

Defined Benefit Plans amid Market Volatility

A report prepared by CFO Research Services in collaboration with Towers Perrin

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At CFO Research Services, Sam Knox directed the research and Peter B. Lull wrote the report.

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About this report

In March 2008, CFO Research Services (a unit of CFO Publishing Corp.) launched its second annual research program with Towers Perrin to explore senior finance executives' views on their company's defined benefit (DB) plan. We sought to evaluate their company's recent changes in plan design and funding or investment policies, as well as responses to various economic and regulatory developments. We also sought to understand executives' pension plan priorities looking ahead to the next two years.

This study set out to examine how finance executives at North American companies have altered their defined benefit programs, as well as to examine their plans for further change in the years ahead. Through a survey and interview program, executives at large companies in the United States and Canada reveal an incremental approach to change in recent years and a pronounced bias toward controlling risk through portfolio management in the next several years.

As part of this program, CFO Research distributed a survey among senior finance executives at companies in the United States and Canada with annual revenues of \$100 million to more than \$20 billion; we gathered 214 responses. We also conducted an in-depth interview program with senior finance executives at the following companies, based in the United States and Canada:

United States

- Arkansas Public Employees Retirement System
- Maritz Inc.
- McWane Inc.
- NewMarket Corp.
- Parkview Health
- Parsons Brinckerhoff
- PPL Corp. (formerly Pennsylvania Power and Light)
- Silgan Plastics Corp.

Canada

- Bombardier Inc.
- NorTerra Inc.
- NOVA Chemicals Corp.

In an effort to further understand the DB pension landscape, the CFO Research team combined the executive opinion data from the survey with company performance and pension data on 65 public companies that participated in the survey. Throughout this report, we refer to this data as the "opinion/performance analysis."

The first step in this analysis was to develop relevant ratios to define company profiles concerning core metrics, value at risk, impact on capital structure, and impact on financial performance. The company data taken from public regulatory filings included corporate assets and liabilities, pension assets and liabilities, pension funded status and expense, and amount of unfunded pension obligations, among other data. We then calculated ratios to allow us to compare companies by pension plan size, funded status, maturity of obligation, and the impact of pensions on their financial performance. Finally, we linked the survey data containing executives' opinions on pensions to the data on their company's pensions.

In the spirit of full disclosure, it is important to mention that all data in CFO Research studies is confidential, and we have an explicit agreement never to share respondent-level data outside the immediate research group working on the study. The team at Towers Perrin, which underwrote this report, was instrumental in defining and considering these analyses, but no one other than the CFO Research staff has seen the company identities or the individual responses to this survey.

CFO Research Services and Towers Perrin developed the hypotheses for this research jointly. Towers Perrin funded the research and publication of our findings, and we would like to thank Sylvia Pozezanac, Keri Alletson, Michael Archer, Steve Bonnar, Sham Janmohamed, Monica McIntosh, Stuart Roth, and Gary Sullivan from Towers Perrin for their support and insight on this project.

Executive summary

Defined benefit (DB) pension plans may never again see the participation rates of the 1960s and 1970s, when as many as two in five workers were covered by these plans. The economic and employment landscapes have changed since then, but nonetheless, DB plans continue to be a valuable tool for attracting and retaining workers to certain types of companies. At other companies, current DB commitments will likely require management to maintain its pension plan sponsorship in some form for years to come.

A broad array of social, economic, and legislative forces will continue to affect the relationship between companies and their employees: Baby Boomers are retiring; financial markets are becoming increasingly sophisticated; and government regulators are bringing closer scrutiny to companies' financial condition. Amid these changes, plan sponsors will alter their plan's design, reassess the risks underlying their DB plan, and employ portfolio management strategies to cope with these new demands. For some companies, plan management will mean simply making minor tweaks to policies and portfolios, while for others the process of evaluating the trade-offs involved with offering these plans will have broad implications for the firms' financial health and their relationships with current and former employees.

This research program among senior finance executives at U.S. and Canadian companies concludes that companies with DB plans have focused most recently on altering their retirement plan designs in iterative steps and managing risk through portfolio allocation. These design changes and investment tactics have been driven more by external influences such as regulation and market performance than by company performance.

More specifically, our analysis of survey and financial performance data reveals that when pensions still play a prominent role at a company, managers are more likely to have a long-term commitment to ongoing management of their DB plan. In addition, data suggests that when pension plans hold significant assets, represent a large or mature commitment to benefits, or have a substantial impact on cash flows or earnings, companies are consistently more committed to funding their pensions in the years ahead, and making incremental changes to their design as needed.

The largely incremental approach of these companies to managing their pension plans now positions them to make further decisions about pensions and their long-term strategies, whether that means a continuing commitment to DB plans or maneuvering toward an exit strategy.

Respondent demographics

CFO Research Services gathered 214 complete survey responses from senior finance executives from the United States and Canada to prepare this report.

Survey respondents hold positions with the following titles:

| | |
|-------------------------|-----|
| Chief financial officer | 34% |
| Controller | 19% |
| Director of finance | 16% |
| VP of finance | 14% |
| EVP or SVP of finance | 6% |
| Other | 11% |

Survey respondents represent a broad cross-section of industries, including:

Asset-intensive industries (56%):

| | |
|--|-----|
| Auto/Industrial/Manufacturing | 18% |
| Energy/Utilities | 10% |
| Chemicals | 7% |
| Food/Beverages/Consumer packaged goods | 5% |
| Wholesale/Retail trade | 5% |
| Telecommunications | 4% |
| Transportation/Warehousing | 4% |
| Construction | 2% |
| Aerospace/Defense | 1% |

Labor-intensive industries (44%):

| | |
|--|----|
| Financial services/Real estate/Insurance | 9% |
| Business professional services | 7% |
| Health care | 7% |
| Technology | 4% |
| Media/Entertainment/Travel/Leisure | 4% |
| Public sector/Nonprofit | 4% |
| Hardware/Software/Networking | 2% |
| Pharmaceuticals/Biotechnology | 2% |
| Other | 5% |

Survey respondents' companies represent a broad spectrum of revenues:

| | |
|---------------------------|-----|
| Less than \$500 million | 12% |
| \$500 million–\$1 billion | 30% |
| \$1 billion–\$5 billion | 36% |
| More than \$5 billion | 22% |

Defined benefit plan popularity has waned, but the plans are unlikely to disappear

Defined benefit (DB) plans were once considered the greatest part of the send-off an employer offered to its workers: a consistent payout for the rest of their lives in exchange for their decades of hard work. It was not unusual for workers to seek jobs based on this promise and to remain loyal to their company, knowing that their commitment would be rewarded in the long run. But changes in the labor market, the broader economy, and the regulatory environment have shifted the landscape of retirement. As a result, DB plans are now significantly less commonplace for private-sector employers and their employees in North America.

Workers are now much more likely to carry their skills to not just new positions but also new companies several times during their working years, and therefore are looking for retirement plans that offer similar portability. According to 2005 data from the Organisation for Economic Co-operation and Development's (OECD) Economic Survey of the European Union, U.S. workers have an average job tenure of four years, while job tenure in Canada and the United Kingdom is eight years on average. The declines of manufacturing industries and organized labor in North America have also contributed to the gradual retreat of the DB plan. Meanwhile, the availability of products for defined contribution (DC) retirement programs and individual retirement accounts or registered retirement savings plans now offer alternatives to DB plans that seem attractive to both companies and their employees.

There is clear evidence that DB pension plans have been in decline for quite some time, but this decline may have stalled: the percentage of employees covered by these plans fell in the United States from 38% in 1980 to 20% by 1996, similar to the rate today. In 1960, 40% of the total workforce in Canada had pension coverage, a figure that began to slip in 1990 and has settled at just under 34% today. Nonetheless, our survey and interview program indicates that there is not likely to be a white flag of surrender for DB plans anytime soon. Indeed, in some segments of industry, these plans are seen by employers as a critical part of their human resources and operating strategies. When the interests of the company and the employee are

aligned and the employee is ready to retire, the company wants that employee to be able to take that step. "I've always thought it's in the best interest of the employees for the company to continue to have a DB plan. If people have worked for a company for a long period of time, they ought to have plans in place to allow them to make their decision, and allow them to move into that next phase of their life," says Charles Nowlin, CFO at McWane Inc., a Birmingham, Alabama, industrial valve manufacturer with \$1.7 billion in revenues. "If you don't have a plan that allows them to move into that next phase of their life, you're not doing the company right, and you're not doing right by those employees."

There is clear evidence that DB pension plans have been in decline for quite some time. Nonetheless, our survey and interview program indicates that there is not likely to be a white flag of surrender for DB plans anytime soon.

Similar sentiments are expressed by François Lemarchand, senior vice president and treasurer of Bombardier Inc., a manufacturer of transportation equipment based in Montreal, Canada. "I think having a DB plan helps the name, the franchise. In Canada, Bombardier is a very well known company," he says of his firm, which recorded \$17.5 billion in sales in 2007 and employs more than 56,000 people. "Along with this reputation comes the need to preserve not only a good working environment, a safe working environment, and reasonable salaries, but also provide the means for the employees to ensure reasonable income at the time of their retirement."

What has driven companies to scale back their DB pension plans? Certainly the demographic changes in the workforce have made an impact, as has the transition from a manufacturing-oriented to a service-oriented economy. With improved information access, an increasingly educated population, and easier transportation and relocation, workers are now much more likely to seek, consider, and land jobs in a wider geographical area than they were a few decades ago. Most recently, the opportunities afforded by the Internet industry, telecommuting, and other trends have further weakened the bonds between employers and their employees, eroding loyalty on both sides of the relationship. Not only are workers much quicker to pursue other job opportunities, but

From Hudson's Bay Co. to the PPA of 2006: How pension regulation in North America has evolved to broaden coverage

The 1800s

- In 1840 the first workplace pension plan recorded in Canadian history was through the Hudson's Bay Co. for "certain retiring meritorious officers"; Ganong Chocolate Factory followed in 1855 with a plan for management.
- In 1875 the first private pension plan in the United States was offered by the American Express Co. (then a freight-forwarding company); railroads soon followed suit.

1900–1949

- In Canada only federal employees, railway workers, and employees of some commercial banks were covered by pension plans in 1900.
- 1908 saw social reformers able to get the Dominion government in Canada to offer a program of government annuities, which allowed people to purchase an income stream for their later years; the problem was that few of the poor could afford such an investment.
- By the 1920s, U.S. pension plans had become fairly common.* Initially, the primary regulator of private pension plans was the Internal Revenue Service, through the Revenue Act of 1921 and the Revenue Act of 1926. These decrees allowed employers a deduction from corporate income and let the funds' portfolios grow tax-free as long as certain minimum coverage requirements were met.
- By 1927 legislation was introduced and passed in Canada that became the Old Age Pensions Act.
- In 1935 the Social Security Act was signed by U.S. President Franklin Roosevelt.
- The U.S. Revenue Act of 1942 called for more stringent requirements and introduced new disclosure requirements, including nondiscrimination requirements, for private pensions.

1950–1989

- In 1951 the Canadian Constitution was amended to allow the federal government to pass the Old Age Security Act (OAS). The act, which took effect in January 1952, established a federally funded pension for all men and women 70 years of age or older.
- The 1959 Welfare and Pension Plans Disclosure Act required plan descriptions and annual financial reports to be filed with the U.S. government.

- As support built for a more comprehensive pension program that would be portable from job to job, the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) were established in 1966. These were compulsory, contributory schemes for salaried and self-employed workers between the ages of 18 and 70.
- Canada introduced the Guaranteed Income Supplement (GIS), part of the OAS program, in 1967 as a temporary measure to further reduce poverty among seniors; it later became permanent.
- In the United States, a more comprehensive Employee Retirement Income Security Act (ERISA) was enacted in 1974 to limit the chance of mismanagement and abuse of pension fund assets.
- The Revenue Act of 1978 addressed a provision in the U.S. Internal Revenue Code under Section 401(k) that allowed employees to defer a portion of their income tax-free to fund retirement plan contributions; these plans took root in the early 1980s.
- In the United States, the Tax Reform Act of 1986 curtailed pensions by lowering contribution limits and constraining tax advantages, and fostered more equitable contributions to defined contribution (DC) plan vehicles.

1990–2008

- By the 1990s, DC plans became common in many U.S. companies, and today more than 80% of private firms with 100 or more employees offer one.
- The CPP was modified in 1998 to increase contributions, and the Canada Pension Plan Investment Board (CPPIB) was put into place to manage funds for future use.
- All OAS and CPP benefits and obligations were extended to same-sex, common-law relationships in 2000.
- The U.S. Pension Protection Act of 2006 (PPA) modified ERISA concerning pension funding requirements and instituted enhanced disclosure of pension funding status.

* Steven A. Sass, *The Promise of Private Pensions: The First Hundred Years* (Cambridge, MA: Harvard University Press, 1997), p. 23.

Private U.S. employers today are four times more likely to fund a DC plan—through which they pay a predetermined amount into an employee-managed investment account—than to fund a DB plan.

employers are sometimes looking for cost containment through head count reductions.

The proliferation of work options coincides with new approaches to investments and retirement savings management. While workers had for years funded their retirement with personal savings, government pension payouts, and company-sponsored DB plans, employees today increasingly prepare for their own retirement using DC plans, personal investment accounts, and other employee-controlled investment vehicles. Many companies have gradually abandoned or frozen their DB pension plans, and have unloaded some of the retirement planning and management burden—and often the cost and risk as well—onto workers themselves. Private U.S. employers today are four times more likely to fund a DC plan—through which they pay a predetermined amount into an employee-managed investment account—than to fund a DB plan. These DC plans now cover 43% of U.S. workers, up from 36% in 1999, according to the U.S. Bureau of Labor Statistics.

But does this transfer of responsibility, control, and risk leave employees and their employers in better financial condition in the long run? Some employers interviewed for this study say that their workers expect to be able to control their assets, while others find their employees unable to deal with the complex choices of asset allocation, risk profile, and long-term financial planning. Leslie Kwasny, corporate controller at NorTerra Inc., an Edmonton, Alberta, Canada, company with investments in transportation and manufacturing, expresses concern for employees. “We get the sense that people participating in defined contribution plans aren’t really as prepared as they think they are for retirement with their own investments,” she says, “and they’re coming to realize, ‘Gee, whatever is in my plan is what I have to live on in the future.’”

Jim Chandler, CFO of the Arkansas Public Employees Retirement System, which oversees assets for 67,000 members, notes that many participants “do not have the

financial background to make good choices” and cautions that for “most employees, or those who are approaching retirement in a defined contribution plan, if the market goes south, they may not be able to recover from it.” He explains that the system’s investment section screens the investment professionals who oversee the DB pension assets, “whereas with a DC plan, [the organization] may do the same thing, but the structure, the distribution, and the risk are left up to the employees who may or may not have adequate financial background or knowledge.”

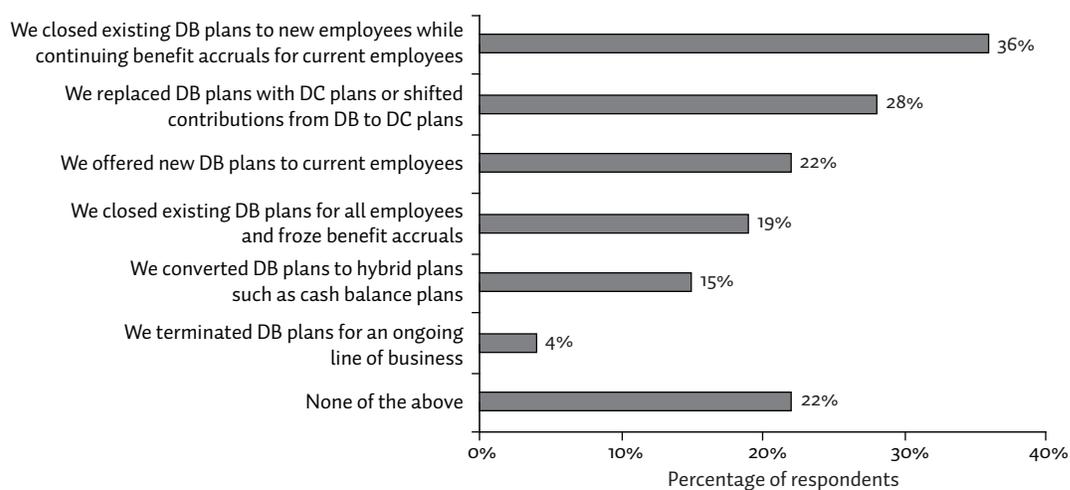
From the employer’s point of view, DB pensions can introduce risk and volatility to performance that can make a hands-off, employee-managed retirement plan much more attractive. Interest-rate fluctuations alter the present value of funding obligations, and pension portfolios generate varying returns. Amid stricter funding requirements and heightened scrutiny from investors, companies must manage these and other pension plan risks with new vigilance. The current capital market environment certainly hasn’t helped pension asset portfolios, and lengthening survival projections coupled with changing age-for-retirement expectations serve to cloud the picture more. It comes as little surprise that finance teams often struggle to balance the needs of their employees, their pension plans, and their company.

Does a DC plan (and its transfer of responsibility, control, and risk) leave employees in better financial condition in the long run? Some employers say that their workers expect to be able to control their assets, while others find their employees unable to deal with the complex choices of asset allocation, risk profile, and long-term financial planning.

Some of the tension of this balancing act is voiced by Larry MacDonald, CFO at NOVA Chemicals Corp., a \$6.7 billion Calgary, Alberta, Canada, petrochemical manufacturer. “DB and DC plans both have value,” he says. “They both have pros and cons, but I think that in today’s world, [given] the fact that employees change jobs a lot more, there’s been much more of a move to planning your own retirement. You don’t get cradle-to-grave from your company anymore. I think it’s the transportability of the workforce and the volatility of the business environment. You’ve got to let people manage

Figure 1. Company DB plan changes have been incremental in the past eight years.

In what ways, if any, has your company changed its DB plan design or offerings since 2000?



their own money.” He feels the need to give them “a fair and reasonable compensation, including company contributions into their DC plan”; thus, Mr. MacDonald’s view on employee preferences and economic reality contributes to his opinion that “the volatility in the marketplace should not be borne entirely by the company on an ongoing basis” through a DB plan.

Executives at many firms that participated in this study concur with Mr. MacDonald and have stepped up their pension plan prudence in response to demands and conditions since 2000. They’ve altered their plan design and portfolio strategies and sought out ways to limit pension risk, control pension expense, and continue to meet long-term financial commitments to employees. And they’ve done so using incremental strategies in which they took tactical steps toward limiting risk rather than more dramatic maneuvers that disrupt their relationships with employees and other stakeholders.

We queried finance executives on whether their company had made any of an array of pension plan design changes since 2000—had they frozen plans to new or current employees, terminated them altogether, replaced them with DC plans, and so on? Four out of five respondents report some form of plan design change in the past eight years, the most common of which involved the so-called soft freeze (in which plans are closed to new hires but remain open to current employees) or conversion from a DB plan to a DC plan. Plan terminations and “hard freezes”

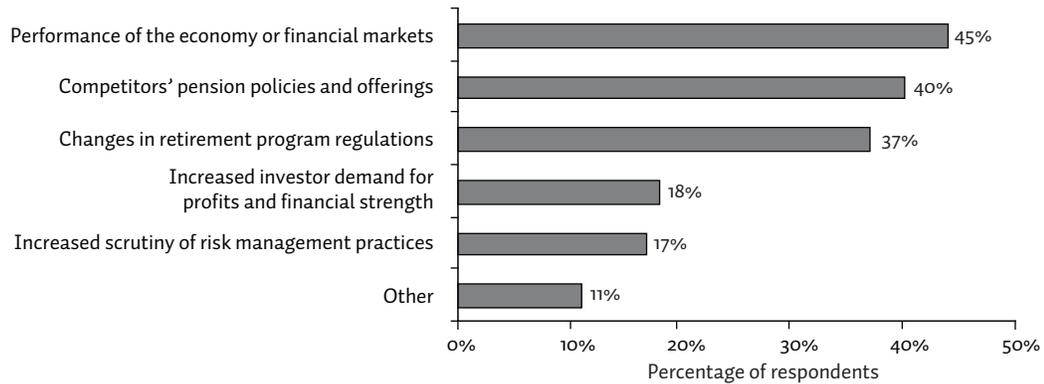
(which entail closing the plan to all employees and ceasing benefit accruals) are cited far less frequently. (See Figure 1.) The two most frequent responses reflect an incremental approach to DB plan management.

To further explore this incremental approach, we segmented respondents into two categories—those who say in a separate question that they are “very likely” to make a plan design change (such as plan termination, a hard or soft freeze, or replacement of a DB plan with a DC plan) in the next 24 months versus all other responses. The results of this analysis show that those who anticipate making changes are substantially more likely to have already made changes to their plan design. In particular, 52% of respondents who are very likely to make some form of plan design change say they have already closed existing plans and ceased accruals for new employees; only 28% of their peers who do not report being “very likely” to make a plan design change have begun such actions.

Dale Kleppinger, senior director, investments and pensions, at PPL Corp. (formerly Pennsylvania Power and Light), an Allentown, Pennsylvania, electric-utilities company with \$6.5 billion in 2007 revenues, notes the importance of having the pension plan as a piece of the benefits package, but also the company’s willingness to change course. “We’re comfortable with what we have, but that being said, we are reviewing all of our benefits routinely to make sure that we’re still getting the most

Figure 2. Market/economic performance, competitors, and regulation have driven change in plan design.

Which of the following external events contributed most materially to the decisions your company has made in DB plan design since 2000?



Note: Respondents were asked to select up to three choices

value for the dollar spent,” he says. “I wouldn’t say we’re wedded to a DB plan forever, but where we sit today, we think it’s adding value.”

A combination of internal and external forces has driven change in companies’ DB plans in recent years. When asked in the survey about external events materially affecting DB plan design since 2000, the “performance of the economy or financial markets” is noted by nearly half of respondents (45%) and “changes in retirement program regulations” is cited by more than a third. (See Figure 2.) Fully 40% of respondents say “competitors’ pension policies and offerings” contributed materially to plan design. Among the largest companies, competitors’ pension maneuvers are especially likely to spur change in DB plan design. In total, 70% of respondents from companies with 25,000 or more employees see competitors’ pension offerings as one of the primary drivers of changes in their own plan design.

Asked about internal events contributing to plan design changes in the past eight years, survey respondents most frequently cite a new approach to rewards strategies and the changing of employees’ pension expectations and desires. (See Figure 3, next page.) The rewards strategy impact is more acute in larger companies, where response rates for this choice are high for companies with 10,000–25,000 employees (48%) and even higher for companies with 25,000 or more employees (53%).

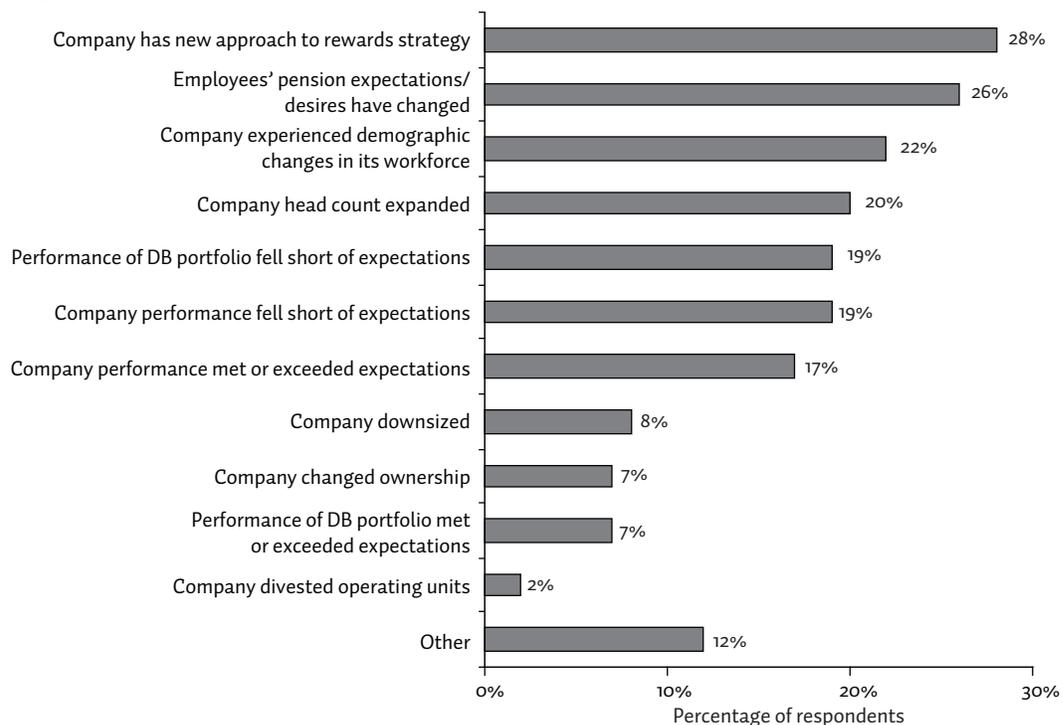
At the largest companies, finance executives are especially likely to see competitors’ pension offerings as one of the primary drivers of changes in their own plan design.

Executives and others interviewed for this study affirm the view that DB plans will remain in place—although often in an altered or frozen state—for a long time to come at many companies. “[DB plans] will be there, but they will be in well-defined areas,” according to Steven A. Sass, associate director of research at the Center for Retirement Research at Boston College. “Unions like them for a variety of reasons. One reason is, unions tend to be dominated by older workers and older workers really want their pensions, but unions are a smaller piece of the labor force, especially in the private sector.”

Rick Ramos, senior vice president and chief financial officer of Maritz Inc., a St. Louis, Missouri, \$1.5 billion sales and marketing-services firm, echoes this sentiment. He sees a future where there will be some grandfathered plans, and then “you’ll probably have a lot of the DB plans where you have unionized workforces, but I doubt you’ll see any new ones crop up. There is just too much financial uncertainty and financial risk associated with the DB plan.”

Figure 3. For internal factors, human capital management—not plan or company performance—drives DB plan design.

Which of the following internal events contributed most materially to the decisions your company has made in DB plan design since 2000?



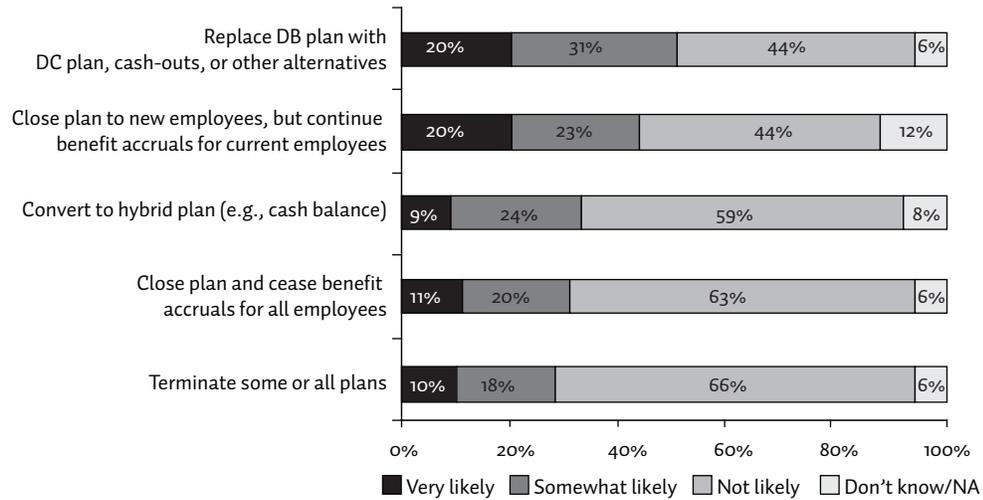
Executives' focus and attention is another factor influencing plan decision-making; even those who have outsourced much of their plan management must spend time fulfilling their fiduciary duties. Derek Schmidt, senior vice president and CFO of Silgan Plastics Corp., a plastic-bottle manufacturer based in Chesterfield, Missouri, explains how and why his company made the decision to change its pension offerings. "We have a personal and ethical duty to take care of our employees. At one point, the DB plan was likely a preferred means of providing that security to our employees," he says. "Our decision to close the fund a couple of years back was based upon the fact that our core competency as a business is making bottles for consumer-product companies and not necessarily controlling large investments. Our duty is really to give our employees a toolbox to secure their retirement, education on how to make those investments, and an investment partner to help them along with those choices." He continues, "Trying to manage the complexity of a DB plan, funding it, and handling all the accounting of it is really a

distraction from operating our core business. We've simply made the choice where we want to focus our organizational efforts, and it's not actively managing people's retirement investments." Ms. Kwasny of NorTerra tries to keep abreast of changes going on, but says of reviewing pension information, "We actually tend to rely on [our outside consultants] quite heavily since we don't have the in-house expertise to devote to this highly detailed and regulated aspect of our business."

In an effort to determine what lies ahead for DB plans, we asked how executives foresee their plan's design changing in the next two years. Very few executives foresee a dramatic change in the design of their plan, and those who do anticipate change expect such incremental changes as the soft freeze and DB-to-DC conversion. A mere 1 in 10 says it is very likely that their company will terminate some or all plans, and a solid majority—more than 60%—say that this scenario is not likely. Respondents hold similarly cautious views on the likelihood of hard freezes and conversion to hybrid plans. (See Figure 4, next page.)

Figure 4. There will be further incremental changes in plan design in the next two years, according to survey respondents.

How likely is your company to take any of the following actions over the next 24 months with respect to your DB plan?



Percentage of respondents
Note: Percentages may not equal 100% due to rounding

The opinion/performance analysis data exposes differences in opinion between respondents from companies with large, well-funded, or high equity-allocation pensions and those from companies with small, less well-funded pensions. The former group is substantially less likely to make dramatic plan design changes than is the latter group.

In total, 60% of executives from companies with well-funded plans say their company is not likely to close its plan and terminate accruals in the next two years, while 43% of the less-well-funded group hold such a view. Similarly, 59% of respondents from companies with a high concentration of equities in their pension portfolio say they are unlikely to close their plan and cease accruals, while 42% of respondents from companies with a low concentration of equities state that closing their plan is not likely.

This sense of caution among survey respondents reflects in part the role that DB plans play in their companies' HR strategies. "We believe DBs are an extremely valuable tool to our employees so that when they retire, they can continue to have the good economic life that they enjoyed while they were working," says David

Fiorenza, vice president and principal financial officer at NewMarket Corp., a \$1.4 billion chemical-manufacturing concern based in Richmond, Virginia. "We have a DB and we have a 401(k) plan, and folks who stay with us as a career will retire with 70-plus percent of their income between the DB and the 401(k)." Mr. Fiorenza's views are echoed by executives throughout the interview program for this report.

Executives who do plan to make design changes seem to be waiting for the right moment. One respondent from a Canadian chemical manufacturer writes in an open-response question: "If the funding ratio gets close to 100%, it would be an opportunity to terminate or convert the plan for the remaining members." By doing so, his company would shed some of the administrative burden and financial risk of the DB plan.

This caution and risk consciousness extends into executives' views on pension funding policy and portfolio management as well. As we'll see in the next section, just as companies are reluctant to dramatically alter the design of their DB plans, they are similarly cautious in their funding policies and management of plan assets.

Risk aversion changes pension portfolio management

The recent combination of regulatory changes and a sustained downturn in financial markets has placed finance teams and pension portfolios under great pressure. As a result, a very solid majority of companies, according to survey data, plan to focus on risk reduction in their pension portfolios at the expense of return on assets. (See Figure 5.) The opinion/performance analysis reveals that companies with large pension funds and those with pensions holding a high equity concentration are especially likely to seek to limit risk rather than to focus on returns in their portfolios.

But despite tough economic times, changes in regulations, and new scrutiny placed on financial statements, executives say that company performance seldom drives their pension funding policy. When asked how closely these issues are tied together, half say that company performance has little, if any, effect on pension funding, and nearly two in five (38%) respond that company performance has a moderate effect on pension funding; not quite 1 in 10 indicates that their company performance determines pension funding. (See Figure 6.)

By a three-to-one margin, finance executives say they will focus on risk reduction at the expense of returns in their pension portfolios in the next several years.

Survey data on funding reveals two notable results: legally mandated minimum-funding requirements (46%) and the desire to adhere to pension-funding policy (45%) were decisively selected over financial statement impacts as being important when making DB plan funding decisions. Considering the financial statement perspective, the impact on cash flows (28%) was considered greater than earnings (19%) or balance-sheet impacts (7%). (See Figure 7, next page.)

Figure 5. De-risking of pension portfolios is emphasized as financial markets founder and reporting requirements tighten.

In your opinion, is your company more likely to focus on increasing the return on, or managing the risk in, its pension portfolios in the next several years?

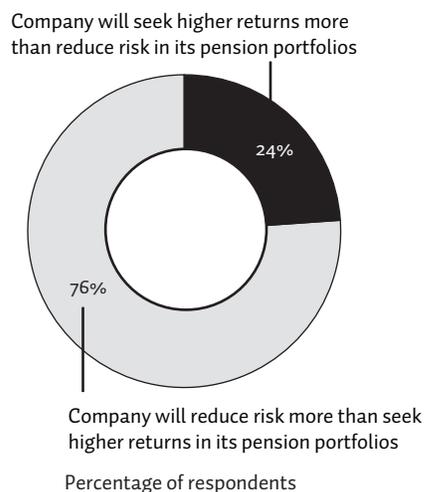


Figure 6. Company performance seldom drives funding policy.

How closely is your pension funding related to company performance?

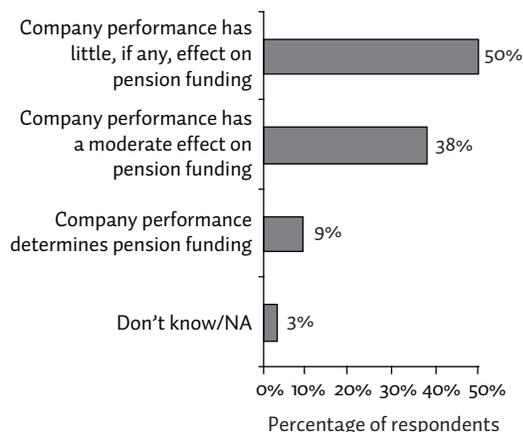
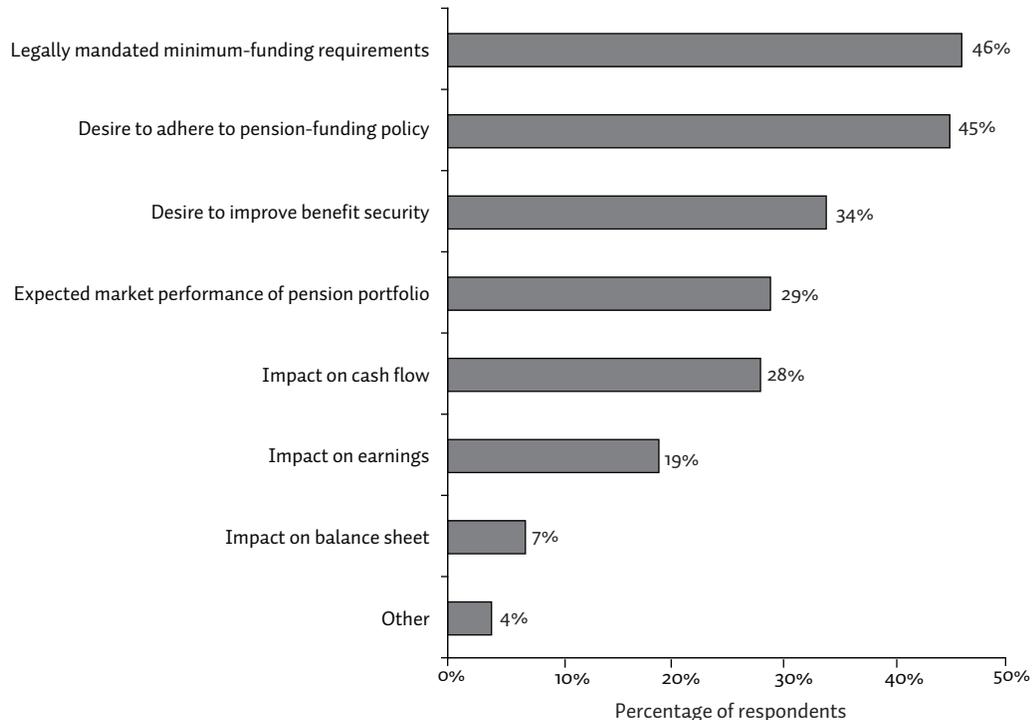


Figure 7. Policy and regulation—not managerial discretion—contribute most frequently to funding decisions.

Which of the following factors contributes most significantly to your DB plan funding decisions?



Note: Respondents were asked to select up to three choices

Data analysis reveals that companies with low funded ratios are especially likely to have their funding decisions driven by legally mandated funding requirements. Fully 59% of companies with low funding ratios say such legal requirements contribute most significantly to their funding decisions, while only 33% of respondents from companies with well-funded plans hold this view. At companies with a low concentration of equities in their pension portfolios, legal funding requirements are more likely to drive funding decisions. In total, 54% of respondents with low equity concentration in their pension portfolios say legal mandates are among the top influencers of their pension decisions, while 38% of respondents from “equity-rich” companies hold this view.

Overall, funding decisions are most often tied to legal mandates and longer-term policies that ensure the health of pension plans. In the words of Mr. Nowlin of McWane, “We look at what makes the most sense in the interest of the health of the plan, which ultimately is in the health of the overall organization for the longest period of time. That’s how we make our funding decisions. We’re not dumping all of our money in there to get

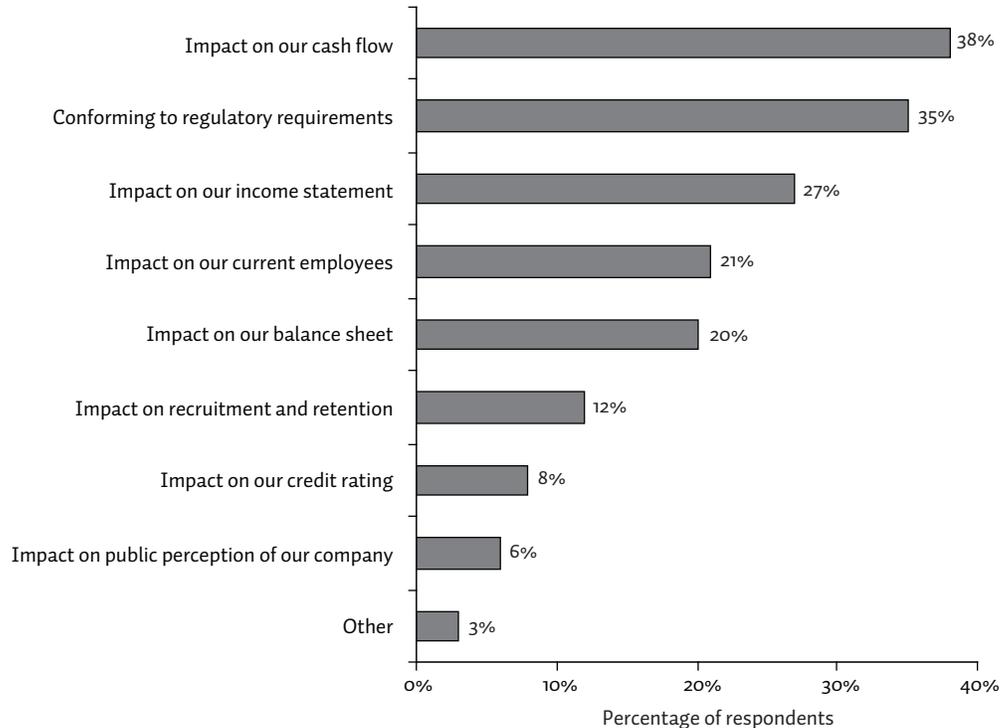
us fully funded in the first year, and we’re not stretching out the longest-possible payment schedule to try and put as little cash in there as possible.”

But while funding decisions are governed by stated pension funding policy and regulation, finance executives report that their executive team does indeed pay close attention to the financial impact of pension funding decisions. When asked about which aspects of DB plans senior management will be most concerned with in the next two years, 38% of respondents choose “impact on cash flow” and 35% select “conforming to regulatory requirements.” (See Figure 8, next page.)

The opinion/performance analysis reveals the larger plans that are poorly funded have an increased equity position—perhaps indicating a desire to cover their shortfall by taking a more aggressive position—and bear a larger cost in the way of pension expense. Unsurprisingly, the attention of senior management at these larger firms will be more focused on addressing the issues of funding gaps and increasing the duration of fixed-income assets to better match the liabilities.

Figure 8. Financial and regulatory concerns will weigh most heavily on senior management.

What aspects of your DB plan do you expect senior management to be most concerned about over the next 24 months?



Note: Respondents were asked to select up to two choices

Finance executives appear to address the most recent changes in U.S. reporting requirements by tackling the risk issues in their pension asset portfolios. Taking a more comprehensive view of corporate exposure, when asked about coordinating pension risk with a broader risk management framework such as enterprise risk management, only one in five (21%) indicates that it is closely coordinated, while nearly half (46%) choose somewhat coordinated. (See Figure 9, next page.) Despite the increasing demands of reporting requirements, these results are not a dramatic shift from the results of the same question in last year’s study.

While funding decisions are governed by stated pension funding policy and regulation, finance executives report that their executive team does indeed pay close attention to the financial impact of pension funding decisions.

The financial status of a pension plan is a moving target, made dynamic by changes in interest rates, rates of return on plan assets, regulatory changes, and changes in company workforce demographics. Paired with plan sponsors’ reluctance to offload their plans to a third party, the three-to-one preference for risk reduction over gain-seeking confirms finance executives’ eagerness to mitigate pension risk primarily through the use of portfolio management methods. (See Figure 5, page 11.) While the desired goal of risk reduction is clear, finding the proper tactics to achieve this may prove more elusive.

Finance executives were queried on their use of risk mitigation methods. (See Figure 10, next page.) Liability-based asset management is favored by just over a quarter of respondents (27%), while settlement with a life insurer is used by about 1 in 6. Slightly more than 1 in 10 selects options for either transferring the plan to a third party or captive insurance solutions. Not surprisingly, Canadians report more frequent use of liability-based asset management than their American cohort. This disparity is likely due to relatively early adoption of long-bond strategies in Canada.

Figure 9. Pension risk is often somewhat coordinated with other risks, but only one respondent in five reports close coordination.

Which of the following statements best describes your approach to pension risk management?

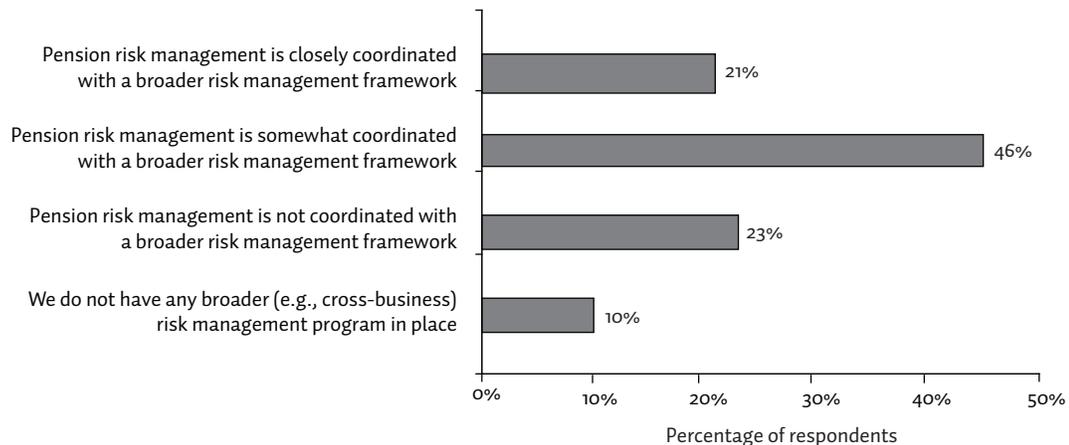
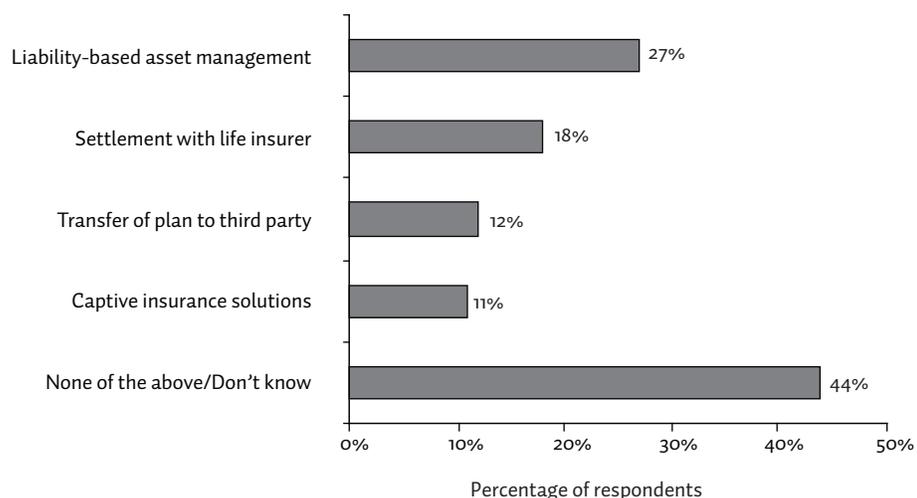


Figure 10. Liability-based asset management prevails as the most common active risk reduction strategy.

In the past three years, has your company used any of the following methods to manage the risk in its DB plan?



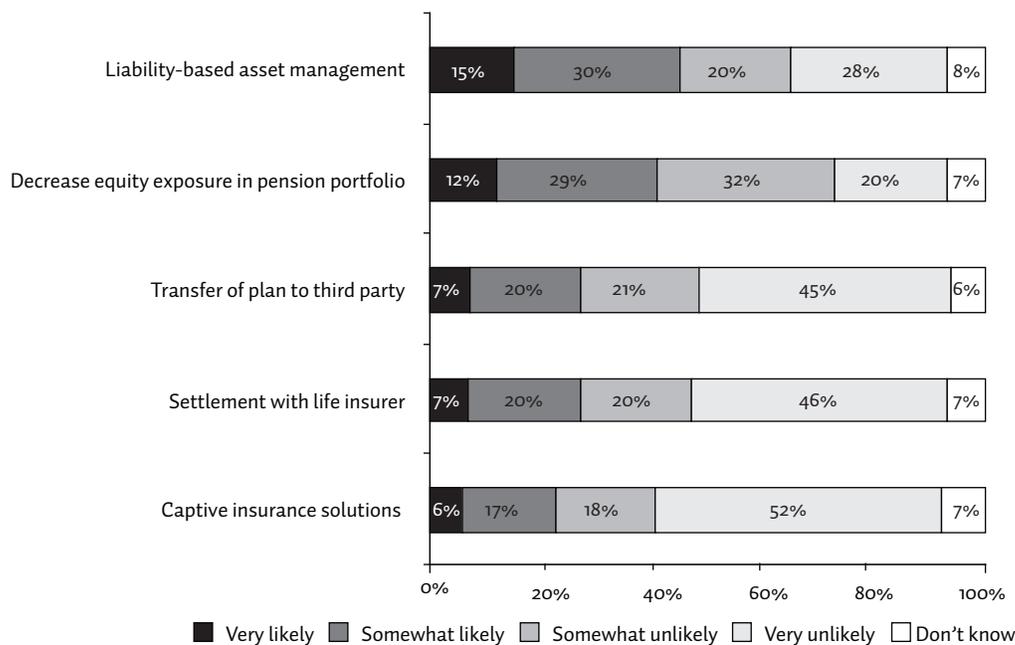
Note: Respondents were asked to select all that apply

When put through the opinion/performance filter, results show that the plans that are considered large, with more mature benefit obligations, have taken steps to implement a liability-driven investment strategy in an effort to manage the risk and volatility issues. One-half of respondents in this survey report using some form of financial derivative to manage risk in their pension plan portfolio. Companies are most likely to use interest-rate swaps and futures, but no category of synthetic financial instrument is used by more than 20% of survey respondents. Thus, adoption of derivatives remains modest at this point.

More active engagement on the methods of risk management is appearing in pension portfolios in both Canada and the United States. Mr. Lemarchand at Bombardier states, "We are very much believers in using derivatives to hedge the risks that are associated with our liability. It has consequential impact on how you manage the assets and, by stabilizing the solvency ratio, benefits both the participants and the sponsor." According to Mr. Kleppinger at PPL, "We're going to extend the duration of the assets that we have in fixed income. We are

Figure 11. Liability-based asset management and lower equity exposure are the most likely sources of risk reduction, say respondents.

In your opinion, how likely is your company to adopt the following methods for managing pension risk?



Percentage of respondents
 Note: Percentages may not equal 100% due to rounding

What are companies likely to do to mitigate some of the risk from their pension portfolios in the future? More than 40% of respondents say they are at least somewhat likely to match the duration of their liabilities and assets using liability-driven investing strategies.

also going to have what I'll refer to as an interest-rate overlay strategy for a portion of the portfolio, where we'll use interest-rate swaps—derivatives, if you will—to further extend the duration so that the duration of the assets gets closer to the duration of the liabilities.”

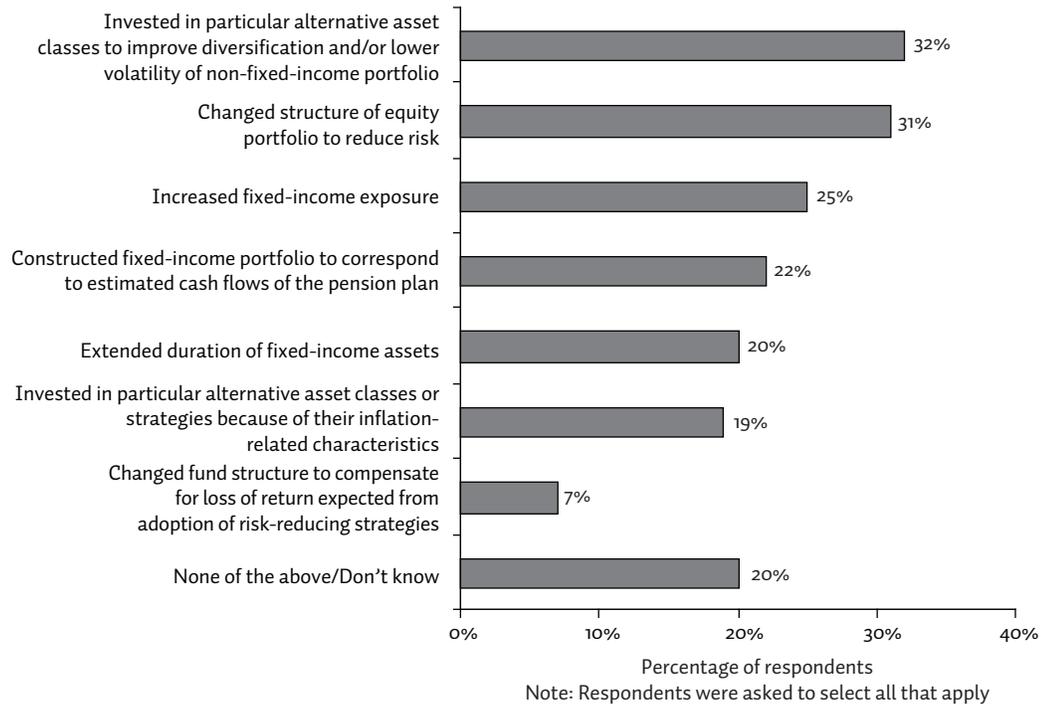
One solution clearly does not fit all pension fund sponsors as they look for appropriate tools to manage their risks. This variety of approaches may be underscoring why they feel as if their DB plan is only somewhat coordinated with their overall risk strategies—other aspects of their business may be easier to calculate and control compared with demographic changes, stock market performance, interest-rate movements, and funding demands.

As Ms. Kwasny of NorTerra says, “The risks that we do assume are really the fact that no matter what happens in our plan from an investment-return perspective, when an employee retires, we have guaranteed him or her a pension. If we have zero dollars in the plan fund, we are still required to fund that retirement income. We could potentially be risking the future cash flows of the company, depending on how the investments do in the planned fund. We also have the risk of choosing appropriate investment managers to ensure that the returns are appropriate to meet the liabilities of the fund.”

So what are companies likely to do to mitigate some of the risk from their pension portfolios in the future? The survey tested five portfolio risk management options, and more than 40% of respondents say they are at least somewhat likely to match the duration of their liabilities and assets using liability-driven investing strategies. (See Figure 11.) More than one-third are likely to shift from equities to less-volatile debt securities, and a solid majority of respondents say they are unlikely to adopt third-party pension plan transfers or insurance solutions.

Figure 12. Companies have managed portfolio risk by altering their equity portfolios, investing in alternative assets, and optimizing their fixed-income portfolios.

In the past three years, has your company used any of the following asset allocation strategies to manage risk in its DB plan?



Companies with high pension expense ratios—that is, those whose ratio of pension expense to pretax income is above the median for companies in this study—as well as those with poorly funded pensions have already begun to shift to liability-based asset management, according to the profiling of survey results in the opinion/performance analysis. Over the next several years, companies with the largest pension funds and those with pension portfolios with a high concentration of equities are especially likely to adopt liability-based asset management as a means of controlling pension risk. And while respondents in aggregate say they are unlikely to call on third parties (such as insurance companies) to assume their pension risk, those with a low concentration of equities and those with less mature pension obligations are more willing to consider transferring a plan to a third party or to settle with an insurer through an annuity or buyout plan.

As for transferring management of its pension assets, Mr. Lemarchand explains that Bombardier had looked at third-party options, and while there may be a cost savings, there may not be an alignment of objectives, giving the company reason to set this option aside. His firm has sufficient assets—more than \$5.6 billion in 22 different plans—to centralize its management of plan assets, and it also acknowledges the social commitment to employees borne by its pensions. “It is in our view part of our social responsibility to provide a reasonable means for employees to save for their pension. Very often companies are in fact abdicating the need to make an optimal management of these assets,” says Mr. Lemarchand. “If you shift it to a third party, it’s not necessarily less expensive, and it is not clear that this third party has the same focus. Also, it is very hard to shift the obligation at the same time. When you do, basically you’re getting insurance, and the profitability margin in there plus the regulatory constraints will forever make these proposals more expensive than assuming the obligations.”

When considering a third-party plan transfer, one source says, “We concluded that if you can’t get rid of [the fiduciary] responsibility, you certainly don’t want to give a third party the control over deciding how the money is invested in your pension plan.”

Third-party outsourcing also was offered to PPL. “We actually have looked at some,” recalls Mr. Kleppinger. “One consulting firm offered to be a named fiduciary for the plan.... The thing that we didn’t like about that is since PPL is the plan sponsor—and we checked with our risk counsel on this as well—you can’t totally get rid of all the fiduciary responsibility that you have by outsourcing it to someone else. We concluded that if you can’t get rid of that responsibility, you certainly don’t want to give a third party the control over deciding how the money is invested in your pension plan. We’d be better served by controlling those decisions ourselves.” PPL does recognize the value of getting expert advice for managing the pension plan. “We did hire a consultant to help us with that—how to manage the plan, and how to design liability-driven investment philosophy, etc.,” recalls Mr. Kleppinger, “but we did not outsource any of the ultimate decision-making authority.”

Respondents say they are most likely to use liability-based asset management to limit risk in the next two years. When asked about asset allocation strategies used in the past three years to manage plan risk, respondents’ two most common choices are investing in alternative asset classes in search of diversification and/or lower volatility and changing the structure of the equity portfolio to reduce risk—each of which was chosen by almost one-third of the respondents. A quarter of finance executives say they increased the fixed-income exposure in the portfolio. (See Figure 12, previous page.) Other fixed-income modifications have also garnered favor. One in five respondents indicates they extended the duration of their fixed-income assets, and about the same percentage indicates that they had matched their fixed-income assets to the plan’s expected cash flows. This data suggests that pension plan sponsors and portfolio managers are stepping away from their conventional 60/40 split between equities and debt in pension portfolios, and that companies are seeking alternative investments with high long-term yields but without the systemic risk of equity markets. In addition, by increasing their fixed-

income holdings and changing the fixed-income portfolio to match their liabilities better, interest-rate risk is being reduced.

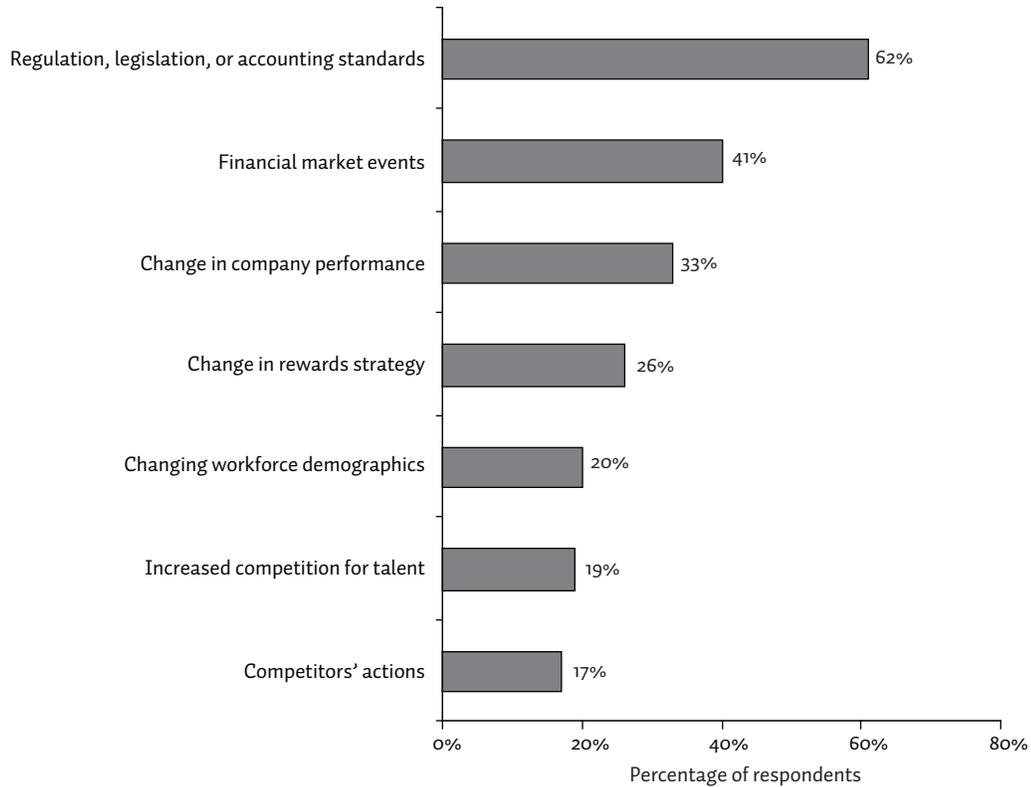
Opinion/performance analysis also uncovered a trend for asset allocation of large plans shifting to fixed income and lengthening duration. Mr. Ramos at Maritz details some of his company’s investment approach: “Our real risk and our real focus is on the liability side, and that liability side is really the thing you need to be worried about and focused on. I think our investment manager said, ‘That’s the enemy you’re trying to defeat. You’re trying to defeat the liability. You’re not trying to win on the return. You’re trying to defeat the liability.’” He continues, “We can make up [return], just by small increases and better performance of our equities or our hedge funds; we can make small strides, but we’re avoiding the greatest risk [by managing to the liability carefully]. Keeping pace with the market from the rest of your portfolio and slaying the liability dragon is good enough.”

No matter how risk is addressed, two variables remain wholly outside the control of pension fund management: overall market performance and regulation. While the former cannot be influenced (let alone be reliably forecast), the latter is a persistent topic of speculation as well as a great motivator of behavioral changes. When asked in the survey, finance executives often said pension regulation has had a great influence on their company’s plan design since 2000, as 37% noted it as having had a material impact on DB plan decision-making. For Maritz and others, regulations greatly affected pension plan choices. “The decision to close or freeze that plan was partially in response to accounting rule changes,” Mr. Ramos points out.

This data suggests that pension plan sponsors and portfolio managers are stepping away from their conventional 60/40 split between equities and debt in pension portfolios, and that companies are seeking alternative investments with high long-term yields but without the systemic risk of equity markets.

Figure 13. External events such as regulation and financial market performance are seen as catalysts for change.

What kinds of events, if any, do you expect would cause your company to change its DB plan design over the next 24 months?



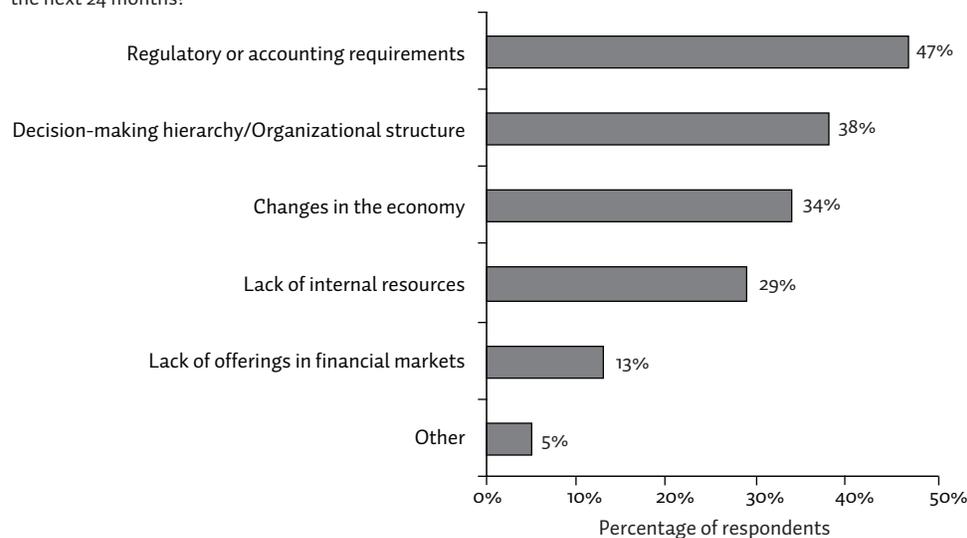
In the future, regulation is poised to be both a catalyst for change in DB plans and one of the most formidable barriers to overcome. Fully 62% of respondents say that regulation, legislation, or accounting standards events would cause their company to change its DB plan design in the next 24 months. (See Figure 13.) In the more detailed opinion/performance analysis, the response to regulation and potential accounting standards changes would be more likely to spur DB plan action from any of those with a profile of a more poorly-funded plan, a high equity allocation, or a large unfunded pension obligation. Prospective financial market events—say, a correction in the equity market or volatility in interest rates—are seen as agents for change by comparatively fewer executives in the survey (41%), as are changes in company performance (33%). The issue of changing regulations or legislation resonated more strongly in the United States compared with Canada, with 76% of U.S. respondents citing it as an issue versus 37% of those in Canada.

A solid majority of respondents—62%—say regulation, legislation, or accounting standards events would cause their company to change its DB plan design in the next 24 months.

Mr. Nowlin at McWane speaks to the issue of dealing with regulations and how it affects the implementation and management of DB plans. He claims that the 2006 Pension Protection Act is “just so draconian in the way it causes you to fund your plan that it’s almost like you’re being punished for having a DB plan. The way they’ve tightened up the funding rules, it accelerates the funding to the plan to the point where it is not only overly aggressive, it is punitive to companies maintaining a DB plan. There’s not a lot you can do about that now, but there’s just been this constant marching in Congress to tighten rules, tighten

Figure 14. Regulatory requirements and organizational dynamics are most likely to hold companies back, say executives.

What obstacles do you think will impede your ability to make timely decisions or desired changes in your DB plan over the next 24 months?



requirements, tighten everything, and all of it ends up resulting in a DB plan as being a fairly high-cost benefit to provide.” He continues, “It is highly regulated. There is an awful lot of money that we have to spend to make sure that we’re always in compliance with all the rules. If they keep up at the pace they’ve been going for the past 10 or 15 years, I’m not sure there will be any DB plans left, other than those that are negotiated in union contracts.” He believes the environment is “hostile” to these plans. “If the government wants you out of something, they don’t have to make it illegal,” he says. “They can pass enough legislation to the point where people look at themselves and say, ‘We’re going to impose some sort of hard freeze or soft freeze, shut down our plan, and move on and enhance your 401(k), or enhance whatever DC vehicle you have.’”

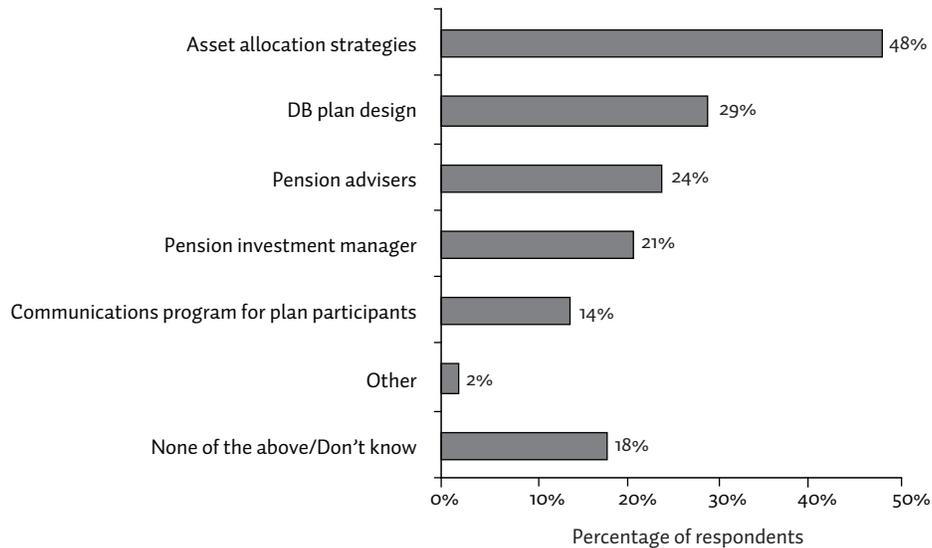
New regulatory requirements and oversight of pensions are the most likely agents for change, say executives, but regulation also stands in the way. To 47% of survey respondents, regulatory or accounting requirements are seen as possible obstacles that could impede them from making timely decisions or desired changes in DB plans in the next two years. Only one-third of respondents (34%) see changes in the economy as impeding decisions or change. (See Figure 14.)

New regulatory requirements and oversight of pensions are the most likely agents for change, say executives, but regulation also stands in the way of executives seeking to make “desired changes in DB plans” in the next two years.

While there has been no single solution to every pension manager’s prayer, at the same time there doesn’t seem to be a shortage of products from financial services providers. According to Mr. Ramos, there are many products being developed very quickly to address pension asset management. Finance executives, he says, “are bombarded with a lot of new products, and you have to be very careful and look at those products. A lot of them are untested, and people are slow to come to these liability-driven strategies for pension plans of our [small] size.” Mr. Ramos notes that the product Maritz selected, a synthetic swap offering for interest rates, is one that is still rather new to the U.S. market. He continues, “There are a lot of new products being added to this market very quickly, and people have to make sure that they understand how they’re going to act and what their risks are, just within those products.”

Figure 15. Capital market volatility has made companies reconsider asset allocation strategies more often than plan design, pension advisers, or other elements of their DB plan.

Have recent trends in the capital markets and the macroeconomic outlook made your company seriously consider changing its...



Note: Respondents were asked to select all that apply

Recent market volatility has driven nearly half of respondent companies to seriously consider changing their asset allocation strategies.

The survey data confirms that a lack of product choice isn't a strong concern, and with the potential windfall to financial services companies beckoning, the pipeline of new products will continue to deliver offerings. Much like life-cycle mutual funds seek to simplify the diversification dilemma for IRA accounts, pension products will seek to address the asset allocation issue, which continues to sit atop the list of concerns of senior finance executives. Indeed, nearly half of all respondents (48%) note it as such. (See Figure 15.) And for those respondents with longer benefit maturities or a lower funded position of their plan, the issue of asset allocation strategies is even more of a concern, according to the opinion/performance data analysis.

Since companies craft DB plan design to meet their needs, it is not surprising that the second most-frequently cited result of capital market trends was to consider changes in their DB plan design (29%). But the markets are inherently uncertain, and many companies don't want to cede control completely to the whims of stocks and bonds. The one place where they can exert influence on the issue of portfolio performance is in their selection of pension investment managers and advisers. When respondents were asked if recent trends in capital markets and the macroeconomic outlook made their company seriously consider changing aspects of their DB plan, changing pension advisers was chosen by 24% and changing the pension investment manager was selected by 21%.

Barriers to change are high, and they matter

Shifting economic outlook, uneven business performance, gyrating financial markets, lengthening life expectancies, uncertain asset-portfolio performance—amid these difficult economic conditions, why would anyone want to be wedded to a massive financial obligation that ebbs and flows regularly? Wouldn't a fixed-cost commitment like a DC plan be much more palatable, especially for financial decision makers? It may seem so. Ms. Kwasny of NorTerra presents this argument on the challenges of varying obligations: "When you get to the point where you need to make those [DB] contributions, they can be volatile, depending on how the markets do and what your valuation says. With the DC plan, you know your number of employees. You know your percentage contribution required to match them, or however your plan is set up, and it's much easier for budgeting and forecasting."

One counterargument is tied closely to the positive benefit to earnings associated with DB plans. Current accounting rules may allow some companies to continue to use their DB plans to present their GAAP earnings in an especially favorable light. Accordingly, one would expect companies to be reluctant to alter their DB plans. But, according to sources in this study, companies don't seem naïvely committed to this currently favorable accounting treatment and are willing to consider dramatic change when they can. As a controller at a \$3.1 billion specialty-chemicals company notes in the free-text section of the survey, "If interest rates and rates of return became higher and/or the premium to settle our defined benefit obligations became lower, we would be eager to shed DB obligations." This eagerness to unload pension obligations is further confirmation of companies' new risk consciousness.

As the survey reveals, three-quarters of respondents say they will seek to reduce pension risk at the expense of greater returns in their portfolio. As Mr. Kleppinger of PPL explains, "I think certainly in the next year or two that we'll be looking more closely at risk than return necessarily. I've already communicated to upper management that this risk reduction doesn't come free of charge, and there will more than likely be a reduction in the returns we can earn on the portfolio because we're not taking as much risk. They were OK with that. What we focused on in the past was just the absolute return on the assets that

we had in the plan." He adds, "What we're going to look at now is more of a balanced approach, looking at not only the assets, but how our liabilities are moving around as interest rates change, and trying to hedge some of that."

Survey responses and interviews conducted for this study expose executives' concern for pensions' near-term impact on financial statements. Recent grim economic news—high oil prices, an equity market correction, and weak employment figures, for example—places greater pressure on nearly all companies' performance. These concerns emerge in survey responses to the question about which aspects of their DB plan senior management would focus on in the coming two years: the impact on cash flow gets the attention of nearly two in five respondents. (See Figure 8, page 13.) Among the three-fourths of respondents who are most concerned with risk, 43% see cash flow as one of senior management's top pension concerns in the years ahead versus 25% of those seeking returns over risk control. Thus, free cash flow to fund pension obligations is taking on a more prominent role in executives' minds as the woes of the economy continue to mount.

Free cash flow to fund pension obligations is taking on a more prominent role in executives' minds as the woes of the economy continue to mount.

In addition to oncoming concerns about the economy and company performance, the issue of lengthening life expectancy factors into any retirement plan calculation. When asked in the survey what events would most likely influence decisions regarding DB plans in the coming 24 months, one senior vice president of finance at a company with fewer than 5,000 employees writes, "Return performance of assets and meeting future obligations. We are concerned with people living longer and the ability to continue paying benefits."

Mr. Sass at the Center for Retirement Research at Boston College echoes similar concerns regarding capital market performance and longevity as he reflects on the crisis at the beginning of the decade. "You had a tremendous decline in funding ratios, and a mandatory requirement that you throw a lot of money into these suddenly under-

funded plans. That's something that you saw not just in the United States but also in England and Canada that had similar funding requirements that forced companies to throw money into their plans at a time when those dollars were very valuable, when the economy was in a recession." He continues, "This became a powerful financial reason to get out of your DB plan. In the '90s, everybody thought pensions were cheap because projected rates of return were high and discount rates were relatively high. Now everybody thinks they're expensive because projected rates of return and discount rates are low, and everybody thinks they're risky, because of the whipsaw reversal of fortunes at the beginning of the decade. So you have a different perception of the long-term cost of these plans, and also longevity is rising."

For some companies, early commitment and planning can achieve a suitable balance of exposure to risk and return—that is, they set a strategy and stick to it. "I'm very prudent

in terms of how I think about risk. When you think about the next 6 to 12 months, I'm sitting at the edge of my chair just like everyone else is in terms of the state of the economy," notes Mr. Schmidt of Silgan Plastics. "With our existing assets in the DB pension plan, we take a conservative approach in terms of our investment strategy. So we aren't necessarily trying to reduce our risk because we already have a strong discipline in place to diversify and avoid unneeded risk."

"In the '90s, everybody thought pensions were cheap.... Now everybody thinks they're expensive because projected rates of return and discount rates are low..."
says a well-known academic researcher.

Using DB plans in an HR strategy

Why do companies continue to offer their workers defined benefit (DB) plans?

"There are basically two reasons," asserts Steven A. Sass, associate director of research at the Center for Retirement Research at Boston College. "One is to attract workers, and the other is to get rid of them."

DB pension plans have long been credited with being an important card in the human resources deck, with some believing they are an ace. "We find that the benefit plan is a draw, actually, for employees. It's one of the things that they really value, and we have three separate unions that work for the company," explains Leslie Kwasny, corporate controller at NorTerra Inc., based in Edmonton, Alberta, Canada. "They would fight tooth and nail to keep it if they needed to."

Mr. Sass doesn't buy into the theories about heavier regulation being the culprit in the DB plans' demise, pointing instead to HR issues involved in DB plans. "Where you don't have a career employment relationship, a DB plan is actually dysfunctional," he says. Workers want a pension they can take with them if they

change employers. From the employer side, DB plans make it difficult to ease people out who don't want to lose the run-up in the value of pension credits before retirement; DB plans also make it expensive to bring in mid-career personnel. "It gums up the ability of both the employer and the worker to have a more mobile workforce."

But DB plans do work well with a long-term employer/employee relationship, according to Mr. Sass. "The employer gets its payoff during the employee's prime working years and the worker gets his payoff at the end. Long-term relationships have productivity compensation patterns where productivity exceeds compensation in the prime years and is less than compensation towards the end. Maintaining the relationship becomes uneconomic for the company, and retirement on pension is the solution." Companies want to move workers along, first through promotions and then through retirement, explains Mr. Sass. "That's the personnel management function of a DB pension plan."

Some companies use their DB plan to get workers in the door, but not everyone is

convinced of its power of attraction. "We are constantly trying to evaluate whether or not new employees perceive the value of a DB plan as something that would help make us an employer of choice," says Charles Nowlin, CFO at McWane Inc., a privately held valve and pipe manufacturer in Birmingham, Alabama, with 7,500 employees. He reports that his HR department doesn't feel it makes a big impact on hiring because "the DB plan is not recognized as a good benefit until the person hits his/her early 40s."

The drawing card aspect of a DB plan is also downplayed by David Fiorenza, vice president and principal financial officer at Richmond, Virginia-based NewMarket Corp., a \$1.4 billion chemical and petrochemical manufacturing company. "I've got to tell you, a DB or an L-M-N-O-P doesn't make any difference if you are just entering the workforce. The first thing is to get a job. The second thing is, do I like the people I work with? I would bet you it's way down on the list of importance as to what kind of pension plan they have."

But Ms. Kwasny maintains that the DB plan is a large and attractive piece of the benefits

For others, there are explicit targets in the trade-offs of managing pension schemes. Bombardier's three goals, as outlined in its annual report to plan participants, are: first, improve the financial position of the plan; second, generate through active management value-added that is higher than the median of comparable plans; and third, reduce the risk of a 10% deterioration in the solvency ratio over any three-year period. According to Mr. Lemarchand, "That's how we define the trade-off between risk and return. The solvency ratio is what we're striving to protect."

And while the strongest response in the survey to the question of which external events would force a DB plan change in the next two years is regulation, legislation, or accounting standards, the second-most-selected concern is for financial market events (41%), followed by a change in company performance, which was selected by a third

of the respondents. (See Figure 13, page 18.) Clearly there are still troubling clouds on the horizon, and the long term likely holds sustained difficulties for the market. The issue for companies with these DB obligations isn't whether to change, but how to do so.

Mr. MacDonald of NOVA Chemicals senses a shift in how his industry is reacting. "We certainly see people starting to look more actively and starting to move into alternative investments to change their risk profiles. We certainly see that people are moving—and this is happening more in Canada than, I think, in the United States—to offshore investments, to having a higher percentage of their assets invested in international equities in particular. But people are also looking at alternative investments," he continues. "Obviously, real estate is one of the ones that is front and center. We are studying movement into alternative investments. We haven't made any major decisions

package for NorTerra because such plans are getting harder to find and take away investment responsibility from the worker. "They know that at the end of the day, regardless of how the plan performs, they get whatever pension it is that their work period has entitled them to," she says of the workforce at the privately held \$395 million holding company.

For some employees, a DB plan can hold considerable appeal, especially as they enter their career middle stages—and their own middle ages. At Canadian firm Bombardier Inc., a manufacturer of transportation solutions with \$17.5 billion in revenues, DB plans are seen as an excellent tool to attract the particular expertise needed. "DB is becoming more of a differentiating factor in our offer to specialized talent in aerospace," explains François Lemarchand, Bombardier's senior vice president and treasurer. "More and more, the DB plan is becoming a means of attracting employees at those layers where people are typically a little older and probably have more experience, and therefore are closer to the time where they start looking at one or the other regime for their pension. So it's beginning to play that type of role."

The challenge for HR departments is being able to impress upon workers the value of a DB plan that they won't get a cent from until years from now. Jim Chandler, CFO of the Arkansas Public Employees Retirement System, believes it is a good benefit and "could be a very good recruiting tool. The typical problem is that the payout or the benefit is so far off for most people that you have trouble getting them to catch the vision of it: 'Give me the money now, and we'll talk about retirement later some time.'"

"The key is making sure people understand in their 20s," adds Mr. Nowlin. "That's when they need to start thinking about retirement because those are the funds that have the greatest opportunity to compound over a 40-year working career. At a young age, I don't believe people catch on to the idea that a DB plan is such a great retirement benefit, and I don't think they appreciate how much retirement security you ultimately get out of a DB plan."

For Dale Kleppinger, senior director, investments and pensions, at PPL Corp. (formerly Pennsylvania Power and Light), the pension functions to attract and retain workers.

"I think the biggest benefit of the plan is that it's certainly a good retention tool. Even if we're hiring somebody at a midcareer-type level, it's still an attraction for someone like that, but for younger employees, maybe not quite so much."

Don't count on DB plans being eliminated in the near future. As Mr. Fiorenza notes, new employees at NewMarket are welcome to join the plan: "We have no intention of closing our plan. It's not frozen, it's nothing—it's wide open. New employees find that very appealing, but I wouldn't say we have it as a recruiting tool because we have extremely low turnover in our company and our competition offers DB plans as well. It's just part of who we are. We don't want to get to the end of the game and have folks not have their benefits."

yet. We certainly haven't changed our other bond and equity portfolios. We certainly have changed exposure to increasing our international exposure and decreasing our Canadian exposure."

The idea of shedding a DB plan may be attractive, but finding the proper way to off-load it can be challenging. Even if a company is willing to pay a premium to a third party, there is always a catch. "In the end, you're going to pay," cautions Andreas K. Rothe, senior vice president and controller at Parsons Brinckerhoff, a \$1.7 billion engineering and construction firm. "It's similar to getting a mortgage. Ultimately there is an interest cost that must be accounted for. So I am not sure whether it is beneficial from a long-term cash-flow perspective." Mr. Rothe explains that the company would like to get the liability of a European subsidiary off its hands. "Having the benefit plan on our books is detrimental to our balance sheet. We've been trying to off-load it, even partially, for several years now, but this has proved difficult due to the low interest-rate environment. Even now with higher bond yields, the credit crunch limits the number of participants in the market willing to buy these liabilities."

"We certainly see that people are moving—and this is happening more in Canada than in the United States—to offshore investments, to having a higher percentage of their assets invested in international equities in particular," says one CFO in Canada.

For many, getting out of the DB game is not likely, whether the idea is appealing or not. In general, the arc has been a gradual decline in DB pension plans, but there is a flattening out of the curve well before the bottom is reached. A large issue for many players is the HR angle, which plays a leading role for labor-intensive companies in particular. (See "Using DB plans in an HR strategy," page 22.) For companies with certain profiles, a DB package is both attractive and necessary from a competitive standpoint for getting workers in the door and keeping them there. Pensions will continue on for them because these companies made the commitment and are willing to continue fulfilling their obligation.

DB plans, once a pillar of the employer/employee compact, have given way to a broad array of retirement plan options over the past 30 years. Demographics, markets, regulation, and company policies have each played a part in the evolution of private-sector retirement.

This research program among finance executives in North America reveals that the DB plan is far from extinction—indeed, for many companies, it remains an essential part of their compensation strategy. For others, it's a stable and manageable commitment. On the other hand, a minority of companies, says the research data, seek drastic change in their DB plans through termination or whole-scale transfer to a third party. Executives report gradual changes in plan design and a keen interest in addressing risk exposure through portfolio management rather than through the architecture of their pension plan.

Through this survey and interview program, senior finance executives reveal the breadth of maneuvers companies have taken, or plan to take, to limit the risk embedded in their DB plans. Across all segments, survey respondents have and expect to continue to address portfolio risk issues through careful asset reallocation strategies, often by adopting liability-based asset management. And among some segments, this portfolio strategy of explicitly matching asset and liability duration is especially likely: companies with large pension plans, a high concentration of equities in their pension portfolios, and those with mature pension obligations are particularly likely to embrace this liability-driven investment strategy to limit risk in the years ahead.

Overall, this research exposes a complex and nuanced pension landscape in which companies seek to understand and navigate economic, accounting, and regulatory uncertainty. Throughout the survey and interview program, executives reveal their preference for risk aversion, incremental plan design change, liability-driven investment, and, to a lesser extent, new risk management methods.

Risk, uncertainty, and dynamic risk management

During a time of regulatory change and pronounced volatility in the financial markets, it does not take a leap of the imagination to believe that most finance executives now emphasize risk reduction over the possibility of higher returns in their pension portfolios. Our latest survey with CFO Research Services reveals that more than three-fourths of the respondents plan to focus on de-risking their retirement plans. This reaction is particularly true at companies with large pension plans—compared to the size of their organization—and plans that tend to be more heavily invested in equities; that is, companies that potentially still have a relatively large pension risk exposure.

The findings also indicate that two-thirds of the finance executives who responded say they attempt to “some-what” or “closely” coordinate their pension risk management with that of other corporate risks—an increase of six percentage points over the 2007 survey findings. While somewhat fewer respondents closely coordinate their pension risk management with broader risk management activities, the current survey makes it very clear that risk management has tightened its grip on the minds of plan sponsors.

Survey findings, however, present a mixed picture when finance executives are asked for their preferred risk management approach. Liability-based asset management is the single-most-common risk reduction strategy, selected by 27% of respondents as a way to address risk and volatility. But a plurality of 44% opted for “none of the above/don't know” when given a choice of settlement with a life insurer, plan transfer to a third party, or a captive insurance solution.

Our experience with clients and the CFO study confirm that plan designs have changed only incrementally at most organizations, particularly those with the large, “mature” plans. Outright plan terminations are still rare for a number of reasons. The plan may still form an important part of employee rewards or may be in a poorly funded status, rendering an outright termination prohibitively expensive. Radical change is either impossible or undesirable. Risk management, rather than plan termination, is the more common response to deal with market

uncertainty and longevity through investment strategies, and gradual changes to plan design. This is logical, by and large, but works best if management operates within a strategic framework.

The case for dynamic risk management

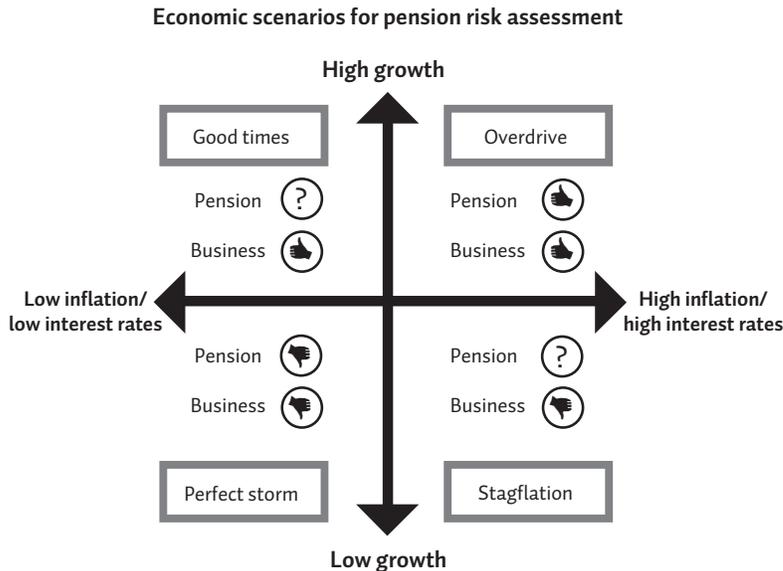
Over time, a pension plan sponsor must address design challenges as well as risk issues. But it must be cautious of making snap decisions when the company or pension plan is vulnerable to a shaky economy or outright recession. A pension plan's sponsor or trustee could find itself responding to market developments in a short-term, impromptu fashion instead of moving its pension plan toward a desirable long-term position.

A more effective approach is to determine where the pension plan should be in 5 or 10 years, and then build an internal consensus for a responsive risk management strategy that will take the plan to the desired outcome. An effective, dynamic risk management strategy—considered and agreed to in advance by stakeholders—can be implemented in a measured fashion to take advantage of changing economic and market conditions. This generally includes aligning the plan's investment and funding policies, as well as the plan's settlement strategy.

With a well-developed risk management strategy in place, a company can determine its risk and capital management priorities to create the proper context for asset allocation and other risk mitigation decisions. Such an approach weighs economic factors as well as broader enterprise objectives, allowing cash flow, accounting and regulatory issues, and even credit ratings to be considered. By looking at risk from a broad or enterprise perspective instead of from a single plan point of view, a sponsor has the added advantage of identifying internal hedging opportunities.

Identifying and measuring financial risks embedded in a pension plan is crucial within the context of a company's overall financial goals. Such an assessment allows for review as to how these risks should be managed over time and produces an action plan that is responsive to changing business and market conditions. Such a plan may involve adoption of one or more strategies, including liability-driven investing (LDI), alternative financing, or a partial or full settlement.

The exhibit below shows four economic scenarios that frame dynamic risk management strategy development. These scenarios range from the “good times” to a sponsor’s nightmare—the perfect storm of deflation and economic slowdown. If there is a very strong correlation between a company’s financial performance, equity returns, and interest rates, it risks succumbing to a “perfect storm” scenario (weak company performance, low equity returns, and low interest rates), making it harder for the sponsor to address its financial needs at the company level during a crucial time.



The need for dynamic plan management has been reinforced through numerous economic and regulatory developments, including Standard & Poor’s May 2008 decision to extend its use of enterprise risk management (ERM) criteria from financial services companies to the credit ratings of companies outside the financial services industry. The rating agency wants to understand top management’s view of risk management frameworks and structures as well as broad policies and metrics. S&P also expects management to have greater insight into the most consequential risks a firm faces—and many companies need to look no further than their defined benefit pension plans to detect a “consequential” risk.

As the report concludes, companies face a complex and nuanced pension landscape. They prefer incremental plan design change and liability-driven investment, but are open to new risk management methods. In the current economic environment, an incremental risk management approach may well be an optimal solution, but it should be the result of a proactive, explicit decision-making process. That decision-making process should reflect an enterprise perspective and consider the full range of pension risk management solutions.

About Towers Perrin

Towers Perrin is a global professional services firm that helps organizations improve performance through effective people, risk, and financial management. The firm provides innovative solutions in the areas of human capital strategy, program design and management, and in the areas of risk and capital management, insurance and reinsurance intermediary services, and actuarial consulting.

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