



Plan Sponsors Motivated to De-Risk Defined Benefit Pension Plans

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Create Opportunities

De-risking a defined benefit pension plan can get complicated for plan sponsors who are trying to go it alone. But failing to de-risk your plan could create an unexpected impact on your balance sheet and income statement, causing financial uncertainty and increased anxiety, ultimately masking your organization's true operating results. To help mitigate these financial risks, plan sponsors may want to consider various de-risking strategies.

There are many possible benefits for plan sponsors who de-risk their pension plans. Consider what might motivate your organization to take the first steps.

What's pushing sponsors to de-risk their plans?

Currently, there are six main factor driving plan sponsors to consider de-risking their defined benefit pension plans.

1. **Actuarial risk.** Forecasting annual pension contributions can be difficult, which adds considerable uncertainty to the organization's annual budgeting process.
2. **Interest rate risk.** Large balance sheet losses can occur when the present value of liabilities suddenly increases due to a drop in the discount rate.
3. **Market risk.** If the trustees have allocated some portion of the plan's assets towards equities, then large balance sheet losses can occur if there is a sharp drop in the stock market.
4. **Improved funded status.** The funded status is likely to have recently improved due to the hikes in interest rates by the Federal Reserve.
5. **Longevity risk.** The life expectancy of beneficiaries has increased, indicating that pension payments could last far longer than is currently anticipated.
6. **Increasing premiums.** Plan sponsors of for-profit companies have seen large increases in their premium payments to the Pension Benefit Guaranty Corporation (PBGC).

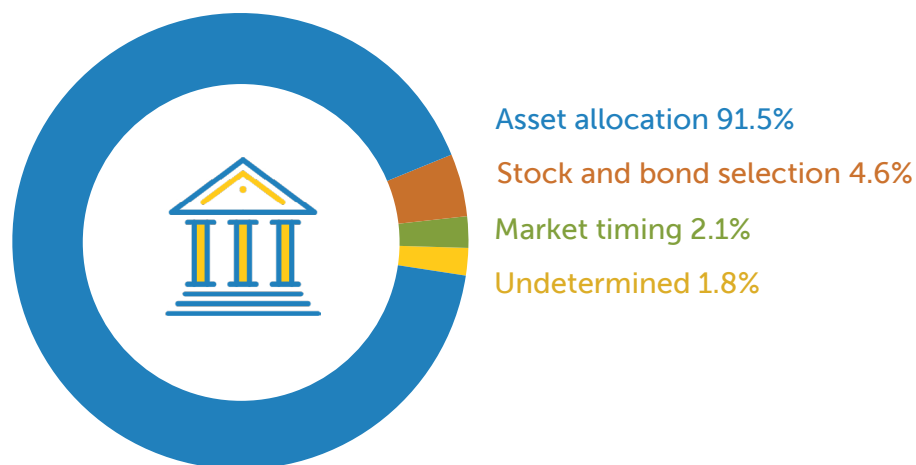
While there is a lot to consider before diving into the de-risking process, these motivating factors are difficult to ignore.

Organizations seeking to de-risk their defined benefit pension plan ought to weigh their options before moving forward and narrowing their focus to either the asset- or liability-side of the balance sheet.

Asset side de-risking

Over 90 percent of the volatility within an investment portfolio is determined by its asset allocation (i.e., what percentage of plan assets are invested in stocks, bonds, alternatives, real assets, etc.)

Sources of the variability of portfolio return



Source: Gary P. Brinson, Brian D. Singer and Gilbert L. Beebower.
 "Determinants of Portfolio Performance II: An Update" *Financial Analysts Journal* May/June 1991.

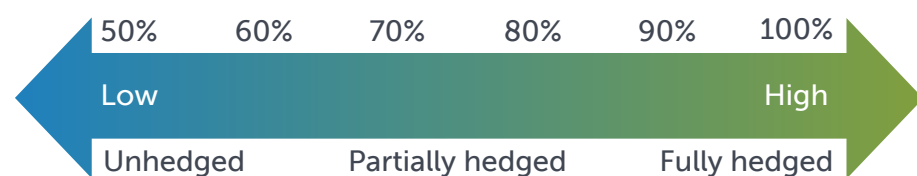
In other words, the asset allocation is the most important decision trustees will make in regards to interest rate and market risk. Given the importance of asset allocation, there are two options for trustees to consider when de-risking their plans on the asset side: the glide path and liability-driven investing. It is important to note that asset side de-risking does not eliminate risk — it only mitigates it through hedging. Furthermore, there are few, if any, perfect hedges, so the plan will still be exposed to so-called "basis risk."

Glide path

The premise of the glide path is to set a plan's asset allocation based upon the plan's funded status. That is, if a plan's funded status is low, then the trustees should choose an unhedged (higher risk) asset allocation. Contrarily, if the plan's funded status is high, then the trustees should choose a hedged (lower risk) asset allocation. Furthermore, as the funded status changes over time, the asset allocation should change according to a pre-determined glide path. A predetermined glide path is meant to impose some discipline on the process and may help prevent the trustees from being swayed by their emotions during periods of heightened market volatility.

For example, if the funded status is low, say 60 percent, then the trustees should adopt a high-risk asset allocation of 65 percent equities and 35 percent bonds. Contrarily, if the funded status is high, say 95 percent, then the trustees should adopt a low-risk portfolio of 10 percent equities and 90 percent bonds. To illustrate, the predetermined glide path of a plan with a low-funded status could be defined by the plan sponsor in their investment policy statement (IPS) with the following language: "Each time the funded status increases by 5 percentage points, the equity allocation should be reduced by 5 percentage points towards a minimum overall equity allocation of 10 percent."

Funded status



When funded status is low, choose an unhedged (higher risk) allocation. (e.g. 65 percent stocks and 35 percent bonds)

Glide path

When funded status is high, choose a hedged (conservative) allocation. (e.g. 10 percent stocks and 90 percent bonds)



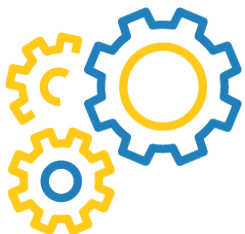
Liability-driven investing

Liability-driven investing (LDI) is a form of asset/liability management that attempts to minimize the volatility of the plan's assets relative to its liabilities, thus stabilizing the residual equity position. The value of the liabilities are measured by calculating the present value of the projected future benefit payments. As such, even small changes in the discount rate could have a large impact on the value of the liabilities, and therefore the balance sheet. LDI uses only a portion of the assets to hedge the entire amount of this interest rate risk. This is done by placing some portion of the plan's assets in high quality, very long-duration bonds (e.g., 20+ year maturities or futures contracts) so that any changes in interest rates will cause the value of the assets to change in tandem with the entire present value of the liabilities. Any remaining plan assets would then be then invested in growth assets such as equities.

It is important to note that LDI is a highly complex strategy. As such, clients should seek the services of proven professionals in this field before moving to implement any LDI strategies.

Liability-side de-risking

There are three options on the liability side for trustees to consider when de-risking their pension plans: freezing the plan, offering lump-sum payouts, and annuity purchases. It is important to note that liability-side de-risking does not eliminate risk, but only transfers it to a third party — typically the employee, retiree, or an insurance company.



Freezing the plan

Plan sponsors may choose to initiate a hard or a soft freeze. With a hard freeze, all future retirement benefits will be locked in at current levels and employees will not accrue additional benefits based upon their salary, age, or years of service. Alternatively, a soft freeze can take many

forms, but they all tend to have a lesser impact on future retirement benefits. For example, a soft freeze may allow future benefits to grow based upon salary increases but not on years of service. A soft freeze may also be targeted towards a specific group of employees, such as new hires only.

When employers freeze their defined benefit plan, they typically begin offering their employees a [defined contribution plan](#), such as a 401(k), [403\(b\)](#), or 457 plan. Defined contribution plans transfer many of the decisions and risks away from the plan to the employee. However, the employees also gain certain advantages, such as the ability to roll their retirement funds into a new employer's plan should they decide to change jobs. Employees can also customize their investment portfolios to suit their own risk tolerance and time horizon as well as adjust their portfolios due to their unique circumstances, such as having a working spouse or other outside investments they may have accumulated.



Offering lump-sum payouts

At retirement, employees may elect to receive a lump-sum distribution or a lifetime monthly benefit payment. A lump-sum payout is typically rolled into an individual retirement account (IRA) and allows the retiree to have more flexibility when managing

their money during retirement. It is important to note that lump-sum payouts transfer the interest rate, market, and longevity risk away from the plan to the retiree. Also, if the retiree does not properly manage the lump-sum payout, then it may not last for their entire lifetime.

An employer may choose to terminate their defined benefit pension plan. Under this scenario, employees are typically given a lump-sum payout equal to the present value of their accrued benefit, which can then be rolled into a defined contribution plan or IRA.



Annuity purchases

Pension plan sponsors can purchase annuities for individual employees at retirement or initiate a buy-out annuity, whereby the plan buys an annuity for every plan participant. In both cases, the plan pays a premium to an insurance

company, and the resulting insurance contract is then owned by the retiree. The retiree's monthly pension benefit will be paid directly by the insurer.

While expensive, annuities can transfer a significant amount of interest rate and longevity risk from the plan to an insurance company. Furthermore, depending upon the legal jurisdiction governing the plan, annuities may allow the plan to discharge its fiduciary duty to its retirees.



How we can help

When it comes to de-risking a defined benefit pension plan, employers have a range of options. Given that plan sponsors owe a fiduciary duty to the plan's beneficiaries, they should seek professional assistance and weigh these options carefully. If you are considering how to [de-risk your defined benefit pension plan](#), our institutional investing professionals can help you [wade through the options](#) to find one that may be right for you.



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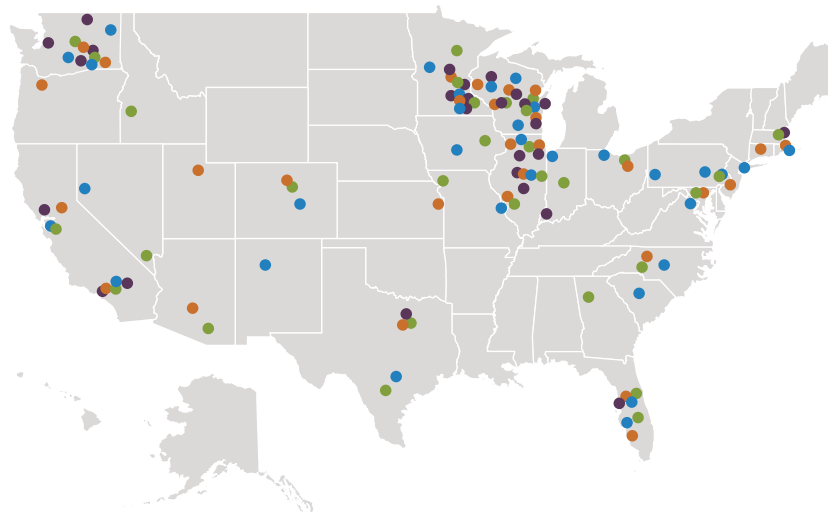
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