

May 2009

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Linking assets and liabilities

**Pension plan
management:
It's a capital
structure decision**

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Pension plan sponsors are currently fully engaged in managing through the second “hundred year” crisis of this decade. Sponsors are rightly focusing on dealing with the requirements of increased contributions and expense, made doubly challenging by the business environment.

At such a time of short-term stress, we might question the relevancy of taking a fresh look at basic issues. But the short-term challenges throw the basic issues into sharp relief, and the basic issues in turn provide essential context for the immediate questions that sponsors are grappling with: How much cash should I allocate to my pension plan? What’s the role of my policy on investment allocation and benefits structure? What’s best for both the plan participant and the sponsor?

For corporate plan sponsors, these questions impinge on basic issues of corporate finance: capital structure and capital budgeting of limited resources. In this publication, we explore issues relating to the position of pension plans in the broader corporate financial picture. This provides an additional framework – looking at structure – to supplement the traditional framework of looking at outcomes.

No single framework captures all the complexities of pension plan financial management, let alone corporate finance. The richness of alternative frameworks can only strengthen financial management going forward. We trust you will find this issue useful in exploring these important and basic issues.

Bob Moreen

Global Leader, Pension Risk Management Consulting

“It’s no use going back to yesterday, because I was a different person then.”

– Lewis Carroll, Alice in Wonderland

As pension plan sponsors navigate through the second “once in a century” pension crisis that has developed in the last decade, they are reconsidering many aspects of their pension risk. While short-term questions about the best course of action to take during the next year or so are important, this article will focus on longer-term issues, such as:

- What level of investment risk maximizes shareholder value for the plan sponsor?
- When is making pension contributions above the minimum required amount an effective use of the sponsor’s capital?
- Do defined benefit (DB) pensions support the mission of the plan sponsor?

The answers to these simple questions tend to be complex – and often elusive. In addressing these questions, sponsors have used sophisticated quantitative analysis from actuaries and investment professionals. With such advanced analyses, why are so many sponsors questioning the soundness of pension financial management decisions they (or their predecessors) made years ago? How could pension managers let the pension plan create so much risk for the sponsor? Were their cost and risk analyses flawed?

The answer to the last question is, “Somewhat.” Traditional methods of analysis provide sponsors with valuable information about pension finance, but when used in isolation to evaluate costs and risks, they may not yield a complete image. As with many complex issues, there are a variety of ways to look at an issue – some of which may conflict – and each provides



valuable insight for decision making. This article presents an alternative framework for thinking about pension risk – not to replace the methods traditionally used, but to augment the way sponsors think about pension risk and paint a fuller picture for sponsors making important decisions.

This alternative framework will explore how pension plan financial management can be rethought as issues related to the sponsor’s capital structure and how these issues interact with other capital structure decisions, such as those pertaining to financial leverage, debt levels, dividends and equity issuance/buyback. For many readers, this may not be a completely new concept – it could be better described as a new twist on a concept that has been used in different forms for a long time. Traditional analytical methods are neither wrong nor the cause of the challenging situations many sponsors find themselves in today, but pension decisions can only be strengthened by adopting an additional perspective. This is particularly true given the current market chaos, which demands a focus on the basics to create adequate plans for managing into the future.

Pension plan management decisions

Pension plan sponsors have three major policy decisions that have the strongest influence on the financial effects of these plans:

- **Contribution policy** – For most plans, the local country law determines the minimum required contribution, but plan sponsors may choose to contribute above this amount for strategic reasons.
- **Investment policy** – This includes the high-level strategic asset allocation, as well as the role of tactical asset allocation and other forms of active management.
- **Benefit design** – This involves determining what combinations and types of DB, defined contribution (DC) and hybrid plans (such as cash balance) best balance human resource needs and financial constraints.

Each of these three policies for controlling pension costs and risks interrelates with the other two, and a sponsor’s specific goals will determine the most effective way to combine all three. Mercer’s Integrated Retirement Financial Management (iRFM) is our framework for analyzing all three of these policies to meet a plan sponsor’s goals (see below).

Mercer’s **Integrated Retirement Financial Management** allows plan sponsors to measure pension plan financial risk and return and interpret them against key performance indicators. The financial risk and associated return can then be managed or mitigated using three integrated policy levers, to find and maintain an optimal balance.

Financial objectives

- ❑ Competitive costs
- ❑ Business risk management
- ❑ Participant risk management



Financial outcomes

- ❑ Cash flow
- ❑ Accounting
- ❑ Economic cost
- ❑ Benefit security

Contribution policy

Of the three pension risk management policies, the contribution policy is the one that most closely aligns with traditional capital structure analysis. The unfunded (or overfunded) pension obligation is a liability (or asset) on the sponsor's balance sheet, and it is treated as a debt-like obligation (or illiquid asset). As a result:

- An improvement in the funded status of the plan is considered debt reduction, all else being equal.
- Incurring traditional debt to raise capital to fund the pension plan is considered replacing one form of debt with another.
- Contributing to reduce the underfunded position of a pension plan is considered moving assets from one part of the sponsor's balance sheet (liquid cash) to another (the illiquid pension plan).

When considering whether to make contributions above the minimum required amount, plan sponsors must compare pension debt to regular corporate debt and address this question: *When is it an efficient capital allocation decision to make additional contributions to the pension plan?*

Many plan sponsors rarely contribute more than the minimum required amount, and there are a number of reasons this may be an optimal capital structure decision:

- Using cash to fund the pension plan reduces the sponsor's liquidity and financial flexibility by putting cash into an irrevocable pension trust.
- Fully funding the plan is a rolling target because asset-liability mismatches cause continual changes to the funded status. For this reason, it may be better to undershoot full funding than to overshoot it; thus, the minimum required contribution can be optimal. This is especially true for frozen plans, as some sponsors of these plans may consider any surplus to be "unproductive."
- The sponsor's cash reserves and credit quality may dictate that getting cash to fund the pension plan simply isn't practical, as risk-adjusted expected returns on the pension investments aren't sufficient to justify the cost of borrowing or using internal cash reserves.
- The sponsor simply may believe that using funds elsewhere in the core business offers a greater opportunity for return, on a tax- and risk-adjusted basis.

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Although the reasons described above may be compelling in some situations, there are also reasons many plan sponsors contribute above the minimum required amount:

- Regular corporate debt may have more predictable payback terms – fixed interest and principal – than an underfunded pension plan subject to the volatility of the minimum funding requirements. This issue is close to the heart of sponsors facing contribution spikes due to requirements of the Pension Protection Act of 2006. Contributing more than the minimum required amounts in some years can be an extremely effective way to provide a cushion against future contribution surprises.
- Pension contributions typically are tax deductible; thus, funding more than the minimum required amount may accelerate receiving the tax deduction and effectively results in an interest-free loan from the government for the amount of the tax subsidy.
- Contributions that reduce the underfunded liability can reduce Pension Benefit Guaranty Corporation premiums.
- For cost-plus, reimbursement or rate-based industries, contributing more than the minimum may also accelerate the employer's ability to recognize revenue.
- The plan sponsor may have significant cash reserves without a more efficient short-term use, and putting them in the pension plan can allow them to be invested tax-free.
- There may be public/investor relations or human resources value to showing a higher funded status.
- There can be an improvement in earnings per share under accounting standards such as FAS87 and IAS19, which incorporate the expected return on assets, since a higher asset base will produce lower pension costs.
- In some cases, the plan sponsor may have a target for the plan beyond the legislative minimum. For example, many frozen plans have a target endgame of termination that will require cash infusion beyond the minimum in an effort to be able to fully settle plan obligations and eliminate sponsorship.
- Improving benefit security for plan participants may also be a consideration.

A plan sponsor's contribution policy doesn't directly dictate the economic costs of the plan; instead, the contribution policy primarily affects when capital is deployed to pay those costs and how that interrelates with other capital structure decisions.

Investment policy

The previous section described an unfunded pension obligation as a debt-like liability of the sponsor; this section will augment this view. Although the plan assets may not technically be owned by the sponsor in many countries – they usually are owned by a trust – the sponsor usually bears the burdens of investment shortfalls and reaps many of the rewards of investment gains. As a result, some people think of the entire pension liability as a debt-like liability of the plan sponsor and that debt is collateralized by the plan assets. This view would reflect the sponsor’s economic exposure to asset ownership and its economic exposure to the plan obligations, and it leads to a very different way of viewing pension investment risk. We’ll call this the “consolidated” view, since accountants would use similar terminology for balance sheet treatment that consolidates the pension assets with the sponsor’s assets and the pension liabilities with the sponsor’s liabilities. The “net” view, which is used in FAS 158 and IAS 19, looks at the difference.

Definition: **“Consolidation”** means considering the pension assets as corporate assets and the benefit obligations as corporate liabilities. In contrast, **“net”** presentation considers only the **“net”** funded status as the balance sheet entry.

kən-sŏl'ĭ-dā'shən


Replacing the net view with the consolidated view would not affect the valuation of the sponsor, but it could affect corporate leverage metrics such as debt/equity ratios. That is, consolidation would not affect the *value* of pension plans, but it would affect the perception of their risks and role in their sponsor’s capital structure.

Let’s look at a simple example: In the following table, consider the two hypothetical companies. They are identical and have pension plans that are large relative to their sponsor, except that Company A’s plan assets are invested in 100 percent equities and Company B’s plan assets are invested in 100 percent liability-matching bonds.¹

	Company A	Company B
Plan sponsor balance sheet		
Regular corporate assets	\$100	\$100
Regular corporate liabilities	\$0	\$0
Market capitalization	\$100	\$100
Financial statement footnote		
Pension assets	\$1,000	\$1,000
Pension liabilities	\$1,000	\$1,000
Funded status	100%	100%
Investment policy	100% equities	100% bonds

¹ In practice, it is typically not possible to create an investment portfolio that perfectly matches the liabilities.

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Both companies have identical market capitalizations and pension plans that are large relative to the sponsor, although Company A's plan has an asset allocation with significantly more risk. In a consolidated view, both companies would have total liabilities of \$1,000 and a debt/market cap ratio of \$1,000/\$100, or 10. In the net view, both companies would have total liabilities of \$0 and a debt/market cap ratio of \$0/\$1,000, or zero.

Looking forward, Company A's pension plan holds a substantial equity position, making its financial performance extremely volatile, although Company A might hope assets grow faster than liabilities. This may enhance or detract from the business, depending on actual experience. On the other hand, Company B's financial performance would be relatively stable, as assets and liabilities will reasonably track one another, and the core business – not the pension plan – will drive overall results.

In which company would you rather invest? The \$1,000 of equities in Company A's plan is worth exactly the same as the \$1,000 of bonds in Company B's plan. The only difference is that Company A is using its pension plan as a source of financial leverage – collateralizing the debt-like obligation with risky assets – rather than hedging the pension obligation with matching assets. In terms of magnitude of risk, the choice between the two is analogous to the choice between a stock and a bond.

How much pension leverage maximizes shareholder value? Some people might argue that the pension plan is a long-term entity, and thus it is best to use risky assets expected to generate higher returns over the long term; these people would prefer Company A's strategy of higher investment risk. Others might argue that issuing regular corporate debt to invest assets in equities is not a core competency of the business,² and using a debt-like obligation to take risk in the stock market is “leveraged beta,” which is something shareholders can do on their own by adjusting their own asset allocations; advocates of this argument would prefer Company B's low-risk liability-hedging allocation, even though it has lower expected returns. It is interesting to note that few corporations will borrow money to invest it in the general stock market for any purpose other than to collateralize their debt-like pension obligations.

Financial leverage (borrowing to invest) is neither inherently good nor bad. However, it must be understood and controlled by management so that it is used effectively to maximize enterprise value. That is, the pension investment policy is fundamentally a capital structure (leverage) decision for the sponsor, as is the contribution policy, and both should be integrated with other capital structure decisions of the plan sponsor.

Benefit design

Benefit design, the third lever of iRFM, is also related to the capital structure of the plan sponsor – albeit in a less direct and measurable way than it is in contribution and investment policies. For many cases, the aggregate knowledge, intellectual capital and motivation of the employee base can be a huge competitive differentiator, though this “human asset” is

² Some plan sponsors may believe they have a competitive advantage in investing pension assets if they are able to hire top-tier investment professionals and access investment areas that are not easily available to retail investors, such as alternative investments.

generally not explicitly stated on the balance sheet. Because a different benefit design affects the value and productivity of these human assets, it can also be considered a “soft” capital structure decision.

While space does not permit fully detailing the different benefit designs and their typical impact on human assets, we will summarize some main points:

First, there is competitive necessity in attracting and retaining the right employees; industries may have quite strongly defined profiles on the types (and levels) of retirement benefits they offer. Although this necessity is not as strong as it used to be, it can be a relatively powerful factor influencing plan design. DC plans typically are attractive to younger employees and may provide useful short- and medium-term retention incentives. Traditional DB plans, on the other hand, have been shown to be very effective in attracting and retaining mid-career employees, and they’ve also been shown to be an effective way to ensure that long-term employees have sufficient financial security to retire when they are at the twilight of their productive years.

The latter issue is something many plan sponsors have observed in early 2009. With the economic downturn, 401(k) balances have lost significant value and many employers are looking to reduce their headcounts; employers with DB plans are seeing less pronounced changes to retirement patterns – in many cases, this affects whether and to what extent layoffs are needed to get through the challenging economy.

In addition, plan design affects how the size of the pension plan relative to the rest of the sponsor changes with the sponsor’s lifecycle. As companies and industries such as automotive and steel mature, a traditional pension plan design will continue to grow even as the sponsor’s size remains flat or shrinks. Other plan designs, such as 401(k), cash balance plans and traditional plans with lump sums, can mitigate this issue. While plan design – including freezing accruals – usually does not significantly affect the sponsor’s risk profile in the short term, over the lifecycle of a sponsor, the plan design will have a lasting impact on the size of the plan related to the rest of the sponsor’s capital structure.

From a purely financial perspective, DB plans can provide the same level of benefit more cost effectively than DC plans. This is because professional asset management allows for lower fees and a reduced likelihood of poor diversification, as well as because the longevity risk protection for participants in DB plans allows funding to the average lifespan, whereas participants in DC plans would need to save more to protect against out-living their assets.

A more nuanced view, however, will ask: Which type of retirement plan will create a better “human asset”? It depends on what type of workforce the employer wants. The key is to realize that retirement plans are more than just a line-item expense or cash outlay; they are an investment in people – an unrecorded asset – and they affect the workforce that will escort the employer into the future.

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Rethinking pension risk

Employers are increasingly viewing their pension financial risk as not being in a silo from the sponsor's broader business, and that it can affect their core business outcomes. An iRFM approach will examine how each of the three risk management levers affects the sponsor's capital structure:

- **Contribution policy** – When is it an efficient capital-allocation decision to make pension contributions in excess of the minimum required amount?
- **Investment policy** – If the pension obligation is debt-like and the assets collateralize that debt, what investment strategy will optimize the financial leverage embedded in this arrangement within the context of the sponsor's other forms of financial leverage?
- **Benefit design** – What type of benefit design will facilitate the workforce demographics for the “human asset” needed to accomplish the sponsor's goals?

The advantages and disadvantages of these capital structure decisions depend largely on regulations, market conditions and the sponsor's individual circumstances. These decisions should be considered and integrated with other capital structure decisions, such as dividend policy, stock issuance and buyback, and incurring or paying down debt. A global plan sponsor, for example, might review all of its plans and find that additional contributions or investment risk may be more desirable in one country than in another. Alternatively, tax rules in some countries provide an advantage to putting heavily taxed investments in the plan to take advantage of the tax-favored status of the pension trust.³ Or, a plan's funded status and size – as well as the financial strength of the sponsor – may influence the optimal level of investment risk.

New thinking on pension risk is helping chief financial officers, treasurers and controllers take a broader view of pension risks, considering them within the context of the sponsor's other business risks. With so many employers making changes to their risk management policies during the last few years – and certainly more changes can be expected after the dust settles on market performance in 2008 – this new thinking often might result in different decisions. Just as there is not a one-size-fits-all capital structure for all enterprises, there is also not a single set of pension policies that is right for everyone. What retirement financial management strategies best fit your organization's capital structure?

³ For a more thorough discussion of global risk management, see the article at <http://www.mercer.com/referencecontent.htm?idContent=1330925>.

About the author

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