

Practical strategies for employers to help manage the costs associated with employee pension plans.

BY CAMERON J. McNEILL AND
KEVIN M. SORHAITZ

IT is always a good idea to be prudent with expenditures, but in this economy, it has become essential. Many companies are just trying to remain viable in this recession as more and more of their peers seek bankruptcy protection. With cash preservation at the forefront, many finance and HR executives are asking, How can we contain our cash costs in connection with our pension plan?

What drives the true cost of having a defined benefit (DB) pension plan? The three most important factors are the cost of the promised benefits, the return on the plan assets that support the benefits and the costs associated with operating the plan.

With this in mind—and with no quick or inexpensive way out of an existing DB pension plan deficit—sponsors are left with a handful of strategies to help them contain costs in the short term. These strategies include reducing future benefit promises, improving returns on plan assets, reducing plan operating costs and using capital more appropriately.

Keep in mind that these strategies deal with surviving today, rather than what might be best for the company in the long term.

Strategy No. 1 - Reduce Future Benefit Promises

It is time for employers to take a hard look at pension plan design. At the core of their considerations should be the benefit multiplier or plan formula, the early retirement reduction formula, the automatic or normal form at retirement, the cost of living allowance or indexing provision and any bridge benefits. Even employers with a unionized workforce must find ways to deal with the DB plan. Any reduction to benefits will obviously be a tough sell to employees, but it may only need to be temporary. And a well-communicated rationale for any changes will go a long way to ease the pain.

For many employers, the current plan design costs a lot of money and may no longer support the company's talent attraction and retention needs for today. If the so-called "war for talent" is real or is at least a concern in your industry, then perhaps the time is right to remove plan provisions that are costly and encourage employees to retire earlier than you want or need.

Legacy plan provisions, such as a bridge pension and unreduced early retirement options, may be working against your company's retention goals. If attracting younger talent is the goal, then it may make sense to offer new entrants a defined contribution (DC) plan. While this will not save you much in the short term, it will set you up nicely in the mid to long term.

Some other plan design changes to consider, with an eye to reducing costs, are as follows.

1. Freeze the DB pension plan – This could be either a temporary or a permanent change. There are many options, including whether to freeze credited service, freeze salaries or grandfather

NOT AT ALL COSTS

current active employees. You may also consider offering a DC component for future service.

2. Reduce the DB formula and add a DC component – Some refer to this as an "A plus B" plan.

3. Use career average pay instead of final average pay – You can provide benefit improvements to track the final average pay when investment returns make it affordable. But be careful—this is not a guaranteed money saver.

4. Introduce or increase employee cost-sharing – This way, for every 1% of pay or \$1 of increased employee contribution to the pension plan, the sponsor will essentially save the same amount.

Strategy No. 2 - Improve Returns on Plan Assets

Fast on the heels of a year that left the average Canadian pension plan with a negative 16% return on assets, many plan sponsors have been reminded of what the downside of risk feels like. In many cases, they are coming to grips with the reality that they weren't financially strong enough to take on the amount of risk they did.

So, how do we deal with that today? The first order of business is to decide whether or not you can handle another year in which the return on assets does not at least equal the increase in liabilities.

Today, many plan sponsors have an asset allocation of roughly 50% equities and 50% fixed income (compared to about 60% equities and 40% fixed income a year ago). While some are fine with the current asset allocation and investment strategy, others are considering a more conservative approach associated with some combination of

decreasing the equity exposure, immunizing a portion of the liabilities and moving toward a liability driven investment strategy.

Given today's increased yield spreads for credit risk, what if a buy-and-hold strategy overweight in quality corporate bond holdings could produce the same expected return as the 50% equity portfolio but with lower volatility? Would you consider it?

The cost-containment goal, from this perspective, is to maximize the return on plan assets while minimizing large negative surprises. Too often, we become enamoured with the lottery scenario of huge equity jumps and forget the real-life pain associated with negative returns.

**TOO OFTEN,
WE BECOME
ENAMOURSED
WITH THE
LOTTERY
SCENARIO OF
HUGE EQUITY
JUMPS AND
FORGET THE
REAL-LIFE
PAIN
ASSOCIATED
WITH
NEGATIVE
RETURNS.**

Strategy No. 3 - Reduce Plan Operating Costs

Plan operating costs fall into two broad categories: investment management fees and other service provider fees. A primary consideration, with respect to investment management fees, is the amount being paid for active management compared to passive management. In other words, has your net return (after deducting investment manager fees) been more or less than it would have been if you had held the index? After all, passive management can be obtained for significantly less cost. If an active manager is not producing appreciably more than the index, then why pay fees for active management?

What you really care about is the return that hits your plan assets relative to your plan liabilities. That said, some investment

styles—particularly the value style—achieve their benchmark returns with much less volatility than the index. The risk/reward trade-off should be a major consideration in developing your manager structure. If you decide that active management fees are worth it, then the next step is to compare your active equity managers with their peers to determine how your net return measures up.

Another area of scrutiny is the costs and returns from your service providers, such as actuaries, auditors, administrators and consultants. Aside from ensuring that your service providers remain competitively priced, it may be to your advantage to enter into a long-term contract in exchange for a discount.

One option that some companies are considering is to take

WHAT YOU REALLY CARE ABOUT IS THE RETURN THAT HITS YOUR PLAN ASSETS RELATIVE TO YOUR PLAN LIABILITIES.

certain tasks in-house, such as annual government filings, pension administration processing and, in rare instances, some of the initial valuation and audit preparation. This way, fees are reduced to only outsourcing of the review and final sign-off. This strategy alone can save a fair amount of money, provided that the right resources and expertise are available in-house. Other companies see outsourcing everything as the answer. Our message is simple: talk to your providers about your options and what would work best for you.

Strategy No. 4 – Use Capital More Appropriately

Given the current financial environment for DB pension plans—rock-bottom interest rates and depressed assets—an obvious quick fix would be an infusion of capital. If a risk analysis of the company's overall balance sheet and total operating costs reveals that an infusion of capital into the pension plan produces a significantly lower overall operating cost to the company, then why not do it?

In addition, if you decide that a lower pension plan risk profile is a better strategic position for your firm, then you can allocate the pension plan assets accordingly to avoid any future surplus concerns. You may be able to balance de-risking the plan assets with an increase in risk elsewhere on the balance sheet that gives you more upside benefit. Keep in mind, though, that in Ontario, you have only until the end of April to include any additional contributions in your actuarial valuation report as of Dec. 31.

Another idea is to look at moving some of your pension obligations out of the plan to an insurance company via an annuity purchase. With the increased yields on corporate bonds, the cost of purchasing a group annuity for a block of pensioners is a lot more attractive today than it was six months ago. You may even be able to get a better price than what the actuarial profession is currently recommending as appropriate for pension solvency valuations due as of Dec. 31, 2008.

If there is a theme for employers, it is to have better corporate governance of pension plans to make sure you get the biggest bang for the not-inconsiderable buck you spend.

For employees, it might be time to stop thinking of a choice between DB and DC, and consider instead the choice of job or no job. Working with employers to reduce costs is in everyone's best interests.

Some legislative changes would also help, and we must all continue to influence that activity. And, of course, keep your fingers crossed for a big rebound on stock markets around the world—but don't hold your breath until it happens.

Lastly, we should not forget how critical healthy employee benefits plans are to this economy. It's time to share the pain. **BC**

Cameron J. McNeill is president and CEO of Buck Consultants, an ACS company, and Kevin M. Sorhaitz is a principal and consulting actuary in Buck's Toronto office. cameron.mcneill@buckconsultants.com; kevin.sorhaitz@buckconsultants.com