Preparing for Higher Pension Liabilities

hooker & holcombe

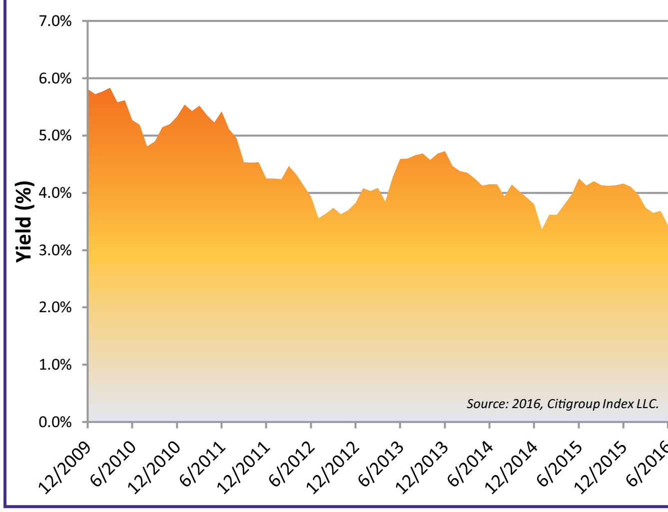
Pension plans have always wrestled with finding an appropriate balance between risk and return in the investment portfolio, and today's investment environment is not making that struggle any easier. The distortion in capital markets is creating unstable relationships, and causing some plan sponsors to question the benefits of a well-diversified portfolio. U.S. 10-year Treasury bonds are trading at yields that are lower than any other period in U.S. history (1.49% at 6/30/16), as investors across the globe search out safety and liquidity. At the same time, U.S. equity markets have never been higher (S&P 500 reached 2,175 on 7/22), telling a much different story than their historical relationship might suggest.

Volatility in the investment markets makes it even more imperative for plan sponsors to pay close attention to their pension liabilities. Not only should a plan's investment strategy be aligned with the liability risk profile, but ample consideration should also be given on how these liabilities are impacted by changes in market factors such as interest rates and risk premiums.

Citi's Pension Liability Index, which represents a commonly used method for determining a single, appropriate discount rate, has declined 0.73% (73 basis points) since 12/31/2015 (Exhibit A). **As bond yields decline, the discount rate used to value pension liabilities also declines, driving up the "cost" of the plan. For a plan with an intermediate liability duration of 16, this could mean an increase in its liabilities of 12%.**

Exhibit A: Citi Pension Liability Index

Representative Intermediate Duration Pension Plan



Our mid-year outlook on interest rates is bearish—we expect low rates to continue to be a challenge for plan sponsors at least through the end of 2016. Understanding and preparing for "lower for even longer" will be crucial in finding solutions to help mitigate the negative implications from lower rates on your organization's balance sheet and annual expense.

2016 Mid-Year Investment Outlook

- Market 'distortion' expected to continue for the remainder of the year
- U.S. interest rates will remain low amid strong global demand and continued slow growth
- Domestic stocks are fairly valued; cyclical strength and low debt servicing bode well for continued, albeit slow, economic growth
- Domestic equities will finish the year near our initial expectations of +7.75%
- Political uncertainly in the Eurozone remains the largest threat to global markets

How do low interest rates affect my organization's pension liability and annual pension expense?

The pension liability represents the future benefit payments current and future retirees will receive from your pension plan expressed in today's dollars (i.e., the present value of future benefit payments). The present value is estimated based on the current interest rate environment; the interest rate used is referred to as the plan's "discount rate". A lower discount rate will increase the present value of future benefit payments (i.e., pension liability). Likewise, higher discount rates will lower the pension liability.

With higher pension liabilities, there is a negative impact on the balance sheet (through AOCI or unrestricted net assets) and pension expense will likely be higher as well.

What can our organization do to mitigate the growing liability?

Although plan sponsors do not have the ability to change the overall interest rate environment (wouldn't that be nice!), they do have the ability to adjust how they prepare and respond to it. Understanding your plan's sensitivity to the lower interest rate environment is critical to responding appropriately.

On the liability side, alternative discounting methodologies designed to mitigate some of the negative effects of lower current interest rates may be effective. A discount rate that is tailored to align with your plan's duration and/or expected future benefit payments may generate a higher discount rate than the generic market rate. A higher discount rate could lower your pension liability.

On the asset side, an investment strategy that is designed to support your plan's funded status may also be appropriate. Utilizing alternative investments such as structured notes or real estate, duration management, and/or cash flow matching may be prudent strategies to consider.

What is liability-driven investing?

Liability-driven investment (LDI) strategies seek to align the risks inherent in the plan's liabilities to the risks within the pension investment portfolio. The goal of an LDI strategy is to limit volatility in the funded status, regardless of the investment landscape. (Funded status refers to the ratio of pension assets to pension liabilities.)

LDI strategies can take many forms, from full market immunization by aligning all market risks, to a "liability-aware" strategy which seeks to limit funded ratio volatility but allows for a mismatch in the risk profile of the assets and liabilities in order to generate higher total return.

Our actuarial and investment consultants are your stable partners in these unstable times. Learn from our experience. Contact an H&H consultant to discuss how the current investment environment may impact your company's pension plan.

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