MORNEAU SHEPELL

Pension Risk Bulletin

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Morneau Shepell publishes original content that provides insights for pension plan sponsors and pension plan administrators on the topic of pension risk.

Our goal is to draw upon our research and experience to advance the conversation on a spectrum of topics related to pension risk management and transfer.

Improving lives. Improving business.

Key points:

- As a result of the pandemic, several risks faced by defined benefit (DB) plans have materialized in Q1 of 2020;
- Different measures taken by governments and central banks have impacted DB plans and future economic outlooks;
- Pension plan setbacks in funded status and the markets' illiquidity have contributed to reduced demand for pension risk transfers even though the supply from insurers is steady for the most part;
- As a DB plan sponsor or administrator, you need to ask yourself some tough but important questions.

The first quarter of 2020 has seen most countries trying to cope with the COVID-19 pandemic and specifically with trying to "flatten the curve." Many central banks, including the Bank of Canada, have tried to address the lack of liquidity of a number of securities through various interventions and governments have committed incredible financial resources to alleviate what will be a dramatic economic shock.

It is too early to quantify the outcomes of the pandemic but clearly, there will be a sharp fall in GDP around the world. The volatility of capital markets is a sign that stakeholders are still evaluating the outcomes from this crisis and trying to determine whether we will have a brave new world post-crisis or a return back to some form of normality. In the meantime, many organizations, busy with managing the impacts of the pandemic on their operations, also have pension plans to supervise, manage and administer.

Is this crisis another perfect storm for DB plan sponsors?

Unfortunately, what could go wrong for most economic risks for pension plans went wrong during Q1 of 2020, at least to some extent. From the standpoint of a DB plan, what has occurred greatly exceeds any prior perfect storm.

Pension risk can mean different things to different people and organizations. Some of the major economic risks for DB pension plans in the current context include equity risk, interest rate risk, credit risk, liquidity risk and last but not least funding risk – a sponsor's inability to make contributions to its plans when their business activities are reduced or even stopped. In Q1, plan assets took a major hit, pension liabilities increased significantly and liquidity was severely hindered. Yet pension payments must still be made and some employers are left wondering how to make ends meet with the prospect of higher contributions in the future. The impact on pension plans is such that on April 15, the federal finance minister of Canada announced a moratorium, through the remainder of 2020, on solvency special payments, to provide temporary funding relief to sponsors of federally regulated defined benefit pension plans. Pension regulators across Canada have announced a variety of relief measures. In addition, the Office of the Superintendent of Financial Institutions, which supervises federally registered pension plans, has temporarily suspended buy-out transactions to protect the benefits of plan members and beneficiaries. There are still eight months left in the year so there is plenty of time to see where the economy goes. That being said, when we talk to fund managers and economists, even the most optimistic ones are not painting a very rosy picture for the rest of the year.

Risk free rates are slowly converging to 0% across the yield curve

With the quantitative easing and the accommodating policy of the central banks, yields on Federal bonds are converging to 0%. That has the potential to become a major issue for any asset owner and particularly pension plans. If the yield on fixed income is close to zero, not only will a good chunk of assets yield significantly less than inflation, but your liabilities may increase another 15% to 40% depending on the specifics of your pension plan. This development will surely lead to serious conversations about strategic asset allocation when you have the equivalent of a cash yield on all of the public fixed income investments that you own, unless you venture further than before on the credit spectrum. This also has serious repercussions; not only for fixed income but for all other asset classes. At what point does your interest rate risk hedge, such as a Liability Driven Investment (LDI) strategy, become less effective when the risk you were hedging against has effectively materialized?

In our opinion, the low interest rate environment is clearly an item that needs to be discussed by investment/pension committees. There are many different paths the Canadian, North American and global economies can take over the next several months and the outcomes of each path should be evaluated.

The makeup of a pension plan's discount rate (and liabilities) has changed over the last 4 months

The interest rate used to determine a pension plan's solvency liability is based on Government of Canada (GoC) bond yields plus a spread. The discount rate used to determine the projected benefit obligations for financial reporting is based on high quality corporate bond yields. As at December 31, 2019, the difference in rates was at its lowest, suggesting that solvency and accounting liabilities were slowly converging. Since then, GoC yields have declined and corporate credit spreads have widen, affecting the value of liabilities differently.

Even a pension plan's going concern liability, which is less sensitive to capital-market fluctuations than the solvency and accounting liabilities, will surely change. The long-term assumptions used by plan actuaries will need to be revisited to address changes in the economic environment post-crisis. Regular touchpoints with your consultant and actuary can help you best manage the impact of the crisis to ensure that your short and long-term objectives are not jeopardized.

How does the crisis affect my pension risk transfer plans?

Your pension risk transfer plans would not be impacted if you de-risked a good portion of your plan assets before the crisis, at least for the amount allocated to purchasing group annuities. If you did not de-risk your assets, this crisis will likely impede your plan to purchase group annuities, unless your willingness to contribute to the plan has changed because of the crisis.

This crisis serves as another harsh reminder that capital markets are volatile and the severity of the setback may be significant. Consequently, plan sponsors and pension committees must make sure that risks taken are aligned with short and long-term objectives.

For sponsors looking to transfer risks in the short term, through an annuity purchase for instance, being ready to transact is of utmost importance. Even if you do not think that a transaction will take place in the next year or so, there is no reason why you should not work on getting your data pristine, i.e., clean and complete, your asset mix lined up and your governance structure and documents ready.

Insurers still want to sell annuities

Most insurers are still open for business and actively providing quotes when requested. They have adapted their quoting methodologies to deal with the large intra-day movements in spreads and liquidity issues seen at the end of the first quarter.

The latter part of March was not the best time to transact given the high volatility and liquidity issues and it is still too early to determine whether activities picked up in April, but we think volume has been low. We believe transactions will resume for most plan sponsors when the liquidity in the bond market is at, or near, the pre-crisis level.

The net impact on annuity purchase price depends on the level of additional yield an insurer can get and the level of additional margin an insurer includes to take into account the increased interest rate volatility. A deeper analysis based on your plan specifics may determine an opportunity to purchase annuities with little–to-no impact on the solvency ratio, especially for sponsors with a significant allocation to a solvency LDI strategy.

Despite the increased volatility, higher credit spreads allow insurers to find higher yielding fixed-income assets which can lead to more attractive group annuity pricing.

Note also that insurers may be better suited to withstand severe market turbulence and provide benefit security for the plan participants than a pension plan. Their assets are mostly invested in fixed-income assets such as public bonds, private debt, real estate and commercial mortgages. One of the most significant risk facing insurers is credit risk and their ability to manage defaults, downgrades or impairment in assets is certainly key to their success. The insurers' capital adequacy ratios are still well beyond the level that would raise concerns at this point but it is still early to evaluate the full impact of the crisis on credit in the broader sense of the word. Group annuities, in the form of a buy-in or a buy-out, are subject to Assuris coverage in the unlikely event of an insurer's insolvency.

The level of coverage will depend on several factors but it is an extra layer of benefit security provided by group annuities. In the coming months, insurers will also review the impact of the pandemic on their longevity assumptions by closely monitoring the situation and the development of vaccines and treatments.

As pension risk transfer experts, we are in constant communication with insurers, reinsurers and regulators to determine the impact on the pension risk transfer space and the opportunities that might arise for plan sponsors looking to transfer risk.

What does this all mean for plan sponsors?

It is important to realize that the objectives of plan sponsors are likely to remain the same regardless of the type of DB plan they have. At a high level, plan sponsors of open DB plans are trying to achieve plan sustainability, while plan sponsors of closed or frozen plans are trying to exit the defined benefit world gradually. One result of this crisis might be that a plan sponsor or an employer's risk tolerance and appetite will change, given that many of the risks referred to earlier have materialized. It is worth asking yourself if you are going to be the same company and the same plan sponsor coming out of this crisis as you were going into it.

In the short term, plan sponsors and administrators should be asking themselves some important questions:

Has my pension risk budget changed?	Establishing or revisiting your pension risk budget is certainly the right thing to do. Finding or confirming how much pension risk you can tolerate and revisiting that analysis regularly can be enlightening. You do not necessarily have to go through the process of an extensive asset liability modelling study but performing at least some scenario analysis might be very beneficial to support your strategic asset allocation. Integrating funding, investment and if appropriate, risk transfer strategies is the best way to help you achieve your objectives.
Am I spending my risk budget efficiently?	Once a risk budget is determined, spend the risk where you expect to be compensated with a premium for taking on this risk. Many sponsors are still heavily exposed to interest-rate risk. With rates at a new all-time low and creeping lower, are we reaching a point where there is interest-rate risk asymmetry, i.e., more to gain and less to lose by not fully hedging the interest rate risk? Should we even consider abandoning our LDI strategy? What if rates were to stay low for an extended period of time? Map out these specific scenarios over a three-to-five year period instead of looking at results over a 20-year period.
Can I still transfer some or all of my pension risk?	Be ready to act and make sure your feasibility study has been performed or updated. Many sponsors do not have that much to gain by retaining most pension risks, while an insurer can actually put these risks to good use within their organizations. It may be at a premium in comparison to a hibernation strategy but at least it becomes someone else's concern. In cases of buy-outs, it also results in added protection for pensioners through Assuris coverage. Longevity swaps can also be a good stepping-stone in this context in order to transfer unrewarded risks to third parties. Swaps are paid for over time and combined with an efficient investment asset allocation could represent little additional cost for large pension plans, and should not be overlooked.
Do I have the right governance structure to supervise, manage and administer my pension investments?	We all want to avoid regrets. Should we have spent more time managing our pension investments while we were managing the business? Many organizations are suited to handle just about any conditions, including a crisis. These organizations are often sponsoring very large plans and have all the resources, financial and human, to deal with adverse conditions. Some do not have that luxury and should consider whether an alternate governance structure may be appropriate, by outsourcing key functions and allowing you to focus on running your company for instance.

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