Managing Retirement Benefits Amid Capital Market Disruption

A report prepared by CFO Research Services in collaboration with Prudential

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An increasing focus on benefits risk management

Providing corporate retirement benefits in today's economy poses severe challenges to the typical company. Sharp declines in financial markets are triggering higher plan contributions for defined benefit (DB) plan sponsors at the same time that corporate revenues and profits are falling. Many participants in defined contribution (DC) plans are delaying their retirement because default investment options, such as target-date funds, have not protected participants adequately. The weaknesses of DC plans are also exposing sponsors to significant fiduciary risks. Retiree health benefits costs continue to rise rapidly due to the pace of healthcare inflation. Finally, companies are wrestling with the complexity of allocating scarce resources across multiple benefits programs in different geographies.

Prudential commissioned this research program on how finance executives are managing retirement benefits in today's environment because Prudential believes that finance executives are critical to managing the risks inherent in such benefit programs. This research demonstrates that finance executives are more involved than ever in their companies' retirement benefit programs, and are prepared to take concrete steps to strengthen them.

Employers shoulder the risks within a DB plan, such as the possibility of a sharp market decline that creates the need for higher cash contributions. This research shows that a majority of employers are actively seeking solutions to help manage such risks. Companies can benefit by incorporating several key elements into their DB risk management approach.

First, a holistic approach to managing DB risks can help companies evaluate these risks in the context of all the risks that a company faces. All other things being equal, companies with revenues that are very sensitive to changes in economic growth should invest more conservatively in their DB plan than companies with revenues that are less sensitive to macroeconomic factors. Second, when used carefully, risk management tools such as Value at Risk (VaR) analysis can provide a valuable framework by which to measure pension risks and to evaluate the benefit of potential risk mitigation measures. Finally, risk mitigation need not be an "all or nothing" proposition. For example, sponsors can eliminate risks related to only the current retirees in their DB plan by purchasing an annuity for these participants. Another example is the gradual introduction of liability-driven investment strategies within a portfolio to reduce risk.

DC plans place significant burdens on employees because employees are responsible for saving adequately and are exposed to the effects of market downturns. However, this research demonstrates that finance executives are concerned about the impact that the recent performance of DC plans is having on their companies, particularly as it relates to the ability of older workers to retire when planned. Finance executives are appropriately focused on strengthening DC plans by making savings decisions automatic, scrutinizing investment choices, and introducing new solutions to protect participants, such as products that provide guaranteed income during retirement.

Not surprisingly, this research indicates that sponsors are shifting toward paying for other post-retirement benefit programs, such as retiree life and health benefits, through pay-as-you-go mechanisms instead of funding such obligations in advance. This is understandable given the financial strains on many companies. However, as the economy recovers, companies can benefit by evaluating the wide range of vehicles available for funding such obligations that provide valuable tax and other financial advantages.

At Prudential, we are committed to providing a robust and tailored set of solutions to help finance executives manage benefits risks. This research is part of our ongoing effort to understand the evolving needs of leading companies. Thank you for taking the time to engage on this important topic.

Bernard Winograd
Executive Vice President and Chief Operating Officer, U.S. Businesses
Prudential Financial, Inc.

FOR ADDITIONAL INFORMATION PLEASE CONTACT:
Kevin Myers, Senior Managing Director
Prudential Financial, Inc.
973-367-5222
Kevin.Myers@Prudential.com

Retirement benefit plans will emerge from the financial crisis on a different footing

Recent disruption in the capital markets has caused many observers to question the long-term viability of both DB plans and DC plans. The fate of DB plans has been in question for many years as plan sponsors have struggled with changing economic and regulatory environments. Sharp declines in DB plan asset levels over the past year have many wondering: will this be the end of DB plans?

DC plans were originally intended to serve as a supplement to traditional DB plans. Today, DC plans often play a primary role in employees' financial retirement strategies. Massive stock market losses in 2008 have caused many observers to ask: have employers and employees put too much emphasis on DC plans?

Our research among senior finance executives who work for companies that sponsor DB plans suggests that, despite recent investment losses, companies are focused on preserving their retirement benefit plans and are taking steps now to restore the financial health of these plans. Finance executives are likely to lead these efforts; in a survey among 140 senior finance executives, respondents say their finance functions will spend more time on managing retirement benefit plans than they have in prior years. More than one-third of respondents will spend more time on their DB plans, DC plans, post-retirement health benefits, post-retirement life insurance, and deferred compensation plans for executives; fewer than 11% say they will spend less time managing these retirement benefits.

In an open-text response, a controller in the software industry comments on how recent events have brought retirement benefits to the forefront of his agenda. "Added disclosure requirements coupled with the effects of the economic slowdown have heightened my focus on retirement benefits." He is not alone. A CFO at a large manufacturing company shares that he also plans to spend more time on managing retirement benefits: "I will spend more time and financial resources to protect [my company's] retirement benefits scheme." And one finance executive says that pension problems currently dominate his role. "I am more focused today on being able to fund the qualified plans that have shortfalls due to the drop in the economy. This used to be about 10% to 20% of my time, but due to the recent impact of the economy, it is now 75% to 90% of my time," says this VP of finance in the telecommunications industry.

Retirement plans will benefit from finance executives' greater attention and, after a period of retrenchment, are likely to emerge on a different footing—one based on a greater appreciation for risk.

ABOUT THIS REPORT

In April and May 2009, CFO Research Services (a unit of CFO Publishing Corp.) conducted a survey among senior finance executives in the United States who work for companies that sponsor DB plans. This survey examines the impact of the financial crisis on companies' defined benefit and defined contribution plans and their plans and priorities for their retirement benefit plans in the near- and long-term.

We gathered a total of 140 complete survey responses from senior finance executives working in a broad cross-section of company segments, as follows:

ANNUAL REVENUE

$500M–$1B	23%
$1B–$5B	46%
$5B+	31%

TITLES

Chief financial officer	35%
Controller	21%
Director of finance	18%
VP of finance	14%
EVP or SVP of finance	8%
Treasurer	2%
CEO, president, or managing director	1%
Other	1%

Respondents work for companies in nearly every industry. The financial services, real estate, and insurance sector and the auto, industrial, and manufacturing sector are particularly well represented.

A more-conservative approach to managing DB plans

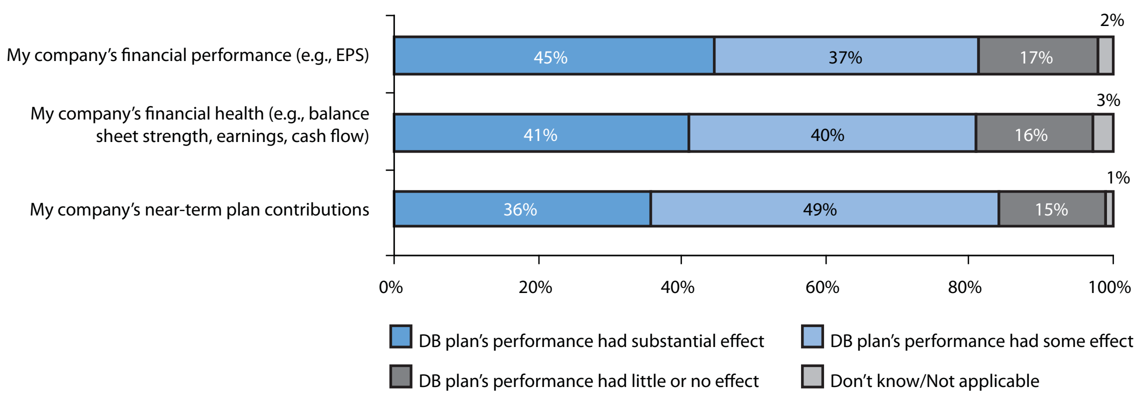
In recent years, companies have struggled to maintain their DB plans' funded status—and the recent dramatic decrease in asset prices has only served to magnify the problem. Until recently, DB plan sponsors' balance sheets were essentially insulated from DB plan performance shortfalls. However, changes in accounting rules and funding regulations, such as the Pension Protection Act of 2006 and U.S. Financial Accounting Standard 158, have increased plan funding requirements and altered the relationship between DB plan performance and overall company performance. Now, DB plan sponsors must address funding shortfalls more quickly than before and watch as mounting pension liabilities and expenses are expressed more transparently on their financial statements.

Respondents to our survey confirm that the recent performance of their DB plans has substantially affected overall company health. Forty-five percent of respondents report that their DB plan's performance has had a substantial effect on their company's financial performance (for example, their earnings per share) over the past year. Forty-one percent of respondents also report that their DB plan's performance has had a substantial effect on their company's financial health (for example, balance sheet strength, earnings, and cash flow). (See Figure 1.)

The financial stress caused by their DB plans is affecting companies' commitment to their plans. Fully 22% of respondents indicate they are very likely to freeze or terminate their DB plans, and 25% say they are somewhat likely to do so. Respondents are, however, most likely to say they will remain committed to their DB plans, with

FIGURE 1. DB PLAN PERFORMANCE HAS SUBSTANTIALLY AFFECTED COMPANIES' FINANCIAL HEALTH OVER THE PAST YEAR.

In the past year, what effect has your DB plan's performance had on the following?

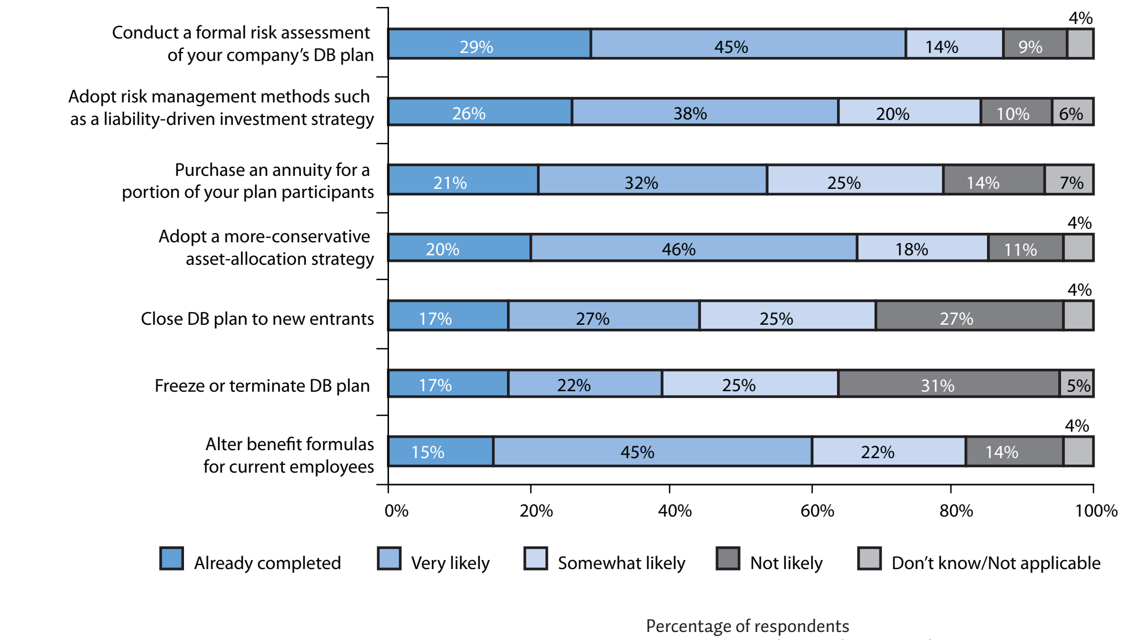


Percentage of respondents
Note: Percentages may not total 100%, due to rounding.

DB plan sponsors must address funding shortfalls more quickly than before and watch as mounting pension liabilities and expenses are expressed more transparently on their financial statements.

FIGURE 2. FINANCE EXECUTIVES IN OUR SURVEY SAY THEY WILL FOCUS ON REDUCING UNCERTAINTY IN THEIR DB PLANS.

In your opinion, how likely is your company to make any of the following changes to its DB plan over the next two years?



Note: Percentages may not total 100%, due to rounding.

nearly a third of respondents saying they are not likely to freeze or terminate (31%) their plans or to close their plans to new entrants (27%), as shown in Figure 2.

For companies that remain committed to their DB plans, a volatile and uncertain economy calls for something different from business as usual. The results of our survey show that companies are taking corrective steps now to address immediate concerns, including near-term benefit payments and looming funding shortfalls. At the same time, companies are taking steps to strengthen their DB plans in the long term. Balancing near-term requirements with long-term commitments requires a delicately calibrated approach to risk.

To address near-term benefit obligations, companies are likely to increase contributions and some may liquidate plan assets prematurely, according to survey data. Indeed, a solid majority of respondents (60%) say that their companies are very likely to increase or already have increased contributions to their DB plans. In addition, 38% of respondents say their companies are very likely to sell or already have sold plan assets prematurely to meet benefit obligations. (See Figure 3, next page.)

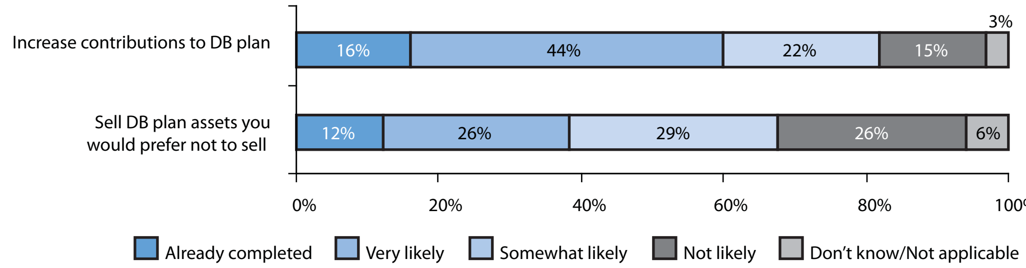
Rethinking risk management strategies

We asked respondents about their priorities for managing their companies' DB plans. We found that executives' highest priorities are centered on driving uncertainty out of their DB plans' performance. Indeed, a majority of respondents (57%) say reducing funded-status volatility is a high priority for managing their companies' DB plans, followed closely by the desire to increase predictability of required contributions (56%). Fifty-three percent of respondents also say that increasing the certainty of reported pension expense is a high priority.

How will companies manage their DB plans so they are less vulnerable to possible future market disruptions? Respondents to our survey say they plan to reduce uncertainty related to their plans through a variety of risk mitigation strategies. The recent financial market meltdown has made it clear that even the most sophisticated investors often underestimated the risks to which they were exposed. So it's hardly surprising that about three-fourths of respondents (74%) say their companies are very likely to conduct (45%) or have already conducted (29%) a formal risk assessment of their companies' DB plans.

FIGURE 3. RESPONDENTS WILL TAKE NEAR-TERM STEPS TO ENSURE THEY CAN FULFILL BENEFIT OBLIGATIONS.

In your opinion, how likely is your company to take the following measures to meet its near-term DB plan obligations?



Percentage of respondents
Note: Percentages may not total 100%, due to rounding.

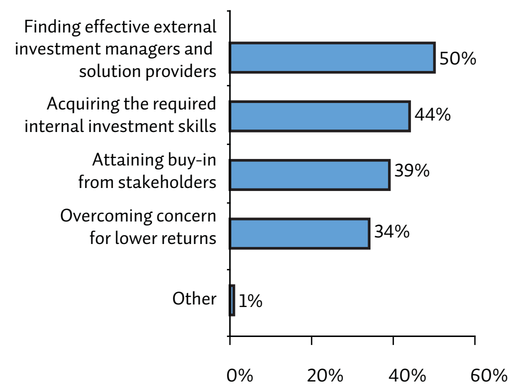
Survey results show that many companies are making portfolio-level changes to their DB plans in an effort to reduce uncertainty. Sixty-six percent of respondents say their companies are very likely to adopt (46%) or have already adopted (20%) a more-conservative asset-allocation strategy. While these adjustments are undoubtedly prudent in the short-term, this broad movement toward more-conservative allocation does raise the question: with aging workers and the looming prospects of rising payments, can companies afford to maintain such conservative positions?

Perhaps with an eye toward resolving this dilemma, the finance executives who participated in our survey appear to be interested in adopting new tools and approaches for managing their portfolios and mitigating risk. Sixty-four percent of respondents to our survey say they have adopted risk management strategies such as a liability-driven investment (LDI) strategy for managing their portfolios (26%) or are very likely to do so (38%). Respondents also say they are now considering adopting risk-mitigation tools such as Value at Risk analysis (66%) as a result of the financial crisis.

As the dust from the recent financial crisis begins to settle, many DB plan sponsors may find themselves at the beginning of a steep learning curve as they work to balance the demands of the present with the needs of the future. And they will do so while many of the fundamental assumptions about financial markets—transparency, rationality, liquidity, and risk—are called into question. Indeed, finance executives participating in our survey cite a lack of expertise from both internal and external sources as the greatest obstacle to adopting a liability-driven investment strategy. Half of respondents (50%) cite "finding effective external investment managers and solution providers" as an obstacle to adopting an LDI strategy; another 44% of respondents say that "acquiring the required internal investment skills" is an obstacle. (See Figure 4.)

FIGURE 4. THE GREATEST OBSTACLE TO ADOPTING AN LDI STRATEGY IS A LACK OF EXPERTISE.

In your opinion, what are the greatest obstacles to adopting a liability-driven investment strategy?



Percentage of respondents

Strengthening DC plans to better protect plan participants

The impact of the capital market collapse certainly hasn't been limited to DB plans. DC account values have plummeted, and although there has been some improvement in capital markets since the beginning of the year, many employees' near-term plans to retire are in jeopardy.

The events of the past year have created a new set of challenges for companies. Employees who have become financially unable to retire when they planned to will certainly bear the brunt of the delay in their retirement plans. However, the negative impact of thwarted retirement plans isn't limited to those who are forced to extend their careers. Workforce productivity and overall employee morale can suffer and companies can find it difficult to retain rising stars when paths to promotion are effectively closed.

Companies that sponsor DC plans are therefore concerned with managing their DC plans to avoid possible future disruptions created by the market—not just because it's the right thing to do for all of their employees, but also because it's the right thing to do for the company.

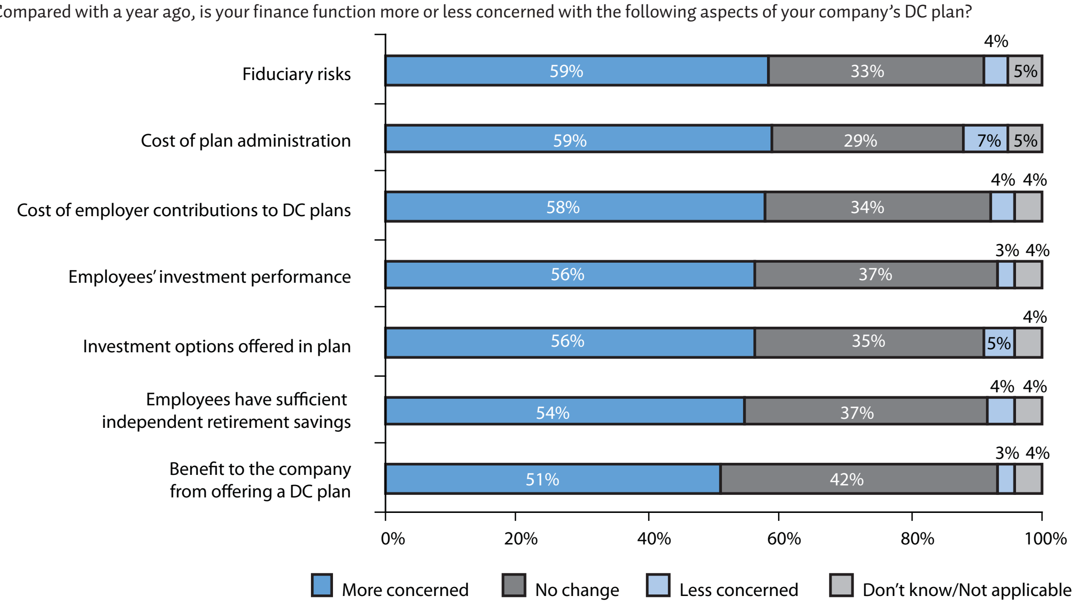
Survey results show that many companies are planning to make changes to their DC plans in order to better support employees' long-term retirement needs. At the same time, survey results show that companies in general are more concerned about the financial impact of their DC plans on the company today than they were a year ago. We queried respondents on their level of concern regarding various aspects of their DC plans, including fiduciary risks, the cost of administration, employees' investment performance, and their DC plans' offerings. Across the board, a majority of respondents say they're more concerned about each of the dimensions of their DC plans than they were a year ago, before the current financial crisis took hold. Respondents most frequently say they're more concerned about fiduciary risks (59%), cost of plan administration (59%), and cost of employer contributions to DC plans (58%). (See Figure 5.) In the words of an SVP of finance in the healthcare industry, "We've cut employer contributions to our 401(k) plans, as the economy hit my firm very hard. And our executive pension plans are under review as well."

New human-capital management concerns

Survey results also confirm that executives are more concerned now than they were a year ago about the problem of employees staying in their current jobs because they cannot afford to retire and the attendant

FIGURE 5. COMPANIES' CONCERNS FOR THEIR DC PLANS ARE CENTERED ON THE FINANCIAL ASPECTS.

Compared with a year ago, is your finance function more or less concerned with the following aspects of your company's DC plan?



Percentage of respondents
Note: Percentages may not total 100%, due to rounding.

shortage of career development opportunities for younger staff. Almost two-thirds of respondents (63%) say employees who become financially unable to retire and therefore "retire on the job" are more of a concern now than they were a year ago. And 62% report that a shortage of growth opportunities for younger staff is more of a concern now than it was a year ago.

These human-capital management problems can be avoided, of course, if employees are able to fund their retirements as planned. Good, consistent investment decision-making can help employees reach this goal, and with this in mind we queried respondents on how well they think employees make decisions about various dimensions of their DC plan investments. Seventeen percent of respondents rate employees' investment-allocation decisions as poor, and 17% say employees make poor decisions about their contribution amounts. But where employees most frequently fall short, say respondents, is with their time-to-retirement planning (which we define as employees' combination of asset allocation, contribution amounts, and risk appetite as they approach retirement): more than one-fourth of respondents (27%) rate employees' time-to-retirement planning as poor.

Redesigning DC plans to increase retirement security

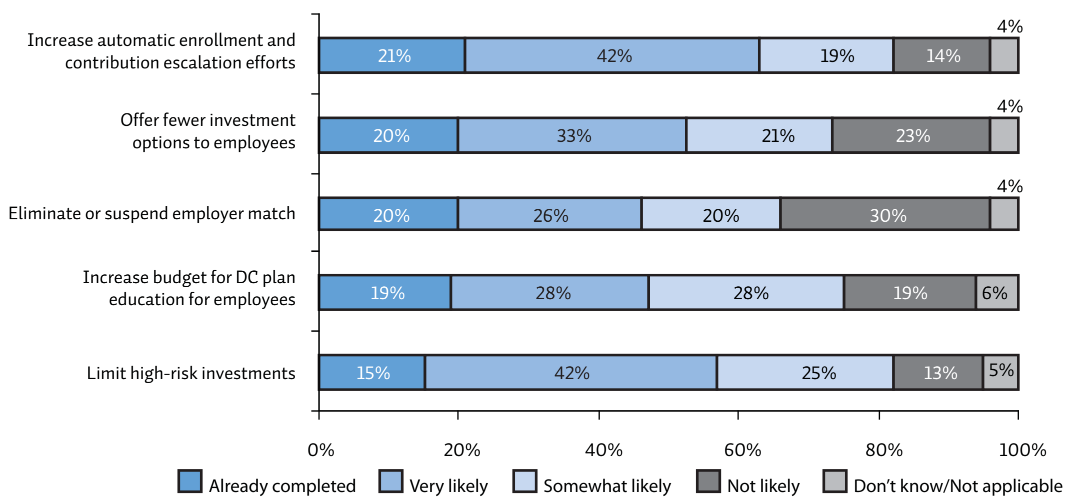
In an attempt to protect employees' DC plan accounts from market volatility, companies are likely to make changes to their DC plans that make them more conservative, according to survey data. Forty-two percent of respondents say they are very likely to limit high-risk investments for their DC plans. Respondents also report that their companies are very likely to add investment products that offer some protection against market declines (44%) as well as more-conservative target-date funds to their DC plans (38%), in line with a renewed focus on protecting employees' portfolios from disruptive market performance.

In their views on automatic enrollment, finance executives confirm a migration toward DC plans that better support employees' retirement planning. Forty-two percent of respondents say their companies are very likely to increase automatic enrollment and contribution escalation efforts. Respondents are less likely to say they will increase funding for DC plan education in the next two years. (See Figure 6.)

In a separate question, we asked, "Do you think it would be beneficial to make your company's DC plan more closely resemble a DB plan by enabling the plan to provide guaranteed income during retirement and by further automating the plan?" More than two-thirds of respondents (69%) answered yes. The steps companies are taking to address new concerns raised by the recent performance of DC plans are in line with respondents' framework for managing their DC plans; that is, they would like their DC plans to provide some of the benefits of traditional DB plans without the risk to the company, of course.

FIGURE 6. COMPANIES ARE LIKELY TO MAKE CHANGES TO THEIR DC PLANS TO BETTER SUPPORT EMPLOYEES' RETIREMENT PLANNING.

How likely is your company to make any of the following changes to your DC plan offerings over the next two years?



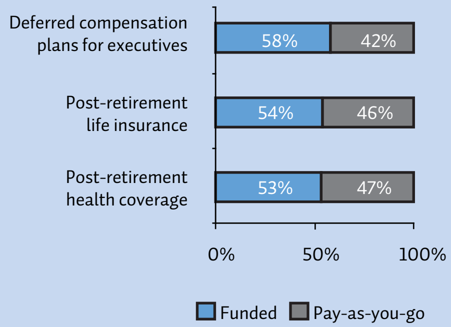
Percentage of respondents
Note: Percentages may not total 100%, due to rounding.

SHIFT TOWARD "PAY-AS-YOU-GO" POLICIES FOR OTHER POST-RETIREMENT BENEFIT PROGRAMS

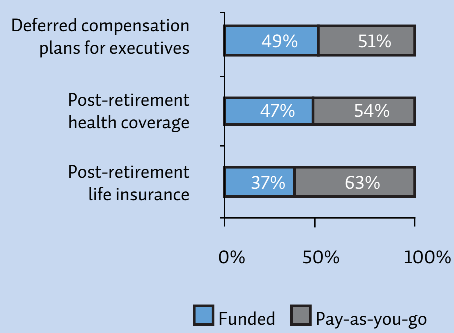
Through this research program, we also sought finance executives' views on managing other post-retirement benefits, such as deferred compensation plans for executives, post-retirement life insurance, and post-retirement health coverage.

We asked respondents how their companies currently fund these retirement benefits, and how they plan to do so in the future. We found that companies, in general, are shifting from a funded model to a pay-as-you-go model, as shown in the figure below. This change is likely a reflection of companies' need to reallocate resources to fund qualified pension obligations in the near term.

CURRENT FUNDING POLICY:



LIKELY FUTURE FUNDING POLICY IN TWO YEARS:



Percentage of respondents whose companies provide these retirement benefits

Note: Percentages may not total 100%, due to rounding.

Renewed appreciation for risk

Severe market disruption over the past year has exposed grave weaknesses in companies' retirement benefit plans. As they work through this crisis, DB and DC plan sponsors are emerging with a greater appreciation for risk than they may have had in the past. Companies are making changes now to both their DB and DC plans to reduce uncertainty through a combination of risk mitigation strategies. Perhaps even more important, companies are evaluating new tools to ensure their retirement benefit plans will meet the long-term retirement needs of their employees. As employers and employees work together to manage through a changed risk and investment landscape, the finance executives who participated in our survey seem devoted to steering their retirement benefit plans back on track. With time, effort, and thoughtful attention, retirement benefit plans could emerge from this crisis stronger and better positioned for the long term than they were before. Finance executives seem to be committed to making that hope a reality.

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Prudential Financial, Inc., Newark, NJ
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