



Faltering Pensions Motivate “Corporate Finance” Approach to Evaluating Risks

By: Chip Hunt and Chip Hardy, PrimeTRUST Advisors

Executive Summary

The slump in the equity markets has devastated the funded status for most defined benefit pension plans. In addressing this problem, pension managers now face new challenges posed by recent changes in pension and accounting rules. In response, new pension management strategies are emerging in an attempt to tackle these tough issues.

Pension plan performance for 2008 is one for the record books.

Unfortunately, this is not good news.

For the year, the funded status of a “typical” defined benefit pension plan declined by more than 30% according to some estimates. One such estimate, by BNY Mellon, indicates a 30% dip in the funded ratio while other another, based upon data from the Citigroup Pension Liability Index, approximates the decline to be closer to 40%. The obvious reason is attributable to poor investment performance in the equity markets that shredded pension asset values. Exacerbating the problem for pension managers, yields on longer-term high grade corporate bonds dropped abruptly late in the year which served to increase the value of plan liabilities; creating an even wider margin between plan assets and liabilities.

In other words, those plans that were about 90% funded at the beginning of 2008 are likely to learn that the funded status slipped to the 54% to 63% range by the year end.

This is yet another of those “rare” perfect storms which seems to occur every few years these days. Remember 2000-2002?

However, *this time*, a dire economy coupled with the current credit crisis adds to the gravity of the situation faced by those companies that offer a pension plan.

This time, pension executives also face new hurdles posed by the Pension Protection Act of 2006 (PPA) and the Financial Accounting Standards Board’s FAS 158. Together, these new rules only add to the challenge already faced by pension finance executives under already exceptionally difficult conditions.



The PPA Effect

Generally speaking, PPA accelerated pension funding obligations for employers by completely replacing the old rules with a new funding standard targeted solely to a plan's *funded status*. A company's required pension contribution under the PPA is equal to the present value of benefits earned during the current year *plus* the amount necessary to amortize any funding shortfall over seven years. In the case of severely underfunded plans, additional rules *further* increase the funding requirements of the employer. As one might guess, most companies will now be facing dramatic funding shortfalls and are expected to see *significantly* increased pension contribution requirements for 2009 and beyond. While the Worker, Retiree, and Employer Recovery Act of 2008 that was passed in December provides some relief measures for pension funding, significant funding challenges still remain.

The FAS 158 Effect

In addition, the new pension accounting rules promulgated by FAS 158 results in greater transparency of a company's pension obligations on their financial statements. Specifically, the new accounting standards require employers to recognize the difference between the *market value* of pension plan assets and the plan's liabilities (expressed as the Projected Benefit Obligation, or PBO) on their balance sheets. In the past, such measures were included in the footnotes.

This change in accounting method means that pension funding deficits will have a more immediate, visible and meaningful impact on a company's financial statements. Secondly, this means the volatility associated with the capital markets exposes financial statements to potentially daunting variations in the plan's funded status.

When considering the potential financial implications of PPA and FAS 158, there are related issues associated with the swings in a pension plan's funded status. These issues include the potential for, and the degree to which, such swings may adversely impact the company's balance sheet, its income statement and required cash flows. Parallel considerations may include the related impact upon existing debt covenants.

Pension Risk is Re-Evaluated

The relative status or condition of these financial measures, in turn, directly affects the viability of the pension plan itself. In other words, if the level of required employer contributions increases significantly beyond traditional budgetary levels, it is unlikely that the company will continue to sustain the plan



indefinitely. It is no coincidence that there is an increase in the number of “frozen” pension plans.

As discussed, a pension plan’s funded status is the driving metric that most singularly influences the volatility of financial variables that really matter to employers; namely net pension expense, shareholder equity and liabilities, and the level of required plan contributions.

New Approaches are being used

Therefore, astute pension managers are beginning to break away from the traditional “investment-only” risk measures employed in the past and are assessing “pension risk” within a new context. More specifically, many executives are now evaluating pension risk more in terms of the potential financial implications to the company.

Employing a corporate finance approach, managers are modeling variations in a plan’s funded status and incorporating the results into company financials to test the impact upon these key financial elements to the company. The process often integrates the resources of actuaries, investment consultants, investment managers, accountants and corporate finance executives.

Essentially the team is implementing an iterative process to assess variations in the risk position of the pension plan relative to company’s financials. This is accomplished by making a series of pension plan asset and liability projections focused on examining the potential variations in the plan’s *funded status* under alternative asset allocation models. This process is designed to establish a set of expectations relating to the *volatility* of the funded status for any given set of investment mixes. The goal is to identify the investment mix that is most likely to deliver the set of expected “funded status” outcomes that falls within the company’s related financial risk tolerance.

This corporate finance approach to managing pensions is a departure from (and an improvement on) practices of the past where “investment only” asset allocation modeling was performed without regard to corresponding affect upon plan liabilities, funded status or other key corporate financial metrics.

New Conclusions are Emerging

Upon considering the results of the corporate finance approach and its influence on the investment mix of the pension portfolio, many pension experts conclude that there are significant benefits of designing an investment portfolio that is *highly correlated* to the plan’s liability structure. This usually means the investment mix will be heavily weighted towards longer-term, high-quality corporate bonds. This somewhat counter-intuitive conclusion is quite often



puzzling to the casual observer who may miss the primary point (controlling funded status volatility) because he has become so accustomed to the “investment only” approach.

To illustrate this point, consider these investment results for the calendar year 1999. In that year, the Lehman Brothers US Government/Credit Long Bond Index lost 7.7%. In determining pension performance from an “investment only” perspective, most pension investment committee members would consider a pension portfolio that generated those results “unsatisfactory”; especially, since in those days, the actuary’s expected investment return assumption was more likely to be 8% to 8.5%. However, in that very same year pension plan liabilities also decreased by 12% (using the Citigroup Pension Liability Index as a proxy for a “typical” pension plan). Effectively, then, the typical pension plan’s funded status *actually improved by 4.3% for the year!!*

What about 2008? The Lehman Brothers US Government/Credit Long Bond Index gained 8.4%, but pension liabilities (using Citigroup Pension Liability Index) also increased by 17.6%, so the funded status lost ground by about 9%; not bad in comparison to the 30%-40% funding shortfall range of for a “typical” plan for the year.

These simple illustrations provide evidence of the benefits of an investment portfolio that is highly correlated to the plan’s liability structure.

It is tempting for most observers to seriously question the idea of designing a pension portfolio which is so heavily invested in bonds. The real point observers are trying to make is that portfolios heavily weighted towards bonds do not earn as much as those portfolios which are more heavily weighted towards equities.

True, generally speaking.

However, under the old pension funding rules, pension executives (consciously or not) were encouraged to utilize pension portfolios more heavily weighted towards equities in order to attempt to match the actuary’s expected return on investment at 8% to 8.5%. In effect, the company’s required plan contributions were already discounted to reflect *expected* future investment returns. Under the old rules, it was only *after recognition* of the fact that, to the extent that portfolios did not actually obtain those returns, that required contributions were increased due to an “actuarial loss”.

The new rules, however, calculate the funding obligation using current corporate bond rates. So, now companies must wait for the “excess” returns to actually materialize before using such to reduce plan contributions.



This is just another of the many reasons that managers are reevaluating their plan funding and investment policies.

Ideally, under the corporate finance approach, employing the resources from the multiple disciplines mentioned earlier, the team of specialists will be able to identify the “sweet spot” in the plan sponsor’s risk/return spectrum after considering the financial impact of the alternative pension modeling scenarios.

Ultimately, it is expected that, after such an evaluation, pension portfolios will be reconfigured to that optimal mix between bond and equity securities that best reflects the company’s financial tolerance for maintaining that equilibrium between preventing further erosion of funded status and obtaining long-term investment growth to actually restore the plan’s funded status.

In turn, it is expected that in the future, Pension Committees will be evaluating pension performance relative to their own plan’s custom liability benchmark which will facilitate improved performance evaluations and will result in healthier pension plans as a result of progressively improving pension monitoring policies.

In closing, it is the authors’ opinion that recent market conditions have been so devastating that investment growth alone will not solve the pension funding shortfall and greater reliance upon future contributions will be necessary to close the funding gap.

PrimeTRUST Advisors is a retirement plan consulting and investment advisory firm. We are committed to advancing awareness of fiduciary standards of care through writing articles, giving presentations, facilitating fiduciary training programs and in practice with our clients. We are an independent ERISA consulting firm working strictly on behalf of employers/trustees. We are vendor neutral and may be able to help without causing a conversion of current providers. Feel free to view our website www.primetrustadvisors.com for additional information, background, and relevant articles.