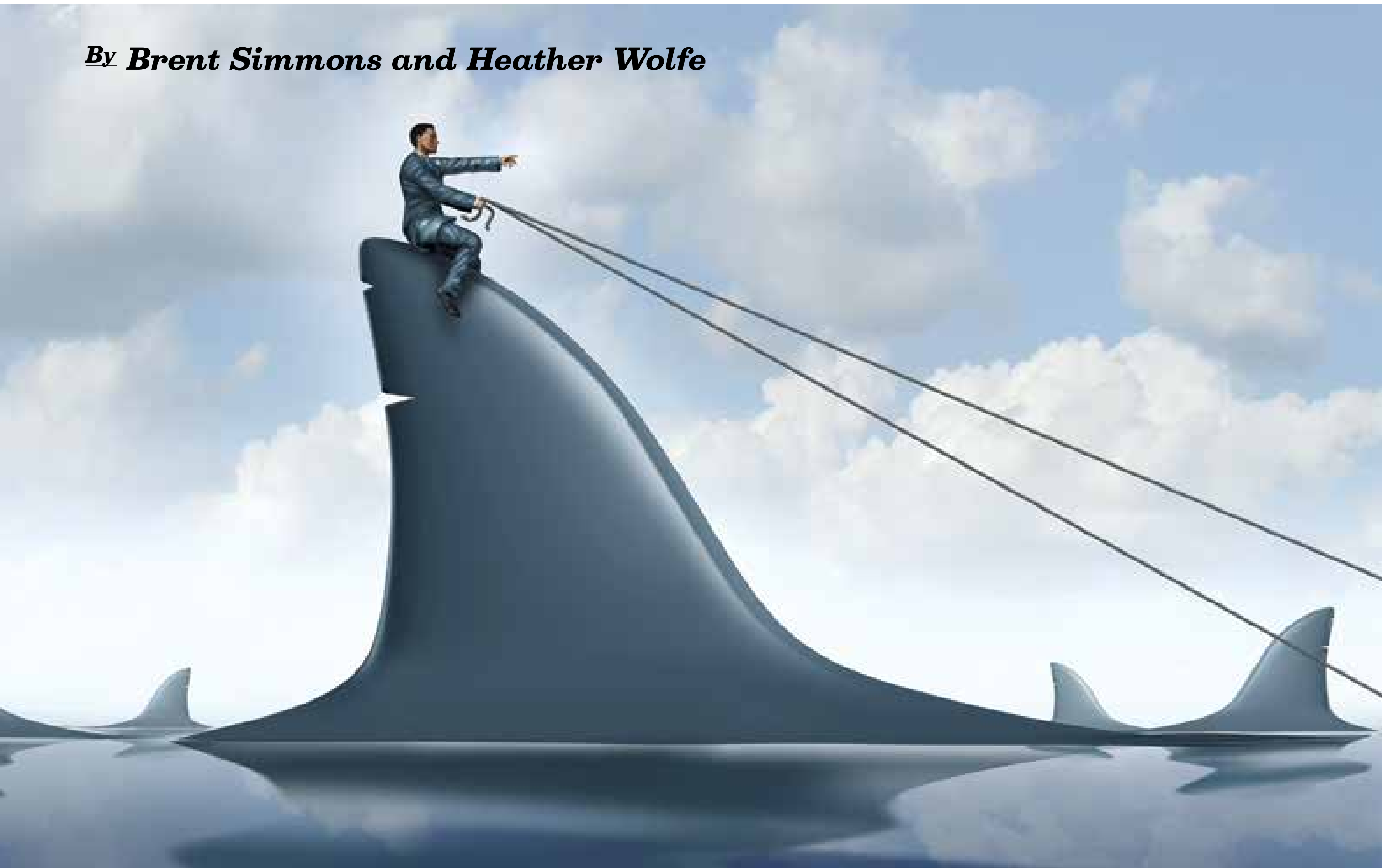
Catch the Wave

To keep their DB plans afloat, sponsors need to ensure that they're managing the risks

By ***Brent Simmons and Heather Wolfe***



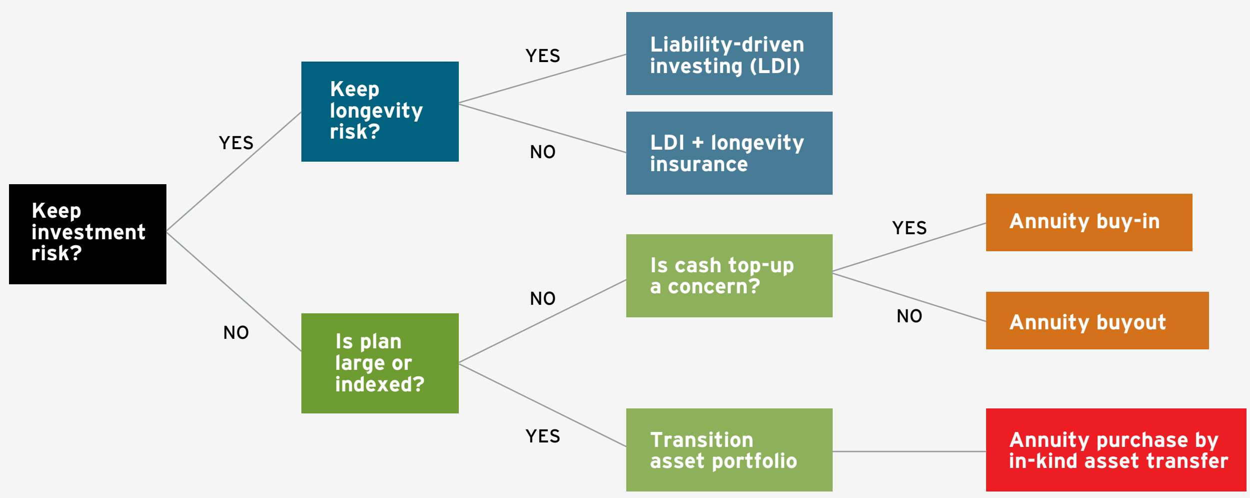
THINKSTOCK

For most companies, pension risk means volatility—either in cash contributions or accounting disclosures, or both. With many Canadian pension plans at or close to fully funded, plan sponsors are changing their philosophy and taking action. According to one global plan sponsor at a recent conference, the cost of *not* managing pension risk can be significant. The sponsor added that the focus is now on "playing not to lose" instead of "playing to win."

Companies pay a price for taking too much risk—whether through higher financing costs or a lower share price—and taking risk in the pension plan limits the amount of risk that the company can use for its core business. Considering pension risk in the context of the entire organization allows plan sponsors to allocate their risk budget for maximum return.

Deploying a company's risk budget in its core business can give the company a competitive advantage and increase its value. In the *Pension Actuary's Guide to Financial Economics,* 2006, experts argue that companies can add millions of dollars of value by reducing pension risk. Also, a study by Grant Thornton found that U.K. employers that de-risked their pension plans enjoyed a 10% increase in

THERE'S A SOLUTION FOR EVERY SITUATION



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their share prices, on average. This shows that shareholders appreciate the risks associated with pension plans and are willing to reward employers that reduce these risks.

So how can plan sponsors reduce pension risk and keep shareholders and plan members happy?

The New Frontier of LDI

Pension promises are bond-like in nature. If a plan is interested in minimizing pension risk, then a portfolio made up entirely of bonds is the right solution. Holding a high proportion of equities (e.g., 60% equities and 40% bonds) means that the plan is taking a 60% long position in equities and funding it using a 60% short position in bonds, leaving the plan with two large bets: one on equities and the other on interest rates.

Unfortunately, equity markets don't provide consistent returns each year and can be quite volatile. So a pension plan with a large proportion of its portfolio in equities has to be ready for bad news, and the company may have to forgo core business activities to divert cash to its pension plan.

Some plan sponsors make a conscious decision that taking equity risk in the pension plan fits within their risk budget. Others acknowledge that they aren't financial forecasting experts and build asset portfolios that move in line with their liabilities—in other words, using liability-driven investing (LDI). The goal of this strategy is not to outperform an asset benchmark (such as the FTSE TMX Universe) but to have the plan's assets move in the same way as the plan's liabilities.

For plan sponsors, this requires a shift in philosophy: the point of the pension plan assets is no longer to invest in equities to try to achieve excess returns, but to ensure that the assets match the liabilities so that there is always enough money to pay member pensions.

LDI is growing in popularity because it can be used to make pension plans sustainable over the long term or to transition to an annuity purchase. Sun Life's 2014 survey of 100 DB plan sponsors reveals that LDI is an emerging best practice:

- 33% are increasing their allocation to bonds;
- 31% are planning to introduce or increase their allocation to LDI; and
- 22% of plans already have a liability-based benchmark.

Some plan sponsors are going further by creating custom LDI portfolios to supercharge yields while still mitigating risk. A custom LDI portfolio is also a powerful tool for a future annuity purchase. The portfolio can be transferred in kind to buy an annuity, reducing market risk, trading costs and the purchase price.

Still other plan sponsors are looking at alternative asset classes (e.g., private fixed income, commercial mortgages and real estate) to replace the expected yield lost from reduced equity allocations.

Longevity Risk Matters

According to Statistics Canada, Canadians are already living about 20 years past age 65, and lifespans are increasing. It's great news—but it also means that plan sponsors will be paying pensions for longer. No one knows how long people will live in the future, and this uncertainty is dangerous for pension plans.

Unlike other risks, there is no reward for taking longevity risk. In fact, getting it wrong can be very costly. A rule of thumb is that every additional year of life expectancy adds 3.5% to pension costs. The new Canadian mortality tables suggest that Canadian pension plans may have been underestimating life expectancy by over two years—which translates to about 7% of liabilities! The cost of improving longevity could be significant, and many plan sponsors are analyzing their own member population to understand the plan's risk profile and the solutions available to manage longevity risk.

For example, annuities transfer investment and longevity risk to an insurance company. In 2013, a total of $2.2 billion of liabilities was transferred to insurers for group annuity purchases in Canada—more than double the amount in 2012. Demand continues in 2014, and, as of June 30, Canadian plan sponsors had purchased more than $1 billion of group annuities, according to LIMRA.

Many plan sponsors are looking at de-risking ongoing plans, not just those that are winding up, and flexible solutions such as annuity buy-ins have exploded. Annuity buy-ins transfer investment and longevity risk to an insurer without requiring a top-up contribution or an accounting settlement. (Although each plan should confirm accounting treatment with its auditors.)

Since 2009, there have been more than 20 annuity buy-ins in Canada covering more than $1 billion of pension liabilities, according to Sun Life estimates. Larger annuity purchases are also becoming more common, with increased interest in strategies such as splitting purchases to optimize pricing, accessing global reinsurers through Canadian insurers and using in-kind asset transfers.

Demand for annuities is also growing because there is compelling evidence that annuities are not expensive. Annuities are like a special type of bond that perfectly hedges pension liabilities. One way to determine the value of an annuity is to compare the expected yield that a pension plan would get by purchasing an annuity versus investing in a bond portfolio.

Most people would expect the yield on an annuity to be lower than that of a bond portfolio and that this lower yield is the cost of purchasing the longevity and investment risk protection. In fact, the opposite is true. When compared with a typical matching bond portfolio, annuities can provide an additional yield of about 85 basis points, on average (based on the published annuity proxy rate over the last six years), according to Sun Life estimates—meaning that the investment and longevity risk are transferred for free.

Your Pension Plan's Journey

Pension risk management is a critical topic for plan sponsors, shareholders, members and analysts, and sponsors are taking action. Whether the ultimate goal is to wind up the pension plan or to make it sustainable for the long term, there's a solution for every situation (see page 44).

As a plan sponsor, ask yourself the following questions:

- What's the end goal for my pension plan: long-term sustainability or full risk transfer?
- Do my stakeholders understand the risks in my plan and the solutions available to manage those risks?
- Which risks are right for my company, and where do I get the most return for my risk budget: in the pension plan or in my core business?

When pension risks are managed effectively, everybody wins. Plan sponsors can focus on their core business and leverage their competitive advantage. Shareholders benefit from a better risk profile. And plan members have more secure benefits. That's why pension risk management is the right thing to do.

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