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Current Pension Risk Management Strategies

Worldwide Employee Benefits Network
New York Chapter

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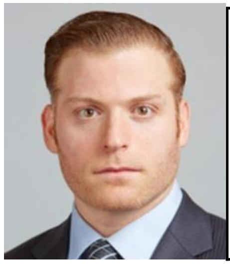
Introductions

Lisa Herrnson, JD

Lisa Herrnson is a Managing Director in PwC's Human Resource Services Practice in the New York office. Lisa has over 25 years of experience in the field of employee benefits, advising clients on the design, implementation and operation of qualified and non-qualified retirement plans, as well as compliance with the requirements of the Internal Revenue Code and ERISA.

Cornell Staeger

Cornell Staeger is a Director in PwC's Human Resource Services Practice in the New York office. He has over 14 years of experience in employee benefits consulting focused on process and controls of day-to-day operations of benefit plans including de-risking efforts.



David R. Cantor, CFA, FRM, ASA, EA

David is a Director in PwC's Pension Risk Management and Investment Consulting Practice. David has over 13 years of experience assisting plan sponsors with managing the risks in their defined benefit programs. David has worked with numerous clients through pension risk management strategies from feasibility analysis through to implementation.

Andrew Cecchetti

Andrew Cecchetti is a Senior Associate in PwC's Human Resource Services Practice in the New York office. He has worked on a number of large pension de-risking projects.

Objectives

- Discuss the drivers behind the decision to pursue a pension risk management strategy
- Provide a current overview of pension risk management strategies
- Consider legal and regulatory developments concerning current pension risk management approaches
- Implementation and execution issues

Pension Risk Management

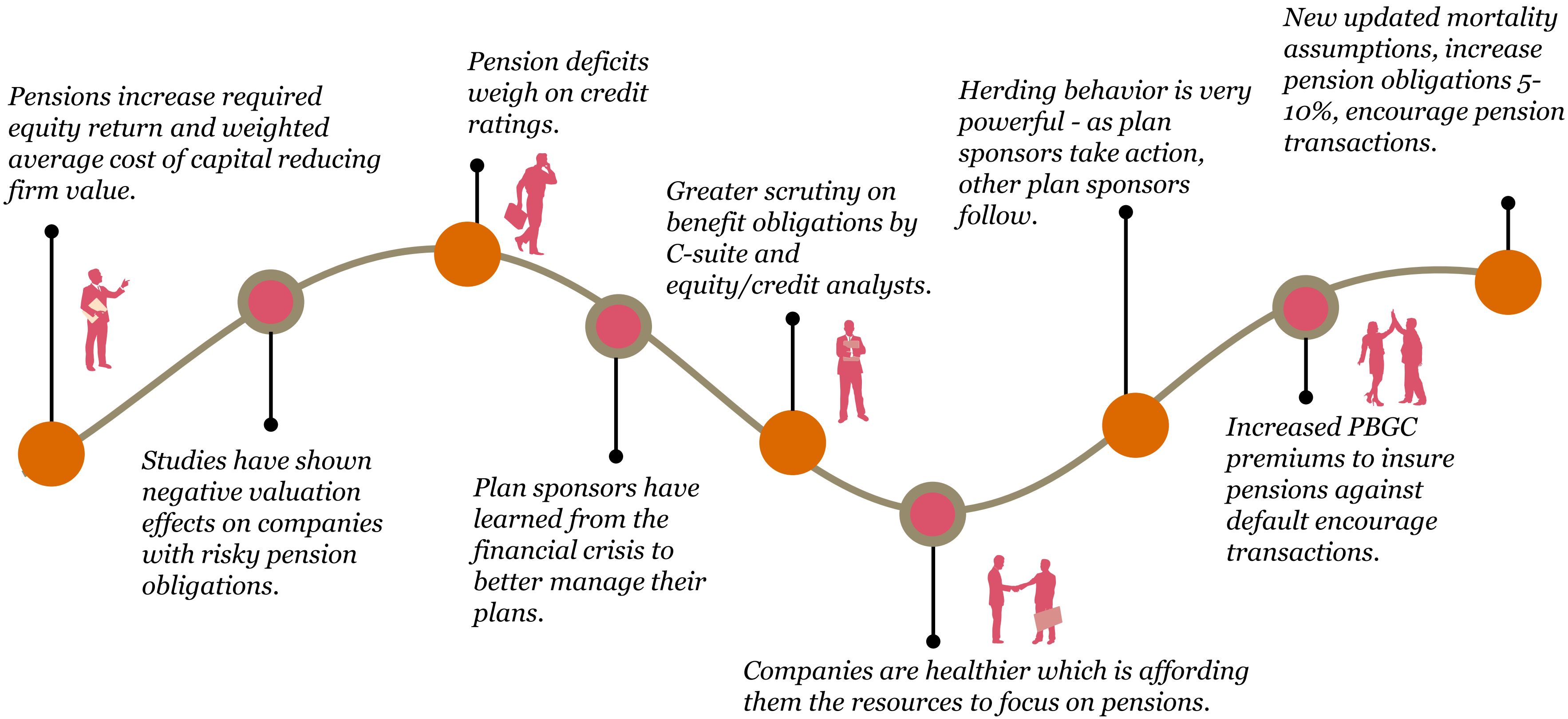
Key themes

"The last decade has been a long and bumpy road for managers and investors in companies that sponsor large defined benefit plans. We think the number one priority of managers and desire of most investors we talk to is to put everything related to DB pensions in the past. We think treating pensions as a legacy issue will be the general strategy of most sponsor company managers. Isolating pension risk and eliminating or at least minimizing the effects to earnings and the balance sheet will take top priority"

- David Bianco, Chief Equity Strategist at Deutsche Bank

- Companies are looking to minimize volatility created by defined benefit pension plans.
- CFOs are looking to reduce the size and materiality of their plans.
- Pensions are increasingly a C-suite issue and require advisors with multi-disciplinary skills (i.e., liability management, investments, risk management and financial analysis).

Why are companies focused on managing pension risk?



Financial, regulatory and psychological factors are driving the trend in pension de-risking

Bipartisan Budget Act of 2015 will likely further spur pension risk management activity

- The Budget Act significantly increases PBGC premiums for defined benefit plans

	Flat Rate Premium	Variable Rate Premium *(for every $ of unfunded vested benefits*
2016	$64	3.0%
2017	$69	3.3%
2018	$74	3.7%
2019	$80	4.1%

- Cost to maintain a defined benefit plan continues to increase.
- Sponsors may consider employing strategies to control these costs.

Bipartisan Budget Act of 2015 will likely further spur pension risk management activity

- The Budget Act also extends interest rate smoothing:
  - MAP-21 (2012) stabilized interest rates by requiring that each segment rate fall within a corridor of the 25-year average of rates for that segment.
    - Corridor initially set at 10% with 5 percentage point increases each year until reaching 30%, the permanent corridor
  - HATFA (2014) extended interest rate smoothing to keep the corridor at 10% through 2017.
  - The Budget Act extends the 10% corridor through 2020, increasing by 5% per year through 2024 when the corridor will reach the 30%.

Change is expected to result in smaller statutory funding requirements.

- ***Plan sponsors will need to weigh smaller requirements against increased PBGC premiums.***
- ***Some solutions have the potential to worsen plan funded status but extension of interest rate smoothing provides some cover.***

Bipartisan Budget Act of 2015 will likely further spur pension risk management activity

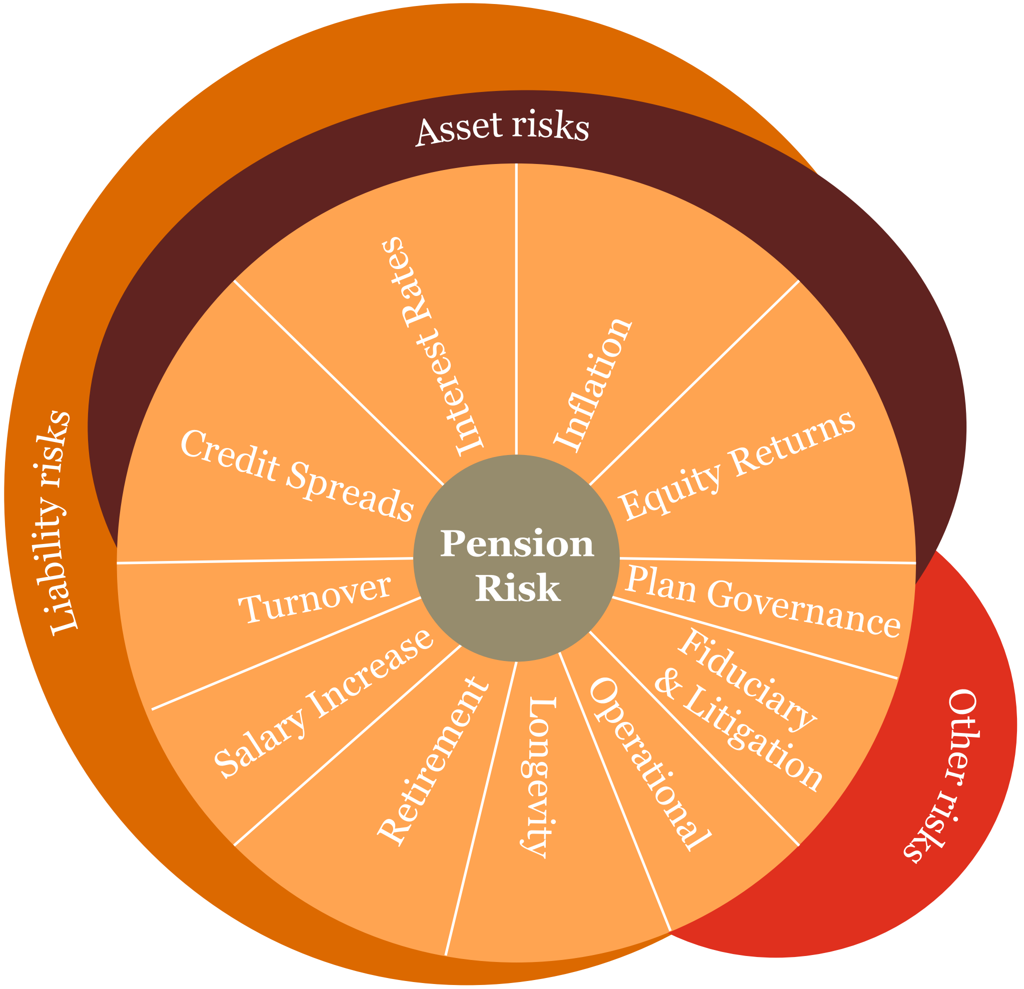
- IRS is expected to revise general tables for plan years beginning in 2017, based on changes in mortality tables published by the Society of Actuaries.

- Budget Act includes a provision that will increase the ability of plan sponsors to use plan-specific mortality tables rather than general tables to value liabilities.

Plan sponsors are considering conducting studies to evaluate how their mortality experience compares to the general tables

Understanding common pension risk factors

Asset risks	• Credit spreads • Interest rates • Inflation • Liquidity • Equity returns
Liability risks	• Credit spreads • Interest rates • Turnover • Salary increase • Retirement • Longevity • Inflation
Other risks	• Plan governance • Operational and compliance • Fiduciary and litigation



Pension Risk Management Toolkit

Benefits ⟷ **Investments** ⟷ **Funding** ⟷ **Insurance**

- **Benefits**
  - Pension Plan Design
    - Freeze DB Plan
    - Convert to hybrid plan
  - Lump Sum Payouts to terminated vested participants
- **Investments**
  - Liability driven investing
  - Dynamic asset allocation (i.e. glidepath construction)
  - Best in class growth portfolio (alternatives, factor asset allocation, risk parity, smart beta, etc.)
- **Funding**
  - Discretionary contributions
  - Debt issuance
  - Stock issuance
- **Insurance**
  - Partial Annuitization
  - Buy-in / buyout
  - Guaranteed LDI product
  - Longevity swap
  - Plan termination

Plan sponsors and fiduciaries should align the de-risking decision making process with their strategic objectives while managing their duty to participants

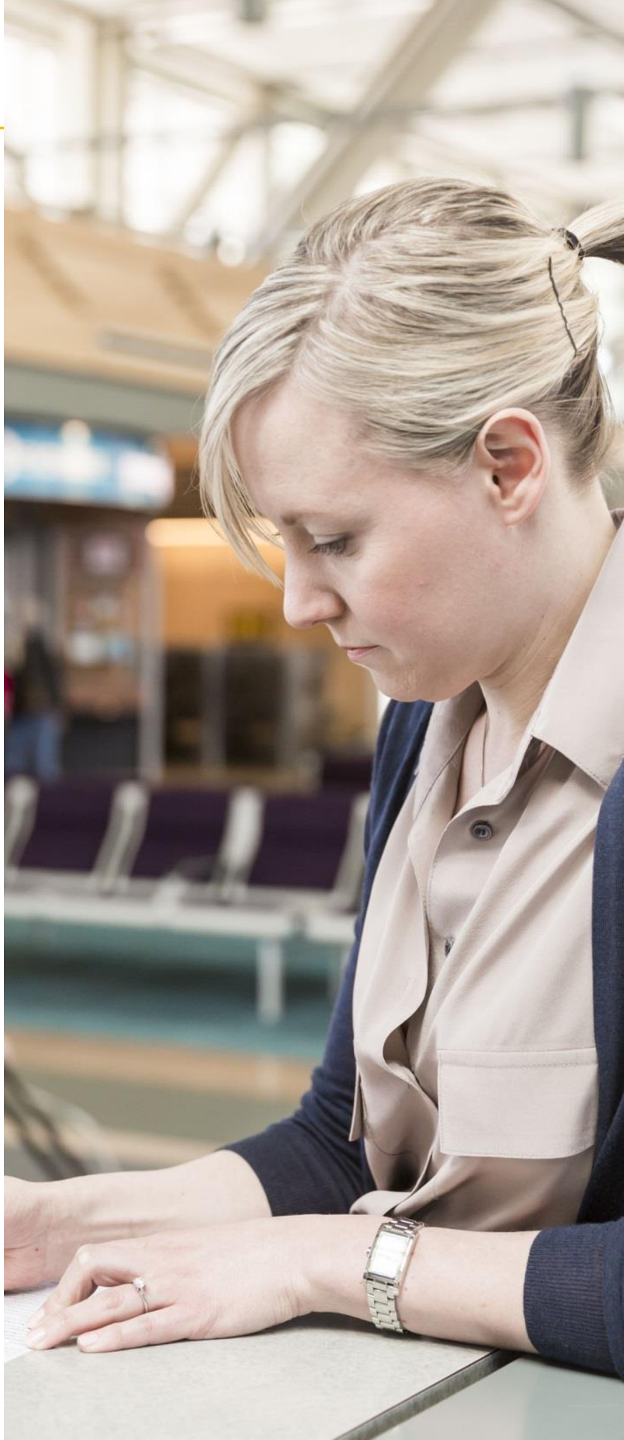
Pension risk management strategy framework

Define corporate objectives	• Understand plan details (e.g. frozen vs active, current funded status, type of assets held, etc.) • Place the pension in the context of the sponsor's overall business and quantify the current risk profile of the plan (e.g., pension liability to market cap) • Define the risk management objective, time horizon, constraints (e.g., liquidity) and any other important considerations • Understand key metrics that influence strategy selection (e.g., corporate cashflow, credit rating, adjusted GAAP/EPS , leverage ratios, funded status, volatility, etc.)
Analyze potential strategies	• Identify strategies that can be implemented and measured against the status quo. For example: - Annuity purchase - Lump sum offering - Optimization of investment strategy - Combinations of strategies • Model impact on key metrics over time and over variety of scenarios to test strategies
Score and implement	• Score the strategies based on how they impact key metrics (e.g., using deterministic, stochastic, historical, scenario-testing methods) against the sponsor's objectives and constraints • Identify the best strategy based on scoring and any qualitative considerations (e.g., fees) • Execute the strategy
Monitor and refine	• Periodically monitor the strategy against defined objectives • Identify whether changes in strategy are required • Reassess other strategies to determine if they may now be appropriate

Lump Sum Buyouts

What is a Lump Sum Buyout?

- Voluntary offering of a lump sum optional form of benefit to former employees who have a fully vested benefit and have not commenced their defined benefit pension.
- Accepted lump sums are typically in full settlement of the participant's benefit, so plan liabilities and assets are reduced by the transaction.
- Common to offer a lump sum for a temporary period of time.
- Lump sum is determined using required interest rates based on corporate bonds.
- Participant may elect to rollover the lump sum distribution into an eligible retirement plan or IRA.
- Participants must also be offered the option to elect an immediate annuity in the normal form of benefit.



Lump Sum Buyout Overview

Assess

Month 1

Identification of Target Participant Pool

- Calculate estimates of financial impact
- Determine special groups and communications strategy
- Collect demographic data
- Verify address/ death/indicative data
- Finalize eligible participants

Calculate

Month 2

Calculation of Benefit Amounts

- Calculate and verify accrued benefits
- Draft and adopt Plan amendments
- Calculate optional forms of payment
- Send initial postcards
- Draft supporting communications

Initial and Reminder Postcards

Communicate

Month 3

Administration of Lump Sum Window

- Compose/Print/Mail personalized packages
- Develop Call Center operations and training
- Communicate and process escalations

Personalized Statement & Decision Guide

Process

Month 4

Elections Made and Documented

- Follow up with participants as needed (i.e. "NIGO")
- Provide election statistics
- Send confirmation letters
- Document/Store incoming mail and phone calls

Finalize

Month 5

Distributions to Participants

- Make payments to participants
- Coordinate with trustee/ administrator
- Maintain audit trail

Call Center Support

Execution Questions to Consider

Eligibility:

- Which groups to target, discrimination issues
- When to cut off (substantial consideration)

Plan:

- How is Plan drafted, structure of proposed amendment, optional forms provided, interest rates

Address verification:

- Utilize third parties to obtain contact information (what is underlying source of the data)
- What is current "bad address" population

Data clean up:

- Planning will need to reflect necessary time to make data complete, including determining if participants are alive, confirm benefit amounts

Benefit:

- Inclusion of early retirement subsidies, multiple benefits, offsets

Execution Questions to Consider (continued)

Interest Rate:

- What is lookback period? What are Plan terms? What is current trend?

Call Center:

- Establish call center with separate toll-free number (insource vs outsource)
- Develop scripts, Q&A, escalation protocols

Guidance:

- What level of support do you provide (inform but not influence)?
- Fiduciary responsibility

Outreach:

- Potential calls (live or auto dials), emails and/or postcard notifications as reminders at before and/or during the window

Execution Questions to Consider (continued)

Marital Status/ Spouse DOB:

- How do you communicate and provide personalized information?

Rollovers:

- Does the DC plan accept rollovers from the DB plan? If not, consider amending the DC plan to allow this option. If rollovers are permitted, make sure the DC plan is ready to handle.
- Will record-keeper allow ACH direct rollovers to other institutions or are participants mailed checks?

QDRO:

- Are QDRO liabilities clearly defined on the administrative system? If the administrator is not able to provide details in time for the offering, these participants are generally excluded (as well as participants with QDROs under determination).
- If included – need to communicate to all parties.

Execution Questions to Consider (continued)

Response time:

- Optimal window period is 30 - 45 days. Reminder postcard if no response one month into response period.
- “Soft close” vs “hard close”

Backend/Processing:

- Do you have a clearly defined procedure for processing distributions? Expect a high volume in a short time period. Packages are processed as received, but last-minute returns and follow-up will extend 2-3 weeks following the election period.
- Payments typically must be made in the year the window is offered. Processing time must be accounted for when selecting window dates to ensure enough time for payment file to be created, tested, and finalized.

Audit Trail:

- Need to ensure that proper documentation is maintained throughout and after the window to ensure compliance with audit procedures.

Legal and Regulatory Developments

Mortality Rate Changes

- Society of Actuaries published new tables

Disclosure of de-risking activities

- PBGC to seek reporting on activities to assess future financial exposure
- DOL to clarify guidance on information provided to participants

IRS Notice 2015-49

- Amends regulations to prohibit a pension plan from offering a lump sum window to participants in pay (i.e. retirees)

GAO Report

- Issued January 2015 – see detailed slide

GAO – Participants Need Better Information When Offered Lump Sums That Replace Their Lifetime Benefits

GAO reviewed 11 packets of informational materials provided by sponsors offering lump sumps to as many as 248,000 participants and found that the packets consistently lacked key information necessary to make an informed decision or were otherwise unclear.

Key Factors
Benefit Options
Lump Sum Calculation
Relative Value
Pros and Cons of Accepting a Lump Sum
Tax Implications of Accepting a Lump Sum
PBGC & PBGC Protection
Instructions for Electing or Rejecting Lump Sum
Contact Information

Communication Goals

Alert:
Opportunity is coming

Inform:
How the program works

Educate:
Guidance on the decision

Act:
How to transact

Finalize:
Complete forms and process payment

Communication Considerations

Anticipate questions: who are the various stakeholders (current employees, retirees); prepare managers, HR and employee relations

Balance messaging to provide required information in easy to understand terms

Make it easy for participants to share offer details with family and financial advisors by providing personalized information

Post all written communications on the website

Keep the opportunity top-of-mind by staggering release of announcement postcards or sending supplemental announcements

Additional options to consider: Webinars, townhalls, Q&As, outbound calls, modeling tools, investment education

Lump Sum Buyout Activities

Key Consideration	Plan Sponsor	Fiduciary	Expertise
Assess business case to offer window	X		Company-specific financial and HR objectives
Determine eligibility	X		Actuarial/Legal analysis for discrimination
Develop and approve communications		X	Internal/external benefits counsel
Amend Plan Documents		X	Internal/external benefits counsel
Calculations	X		Actuary and record keeper
Distributions	X		Trustee and record keeper
Post-window Asset Allocation		X	Pension investment strategy (post-placement)

Post Window Considerations

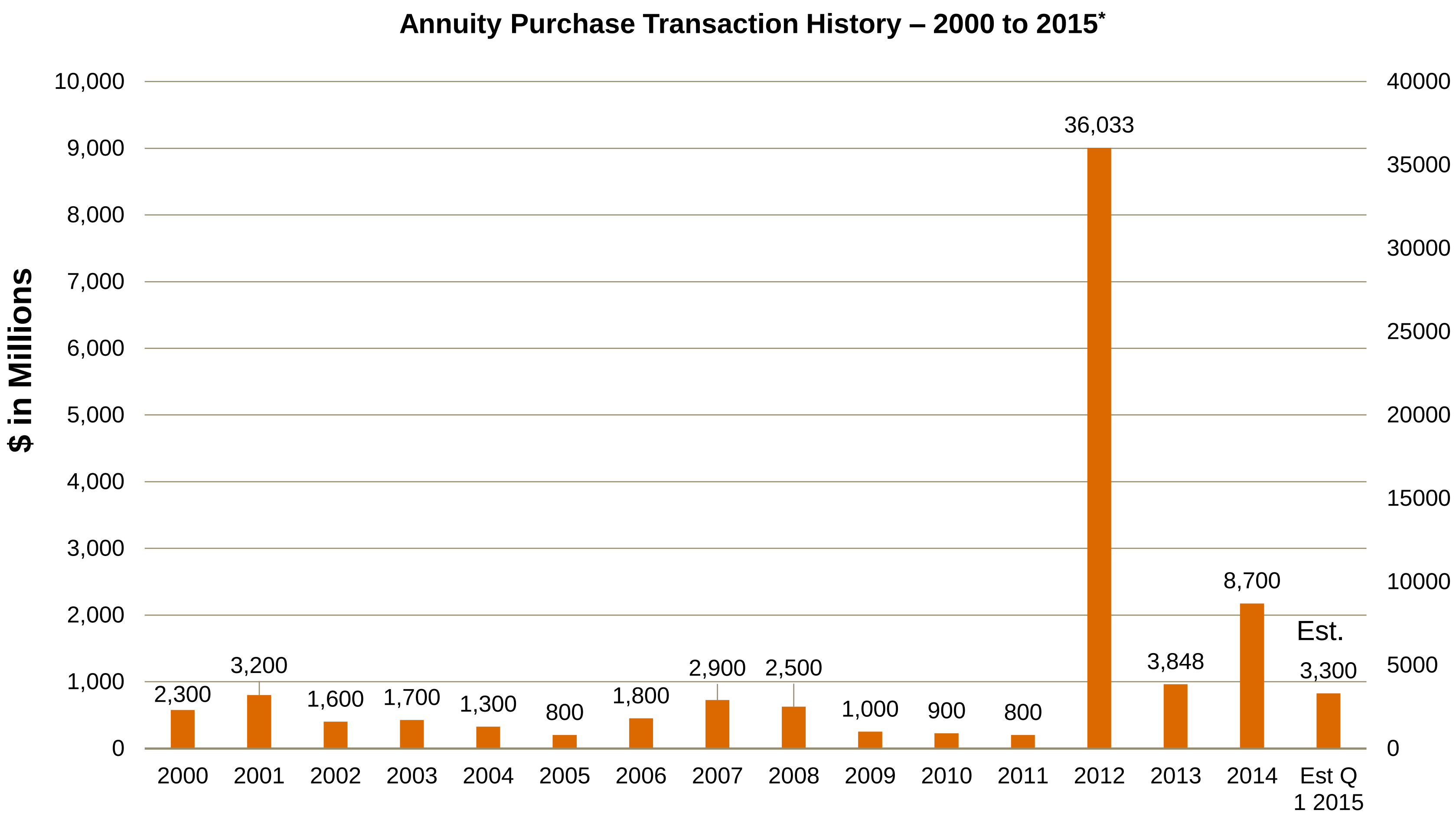
- Review asset allocations
- Manage documentation with record keepers and trustee
- Maintain audit trail
- Develop guidelines for any claims and appeals
- Consider any action for "lost participants"

Pension Risk Transfer

Pension risk transfer is an emerging trend

- Group pension annuity sales were $8.5b in 2014, a 120% increase over the 2013 total of $3.8b.
- In total, the number of buyouts in 2014 totaled 277 compared to 217 in 2013.
- Total buyout sales in 2014 were the third highest since numbers have been record-kept back to 1986.
- Recent deals include:
  - JC Penney – $1.5b partial annuity purchase with Prudential
  - Philips Electronics – $1.2b partial annuity purchase split three ways with Legal & General, OneAmerica and Prudential
  - Lincoln Electric – $425m partial annuity purchase with Principal
  - West Pharmaceuticals Services – $140m partial annuity purchase with Metlife
- As most pension plans are not in a position to fully terminate, many companies are currently looking to focus on partial risk transfers in the form of a lift-out.

Historical annuity transactions



Source: PwC, LIMRA

* Estimate for full 2015 is approximately $12b.

Phases to execute partial pension risk transfer

1	2	3	4	5	6	7
Phase I Strategic Analysis	**Phase II** Project Planning	**Phase III** Prepare RFP	**Phase IV** RFP Analysis	**Phase V** DOL 95-1 Analysis	**Phase VI:** Select Carrier	**Phase VII** Post-selection implementation

Phase	Key Activities
Phase I – Strategic Analysis	• Qualitative and quantitative evaluation of suitability of transaction using illustrative buy-out quotes • Stochastic modeling of statutory funding requirements, P&L and other pension metrics pre and post buyout • Measure impact buyout may have on share price, credit rating, etc • Sensitivity test results to changes in buyout group and other assumptions • Compare annuity purchase price to the ASC 715
Phase II - Project Planning	• Assess current buy-out market • Identify insurance carriers for solicitation of bids and establish evaluation criteria • Set desired timing and work plan to complete the transaction • Discuss roles and responsibilities
Phase III/IV – Prepare Request For Proposal (RFP) and Analysis	• Collect and review individual participant data • Document pricing assumptions and bid specification • Share any plans company may have with respect to asset transfer • Write and distribute RFP to the insurance carriers • Evaluate RFP responses based upon evaluation criteria • Compare quotes and any assumptions, caveats and terms/conditions used by the carriers in determining their quotes • Evaluate quotes relative to indicative quotes used in Phase I and update strategic analysis, if needed • Evaluate annuity purchase structure analysis and identify areas that need further clarification
Phase V – Conduct DOL 95-1 Safest Available Annuity Analysis	• Company acts both in a settlor and fiduciary capacity • To perform analysis needed to satisfy DOL 95-1, evaluate the credit worthiness and claims paying ability of the carriers • Issue a report documenting analysis with a determination of whether annuity provider satisfied DOL 95-1 criteria
Phase VI – Final Insurance Carrier Decision	• Reach final decision on insurance carrier • Document company's process and decisions
Phase VII – Post-selection implementation	• Negotiate and finalize policy terms • Review and finalize the accuracy of information and consistency of details • Finalize asset strategy and develop communication strategy for affected group

Current insurance carriers underwriting pension group annuity contracts

#	Insurer
1	American General Life
2	American United Life (One America)
3	Banner Life (Legal & General America)
4	Massachusetts Mutual
5	Minnesota Life
6	NY Life
7	Voya Life
8	Metropolitan Life
9	Pacific Life
10	Principal
11	Prudential
12	Transamerica
13	United of Omaha
14	Western & Southern

Fiduciary vs. settlor decisions in executing an annuity purchase

Key Consideration	Settlor	Fiduciary	Expertise
Group to annuitize	X		Company-specific financial and HR objectives
Decision to annuitize	X		Company-specific financial and HR objectives
IB 95-1 Safest Available Requirements		X	Insurer financial assessments
Asset-in-Kind Transfer		X	Sourcing of funds (inside the plan) to transfer
Account Structure		X	General vs. Separate Account
Number of Insurance Companies		X	Split deal vs. single insurance company
Selection of insurer(s)		X	Combined assessment of key decision factors
Post-transfer Asset Allocation		X	Pension investment strategy (post-placement)

Independent Fiduciary

Plan sponsor may use an independent fiduciary to avoid conflicts of interest when the same individuals act in corporate and fiduciary capacities

- An independent fiduciary can advise the fiduciaries charged with selecting the annuity
- Be the final decision-maker on the annuity provider

DOL 95-1 requirements

DOL Standards require that a fiduciary consider (at a minimum) the following issues.

Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert.

- The quality and diversification of the insurer's investment portfolio;
- The size of the insurer relative to the proposed annuity contract;
- The level of the insurer's capital and surplus;
- The lines of business of the insurer and other indications of an insurer's exposure to liability;
- Structure of the annuity contract and guarantees supporting the annuities, such as the use of insurance company separate accounts; and
- The availability of additional protection through state guaranty associations and the extent of the guarantees

Carrier ratings may (and should) be considered but may not be the sole criteria

Potential Litigation – Lee v. Verizon

- Plan sponsor purchased a group annuity contract through Prudential and transferred significant pension liabilities ($7.5B).
- Annuity purchase affected 41,000 participants while 50,000 remained in the Verizon DB plan.
- Case brought by two classes of plaintiffs – one representing those transferred to Prudential and one by participants who remained with Verizon.
- Participants argued for breach of fiduciary duty on the prudence of the transaction and that Verizon failed to get consent and also discriminated against specific classes of retirees.
- 5^{th} Circuit recently confirmed that Verizon did not violate ERISA.

Discretionary Contributions

Issuing Debt to Fund a Pension Plan

- The Bipartisan Act extends interest rate smoothing. This will lead to reductions in statutory funding amounts. Sponsors will need to weigh reduced contributions against higher PBGC premiums and other uses of capital. Issuing debt to finance the plan may be an attractive solution:
  - Reduces PBGC Premiums
  - Does not impact company capital structure as transaction is really a debt for debt exchange
  - Take advantage of low interest rate environment
  - Create own amortization schedule, extending the funding period beyond seven years
  - Creates predictable and stable contributions
  - Increased earnings per share due to expected return on asset assumption allowed under US GAAP
  - Accounting stabilization – financing debt can be carried at historical cost
  - Credit impact neutral according to publically released statements by Moody's

Impact on Credit Rating – From Moody's

Because of the contractual nature of pension obligations, we view underfunded pension liabilities as similar to senior debt

We adjust primary financial statements. Artificial smoothing distorts the measurement of pension expense

Strategy	Summary	Credit Implication
Voluntary Contributions	Contributions in excess of required	Positive
Liability Driven Investing	Switching asset allocation to more effectively match duraytions	Neutral
Plan Freeze	Ceasing some or all benefit accruals going forward	Positive
Defeasence of Plan Obligation	Annutizations	Neutral
	Lump sum settlements	Positive

Pension contributions in excess of required akin to pay down of debt

Credit impact dependent on source of cash

- Debt –Neutral
- Excess FCF –Positive
- Own Stock –Positive

Tax deduction if used to reduce leverage –Positive

Simple Case Study – Fund Now via Debt Offer or Contribute Over Time

- Amount of unfunded benefits: $20m
- Liability discount rate: 5.0%
- Pension asset return: 5.0%
- Inflation 2.5%
- Corporate tax rate: 35%
- Corporate debt structure: 7-year bond with level payments
- Break-even interest rate – used to compare two payment streams and solve for interest rate that would make present value of the payment streams equivalent
    - If sponsor's borrowing rate is less than break-even rate then more favorable to borrow and fund
    - If sponsor's borrowing rate is more than break-even rate then more favorable to fund the pension plan annually

Determining the Breakeven Rate

Year	Underfunded	Contribution*	PBGC VRP*
2015	$20,000,000	$3,456,396	$600,000
2016	$17,543,604	$3,456,396	$649,113
2017	$14,964,387	$3,456,396	$613,540
2018	$12,256,210	$3,456,396	$515,067
2019	$9,412,625	$3,456,396	$405,455
2020	$6,426,859	$3,456,396	$283,762
2021	$3,291,806	$3,456,396	$148,975
Break-even rate	5.0%		8.76%

Based on a 35% corporate bond rate the breakeven rate increases 8.76% + 5% * (.35/.65) = 11.45%

* Assumes 5% discount rate and return and 2.5% inflation

Additional Factors that Affect the Break-even Rate

- Change in re-payment horizon
- Level of corporate tax rates and deductibility of pension contributions and debt interest payments
- Contribution pattern under funding rules
- Market volatility
- PBGC per participant limit

Take-aways

Closing points

- Companies with defined benefit plans are looking to better manage these programs for financial, regulatory and psychological reasons.
- While many solutions exists, the specifics of the particular organization will drive the ultimate choice of strategy.
- Lump sum windows, pension risk transfer and borrowing to fund are three popular strategies companies are using.
- To execute these strategies, plan sponsors need to employ a holistic and disciplined approach that considers financial and legal perspectives.

Questions?

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