MEANS AND MARKETS HAVE ALIGNED:

Why You Should Consider De-risking Now

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A resurgent economy, strong equity markets and modestly higher interest rates are providing a tailwind to plan sponsors. The change in economic sentiment is driven in large part by expectations that companies will get a boost to cash flow from lower corporate tax rates, infrastructure spending and reduced regulations under the new administration.

Sponsors with well-funded plans could consider a large pension risk transfer transaction to meaningfully reduce risk. Other sponsors with limited de-risking budgets could engage in targeted retiree buy-outs or borrow to improve their plan’s funded position before embarking on a de-risking journey. Building a strong defense now may position companies, particularly those in cyclical industries, to better endure the next downturn, allowing them to pursue growth initiatives at a time when their competitors may be cutting back. This environment could be fleeting, however, and we believe now is the time to prepare for a lower-risk future.

INTRODUCTION

Equities have gained over 12%, and the 10-year U.S. Treasury has increased by 33bps since the election.¹

The average funded status of pension plans has risen from 77% Post-Brexit² to 85% as of March 31, 2017.

Costs of maintaining a plan continue to rise.

¹ S&P Capital IQ as of 5/31/2017.
² Source: Milliman Pension Funding Index, as of June 2016.
WHY DE-RISK NOW?

Costs of maintaining a plan are increasing—Pension Benefit Guaranty Corporation (PBGC) premiums—both flat-rate and variable rate—have increased significantly and are a cash drain for plan sponsors.

- The flat-rate premium will increase to $80 by 2019, a 16% increase compared to the current rate.
- The percentage of unfunded vested liability that must be paid in variable premiums will escalate to at least 4.2% in 2019, an increase of 24% over today’s cost.
- The unvested pension liability, used to calculate variable premiums, will increase next year when the IRS adopts a new mortality basis (RP-2014 with scale MP-2016).
- PBGC premiums are even more burdensome on pensioners with small benefits.

Plan sponsors are facing rapidly rising costs to manage their plans

Favorable economic conditions and anticipated tax reform—An improved outlook for growth and gradual Federal Reserve monetary tightening policies have helped equities advance and interest rates recover from their mid-summer lows. The average plan is now 85% funded, compared to 79% one year ago. Funded status is expected to improve further if tax reform proposals are implemented. Sponsors may want to consider accelerating pension contributions to maximize higher tax deductions as tax rates may be lowered to 15% or 20% under current proposals. Additionally, if implemented, the proposed one-time lower tax rate on overseas earnings should encourage companies to repatriate cash, which could be used for pension contributions.

\(^3\) Source: PBGC (http://www.pbgc.gov/prac/prem/premium-rates.html)

\(^4\) Source: Milliman 100 Pension Funding Index, March 2017.
Funded status has improved since Brexit

As funded status improves, plan sponsors face an increasingly asymmetric risk and reward profile—Sponsors that retain risk assets as funded status improves receive diminishing economic benefits as excess funds cannot be used for other business purposes and are disregarded by rating agencies in their evaluation of leverage, while downside risk grows. Equity markets also possess asymmetric characteristics. An analysis of Shiller’s Cyclically Adjusted Price to Earnings ratio (CAPE), a measure widely used in the market, reveals that the stock market is richly valued today, with a CAPE ratio of 29.2 in April 2017, which is in the 95th percentile of historic market valuations.

Source: Milliman Pension Funding Index, March 2017.
Equity markets exhibit significant asymmetry

Interest rates have risen, signaling a strong domestic economy and prospects of higher inflation. However, lackluster growth in the rest of the developed world sets a ceiling on U.S. rates. The United States is among the highest yielding developed countries, with 10-year government bonds in Japan and Germany close to 0%. Plus, continued demand for long-dated bonds from pension plans and insurers, and potentially reduced bond supply under the new administration’s tax reform proposals, is likely to put continued pressure on long bond yields. These factors suggest sponsors are better off not waiting for a further rise in interest rates, since a low-for-longer rate scenario cannot be ruled out.

Efficient pension risk transfer market—The pension risk transfer market continues to evolve with the entry of new players and innovative solutions, such as the recent multi-insurer split transactions executed for PPG, Kimberly-Clark and Philips. Sponsors with plans of all sizes can find a competitive market for their de-risking needs, with over 26 transactions executed last year in the $100 million to $1 billion range, and two transactions over $1 billion. WestRock, United Technologies and PPG are some of the more well-known firms to transfer pension risk in 2016.


April 2017 Ratio: 29.19
(Average: 16.8  Median: 16.1)
Falls within highest 3.91% of observations.

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DE-RISKING OPTIONS

Well-funded plans—Plans that are well-funded may want to consider a pension buy-out to address risk. In recent years, sponsors have focused on transferring liabilities associated with retiree populations, which are the most efficient to buy out.

- **Large retiree buy-outs**—Retirees are typically the largest pool of plan participants, so plan sponsors can settle a significant amount of liability for an attractive price. Large scale buy-outs are the most effective way to achieve significant risk and expense reduction. General Motors, Verizon and Motorola are among the prominent sponsors that have executed large retiree buy-outs to address pension risk.

Underfunded plans—Plan sponsors with underfunded plans have multiple solutions. They can either target a specific population to buy out today, or issue debt to improve the funded status of their plans before embarking on a de-risking strategy.

- **Targeted small-benefit retiree buy-outs**—Targeted buy-outs can help sponsors de-risk with maximum benefit, while respecting their limited de-risking budgets. Plan sponsors can work with a consultant, and partner with insurers who can provide insight on current market pricing for cohorts within the retiree population. The retiree cohorts offering the greatest efficiency are those with the smallest benefits, those that have been in retirement the longest, and those who worked in blue collar positions.

  The most common approach to selecting a target population is to start with retirees having the smallest benefit, because they tend to have shorter life expectancy than those with larger benefits, as benefit size is generally indicative of wealth and access to quality healthcare. Therefore, an annuity for a small benefit participant will be less expensive per dollar of pension benefit than an annuity for a large benefit participant. Additionally, small benefit cohorts also offer another opportunity for cost savings since PBGC premiums and administrative costs are significantly larger on a relative basis for small benefit cohorts.

  This type of strategy may offer the certainty plan sponsors want and the benefit security plan participants need. However, before deciding which population to annuitize, the sponsor should consult the plan’s independent fiduciary to ensure the selection process was conducted in accordance with applicable laws and regulations.

- **Borrowing to fund**—Companies can also reduce expenses and enhance their capital structure by taking advantage of a borrow-to-fund strategy to replace volatile, expensive pension debt with lower cost, fixed-rate obligations. Despite the recent rise in interest rates, this could still be a net present value (NPV) positive strategy for certain plan sponsors. In fact, just this year, several notable plan sponsors have issued debt for this specific purpose, including FedEx Corp. ($1 billion), Delta Air Lines ($2 billion), DuPont ($2 billion) and Verizon ($3.4 billion). This comes on the heels of a robust second half of 2016, when more than $3.2 billion of pension contributions were made using a borrow-to-fund strategy.

Retiree liabilities:

- Shorter life expectancy
- Less longevity risk
- Reduced investment risk
- No behavioral risk

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Small benefit liabilities are the least efficient for plan sponsors to hold

The smallest benefit sizes are the most expensive liabilities for the sponsor to maintain. As you can see, the economic liability for these benefit sizes is high due to administrative costs, PBGC expenses and investment management expenses which are disproportionately large relative to the size of the benefit.

Note: GAAP and economic liabilities reflect RP-2014 mortality table with MP-2016. GAAP liability is calculated by discounting projected cash flows using spot rates along the Citigroup Pension Discount Curve. Economic liability is calculated by discounting projected cash flows using spot rates along the Citigroup Pension Discount Curve adjusted for investment management fees and the risk of credit defaults and migrations. These are estimated at 30 and 24 basis points, respectively. It also assumes per person administrative expenses of $40 per year and PBGC expenses per person of $69 in 2017, $74 in 2018, $80 in 2019 and indexed thereafter, plus PBGC variable rate premiums of 3.4% of unfunded vested benefits in 2017, 3.8% in 2018, 4.2% in 2019, and indexed with inflation thereafter, capped at $517 per person in 2017 and indexed with inflation thereafter. Funded status for variable rate premium assumed to be 85%.
WHO SHOULD DE-RISK?

Pension-heavy companies—Studies have shown pensions weigh on the stock prices of pension-heavy companies by increasing a company’s beta and cost of capital. This is because a firm’s stock beta typically reflects the riskiness of the company, including its pension plan. This risk has manifested itself through plan contributions—S&P 500 companies have contributed approximately $300 billion to their plans since year-end 2000, significantly constraining their cash flow and financial flexibility. In times of crisis, pension heavy stocks underperform the market, and during these times, pension de-risking discussions often take center stage on earnings calls and in corporate boardrooms. However, in good economic times, pension discussions are often relegated, and companies tend to focus on earnings growth and cash return strategies. By implementing risk management strategies in good times when they have the means to do so, companies can build a strong defense so they can prosper even during a downturn.

Cyclical companies—Certain companies are more vulnerable to swings in the business cycle or the prices of commodities, and tend to suffer when both the business and the pension plan underperform simultaneously during a downturn, impeding financial flexibility. As a result of their sensitivity to economic forces outside of their control and generally high degree of operating leverage, these sectors, such as consumer discretionary and materials, tend to possess high cash flow volatility relative to other areas of the economy. Companies in these sectors become more vulnerable if they sponsor a large pension plan, and tend to significantly underperform compared to their less pension heavy peers, as shown below.

Pension risk may have the greatest impact on the valuation of cyclical firms

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Note: Represents the value of $1 invested in each segment at the beginning of the period. A comparable percentage return can be obtained by subtracting 1 from the final number (i.e., 6.41 – 1 = 541% return). PBO ÷ Market Cap of companies are sorted annually by quartile to determine pension heavy and pension light groupings. Calendar year total returns for each grouping are averaged annually. Firms in this study may migrate into or out of the pension heavy or pension light groupings based on their annual pension overhang relative to the quartile thresholds.

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DE-RISK WHILE YOU HAVE THE MEANS TO DO SO

The current economic and regulatory landscape has produced desirable conditions for pension de-risking. However, this environment could be short-lived. By implementing risk management strategies while they have the means to do so, companies can build a strong defense now so they can pursue growth initiatives even during a downturn.
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