# Pension risk management: it's a brave new world

Pension risk management is on every boardroom agenda these days. For most companies, pension risk means volatility – either in cash contributions or accounting disclosures, or both. With many Canadian pension plans at or close to fully funded, plan sponsors are changing their philosophy and taking action. In a recent presentation, one global plan sponsor commented that the cost of not managing pension risk can be significant, and they are now "playing not to lose" instead of "playing to win".

## Pension risk is not an island

Risk is a limited resource and companies pay a price for taking too much risk, whether through higher financing costs or a lower share price. Taking risk in the pension plan limits the amount of risk the company can use for its core business. Considering pension risk in the context of the entire organization allows plan sponsors to allocate their risk budget for maximum return.

Companies are experts in their core business and deploying their limited risk budget accordingly can give them a competitive advantage and increase the value of the company – a great outcome for the company, shareholders and employees. Most companies are not experts in running pension plans and don't have a competitive advantage in this area. In fact, some experts argue that by reducing pension risk you can add millions of dollars of company value[1].

Analysts are also paying more attention to pension risk. A study by Grant Thornton[2] found that U.K. employers who de-risked their pension plans enjoyed an average 10 per cent increase in their share prices. This shows that shareholders appreciate the risks associated with pension plans and are willing to reward employers who reduce risk.

[1] Pension Actuary's Guide to Financial Economics, 2006
[2] DB pension plan de-risking, 2011

## Moving away from making calls on equities and bonds

Pension promises are bond-like in nature. If a plan is interested in minimizing pension risk then a portfolio made up entirely of bonds is the right solution. Holding a high proportion of equities (for example, 60 per cent equities and 40 per cent bonds) means that the plan is taking a 60 per cent long position in equities and funding it using a 60 per cent short position in bonds—leaving the plan with two large bets, one on equities and the other on interest rates.

Unfortunately, equity markets don't provide consistent returns each year and can be quite volatile. So a pension plan with a large proportion of its portfolio in equities has to be ready for bad news as well as good. For most plan sponsors, bad news in their pension plans creates material challenges for them. The result may be that they have to forgo core business activities to divert cash to their pension plans.

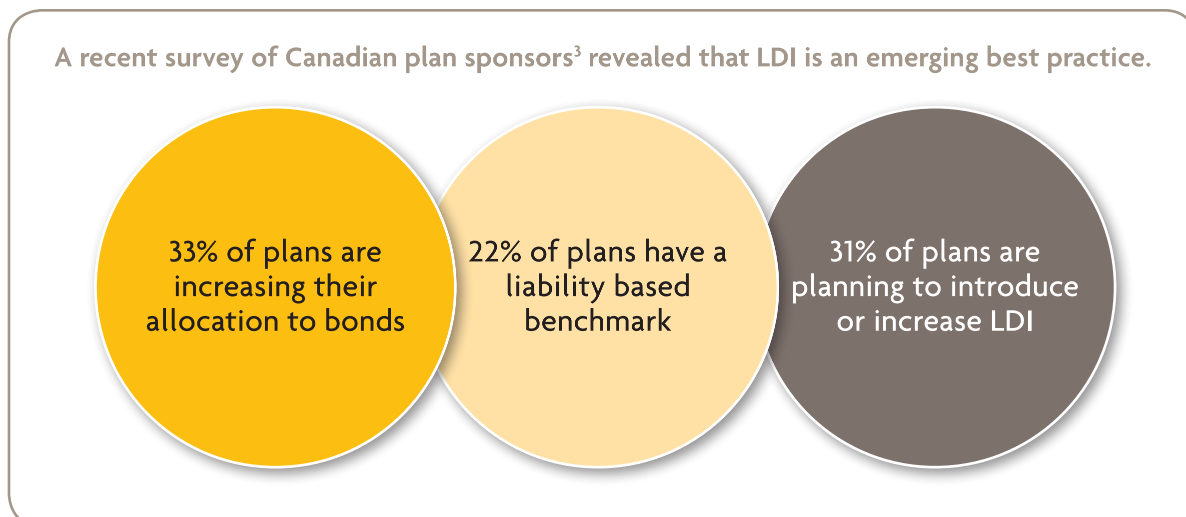
Some plan sponsors are making a conscious decision that taking equity risk in the pension plan fits within their risk budget, as they hope to use the excess returns that can be generated to improve the plan's funded position, or reduce costs.

On the other hand, many plan sponsors are acknowledging that they aren't financial forecasting experts and are building asset portfolios that move like their liabilities. This is called liability driven investing, or LDI. The strategy is not to outperform an asset benchmark (such as the FTSE TMX Universe), but to have the plan's assets move the same way as the plan's liabilities move.

This requires a shift in philosophy from employers. The point of the pension plan assets is no longer to invest in equities to try to achieve excess returns. Instead, the point of the pension plan is to ensure the assets match the liabilities so there is always enough money to pay member pensions.

## Liability driven investing is the new frontier

LDI is growing in popularity because it can be used to make pension plans sustainable over the long term or to transition to an annuity purchase.




Some plan sponsors are going further and creating custom LDI portfolios to super charge yields while still mitigating risk. A custom LDI portfolio is also a powerful tool for a future annuity purchase. The portfolio can be transferred in-kind to purchase an annuity, reducing market risk, trading costs and the purchase price.

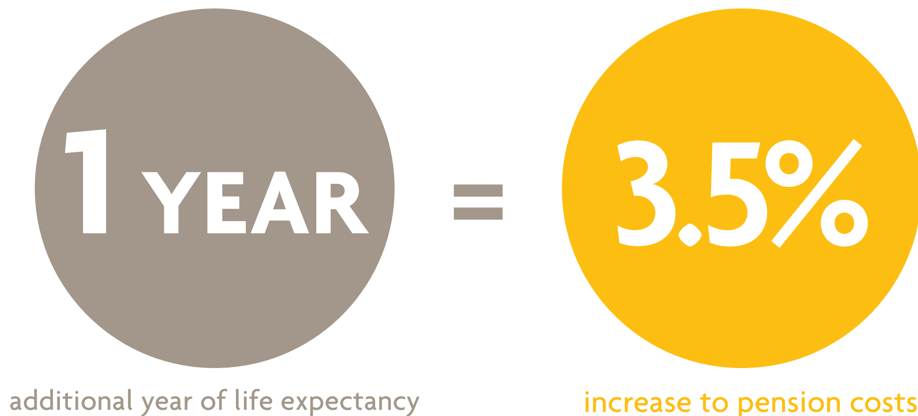
Other plan sponsors are looking at alternative asset classes (like private fixed income, commercial mortgages and real estate) to replace the expected yield lost from reduced equity allocations.

[3] 2014 Sun Life Investment Management Defined Benefit Plan Report

## Longevity risk matters

With the long-awaited arrival of new mortality tables for Canadian pension plans, longevity risk is getting more attention. According to Statistics Canada, Canadians are already living about 20 years past age 65 and this is increasing. It's great news that Canadians are living longer, but it means that plan sponsors will be paying pensions for longer. But no one knows how long people will live in the future and this uncertainty is dangerous for pension plans.

Unlike other risks, there is no reward for taking longevity risk. In fact, getting it wrong can be very costly. A rough rule of thumb is that every additional year of life expectancy adds 3.5 per cent to pension costs. The new Canadian mortality tables suggest that Canadian pension plans may have been underestimating life expectancy by over two years[4], which translates to about seven per cent of liabilities! The cost of improving longevity could be significant and many plan sponsors are analyzing their own population to understand the risk profile of their plan and the solutions available to manage longevity risk.




## Annuities are in demand

Annuities transfer investment and longevity risk to an insurance company. 2013 was the biggest year on record for Canadian group annuity purchases with $2.2 billion of liabilities transferred to insurers[5], more than double 2012. Demand continues in 2014 and as of June 30, Canadian plan sponsors had purchased over $1 billion of group annuities[6].

Many plan sponsors are looking at de-risking ongoing plans – not just those that are winding up – and flexible solutions like annuity buy-ins have exploded. Annuity buy-ins transfer investment and longevity risk to an insurer, without requiring a top-up contribution or an accounting settlement.[7] Since 2009 there have been 20 annuity buy-ins covering over $1 billion of pension liabilities[8]. Larger annuity purchases are becoming more common, with strategies like tranching purchases to optimize pricing, accessing global reinsurers through Canadian insurers and in-kind asset transfers starting to catch on.

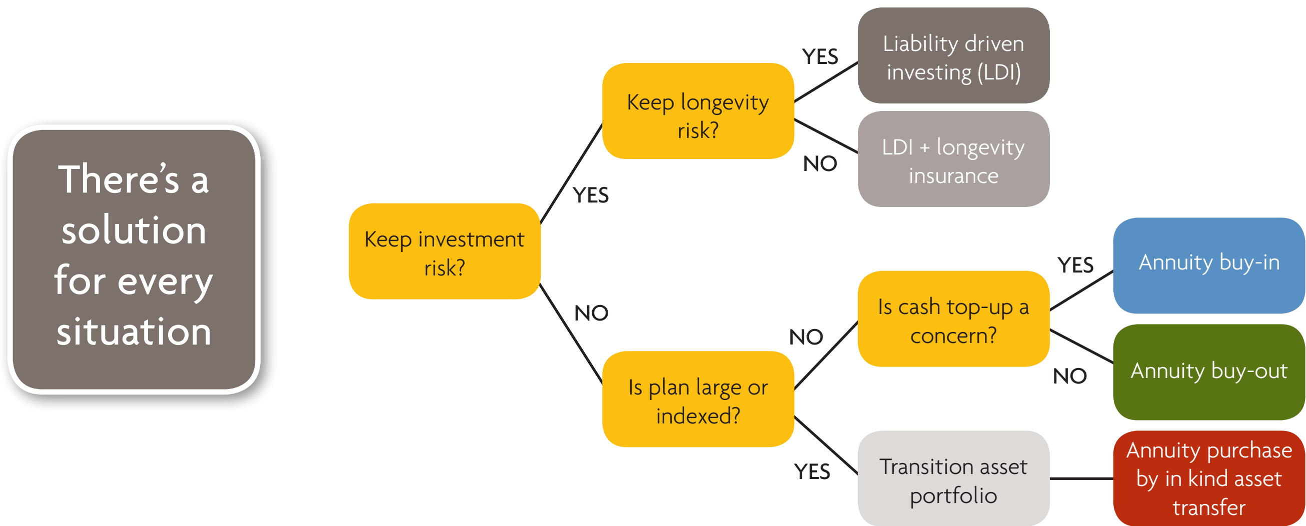
Demand for annuities is also growing because there is compelling evidence that annuities are cheap.

Annuities are like a special type of bond that perfectly hedge pension liabilities. One way to determine the value of an annuity is to compare the expected yield that a pension plan would get by purchasing an annuity versus investing in a bond portfolio. Most people would expect the yield on an annuity to be lower than a bond portfolio and that this lower yield is the cost of purchasing the longevity and investment risk protection. In fact, the opposite is true. When compared to a typical matching bond portfolio, annuities can provide an additional yield of about 85 basis points, on average, over the last six years[9]. This means that investment and longevity risk are transferred for free!

[4] For a male age 65 in 2014, comparing UP94 with the AA improvement scale to CPM combined base table with CPM-B improvement scale
[5] LIMRA
[6] LIMRA and Sun Life estimates
[7] Each plan should confirm accounting treatment with their auditors.
[8] Sun Life estimates
[9] Sun Life estimates based on blended annual expected yield for a FTSE TMX bond portfolio with a duration of 10 years compared to the published annuity proxy

## The future is bright

Pension risk management is a critical topic for plan sponsors, shareholders, plan members and analysts. With the change in philosophy described earlier, plan sponsors are taking action to ensure the future sustainability of the company. Whether the ultimate goal is to wind-up the pension plan or to make it sustainable for the long term, there's a solution for every situation.




As you think about your own journey, ask yourself the following questions:

- What's the end goal for my pension plan – long-term sustainability or full risk transfer?
- Do my stakeholders understand the risks in my pension plan and the solutions available to manage those risks?
- Which risks are right for my company and where do I get the most return for my risk budget – in the pension plan or in my core business?

Everybody wins with pension risk management. Plan sponsors can focus on their core business and leverage their competitive advantage. Shareholders benefit from a better risk profile and plan members have more secure benefits. Pension risk management is the right thing to do. Don't just be brave, be bold and start your pension risk management journey today.

## ABOUT THE AUTHORS

Brent Simmons 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.

With nearly 20 years of experience in the pension and insurance industry, Brent uses his unique blend of pension and life insurance actuarial knowledge to translate defined benefit pension problems into life insurance solutions for plan sponsors. His experience includes annuity products, liability driven investments (LDI), defined benefit pension plans, life insurance, custom fixed income products, risk management, de-risking pension plans and financial reporting for pension and insurance products.

Heather Wolfe works closely with consultants and plan sponsors to develop innovative, customized solutions to the challenges they face in their defined benefit pension plans.

Heather is a Canadian and U.K. actuary with over 20 years of experience as pension consultant and plan sponsor. She joined Sun Life Financial's Defined Benefit Solutions team in 2011, bringing her well-rounded perspective to help plan sponsors de-risk their DB pension plans.

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