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viewpoint

PENSION RISK MANAGEMENT

For many organizations, the pension plan is the company's single largest long-term liability. Volatile economic conditions have caused dramatic swings in pension liabilities. Companies can't manage the financial market, but they can manage their pension plan's exposure. Richard Imperato, retirement practice leader for Watson Wyatt's Michigan Office, explains how.

How big an issue is pension risk?

The exposure of a company to pension risk is determined by the size of its liability, not necessarily how well-funded its pension fund is. "Liability" in this case refers to the commitments made by a company to its employees and its retirees in terms of the value of the promised payouts.

At the end of 2002, the proportion of pension liability to market capitalization for the 563 Fortune 1000 companies that sponsor pension plans averaged just under 20%. But for automakers and their suppliers, it was more than 100%—primarily because the auto industry is labor-intensive and has huge liabilities attributable to their legacy workforce. Conditions improved somewhat last year, but the three-year slide in the capital markets is far from reversed. The industry is still out of balance, and the appropriate action now could result in significant economic value.

How well prepared are most companies to manage their pension risk?

The deterioration in the funded status of pension plans over recent years has exposed this risk. Companies that expected never to have to fund their pensions again are now having calls on their cash. To better inform shareholders and analysts of pension risk, annual reports now require expanded footnote disclosures for pensions, and management discussion and analysis now include pension assumptions and the probable impact on their pension liability of alternative assumptions.

Most companies are familiar with managing their assets, but few have the staff to integrate asset management with the behavior of their pension liabilities. Risk budgeting is the process to do just that.

What is "risk budgeting"?

Pension risk budgeting is a process to help identify the appropriate level of risk for a pension plan and thereafter maximize the investment return per unit of risk. Risk is defined as investment risk, corporate risk and benefit security, and it is different for each company.

The risk budgeting process determines the correlation between a company's financial performance and that of its pension plan and helps the company map out a strategy.

How does risk budgeting work?

It's a three-step process: setting the risk budget, determining a strategy for spending the risk budget and implementing the program.

Setting the risk budget means determining how much overall risk is acceptable to a company in terms of its cash flow, earnings per share or shareholder's equity. This step involves simulating extreme market variability and looking at its impact on the company's pension plan. The company's tolerance for fluctuations determines its pension risk budget.

Once the budget is set, assets and portfolio structures are analyzed to determine how best to maximize return within the parameters of the budget. The final step is to implement a funding policy, asset allocation and investment manager structure to maximize expected returns within the established risk constraints.

Who should consider risk budgeting?

There is no universally "right" formula that is appropriate for all companies. Results will vary based on the type of pension plan, the funded status of the plan and the company's risk tolerance toward its key financial metrics. Automotive companies with large legacy liabilities are prime candidates for risk budgeting because they cannot manage their liabilities down in the short term. As a result, they need to put more emphasis on asset/liability management strategies like risk budgeting.

How does Watson Wyatt help companies create an effective risk budget?

Watson Wyatt is especially well suited to help because of our experience working with the automotive industry and our extensive knowledge of liabilities and how they behave. We understand assets, liabilities and finance—and we have powerful modeling tools, such as our Pension Risk Index, that enable companies to compare their own pension risk against industry benchmarks. With this expertise we can assist with the assessment of pension risk and help a company develop a unique risk budgeting strategy.

For more information about Watson Wyatt Pension Risk Management capabilities, please contact Richard Imperato in Southfield, Mich., by phone at (248) 358-7817 or by e-mail at richard.imperato@watsonwyatt.com.