. Some issues involve looking at whether or not the necessary internal resources are in place given staff reductions and the increased workload to satisfy due diligence needs. Many executives that currently use external consultants feel 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, plan sponsors 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 plan sponsors are now concerned with.

7. 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 under-funding 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 statements³.

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 now than ever before to clearly understand pension finance and to find ways to accurately forecast and communicate the pension's impact on corporate finances.

Conclusion

The past year has created a series of challenges for financial executives overseeing pension plans. At the end of 2008, as one of the most volatile investing years in history came to a close, financial executives overseeing pension plans were already prepared for the 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 plan sponsors 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. Financial executives 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.

Upcoming Roundtable Events

- Houston, TX - (August 13, 2009)
- Minneapolis, MN (August 27, 2009)
- St. Louis, MO (September 17, 2009)
- Cleveland, OH (September 24, 2009)
- Waltham, MA (October 7, 2009)
- New Haven, CT (October 8, 2009)
- Detroit, MI (October 22, 2009)

For more information on the events please email roundtables@seic.com or visit www.seic.com/roundtables.

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³ "Pension Review 2009 — Fallout from Funded Status Decline Just Beginning" Goldman Sachs (June 2009)