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POST-CONFERENCE BRIEF

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Pathways to LDI

Ways to reach the right funded status for more flexibility to engage in pension risk control strategies

After a year of heightened volatility — in both bonds and stocks — the average funded status of corporate pension plans by and large is unchanged from a year ago. That fact, and the impact of the volatility on defined benefit plan assets, have given chief financial officers one more reason to move some or all of their pension fund assets off their balance sheets.

But to do that, they need to get that funded status to a certain level — 80% — where CFOs begin to have greater financial flexibility to pursue a pension risk strategy or move toward a liability-driven investment strategy on their way to a potential full termination.

"If your plan is below 80% funded, you might be looking for some additional alpha from your equity exposure," said Sumit Kundu, head of defined benefit actuarial at MassMutual, speaking on the sidelines of Pensions & Investments' Managing Pension Risk and Liabilities conference. "But once they are over 80% funded, plan sponsors can start thinking about adopting glidepath strategies that move them toward more fixed-income or derisking steps like offering a lump sum window to reduce the pension footprint."

The ways for plan sponsors to improve their plan's funded status are straightforward: contributions from the company and an increase in the value of the risk assets, such as stocks, in the portfolio. Many companies made pension contributions before Sept. 15, 2018, to take advantage of one of the features in the 2017 tax reform bill. The bill lowered the corporate tax rate to 21% from 35% and, with pension plan contributions partially tax deductible, CFOs moved to make contributions that could be deducted at the higher rate.

Kundu added that companies have also been leveraging something else to improve their pension plan's funded status: low interest rates.

"With interest rates being historically low, we have seen plan sponsors borrow money from the market and put it back into their pension plan to achieve better funded status and thus reduce [Pension Benefit Guaranty Corp.] premiums," he said. "Interest payments are usually tax free, so that also adds some economic impetus to take that action."

But the flip side of lower interest rates, Kundu said, is that they can potentially prevent plan sponsors from doing a lump-sum transaction because the hit to the asset side of the ledger could drop them below that critical 80% funded-status level.

The volatility — or even movement — of a plan's funded status around 80% means that plan sponsors should have what Kundu called "trigger points" in their glidepath strategies to indicate when they need to increase or decrease their risk assets.

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"As plans reach [the 80%] trigger point in their glidepath strategies, they derisk by going into more fixed income. We also have seen instances where plans rerisk, meaning that they have moved to more equity exposure," he said. "So the glidepath is not one way, it is two ways, and we have seen both of these."

He added that plan sponsors can run the gamut, from fully funded plans going into LDI strategies to underfunded plans seeking to improve their funded status. All plans, however, focus on volatility.

"We are seeing a wide spectrum of strategies in place," Kundu said. "On one end of the spectrum are those that needed alpha to close the funded status and at the other end of the spectrum are plans that went for full LDI. In the middle of that spectrum, most plans contemplate at least some LDI or derisking option to mitigate funded status volatility risk. So everybody has these volatility risks in mind, but depending on their financial situation, they take one approach or another."

The other key factor in determining if a plan can derisk and move toward an LDI strategy or pension risk mitigation strategy is whether it is open, closed or frozen.

"If you have an active pension plan that is accruing, you can argue against going for full LDI because you lose the alpha that might be needed from the equity market," Kundu said. "That will guard against all the new accruals in your pension plan. And if your plan is underfunded, you may need to keep your equity strategy in place because you need that alpha. But when you are in that situation, you might be looking to do some opportunistic carve-out strategies, like a lump sum window or annuity buyout."

Plan sponsors also need to consider their ultimate end game and overarching retirement philosophy.

"Are they trying to provide retirement strategies or are they trying to just compete in the market?" Kundu asked. "Do they have a young workforce who doesn't care about a pension? Then why should they spend money on their pension plan? Rather, they should provide retirement options through their 401(k).

"These are the few considerations that plan sponsors need to think about before trying to make a decision on LDI versus having a pension plan at all or going for a full defined contribution approach," he said. "Also, if they are thinking about LDI and they have a plan termination on the horizon, they have to first freeze the pension plan, and only then can they think about terminating the pension plan. Long story short, I think the status of the pension plan as well as human resources and finance goals are some of the top things they need to consider before going to LDI."

Kundu said plan sponsors need to keep two more factors front and center when thinking about derisking or employing an LDI strategy: keeping a close eye on the plan's funded status and remembering that it's not just about the liability side of the equation.

"Some of the best practices are monthly or quarterly funded status reviews and then taking action [with] the glidepath strategy based on the funded status," he said. "Also, I think keeping them focused on the fact that defined benefit plans have both a liability side and an asset side, and they should not consider any strategy like LDI in isolation. They should, rather, consider both these strategies together and closely monitor which strategy makes sense at what point in time, depending on market as well as regulatory conditions." •

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