FROZEN ALIVE

Managing a Frozen Pension Plan

Strategic Investment Group®

Fiduciary Insights

FREEZING A PENSION PLAN FORCES FIDUCIARIES TO CHANGE THEIR HABITS, POSING NEW MANAGEMENT CHALLENGES IN THE AREAS OF INVESTMENT POLICY, OVERSIGHT PRACTICES, AND STAFFING.

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Frozen, but Not Dead

Within the past few years, the trend toward freezing or closing corporate defined benefit (DB) plans has picked up momentum. In fact, the number of firms that have frozen or terminated their DB plans has tripled since 2001. To date, most of the discussion about freezing pension plans has understandably centered on the effect the curtailment of benefits will have on employees, while the impact on fiduciaries charged with managing a frozen plan has received scant attention.

As fiduciaries will discover, freezing a pension plan has significant ramifications for the plan's oversight and management. For example, a frozen plan normally has a different investment policy than an open-ended plan, with different risk and return objectives. Governance may be more difficult, depending on how fiduciaries respond to the change in the plan's objectives. As the pension industry is reshaped by the freezing of many corporate plans, staffing an internal pension group may become problematic. New ways of supervising the assets, such as outsourcing, may become more appealing. Such issues may have been viewed as secondary by a firm's top management when it made the decision to freeze its plan, but they are primary for the fiduciaries.

These issues arise because freezing a pension plan does not kill it. In the typical case, a firm simply halts the accumulation of benefits for its current employee population. Although a frozen plan's liabilities no longer grow, the benefits remain to be paid. The assets must still be managed over many years, through often perilous market conditions. Hence, when a pension plan is frozen, it is effectively frozen alive. Furthermore, it will continue to live and breathe for decades, as long as any of its beneficiaries do.

How Freezing Affects Investment Policy

Investment policy is naturally among the first things affected by freezing a pension plan, since all of the basic drivers of an investment policy – such as return objectives, risk tolerance, and time horizon – are fundamentally altered by the freezing of liabilities. Halting the accumulation of benefits makes a plan mortal, giving it a finite time horizon like that of an individual. As the plan pays out its assets, the approach of its expiration increasingly dictates its investment policy.

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A frozen plan, with its relatively certain time horizon and fixed liabilities, often requires a lower risk policy portfolio than an open-ended plan. This is because the rationale for higher-risk asset classes, such as equities, depends largely upon the expectation that liabilities will grow indefinitely and that the plan's long time horizon will allow time to recuperate after the periodic negative shocks equities can bring. Indeed, the higher returns of equities are appropriate for funding an expanding liability stream. In contrast, a frozen plan's ever-dwindling time horizon and shrinking asset base tend to reduce the plan sponsor's risk tolerance, and the act of limiting liabilities effectively turns them into a stream of more or less fixed payments that can be estimated. In many cases, the risk and return profile of the frozen plan calls for more exposure to fixed income, and less to equity.

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Since the growth of a frozen plan's liabilities has been stopped, matching the liabilities with a fixed income portfolio of comparable duration immunizes the plan sponsor against market risks, especially interest rate risk. However, locking in a stream of fixed payments makes sense only if the frozen plan is well funded; if the plan is underfunded, a continuing allocation to equities and other higher return asset classes may be advisable

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to help close the gap between assets and liabilities. Asset class diversification, in that case, will still reward the plan with higher returns at lower risk. Portable alpha strategies may also be attractive, because of their superior efficiency in delivering return per unit of risk.

The often greater liquidity needs of a frozen plan also affect investment policy. A frozen plan, with its dwindling asset base, usually distributes its assets at a faster rate than an open-ended plan. A high withdrawal rate makes illiquid long-term investments such as private equity and private real estate less practical. It also drives managers to prefer less complicated asset allocation structures, with fewer interdependent and complementary investment vehicles that must be liquidated. Although a more consolidated investment structure is easier to maintain when assets are being sold off at a higher rate, it is nonetheless important to maintain diversification, and thus portfolio efficiency. Often the best means to accomplish all of these objectives is to use fewer but more broadly diversified investment vehicles, to cover more investment ground.

Out of Sight, Out of Mind

Freezing a pension plan does not change the legal obligation of fiduciaries to manage the plan in the interest of the beneficiaries. The fiduciaries of a frozen plan are just as liable for their actions as those of any plan. Nonetheless, they may find that freezing a plan diminishes their ability to carry out their duties with the same level of care as before.

Once a plan is frozen, a company may not demonstrate the same commitment to it, considering it out of sight and out of mind. The members of the investment committee may not be as interested in devoting their time and energies to it, especially if the plan's investment complexity has been reduced. This situation may lead to inattention, which is likely to worsen as the plan's time horizon and assets shrink.

A Disappearing Talent Pool

Knowing that a pension plan is being slowly liquidated may also have a negative effect on the internal pension staff. With many firms freezing their plans at the same time, potential staff members may view managing corporate pensions as a dying specialty, not only within their own firms but everywhere. Recruiting new staff members may become more difficult, as potential employees view a stint in the pension area as unattractive. An industry-wide deterioration in the expertise of internal pension staffs could result.

If the quality of the internal pension staff declines, the risks to the firm of making investment mistakes will rise, and the firm will become more dependent on external talent for expert advice. But external staff may be harder to find, as experienced corporate pension officers become a rarity. At the same time, firms will find that the efficiency of managing the pension with an internal staff is declining in proportion to the asset base. Eventually, the plan assets will reach a size where internal management is clearly no longer cost-effective.

Outsourcing the Frozen Pension Plan

Staffing issues and cost pressures may drive many firms to outsource the entire function of managing their frozen pension plans. Firms that previously felt that running an internal pension operation gave them control over their pension plans may choose to divest themselves of the burden. A trend toward outsourcing large corporate plans, like the current trend toward freezing them, could take hold within a few years, led by a few bellwether corporate funds.

If outsourcing of large plans becomes more common, the number of ways to outsource pension management may grow, as competition for assets intensifies. Today, the main option for corporations wishing to outsource their pension plans is the manager-of-managers (MOM) firm. Some MOM firms, but not all, are willing to assume the role of named fiduciary and accept discretionary responsibility under ERISA. In coming years, the number and size of such firms may expand to accommodate a surge in business. Meanwhile, financial firms that have traditionally performed other roles in pension management, such as large custodial banks and insurance companies, could become more interested in the pension outsourcing business as they see large corporations offloading huge pension assets. Investment banks may offer corporations new their fixed liabilities. In ways now unforeseen, the financial services industry will rearrange its offerings of products and services to accommodate the changing needs of plan sponsors.

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Changing Habits

Fiduciaries as well as employees will be dealing with the consequences of freezing defined benefit pension plans for decades to come. Companies that are contemplating freezing their DB plan should anticipate these effects, because managing a frozen plan will force them to adopt new policies and practices, and break some old habits. Perhaps the first and hardest habit to break will be the mental habit of thinking that DB plans in their current structure and the old ways of managing them will be around forever.

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Strategic Investment Group

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We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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