HEALTH WEALTH CAREER

PENSION DE-RISKING STUDY – PLAN SPONSOR FOCUS GROUP

ANALYZING THE DRIVERS OF PENSION DE-RISKING ACTIVITY

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PREPARED IN PARTNERSHIP WITH THE OFFICE OF THE PBGC PARTICIPANT AND PLAN SPONSOR ADVOCATE

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OBJECTIVE AND BACKGROUND

As part of the first phase of a two-phase study in partnership with the Office of the PBGC Participant and Plan Sponsor Advocate (OPPSA), Mercer analyzed the underlying causes and drivers of pension de-risking activity, with a particular focus on factors that are related to the Pension Benefit Guaranty Corporation (PBGC) as well as those under Congressional jurisdiction. Examples of pension de-risking can be found in Appendix A.

The initial phase of the study yielded quantitative conclusions based on data from a variety of single-employer plan sponsors collected from discussion topic responses, surveys, press releases and government filings. The findings were published in the Advocate's 2017 Annual Report.

Phase One's findings provided evidence of an actively evolving defined benefit pension plan landscape – one in which most plan sponsors are continuously considering, evaluating and implementing various de-risking strategies. The initial results highlighted several important observations regarding the status of defined benefit pension plans and de-risking activity, including the following:

- De-risking is on the rise, especially risk transfers
- Financial and funding volatility and the rising level of PBGC premiums are driving risk transfer activity
- The current structure of PBGC premiums creates incentives for risk transfer for certain sponsors
- Other PBGC-related factors (for example, compliance issues and the Early Warning Program) are significant pain points for some, but generally not widespread enough to drastically impact risk transfer activity levels
- The defined benefit value proposition is shifting and plan termination is often the end goal
- Industry, plan size and funded status influence levels of de-risking activity

The second phase of this study consisted of a focus group comprised of a diverse cohort of plan sponsors, designed to gather a more qualitative perspective on the drivers of de-risking activity to complement the robust, data-driven conclusions reached in the study's first phase. This focus group served as an opportunity to hear directly from plan sponsor decision-makers on issues surrounding pension de-risking actions and future plan outlooks. Information about the composition of the focus group may be found in Appendix B.

However, by and large, the focus group participants echoed the key findings from the first phase of the study; their commentary confirmed what the data had already revealed.

What follows outlines the overarching themes from the plan sponsor focus group and helps to provide more context, if not "color," behind pension de-risking activity.

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FOCUS GROUP METHODOLOGY

A total of seven plan sponsors participated in the focus group, partaking in one of three conference calls.[1] The focus group was generally guided by a prepared set of questions provided in Appendix C but the discussion was open to any relevant topics raised by participants. The prepared questions asked plan sponsor representatives to opine on their decision-making processes surrounding maintaining open defined benefit plans and undertaking de-risking activities, their viewpoint on PBGC premiums and operational complexities pertaining to defined benefit plans and their ultimate outlook on the future of their plans. To ensure full candor, participants were promised anonymity; names of participating entities were not shared with OPPSA or the PBGC, and are not included in this report.

As is the case with any focus group, the plan sponsors selected to participate will not be perfectly representative of the larger plan sponsor universe. However, we chose a diverse group of plan sponsors with the goal of using their important and direct feedback to supplement the robust quantitative analysis performed in the first phase of the study.

Plan sponsors who participated in the focus groups were decision-makers from various backgrounds within their respective organizations including human resources, finance and treasury. Their representative organizations varied in size, industry, ownership structure and pension plan size and status. A summary of the participating entities is provided in Appendix B.

PBGC-related factors were an important element of this study. In this context, it is important to make the distinction that not all PBGC-related factors are formally regulated by the PBGC. As an example, PBGC premiums, which are a large part of the discussion in this report, are certainly PBGC-related, but are ultimately set by statute.

[1] The number of participants in the focus group was limited due to the Paperwork Reduction Act of 1980.

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KEY FINDINGS

DE-RISKING IS ON THE RISE AND CONTINUES TO BE TOP-OF-MIND

On the whole, focus group participants made one message loud and clear: each organization is in tune with the de-risking options available, their prevalence in the pension space and the value they can offer plan sponsors. All the participating entities had performed at least some degree of de-risking, whether in-plan de-risking or risk transfer, and that trend showed no signs of slowing. This was true independent of the status of the sponsors' pension plan(s) (e.g. open, closed or frozen).

Plan sponsors participating in the focus group were in strong agreement that de-risking dramatically reduced risk and liability, often significantly. This de-risking trend, backed by pension industry data collected in the first phase of this study, highlighted that de-risking is not viewed solely as a means to exit the defined benefit pension system in the short-term; rather it is a practice embraced by plan sponsors across the board, including those heartily committed to maintaining ongoing pension plans.

One respondent even took this a step further to suggest that it was the entities' *responsibility* to evaluate these de-risking tactics to make the most appropriate economic decisions for their organizations.

"I think it's our job to always continue to look for ways to transfer risk and to minimize the risk to make the best economic decisions both for the company and for our retirees."

Whether a step closer to winding-up a pension plan or a fiscally responsible way to maintain an ongoing plan, it was undeniably clear that de-risking is top-of-mind for all of the plan sponsors participating in the focus group. De-risking has become a part of the pension plan journey, regardless of a plan sponsor's destination or current location on the path.

FINANCIAL VOLATILITY AND THE RISING LEVEL OF PBGC PREMIUMS ARE DRIVING RISK TRANSFER ACTIVITY

Another message that was reiterated across the board was that financial and funding volatility and PBGC premiums are driving de-risking efforts and risk transfers. These were also two of the primary drivers of risk transfer activity identified in the first phase of this study.

The participating plan sponsors were also in solidarity about the prevalence of de-risking tactics in the pension sphere, as well as the main factors driving those risk transfer efforts. In discussing these main de-risking drivers, sponsors focused on the significant liability variation caused by shifts in the interest rate environment and the balance sheet, earnings and funding volatility those shifts introduce. Further, plan sponsors cited the uncertainty of changes in government regulations and assumptions such as mortality as additional sources of financial volatility.

Longevity improvements result in liability increases for sponsors of traditional defined benefit pension plans since participants are expected to receive benefits over a longer period of time. Mortality studies are performed periodically by organizations such as the Society of Actuaries (SOA); once new mortality tables are released, their usage is widely adopted. Focus group participants referred to such variability as unfavorable and even as an “unacceptable risk.”

On the topic of PBGC premiums, the field of respondents was once again united. The following themes prevailed in the discussions on PBGC premiums:

- Evaluating de-risking strategies often comes down to a cost-benefit analysis. Increasing administrative costs, specifically rising PBGC premiums, has made the economics of de-risking more favorable. Several participants highlighted escalating premiums as a reason why they executed risk transfer transactions instead of in-plan de-risking solutions.

- Decisions to execute risk transfers such as lump sum payout offerings and the purchase of insurance contracts (“buy-outs”) are largely driven by PBGC premiums. The primary source of economic savings in such exercises is lower PBGC premiums.

- For participants with small benefits, the economics of risk transfer are even more pronounced. The plan pays PBGC premiums based on headcount, even if the actual benefits owed to participants are very small dollar amounts. These participants with small benefits are disproportionately expensive to administer and it becomes economically attractive to transfer them out of the plan.

- Financially secure sponsors that have responsibly managed their pension plans do not expect to utilize protections provided by the PBGC and therefore see little value in their premium payments. Those same sponsors see little to no incremental benefit in the rising PBGC premiums; instead, they often feel that they are simply subsidizing sponsors with poorly funded pension plans or those who have already gone bankrupt.

- The structure of PBGC premiums is incentivizing a bifurcation of behavior among plan sponsors; the structure motivates healthy plan sponsors to exit, potentially leaving PBGC to insure an increasingly unhealthy pension universe with a shrinking premium base.

Focus group participants had candid comments about the impact of PBGC premiums on de-risking decisions.

"The PBGC premiums have inflated way higher and way faster than anything that would be considered reasonably acceptable."

"[T]he higher the premiums go, the threshold for where we'll de-risk, it just gets closer. It's purely [an] economic thing."

"The funding mechanism may be perverse in the sense that it's sort of charging the good plans and the good employers for the evils of the bad employers."

"For us, if we freeze our plan, it will be no question because of the PBGC premiums."

"[T]he way that the PBGC system is set up, it almost penalizes folks for holding the plan and trying to maintain the benefit."

"We justified our [retiree annuity purchase] strictly on PBGC premium savings."

OPERATIONAL COMPLEXITIES ARE SIGNIFICANT PAIN POINTS FOR SOME, BUT GENERALLY NOT WIDE-SPREAD ENOUGH TO DRASTICALLY IMPACT RISK TRANSFER ACTIVITY LEVELS

When asked to opine on the various operational complexities of dealing with the PBGC and other governmental agencies such as the Department of Labor (DOL) and the Internal Revenue Service (IRS), participating sponsors had common responses in line with data collected in the first phase of this study.

The predominant theme among these responses was that while such operational complexities may not arise often, they are difficult to deal with when they do arise. These operational complexities are particularly challenging for sponsors with lean internal resources to manage the plan. Plan sponsors noted that they have experienced impracticality in their interactions with such agencies, which resulted in excess time spent and higher administrative costs. One plan sponsor described such interactions as “death by 1,000 cuts.”

Nonetheless, the general consensus was that operational complexities alone were not enough to significantly drive risk transfer activity.

THE DEFINED BENEFIT VALUE PROPOSITION IS CHANGING AND PLAN TERMINATION IS OFTEN THE END GOAL

Similar to what was found in the first phase of this study, another overarching theme among focus group participants was the comprehension of a changing defined benefit value proposition. With the exception of plan sponsors operating in industries still heavily dominated by defined benefit plans, plan sponsors widely agreed that changes in market and workforce dynamics and shifts in philosophical outlooks were also drastically changing the pension landscape.

Sponsors recognized that for many industries, a steady movement away from defined benefit plans toward defined contribution plans has eliminated much of the competitive advantage of offering a defined benefit plan. Employees in such industries no longer expect defined benefit plans, leaving little incentive for plan sponsors to provide them as an attraction and retention tool.

“[W]hen we froze the [pension] plan, we’ve taken away a reason for people to stay with the company. We haven’t given them a reason to go anywhere because they are not going to go anywhere and find a [defined benefit] plan.”

Additionally, plan sponsors recognized that an increasingly mobile workforce leads employees to value a more portable benefit structure. Participating plan sponsors referenced this trend as an argument in favor of defined contribution plans over defined benefit plans.

Focus group participants also emphasized the evolving outlook that individuals should hold the ultimate responsibility for their retirement security. There was a strong sentiment that employers do not need to carry the brunt of retirement savings. In fact, some sponsors suggested that providing a defined contribution plan granted employees more control to adjust benefits to their varying circumstances. This shift away from a paternalistic mindset was common among several focus group participants. For plan sponsors with global operations, this less paternalistic outlook also seemed to resonate outside of the U.S.

Nevertheless, focus group participants were also in strong agreement that employees accruing benefits in a defined benefit plan, especially those nearing retirement, valued those benefits. They acknowledged that many employees in a defined contribution plan will never save as much money as the amount of the benefit they would have accrued if they were covered by a defined benefit plan. Focus group participants echoed concerns about this potential savings crisis – one in which employees are inadequately prepared for retirement and do not have the security of a defined benefit pension benefit. However, despite these compelling reasons, market forces did not support the continuation of their pension plans. While surely not decisions made lightly, the ultimate choices to freeze pension plans, execute risk transfers and terminate plans often comes down to economics and market competitiveness.

"[The defined benefit plan] is just not part of our business any longer and not something we really would want to continue to operate."

With a changing value proposition and an increasing level of de-risking activity, plan termination is often viewed as an end goal for plan sponsors moving away from defined benefit offerings. Several focus group participants reiterated that if they could reach an optimal funding level, they would execute a plan termination. They cited termination as a better alternative to maintaining a pension plan, paying administrative costs and continually seeking ways to de-risk. These sponsors also noted that as defined benefit plans become less common, finding resources to administer the plans will become more of a challenge.

"I would say to the degree that we get our plans frozen and balanced to the point where we feel we could move the liability to an insurance company at a very low premium or no premium, we would do that. I don't see us holding onto the pension and the administration of the hassles."

However, other participating plan sponsors took a different view. One noted that it was a "fundamental value for us to provide benefits into retirement," and that their desired end state would be a fully-funded, de-risked plan. Others took the position that certain benefits could be managed more cost-effectively in house:

"It's been shown that for some folks, hibernation strategies[2] or running an in house LDI strategy can be materially more cost effective than risk transfers."

[2] Hibernation investing involves putting plans in a steady state while winding them down over time and/or gradually preparing for pension risk transfer over a longer period of time.

INDUSTRY INFLUENCES PENSION OUTLOOKS AND LEVELS OF DE-RISKING ACTIVITY

Certain industries have maintained a strong commitment to ongoing defined benefit plans. For focus group participants in these industries, the pension outlook is noticeably different. Employers have a competitive necessity to offer pension plans and view them as a cost-effective way of providing retirement benefits.

"The main driver for keeping us in an open pension plan is competitive practice."

While certain sponsors may still look to de-risking tactics as a means of proactively managing their plans, they do not necessarily view de-risking as a step toward eliminating their pension offerings entirely – a viewpoint shared by many further down their de-risking journeys.

SINGLE-EMPLOYER PLAN SPONSORS ARE NOT IN FAVOR OF MOVING FUNDS TO THE PBGC MULTIEMPLOYER PROGRAM

An additional topic that voluntarily came up in the focus group discussions was the use of premiums from the single-employer PBGC program to fund the large deficits in the multiemployer program. Participating plan sponsors strongly opposed this.

One participating sponsor even noted that if such an arrangement were implemented, they would be encouraged to examine de-risking alternatives.

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CONCLUSIONS AND FUTURE CONSIDERATIONS

Information gathered from plan sponsors in the focus group widely supported key findings identified in Phase One of the study. These qualitative inputs provided an additional layer of recognition for some of the most vital issues facing the pension landscape as a whole. Namely, the increasing prevalence of de-risking activity, a significant concern over rising PBGC premiums and a broadly changing outlook on defined benefit plans.

Potentially even more valuable, participating plan sponsors provided insight into their decision-making processes regarding de-risking activity. It is abundantly clear that cost-benefit analyses and a detailed evaluation of economic savings are often the ultimate gateways to de-risking activity. While other factors are surely at play, PBGC premiums heavily impact the economics of de-risking activity, specifically risk transfers.

As was the conclusion in Phase One of the study, the findings in Phase Two suggest that a reduction in future PBGC premiums would have a significant beneficial impact on reducing further risk transfers and preserving the remaining plans in the defined benefit pension universe.

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APPENDIX A – EXAMPLES OF DE-RISKING TECHNIQUES

Examples of De-Risking Techniques

RISK TRANSFER (OUT OF PLAN DE RISKING)	IN PLAN DE RISKING
Lump sum payout offerings[3]	Liability-driven investment strategies[4] (LDI) and hibernation investment strategies
Purchase of insurance contracts (buy-out)	Plan design changes such as account-based formulas or variable annuities
Full plan termination	Plan closure or freeze

[3] This includes temporary lump sum windows and plan amendments to offer a permanent lump sum option.

[4] This includes insurance solutions ("buy-in"), which are prevalent in the UK but relatively uncommon in the US. A buy-in is an insurance contract that transfers risk for a subset of participants to the insurer. However, in contrast to a buy-out, the participants remain in the plan and the contract is held as a plan asset. Such arrangements are relatively unattractive to plan sponsors in the US because the sponsor must continue to pay PBGC premiums on covered participants.

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APPENDIX B – SUMMARY OF FOCUS GROUP PARTICIPANT ORGANIZATIONS

OWNERSHIP STRUCTURE	INDUSTRY	PLAN STATUS	DE RISKING ACTIONS COMPLETED
Privately held	Wholesale / Retail Trade	Closed to new entrants	Lump sum payout offering; purchase of insurance contracts (“buy-out”); plan design changes
Publicly traded	Auto / Industrial / Manufacturing	Benefit accruals frozen for some groups, open and accruing for others	Lump sum payout offering; liability-driven investment strategies (LDI); plan design changes
Not-for-profit	Education	Open and accruing benefits	LDI
Privately held	Media / Entertainment / Travel / Leisure	Closed to new entrants	Lump sum payout offering
Publicly traded	Auto / Industrial / Manufacturing	Benefit accruals frozen for some groups, open and accruing for others	Lump sum payout offering; purchase of insurance contracts (“buy-out”)
Publicly traded	Packaging	Open and accruing benefits	Lump sum payout offering; purchase of insurance contracts (“buy-out”)
Publicly traded	Energy / Utilities	Open and accruing benefits	Lump sum payout offering; LDI

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APPENDIX C – FOCUS GROUP QUESTIONS

1. If your organization sponsors an open defined benefit plan, what are the drivers that keep it open?

2. If your organization closed/froze a defined benefit plan(s), what were the primary reasons? What, if anything, could have changed your course and led your organization to maintain an open/ongoing plan?

3. If your organization previously decided to execute risk transfer, what were the primary drivers?

4. If/when interest rates rise, will your organization look to exit their defined benefit plan offering(s) promptly?

5. How concerned are you about rising PBGC premiums? Do rising PBGC premiums impact your organization's defined benefit plan outlook?

6. Do you think the PBGC is efficiently executing its mission of protecting and preserving pension plans and participants?

7. What is your view on the operational complexity of the PBGC? How about the operational complexity of other governmental agencies (e.g. DOL, IRS)? Does this complexity lead you to want to leave the DB system?

8. *For ongoing plans*: Do your employees value the organization's defined benefit plan(s)? Do you see it as a valuable tool for attraction and retention?

9. Is your organization concerned about the retirement security of employees? Does this thinking impact decisions about your organization's defined benefit plan(s)?

10. Does your organization have plans to execute risk transfer or full plan termination in the near future? If so, what and when?

11. *Special question for not-for-profit organizations:* Does maintenance of a defined benefit plan(s) adversely impact your organization's operations? If so, what drives this (e.g. plan administration, funding, operational complexity) and is there anything that could be done to ease this burden?

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