DB SOLUTIONS InSights

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The DB Pension Division:

a new way to look at your DB pension plan and *grow your company*

It's hard to read the business news these days without seeing references to private sector companies de-risking their defined benefit (DB) pension plans. This de-risking activity is occurring in the face of historically low interest rates.

What's spurring all this action? Well, many of these companies have realized that they don't have a complex and convoluted DB pension problem – instead they have an old-fashioned business problem, dressed up as a pension problem.

In this article, we explain how private sector companies are evaluating DB pension plan decisions in the context of their overall business in order to increase shareholder value.

The new pension philosophy

As plan sponsors begin to view the pension plan as an integrated part of their company…

…they realize taking pension de-risking action can magnify the competitive advantages in their core business.

Sun Life Financial

Markets reward pension de-risking

Companies that have taken pension de-risking action have generally been rewarded by shareholders and analysts.

Exhibit 1[1]

The following shows that almost all companies announcing significant pension de-risking activities earned excess single day returns on the day of their announcement.

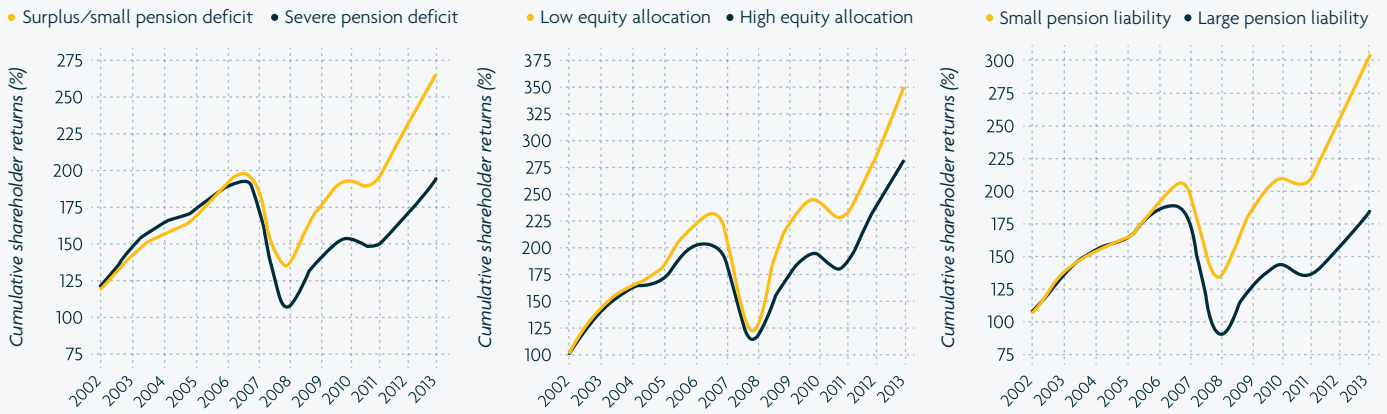
Market reactions to de-risking activities		
Kimberly-Clark	+0.1%	**February 23, 2015**: Annuity contract for approximately 21,000 retirees in the U.S.
Bristol-Myers Squibb	+0.8%	**September 30, 2014**: Annuity contract for approximately 8,000 U.S. retirees
Motorola	+2.3%	**September 25, 2014**: Annuity contract for 30,000 retirees and a lump sum offering to 32,000 term vested participants
NCR	+0.6%	**November 19, 2013**: U.K. pension annuitization
Verizon	+2.6%	**October 17, 2012**: Annuities for management retirees ("lift-out"); Earning release also impacted announcement day returns
NCR	+6.4%	**July 31, 2012**: Lump sums to certain deferred vested; $100M NPV benefits disclosed
General Motors	+1.6%	**June 1, 2012**: Annuities (spin/termination) and lump sums to retirees
Ford	-2.50%	**April 27, 2012**: Lump sums to U.S. salaried and term vested participants; Earning release also impacted announcement day returns
Honeywell	+3.4%	**November 15, 2010**: Accelerated funding; asset de-risking strategy MTM pension accounting

Note: Announcement day returns relative to the S&P Index.

Exhibit 2[2]

Analysis by Citi's Financial Strategy and Solutions Group demonstrates that S&P 500 firms with smaller than median pension liabilities, deficits or equity allocation outperform their industry peers.

Firms with smaller pension deficits/liabilities, lower equity allocation outperform



Source: FactSet.

Note: Stock price return based on annual year-end sorting of companies in the S&P 500 based on whether they are above or below the median level of 1) pension deficits relative to market capitalization in the industry, 2) equity allocation in the industry, or 3) pension liability size relative to market capitalization in the industry.

It may be hard to imagine how replacing higher yielding investments, such as equities, with lower yielding investments, such as fixed income or group annuities, could create shareholder value. **To see why pension de-risking activity has been rewarded, it's helpful to take a new perspective and to think of your DB pension plan as a division within your company.**

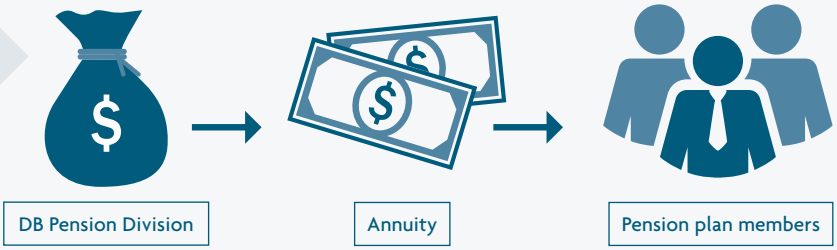
[1] Source: De-risking in a Low Interest-Rate Environment; The Prudential Insurance Company of America; 2015.
[2] Source: Time to Risk Transfer; Financial Strategy and Solutions Group, Citigroup Global Markets; 2014.

Welcome to the DB Pension Division

Many divisions of a company operate by borrowing money and investing it in the hopes of achieving a superior return. For example, if you borrow money to build a new manufacturing facility or make an acquisition, you do so with the expectation of achieving a return that exceeds the cost of servicing the underlying debt. This concept is often referred to as financial leverage.

Thinking of the DB pension plan as a division within your company helps illustrate how asset allocation decisions in the pension plan affect financial leverage, even if this financial leverage doesn't show up in traditional accounting presentations.

In essence, your DB pension plan is an insurance subsidiary – the "DB Pension Division" – that provides a single product (an annuity) to a single group of customers (your pension plan members).



Just like other divisions, the DB Pension Division has creditors (in this case it's the plan members) and invests the borrowed money with the hopes of achieving a superior return. The DB Pension Division is profitable if its investments perform well and outpace its payments to creditors.[3] However, if its investments perform poorly, the DB Pension Division may require cash infusions from other areas of the company.

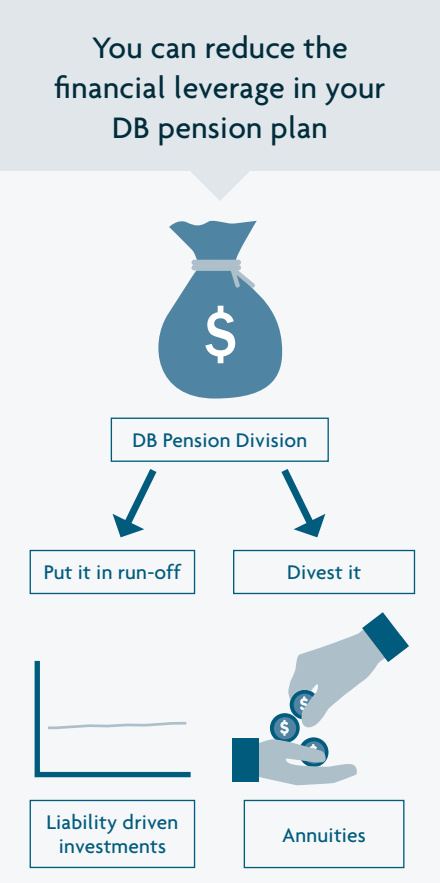
This is financial leverage, but it's hidden, because return-seeking pension assets are netted with pension liabilities and only the plan surplus or deficit shows up in traditional accounting presentations. In the core business, return-seeking assets (equipment, plant, etc.) are classified as assets and the debt funding those assets is classified as liabilities. As a consequence, traditional debt/equity ratios capture the leverage in the core business but not in the pension plan.

Since the amount of financial leverage deployed directly impacts the overall riskiness of a company, most companies have a limited appetite for it and use it strategically to increase shareholder value.

[3] Pension surplus rules may limit the ability for a company to benefit from a profitable DB Pension Division.

The question isn't "should you take risk?"; the question is "where is the best place to take risk"?

Perhaps surprisingly, even if a company expects equity returns in the DB Pension Division to outpace the underlying cost of servicing the liabilities, it may not be a good use of financial leverage.



For example, if pension plan assets are invested in equities, the business model of the DB Pension Division can be boiled down to issuing debt (by making long-term debt-like promises to its pensioners) to invest in return-seeking assets like equities. It's unlikely that a company would employ this business model in any other division because it doesn't create a competitive advantage for its shareholders.

When a profitable company has a division that doesn't create a competitive advantage, they may decide to put it in run-off or try to find a buyer to divest it. Then they reinvest in businesses they know well where management is more likely to create a competitive advantage for its shareholders.

Luckily, it's easy to reduce financial leverage in the DB Pension Division.

You can reduce financial leverage in the DB pension plan by investing pension assets to match the liabilities (commonly known as liability driven investments or LDI) or by purchasing annuities. LDI is similar to putting the DB Pension Division in run-off because the assets are reconfigured to match pension payments, thereby minimizing risk. Purchasing annuities is similar to divesting the DB Pension Division because pension liabilities are removed from the balance sheet. Many plan sponsors are using one or both of these approaches for different portions of the pension plan. For example, some plan sponsors are using LDI to reduce risk for their active members and annuity purchases to divest their retired members.

Many plan sponsors are realizing that they don't have a competitive advantage in making calls on equity markets and interest rates – but they do have a competitive advantage in running their core business. As a result, they're de-risking their pension plans.

Should I invest in my company or in the equity of other companies?

Taking pension de-risking action allows a plan sponsor to redeploy financial leverage from their pension plan to their core business where they have more expertise and are more likely to create shareholder value.

For example, if a CFO has better business opportunities than making calls on equity markets and interest rates in the DB pension plan, this CFO could de-risk the pension plan and redeploy that financial leverage to invest more heavily in the growth of the core business. In fact, an important academic study by Nobel Prize-winning economist Robert Merton shows that by de-risking the pension plan, the CFO can increase financial leverage in other areas of the company without increasing the company's equity beta, or the weighted average cost of capital for the company.[4 5]

This has been appealing to many companies because it allows them to invest in their core business, while simultaneously recapturing management time and resources from a non-core business (the DB Pension Division) at no additional cost. This is a key reason to do a pension de-risking transaction, but there are other valuable reasons to do it as well.

Benefits of implementing a pension de-risking strategy	Explanation
Avoid trapped surplus	Excess returns generated by your business can be accessed by your company immediately while excess returns generated by pension equities may become trapped surplus in the pension plan.
Generate significant tax savings	An academic paper written by Fischer Black[6] shows that investing pension assets in fixed income (decreasing financial leverage in your pension plan) and simultaneously borrowing on the corporate balance sheet to invest in your core business (increasing financial leverage in your core business) would result in significant tax savings without increasing overall enterprise financial leverage.
Reduce investment management fees	For an LDI strategy in which you move from equities to fixed income, fixed income investment management fees are generally lower than equity investment management fees.
Enhance benefit security and reduce pension volatility	Fixed income assets are highly correlated to pension liabilities, reducing pension volatility and increasing the chance that pension benefits remain secured even during times of financial turmoil. Purchasing annuities reduces pension volatility to zero and can result in increased benefit security for the plan members whose benefits are settled.

As with any change in corporate strategy, it's important that rating agencies, analysts and shareholders understand the benefits of the change. As such, companies should create a comprehensive communication plan to educate their stakeholders on the reduction in enterprise financial leverage achieved by pension de-risking activities as well as the other benefits noted above.

As we outline earlier, the market recognizes these benefits and has generally rewarded companies for taking de-risking action.

[4] Source: Allocating Shareholder Capital to Pension Plans, Merton R.C., 2006, Journal of Applied Corporate Finance.
[5] An important step in replacing off-balance sheet financial leverage in the pension plan with on-balance sheet financial leverage in the core business is to educate your rating agencies on the permanent reduction in enterprise risk achieved by the pension de-risking activity.
[6] Source: The Tax Consequences of Long-Run Pension Policy, Fischer Black; 1980; Financial Analysts Journal, 36(4), 21-28.

Why isn't everyone doing this?

At this point, you may be asking yourself if these benefits are really so great, why haven't even more companies de-risked their defined benefit plans? A big part of the reason is inertia created from old accounting rules that obscured pension risk and encouraged investment in equities.[7]

There are also several common misconceptions in the market today about the impact that a pension de-risking transaction can have. Companies that have taken de-risking action have successfully addressed these misconceptions – often by reframing them using an enterprise-wide view.

Pension-centric misconception	Enterprise-wide view
"De-risking is too expensive because it will increase pension liabilities and funding costs."	"My company should redeploy financial leverage to invest in our core business because it's a better investment than pension equities. The excess returns from the core business can then be used to fund the pension plan."
"We don't want to lock in pension deficits in a low interest rate environment."	"We should take advantage of low interest rates by issuing debt to finance pension de-risking activity. An additional benefit is that the interest on the debt issue is tax deductible."
"We need equities in the pension plan to hedge future salary growth."	"We should redeploy financial leverage to invest in our core business, where returns are more likely to be correlated with our employees' salary growth."
"We've done an asset liability study and are comfortable taking equity risk."	Unfortunately, asset liability studies often miss the point. The question isn't "are we comfortable taking equity risk?"; it's "if we're going to use financial leverage, is it better used to gain equity exposure in our pension plan or to finance growth in our core business?"
"Does equity investment in the pension plan increase our share price?"	"In order to increase our share price, do we drive growth in our core business, or in our pension plan?"
"Pension deficits are a preferred source of financing because terms are more favorable than borrowing on the corporate balance sheet."	"Corporate debt is preferred to a pension deficit because it is less volatile and results in more stable leverage metrics. An additional benefit is interest on corporate debt is tax deductible."
"It's better to take risk in the pension plan because investment losses go through OCI rather than income."	"It's better to invest in the core business so that business returns can be fully recognized in income. Pension investment income is capped at the rate on high quality bonds under IAS 19. Excess pension returns flow through OCI. In addition, IFRIC 14 (asset ceiling) may further restrict pension investment income."

[7] Source: Accounting/Actuarial Bias Enables Equity Investment by Defined Benefit Pension Plans; Jeremy Gold; North American Actuarial Journal; 2005.

What does the future hold?

As plan sponsors overcome these pension-centric misconceptions and begin to view the pension plan as an integrated part of their company, they are coming to the realization that taking pension de-risking action can magnify the competitive advantages in their core business.

They are also benefiting by avoiding trapped surplus, generating significant tax benefits, reducing investment expenses and enhancing benefit security for their plan members. In response, these firms have been rewarded by their shareholders and analysts.

Isn't it time to retool your DB Pension Division and refocus on your core business?

About Defined Benefit Solutions

Defined Benefit Solutions is a team of experienced pension and investment professionals, whose mandate is to help Canadian companies manage the risks of their defined benefit pension plans. We work closely with plan sponsors, consultants and other industry experts to deliver innovative, customized solutions – annuity buy-outs, annuity buy-ins, longevity insurance and liability driven investments – that address the specific challenges of each plan sponsor.

About Sun Life Financial

Sun Life Financial is a leading international financial services organization providing a diverse range of protection and wealth products and services to individuals and corporate customers. Sun Life Financial and its partners have operations in a number of markets worldwide, including Canada, the United States, the United Kingdom, Ireland, Hong Kong, the Philippines, Japan, Indonesia, India, China, Australia, Singapore, Vietnam, Malaysia and Bermuda. As of September 30, 2017, the Sun Life Financial group of companies had total assets under management of $934 billion.

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Brent leads Sun Life Financial's Defined Benefit Solutions team, which helps some of Canada's largest employers manage the risks in their defined benefit pension plans with innovative, customized solutions that address the specific challenges of each plan sponsor.

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For more information about Sun Life Financial's de-risking solutions, visit sunlife.ca/DBSolutions