COLUMBIA THREADNEEDLE INVESTMENTS

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UNDERSTAND PENSION FUNDING CHALLENGES. MASTER THE SOLUTIONS.

2012 saw the launch of a new set of pension de-risking tools and corporate actions that continue to evolve.

The one constant is the need to stabilize pension funding levels.

One of the greatest challenges pension managers have faced since the turn of the century is the volatility of pension funding levels. Returning to the high funding levels seen at the end of the 20th century and beginning of 21st — levels now required by the Pension Protection Act of 2006 — has tested even the largest employers.

In 1983 there were 175,143 private sector pensions in the U.S. By 2016 that number had decreased to 46,200.[1] And as the effort to reduce and eliminate pension liabilities continues, that number will continue to decline.[2] But private sector defined benefit plans still have approximately $3 trillion in assets[3] — creating a challenge but also a big opportunity for financial advisors to:

- Assist CFOs and plan decision-makers in managing this critical area and its effect on corporate balance sheets
- Help plan participants recognize where they have decision points and how to make informed elections

Reducing liability requires an array of tools

Pension de-risking is the term that emerged in 2012 and captures all the tools available for companies looking to reduce their liabilities. Plan sponsors will typically use more than one option in the pension de-risking toolkit, either together at one time or sequenced over the course of a multi-year de-risking strategy. Options include freezes that prevent new employees from participating or that end the accrual of benefits, moving assets and participants out of the plan, possibly terminating the plan, and managing the pension portfolio in a manner that reduces the funding level volatility — a strategy known as liability-driven investing (LDI).

Tool 1: 401(k) plans

The first tool in pension de-risking was the introduction of 401(k) plans in the late 1970s and early 1980s. Their emergence as more than a supplemental retirement savings tool and their rise to the dominant retirement vehicle in the private sector represent a shift of retirement funding risk away from the employer on to the individual.

Tool 2: Pension freezes

A common way to reduce pension liability is to put a plan freeze in place. There are two types of freezes: a soft freeze and a hard freeze. A soft freeze limits participant growth by setting a date after which new employees are not eligible to participate in the plan. Existing plan participants continue to earn (accrue) benefits, but new hires are no longer eligible. A hard freeze is when the company stops the accrual of benefits. A participant still has the benefits they've already accrued, but after the hard freeze date additional years of employment and future wages are no longer applicable in calculating the final pension benefit. For example, you may have worked long enough to accrue the replacement of 60% of your eligible compensation in retirement, but once a hard freeze is in place, you cannot accrue a higher replacement percentage.

1 Source: MetLife PRT Survey
2 Source: Department of Labor report https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletin-historical-tables-and-graphs.pdf
3 Source: Department of Labor's Employee Benefits Security Administration's 2018 Private Pension Plan Bulletin 1975 to 2016

Lockheed Martin is an example of a company that took this approach. In 2006 the company put a soft freeze in place, and in 2016 it began a two-stage implementation of a hard freeze, terminating the accrual of pay-based services. In 2020 it will stop factoring service-based benefits into the benefit formula. During the two-stage hard freeze the company added a non-elective company contribution to the 401(k) plan. The company contribution began at 2% in 2016 and will increase to 6% in 2020, once the hard freeze is fully in effect.[4]

Tool 3: Lump-sum windows

Companies and plan participants are all concerned about longevity risk. Individuals fear running out of money in retirement, while companies worry that plan participants will have far longer life spans in the future. One way a company can address this risk is by decreasing the number of participants in the plan, which may be done by offering lump-sum distributions.

A lump sum can be added to a plan as a distribution option at retirement, serving as an alternative to the various distribution options for lifetime income payments. Some plans even allow participants to choose both options in a 50/50 arrangement entailing a lump sum of half the benefit and a lifetime payment election for the other half.

At the launch of a new era in pension risk management in 2012, GM, Ford, Verizon and other large companies took lump sums to a new level by offering lump-sum windows (LSW) to certain separated (no longer employed by the company) participants. A lump-sum window offers selected plan participants a chance to choose a lump-sum distribution for which they would not otherwise be eligible. The election must be made within a certain timeframe defined by the plan.

Electing to accept the lump-sum window offer doesn't guarantee the lump sum will be paid. The pension plan has a specific goal to reduce the number of participants and lessen the liability by a certain percentage but will extend the offer to a total number of participants that — if they all accepted — would exceed the goals. Once the window is closed, the plan determines which lump-sum elections it will accept, and usually it's done in ascending order: starting with the lowest lump-sum amount and working its way up. Those with the largest lump-sum amounts are less likely to have their elections accepted.

What leads participants to accept a lump-sum window offer, removing the plan sponsor's obligation to the participant? It can be any number of factors ranging from health concerns, the amount of pension benefit accrued, other sources of reliable income and a new risk factor: "Will my company be around to support me for 20 to 30 years or more of retirement?" Pension defaults, less than stellar funding levels of plans, dramatic disruptive changes within companies and entire industries, and even pension de-risking actions themselves have led some plan participants to reconsider the degree of guarantee that a pension plan offers and thus elect to take control of the assets.

The acceptance rate of lump-sum offers varies considerably from case to case, but since the beginning of the lump-sum window surge in 2012 a meaningful percentage of those offered the option have accepted. At the start of the lump-sum window surge, General Motors reported that 30% of the salaried participants who were offered the lump sum accepted it.[5]

Tool 4: Pension-risk transfers

It's not unusual for either a freeze or a lump-sum window to precede a pension-risk transfer (PRT). PRTs involve a transfer of plan assets and participants to an insurance carrier who will bear the responsibility for dispersing the pension payments. Once participants and the associated assets are sent to an insurance carrier, they are no longer part of the pension plan and no longer the responsibility of the company sponsoring the plan.

Most pension-risk transfers are partial, that is the plan continues to exist and certain participants remain in the plan. Weyerhaeuser is an example of a company using both an LSW and a PRT to reduce the number of participants along with the liability. In 2018 an LSW was offered to 24,000 participants. The company's goal was to reduce the number of participants by 50% and plan liabilities by 30%. Weyerhaeuser did not expect the LSW alone to meet their objectives and so will execute a $1.5 billion PRT in 2019.[6] But in the end, the company still has a pension plan, plan participants and pension liabilities that must be managed and met.

4 Source: Lockheed Martin Press Release and 10-k filings http://www.lockheedmartin.com/us/news/press-releases/2014/july/0701hq-pension-freeze.html
5 General Motors Company 10-31-2012 8-K filing
6 Source: http://investor.weyerhaeuser.com/2018-08-23-Weyerhaeuser-to-reduce-pension-liabilities?&printable

Tool 5: Plan termination

A 2018 MetLife Survey of 102 defined benefit (DB) pension plan sponsors (86% were $100 million or more in size) found that 76% of the plan sponsors with de-risking goals are considering a complete divesting of their DB plan liabilities at some point in the future — in other words, a plan termination.[7]

A PRT can be used to fully terminate a pension plan. Bristol-Myers Squibb (BMS) announced a full termination of its plan this year — an option because of how well-funded the plan is. While most private sector plans are less than 100% funded, the BMS plan is 147% funded. Plan participants will be offered a lump-sum window and those who do not take it will be transferred to Athene, an insurance company, which will manage all the pension payment obligations. At the end of 2019 the pension plan will no longer exist, and the 401(k) plan will become the only qualified retirement plan offering at BMS.[8]

Tool 6: Liability-driven investing (LDI)

A paradigm shift is for plans to move from performance-driven assets to a portfolio designed to manage the funded status of the plan and the risk to the sponsor's financial position. Liability-driven investing starts by examining pension obligations and cash flows to design a custom liability benchmark tailored to the specific risk objectives of the plan sponsor. The analysis is used to design a tight duration-matched fixed-income strategy with the goal of reducing funded status volatility.

Since the turn of the century, private sector pensions have experienced a roller coaster of funding percentages. There's no reason to believe that the roller coaster ride will end, absent investment strategies designed to stabilize funding levels.

Exhibit 1: Sample custom liability benchmark comparison

				Partial Durations						
	Rating[10]	Yield (%)	Duration[11]	1-year	2-year	3-year	5-year	10-year	20-year	30-year
Liability[9]	Aa2	4.05	13.51	0.0	0.0	0.1	0.3	2.1	4.5	6.5
Sample Custom Liability Benchmark (CLB)[12]	A1	4.36	13.51	0.0	0.0	0.0	0.4	2.1	4.5	6.5
Difference		0.31	0.00	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bloomberg Barclays Aggregate Index	A1	3.28	5.71	0.1	0.3	0.5	1.3	1.2	1.2	1.1
Difference		-0.77	-7.80	0.1	0.3	0.5	1.0	-0.9	-3.4	-5.4
Bloomberg Barclays U.S. Long Credit Index	A3	4.90	13.33	0.0	0.0	0.1	0.4	2.0	5.8	5.0
Difference		0.85	-0.18	0.0	0.0	0.0	0.0	-0.1	1.2	-1.5

A typical plan with a liability duration of 12 years and fixed-income assets managed against Bloomberg Barclays U.S. Aggregate Bond Index, with a duration of roughly 6 years, is left with a rate sensitivity mismatch, as much of the pension liability can be bunched in the 20-year to 30-year part of the yield curve. Since interest rates determine the discount rate used for valuing liabilities, the focus of the de-risking strategy (hedge) is on the interest rate sensitivity of the liability.

Duration plays a key role. LDI attempts to align the interest rate sensitivity of assets and liabilities through duration-matched fixed income. At a minimum, the fixed-income portion of the portfolio should have an LDI focus. Plan sponsors often adopt a glide path to increase the percentage of the portfolio under an LDI strategy as plan funding percentages improve.

7 Source: Met Life survey
8 Source: https://news.bms.com/press-release/corporatefinancial-news/bristol-myers-squibb-transfer-38-billion-us-pension-liabilitie
9 Projected benefit payments discounted using the December 31, 2018 FTSE Pension Discount Curve: 4.01% yield
10 Credit quality is based on the average rating of the FTSE Pension Discount Curve
11 Effective duration
12 Sample custom benchmark composed of 75% Bloomberg Barclays U.S. Long
Source: Columbia Management Investment Advisers, LLC
Graphic is for illustrative purposes only and does not represent analysis of any specific plan`2

Restoring a plan's health may require a non-traditional approach

The Funding Target Attainment Percentage (FTAP) is an actuarial calculation of a plan's health and its ability to meet its future obligations to its current participants. Determining the funding percentage is a complex formula that factors in the demographics of the plan participants, the returns or losses in the portfolio, and the annual contributions made by the company to the portfolio.

Less than 100% funding can be caused by inadequate company contributions, portfolio losses or lower than expected returns, or the introduction of a new life expectancy table that increases the average duration of retirement payments a plan is expected to make. In addition, mark to the market accounting requirements by the Financial Standards Accounting Board (FASB) for private sector pensions has lessened the ability to "smooth out" funding level calculations over longer time frames and have therefore introduced greater volatility in pension funding levels. Collectively these changes have made it challenging to keep a plan fully funded in the present and the future using investment approaches that may have been effective in the past.

Companies that either can't or don't want to terminate their pension plans have strong incentives to keep the funding level at or near 100%. Underfunded plans create a liability, since the company will have to make large contributions to close the gap. They also create a current expense; private sector plans are required to pay per-capita insurance premiums for each plan participant to the Pension Benefit Guaranty Corporation (PBGC). The PBGC, which provides insurance for participants if a pension plan defaults, also charges an additional risk premium for underfunded plans. After many years when Congress would not approve the PBGC's requests to increase premiums, the significant underfunded labiality that the PBGC itself carries on the defaulted plans for which it's responsible has led Congress to allow a steady increase in PBGC premiums.

In 2017 and 2018 several large corporations made huge contributions to meet funding requirements. For example, in 2017 Verizon contributed $3.4 billion, Delta $3.2 billion and DuPont $2.9 billion to their plans to address funding gaps. In 2018 Lockheed Martin topped them with a $5 billion plan contribution in the middle of its staged implementation of a hard freeze. Large contributions are often necessary to prepare for pension de-risking actions. At the end of January 2019, Lockheed Martin made a pension risk transfer of $1.8 billion and 32,000 plan participants to Prudential Insurance.[13]

For any plan that has improved its funding status, maintaining that status is a priority.

Smart decisions start with understanding the landscape

Both corporations and plan participants face challenges and critical decision points at every point in the pension de-risking continuum.

CORPORATIONS' NEEDS	PLAN PARTICIPANTS' NEEDS
■ Full understanding of the suite of tools in the pension de-risking toolkit ■ Guidance on creating a comprehensive pension de-risking strategy that may take place in staged intervals and over a number of years ■ Help in smoothing out the volatility of plan funding levels as a comprehensive de-risking strategy is conceived and implemented	■ Education on the full implication of the trends in corporate de-risking actions ■ Understanding of how pension de-risking may affect them personally ■ Help in finding ways to replace any reduction in expected retirement income because of pension de-risking steps taken by their plan sponsors ■ Guidance on whether to accept lump-sum window offers

We have the tools and resources to help you navigate the pension de-risking landscape and capture opportunities in the defined benefit market.

Contact your Columbia retirement investment consultant to learn more.

13 Source: Lockheed Martin press release Jan 29, 2019, Delta press release July 13, 2017 ,Verizon press release April 20, 2017, Dupont press release July 25th 2017

To find out more, call 877.894.3592
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