HOW **DE-RISKING** YOUR DB PENSION PLAN CAN IMPROVE YOUR **SHARE PRICE**

DE-RISKING IS GOOD FOR EVERYONE

It's hard to read a news feed these days without seeing some mention of how plan sponsors are managing their defined benefit (DB) pension plan risk. Whether it's a company making special contributions to their pension fund, closing their defined benefit pension plan to new employees, or going to arbitration over pension issues, DB pension plan risk management is front and centre.

Better risk management increases benefit security for plan members and controls cash and accounting volatility for plan sponsors, but new research suggests that de-risking your DB pension plan is also good for shareholders.

Research from Kelvin Wilson at Grant Thornton U.K. LLP, a leading financial and business advisor, found empirical evidence that U.K. companies that have de-risked their pension plans benefitted from an average increase of 10.2% in their share price.[1]

Let's review DB pension plan de-risking to better understand why de-risking can have such a positive impact on share price.

[1] 'DB pension plan de-risking', Grant Thornton UK LLP, 2011

WHY ARE COMPANIES DE-RISKING?

De-risking is the new buzzword in DB pension plan circles. DB pension plans have become a significant issue for companies as more transparent accounting requirements and dramatic market fluctuations highlight the risks inherent in many DB plans. Key risks include operational risk, equity risk, interest rate risk, longevity risk, and inflation risk (for indexed plans).

Pension de-risking means implementing strategies to remove or reduce these risks, so plan sponsors can focus on their core business. Strategies range from risk management to full risk transfer and include plan design changes, changes in investment strategy to invest assets to move more in line with liabilities (liability driven investing), annuity purchase to transfer all risks to an insurer's balance sheet and new solutions like longevity insurance.

Plan sponsors around the world are de-risking their pension plans:

- to reduce the volatility of both cash contributions and earnings per share,
- to reduce their capital volatility,
- to reduce management time and attention for the DB plan, and
- to optimize the enterprise risk budget.

WHY WOULD A DB PENSION PLAN AFFECT SHARE PRICE?

Information about Canadian DB pension plans is disclosed in company financial statements. Pension expense, an assessment of the true cost of the pension plan, goes through the income statement. The pension plan's surplus or deficit is disclosed in the notes to the balance sheet. Investors and analysts review this information, and often do their own more detailed analysis, especially for plans that are large compared to the size of the company.

In a 2006 U.S. paper, Jin, Merton, and Bodie found that the greater risk associated with equity-heavy pension plans shows up in more volatile stock prices, even though this shows up nowhere on a plan sponsor's balance sheet. The authors confirmed that there is a relationship between pension risk – as measured by funded ratio and investment strategy – and investment returns by looking at what actually happened to share prices.[2]

Major accounting changes are coming in 2013 for Canadian companies that will even further highlight DB pension risk to the capital markets. Starting January 1, 2013, pension surpluses and deficits will be recognized immediately on the plan sponsor's balance sheet, along with asset and liability gains and losses. New commentary will be required explaining the risks associated with the DB plan and how the pension plan could affect the timing and uncertainty of the company's future cash flows.

These changes mean that instead of pension plan gains and losses being slowly reflected on the plan sponsor's balance sheet over 15 or 20 years, they will now be reflected immediately. For example, an investment loss in the pension plan will now immediately reduce a plan sponsor's level of shareholder's equity, which could impact loan covenants.

CANADIAN PENSION **DE-RISKING SOLUTIONS**

Liability driven investing (LDI)	Investing pension plan assets to behave in the same way that the plan's liabilities behave, using pooled funds or a customized portfolio.
Longevity insurance	Insurance against the possibility that plan members live longer than expected, with the insurer covering the cost of additional pension payments for longer-lived members
Annuity buy-out	A traditional group annuity contract that transfers all the risks for a group of members from the plan sponsor's balance sheet to an insurer's balance sheet.
Annuity buy-in	An innovative, flexible group annuity that transfers all the risks for a group of retired members to an insurer, but is invisible to plan members. An annuity buy-in is an investment of the plan that requires no top-up contribution from the plan sponsor and triggers no accounting settlement.[3]
Plan design changes	Changes to future benefits or cost sharing arrangements or implementing a new pension arrangement for new members or all future service.

[2] 'Do a firm's equity returns reflect the risk of its pension plan?', Journal of Financial Economics, 81(2006), 1-26.
[3] Plan sponsors should confirm the need for an accounting settlement with their own auditors.

AN ENTERPRISE RISK MANAGEMENT APPROACH

Historically, pension risks were measured in isolation from the enterprise. But pension risks can be highly correlated with risks the plan sponsor is taking outside the pension plan, and there is increasing recognition that it's critical to define, map, quantify and consolidate these risks at the enterprise level.

The "costs" of not managing risk at the enterprise level can be significant:

- disruption of loan covenants and capital ratios,
- limiting dividends and other distributions to shareholders,
- lower earnings from higher pension costs,
- hits to the balance sheet from larger pension liabilities,
- a drain on cash due to increased pension contributions,
- a drop in the share price since the plan has a larger claim on the company, leaving less for the shareholders.

Many companies are now practicing enterprise risk management and include the pension plans when deciding how to optimize their risk budget. Historical research is being re-visited and tough questions are being asked about the best use of a company's limited risk capacity and capital. Studies have shown that ignoring the pension plan can greatly overestimate the cost of capital, sometimes by as much as 30%.[4] This means that capital projects with a positive impact for the company could be rejected by management.

DE-RISKING IN ACTION

The aforementioned research from Kelvin Wilson at Grant Thornton U.K. LLP includes a case study which provides great insight into the impact of de-risking.[5]

Sector:	Automotive
Annual turnover:	£40m
Pension liabilities:	£100m
Pension fund assets:	£80m
Deficit/funding ratio:	£20m/80%
Deficit contribution:	£1.5m per annum for 5 years
Market cap:	£60m
Share price pre de-risking:	£0.2783

KEY ISSUES

- Owners want to sell operating business and exit within three years.
- DB pension deficit could undervalue the selling price of the business.
- Proposed level of contributions is unattractive to new investors.

DE-RISKING STRATEGY EMPLOYED

- Partial de-risking through a pension annuity buy-in.
- The strategy was implemented with a well- capitalized, specialist U.K. insurance company.
- £30m worth of liabilities were de-risked, with £32m of pension fund assets transferred to the insurer (the insurer valued the liabilities at £32m).
- The company paid an extra £5m into the pension fund to cover the £2m insurance cost and improve the funding ratio.

EFFECTS OF DE-RISKING STRATEGY

- The company's share price rose by 15% from £0.28 to £0.32 following completion of the de-risking deal.
- Market capitalization increased from £60m to £69m.
- Investment, longevity, inflation and interest rate risks were hedged for all the fund's retired pensioners.
- The funding ratio improved from 80% to 83%
- Going forward, a higher discount rate was used to value the pension liabilities, given the perceived lower risk in the pension fund.
- Annual contributions came down from £1.5m pa to £1m over a longer time period (10 years instead of 5 years).

[4] 'Do a firm's equity returns reflect the risk of its pension plan?', Journal of Financial Economics, 81(2006), 1-26.
[5] 'DB pension plan de-risking', Grant Thornton U.K. LLP, 2011

THE FUTURE FOR CANADIAN PLANS

Research clearly shows that DB pension risk can affect share price and that markets are starting to appreciate the considerable long-term benefits of tackling DB pension plan risk. The costs of operating a DB pension plan are rising dramatically and will continue to rise in the years to come. In the U.K., many believe that we are now at the point where the cost of de-risking will be less than the long-term cost of doing nothing.

Canadian plan sponsors are just beginning their de-risking journey and as more plans take action, we expect to see many developments:

- More interest in a wide range of de-risking solutions, especially LDI and annuity purchase. A wide range of LDI solutions are already available, and $1.4 billion of pension liabilities were transferred to Canadian insurers in 2011 – the largest amount seen in one year.
- The new accounting rules in 2013 will further highlight the true economic cost of DB pension plans and companies carrying significant pension risk may be pressured to de-risk.
- Demand for fixed income investments will continue to increase and there may be a first mover advantage for plan sponsors that get out of the gate quickly.
- The market will continue to innovate, developing new solutions to meet new needs.

Which forward-thinking Canadian companies will take serious de-risking action first, and what will the impact be on their share price? We probably won't have to wait long to find out.

THE CANADIAN DB LANDSCAPE

Canadian plan sponsors remain committed to DB pension plans and 96% of Canada's pension assets are in DB pension plans.[6] According to Statistics Canada, there are about 7,000 DB plans in Canada, covering 4.2 million Canadians, with pension assets of about $1.2 trillion. As sponsors look for ways to manage DB pension risk, a recent Towers Watson survey suggests that 38% of DB plans are now closed[7] and investment strategies are changing. The average Canadian DB plan is now invested about 59% in equities and other non fixed income assets, down from 72% in 2001.[8]

[6] Towers Watson Global Pension Assets Study 2012.
[7] Towers Watson 2012 Survey of Pension Risk.
[8] Towers Watson Global Pension Assets Study 2012

RESEARCH FROM GRANT THORNTON U.K. LLP

Company	Date	Type of de-risking	Transaction size	Change in share price
Babcock	May 2009	Longevity swap	£1.9bn	16.5%
Dairy Crest	June 2009	Annuity buy-in	£310m	16.0%
Royal Sun Alliance	July 2009	Longevity swap	£1.2bn	15.0%
British Airways	July 2010	Synthetic annuity buy-in	£1.3bn	10.0%
Denso	September 2009	Annuity buy-out	£140m	6.0%
BMW	February 2010	Longevity swap	£3.0bn	6.0%
Cadbury	December 2009	Annuity buy-in	£500m	6.0%
			Average	**10.2%**

ABOUT THE AUTHOR

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