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Retirement, Risk & Finance Perspective

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Trends in pension plan management: Reactions to a recession

The past two years have placed a great deal of strain on the US retirement system, as new rules collided with significantly lower funded levels of pension plans and plan sponsors found themselves cash-strapped. We've seen a number of different reactions to the environment. Some, such as 401(k) match freezes, are short-term solutions to manage cash through several quarters.

Other changes, however, will have longer-range implications. As plan sponsors increasingly focus on risk management, both plan designs and asset allocations have come under inspection. Pension plan freezes have continued as sponsors attempt to control costs by limiting future accruals, and there has been an ongoing trend toward better-matched assets and liabilities to control the historic pension volatility. The costs associated with reducing or eliminating benefits will need to be factored into planning for the workforce of tomorrow, and plan participants will share more of the costs – and risks – of providing for their own retirement.

This Mercer *Perspective* explores the struggle many employers have faced in managing their defined benefit (DB) pension plans. We look through the eyes of two fictional corporate executives who are involved with overseeing their respective employers' retirement programs. Our characters discuss how they have managed costs during the Great Recession, and how they are currently trying to manage risk through changes in plan design and investment strategies. We hope you will find their conversation both entertaining *and* thought provoking.

Meet Nick and Nora

Our fictional executives are **Nick**, a chief financial officer of a major telecommunications firm, and **Nora**, a chief human resource officer with a multinational software company. In their discussion, Nick and Nora touch on many of the hot issues that we hear from real DB plan sponsors. Nick and Nora last spoke to each other in a 2006 *Perspective*, when they were discussing whether or not to freeze their DB plans and move to defined contribution (DC) plans.

Here, Nick and Nora bump into each other at an airport lounge and express their views openly.

Nora: Well, hello there, Nick! How long has it been?

Nick: Nora! Good seeing you. I think it's only been a few years since we've spoken, but it feels like forever. As I recall, the last time we saw each other, we had a point/counterpoint discussion about freezing our pension plans. I'm almost afraid to ask where things stand with your company these days.

Nora: Don't be. We're all in a similar boat, bailing out through the Great Recession. But it should come as no surprise to you that the funded level of our pension plan has deteriorated. Without the options offered by the IRS last year to re-elect methods, we would have had to tell employees that certain benefit options that they are very fond of – like lump sums – would not be available now due to "benefit restrictions." As I'm sure you'll agree, pension plans are still an important employee benefit, and when things go wrong with them, it reflects poorly on the entire organization. It was a near miss for us.

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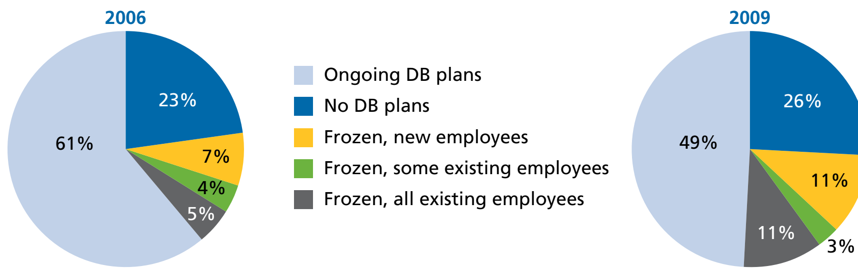
Nick: The gospel truth! But the stock markets have conspired to make all our lives more difficult with wide swings from month to month – although some investments have recovered, but who knows for how long. We did a lot last year to limit the risk to the pension plan due to rising liabilities and declining assets. We increased our allocation to fixed income assets and extended the duration of our fixed income portfolio, so now our assets and liabilities move more or less in tandem. That said, it has been an impossible situation to manage over the past couple of years, when interest rate spreads swung so wildly and rating agencies constantly changed their views of certain types of securities.

Nora: Well, we're still weighing the question of whether to freeze our pension plan or not. If we were to freeze the plan, there are two issues we would need to analyze: whether to soft freeze so new employees cannot join or whether to hard freeze for everyone. If we were to hard freeze for everyone, should we suspend all future accruals or allow benefits to grow with future pay? I've been reading in the financial press that less than half of Fortune 200 companies still maintain some type of an active DB plan for new employees. That puts us on the spot, especially in this brutal economic environment.

Key recession reaction: Plan freezes continue their general cooling trend.



Source: Mercer analysis of publicly available Fortune 200 information

Nick: We've gone ahead and snagged some cash savings by suspending our 401(k) match, but we've made it clear to our employees that this is only a temporary measure. We've seen our competitors behave in a similar way, and have recently observed that some companies are starting to reinstate the match. The DB issue is thornier. We want to manage that pension-expense volatility and reduce the absolute expense and contributions while scaling down our legacy liability – but it all comes down to whether or not the DB plan is really a differentiator in attracting and retaining key employees. I'm not so sure it is for either of our industries.

Nora: Really? I think you may still be misreading the value of a DB pension plan to any and all generations. Maybe we're both heavy on Gen X and Gen Y employees, but it goes without saying that everyone is losing faith in the ability of DC plans to provide long-term retirement security, especially since many participants are still recovering from significant drops in their plan balances. Participants just can't keep up with the models that suggest they should be earning 8% or more a year.

Nick: The bottom line is that DC plan expenses are much more straightforward for the company to provide and manage – annual expense equals annual contribution. And, according to the latest research from Mercer, DC plans are looking like the wave of the future; companies spend more on DC benefits than on any other part of their retirement programs. DB plan costs are so much more complex. And while freezing the plan will eliminate costs for new benefits, it won't help with our legacy costs.

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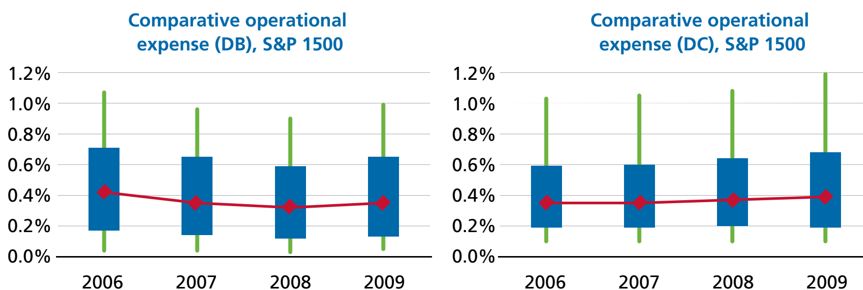
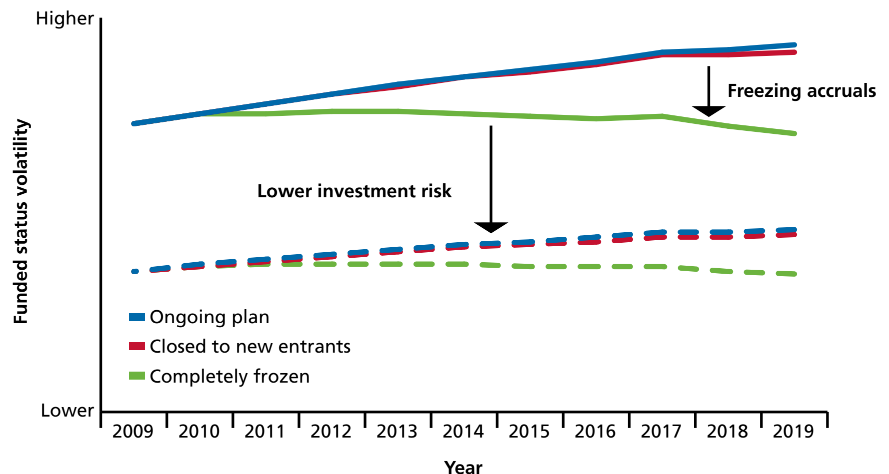
Key recession reaction: Company spending on DC plans was higher than DB service cost in 2009.



Source: Mercer analysis of publicly available information. For more details, visit www.mercer.com/retirementbenchmarking.

Nora: You really must look at all available risk-reduction techniques before you throw the DB baby out with the pension bathwater. I think the key to making DB plans work lies first in having the CFO tackle the big problem: the historic, and deliberate, mismatch of assets and liabilities that created the volatility in the first place. Only then can you truly get back to basics and the strategic plan design – get the design right and it can help you better manage the future workforce.

Key recession reaction: The trend toward lowering investment risk continues.



"You can only reduce costs in a retirement program by reducing benefits, and that goes for both DB and DC plans."

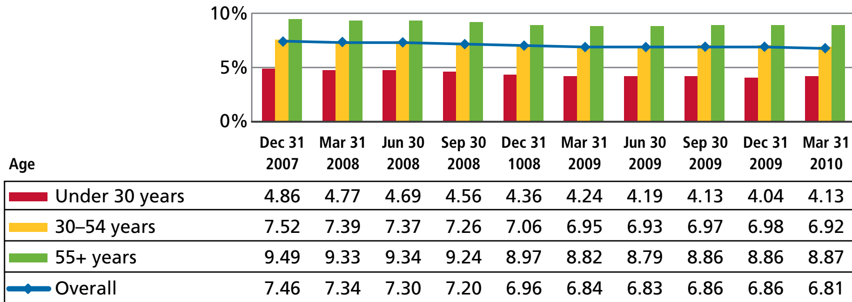
Nick: Not too subtle, Nora! But we generally agree. There is one decision that's worth thinking about: Should you move to a risk-reduction strategy all at once? We've been looking at de-risking solutions that would allow us to implement our strategy gradually over time, banking contributions and gains as they occur. Pension costs are a relatively small piece of total employee costs, and DB service costs aren't as volatile as total expenses. When we looked at the investments, we saw that there were ways of making things work by employing different investment strategies with slightly lower benefits and significantly lower volatility. We've asked ourselves whether our concern is about the absolute level of cost or whether it's about volatility. Heck, if the average were stable, would the DB plan even be in question?

Nora: We're also going through the same exercise – is the objective to reduce cost, reduce volatility, or both? You can only reduce costs in a retirement program by reducing benefits, and that goes for both DB and DC plans. You can do it on a temporary or on a permanent basis whether you freeze or suspend a plan. But admittedly, you can realize short-term savings quicker through DC plans. In the software industry, our workers know what the score is and they want a good total reward proposition.

They'll accept that the retirement picture is clouded now and that they'll have to bear a greater share of the costs and risks of planning for retirement, but they see hope in things like flexible benefits and career development. But it has been a challenge to educate employees about taking responsibility for their own retirement and risk management. For example, we find that even though the overall asset allocations in our 401(k) plan accounts are similar to our pension trust accounts, employee rates of return significantly lag behind our pension fund returns.

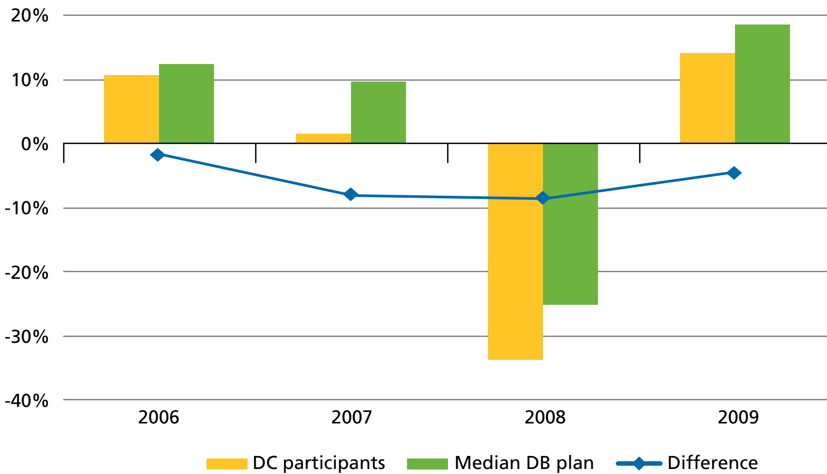
Key recession consequence: Employees contribute less to 401(k) plans and their investments underperform pension funds.

Average DC contribution rates as a percent of pay



Age	Dec 31 2007	Mar 31 2008	Jun 30 2008	Sep 30 2008	Dec 31 1008	Mar 31 2009	Jun 30 2009	Sep 30 2009	Dec 31 2009	Mar 31 2010
Under 30 years	4.86	4.77	4.69	4.56	4.36	4.24	4.19	4.13	4.04	4.13
30–54 years	7.52	7.39	7.37	7.26	7.06	6.95	6.93	6.97	6.98	6.92
55+ years	9.49	9.33	9.34	9.24	8.97	8.82	8.79	8.86	8.86	8.87
Overall	7.46	7.34	7.30	7.20	6.96	6.84	6.83	6.86	6.86	6.81

Retirement plan asset returns



Source: Mercer Outsourcing

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"For some employers, a DB plan is a better fit with their workforce strategy, so they should continue to maintain the plan while looking for ways to reduce cost and manage volatility. For others, maintaining a DB plan provides little or no benefit competitively or with respect to their workforce strategy."

Nick: We're not so far apart, then. Maybe it all comes down to comparing the value of maintaining DB and DC plans and making sure that we thoroughly explain it to our employees. For some employers, a DB plan is a better fit with their workforce strategy, so they should continue to maintain the plan while looking for ways to reduce cost and manage volatility. For others, maintaining a DB plan provides little or no benefit competitively or with respect to their workforce strategy. For these employers, freezing the plan may make the most sense – but they shouldn't forget about transitioning mid-career and longer-service employees to the new design!

Key recession reaction: Companies are not worrying as much about managing transition as they are about staying afloat.

"Grandfathering" refers to the rule that allows a portion of the plan population – usually an older group – to remain covered by the prior plan formula or certain features of it. Keeping the old plan can be done automatically or chosen as an elective. A group may also be offered an unrelated formula to "bridge" between the old program and the new. These grandfathered benefits may introduce new problems, such as discrimination issues or "cost creep."

Nora: That's an agenda item for a whole other conversation – actually, it's on the table for a meeting I'm heading out for. And that's my boarding call! Gotta go. Keep the faith!

Nick: Goodbye, and good luck!

Postscript

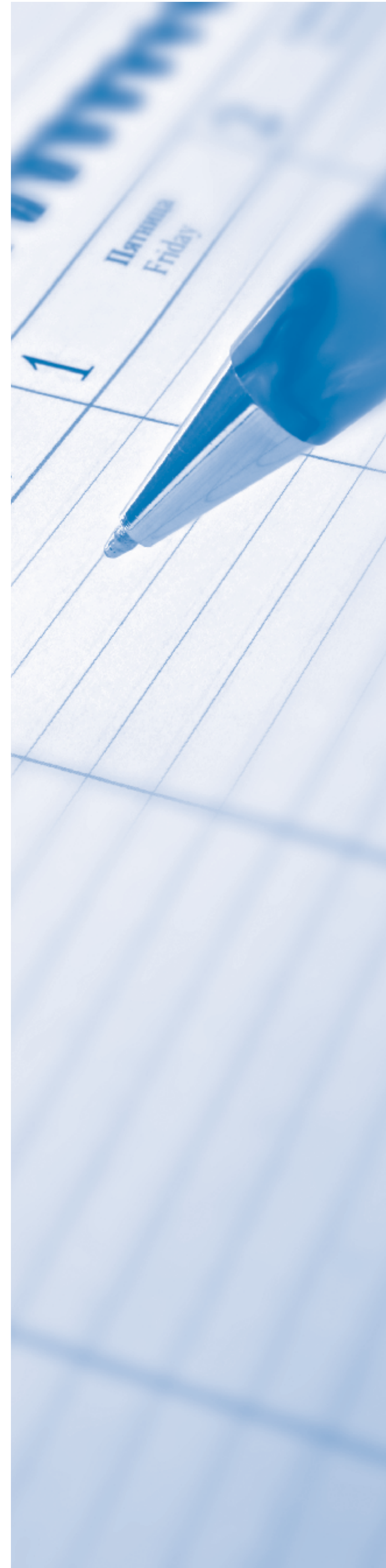
As a result of the Great Recession, sponsors of retirement plans have been forced into action. Nick and Nora have outlined several of the short-term recession reactions that have been prevalent:

- Maximizing IRS-permitted flexibility in the method elections, and taking advantage of "funding relief" that allowed plans to avoid recognizing some of the interest rate volatility observed during the last few years
- Freezing DC matches
- Taking a long, hard look at both the DB and the DC plan designs, in light of the need for speed, which often limits the amount of thought being given to transitions

Longer-term trends in financial risk management of pension plans have also continued, and even accelerated, during this recession. Asset-liability matching began to gain traction in the last recession in the early part of the century, and not only are those early adopters weathering the current recession with better results, but many have also been able to lock in significant gains on swaps portfolios when the credit spreads jumped in the latter part of 2008.

Perhaps the most fascinating new trend is that pension sponsors are starting to realize that it's not the plan design that drives the volatility, but the deliberate risk-seeking behavior that results in a mismatching of assets to liabilities. That is, freezing a plan does little to mitigate the underlying volatility. Unfortunately for many sponsors, it may be too late – with such a long-lasting trend toward closing plans, the "everyone else is doing it, so it must be a good idea" has permeated boardroom thinking, replacing many facts with impressions.

By implementing thoughtful risk reduction strategies with immediate changes in investments, or through a dynamic de-risking strategy, pension plan sponsors may be able to reduce cost volatility with less drastic changes in plan design.



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Related Mercer resources

- *Mercer Dynamic De-risking Solution: An integrated approach to pension risk management* **www.mercer.com/referencecontent.htm?idContent=1388375**
- *How Does Your Retirement Plan Stack Up?* – A survey of retirement benefit health, materiality, volatility, sustainability and management actions for the S&P 1500 **www.mercer.com/retirementbenchmarking**

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