# The Investment Impact of PPA and FASB on Corporate Defined Benefit Plans

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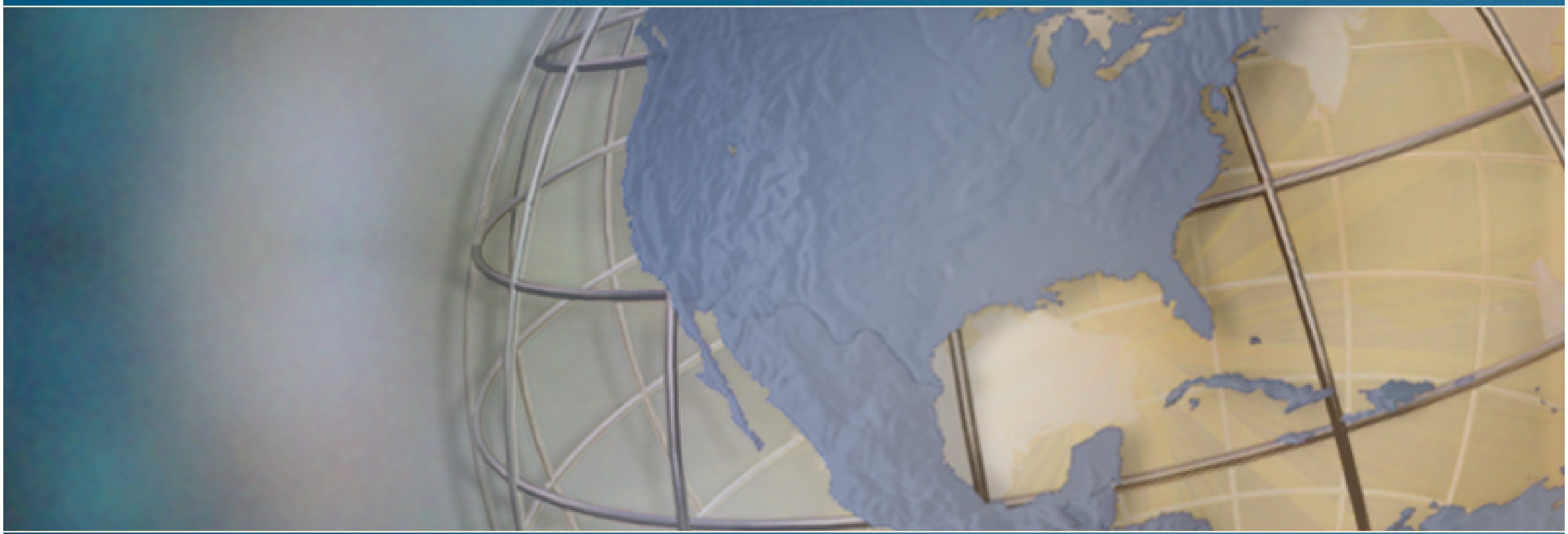



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# A “big picture” perspective

- Forget the details, they obscure the big picture
- Focus on the philosophy
  - What hasn’t changed
  - What has changed
  - The Defined Benefit (DB) sponsor’s new (realistic) perspective
  - The risk management business
- A context for everything you’ve heard today



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# What hasn't changed

- Actual liabilities
  - As distinct from the value placed on them
- Capital markets: uncertainty and expected risk premia
  - As distinct from their recognition and timing
- Economic reality: the sponsor still underwrites DB
  - And requires a risk premium for affordability
  - DB is a financial operation of the sponsor



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# What has changed

- **Value placed on liabilities**
  - **Strictly accrued, under PPA: service and pay to date**
    - **FASB still uses projected salaries**
  - **Bond yields, no equity risk premium**
    - **Value of benefits, as distinct from funding target**
- **Value placed on assets**
  - **Little or no smoothing of market value**
  - **Risky assets no longer favored artificially**
- **Recognition of sponsor's potential mortality**
  - **Shortened period to pay off deficiencies**
- **Recognition of "DB = financial operation"**
  - **Balance sheet recognition of surplus or deficiency (FASB)**
  - **OK to pre-fund in good times (PPA)**

PPA = Pension Protection Act, FASB = Financial Accounting Standards Board

# The sponsor's new (realistic) perspective

- DB still plays a role in staff retention
  - EITHER "I still need that risk premium to keep it affordable"
  - OR "No longer artificially favored, let's freeze" (it's a Defined Contribution dominated world anyway)




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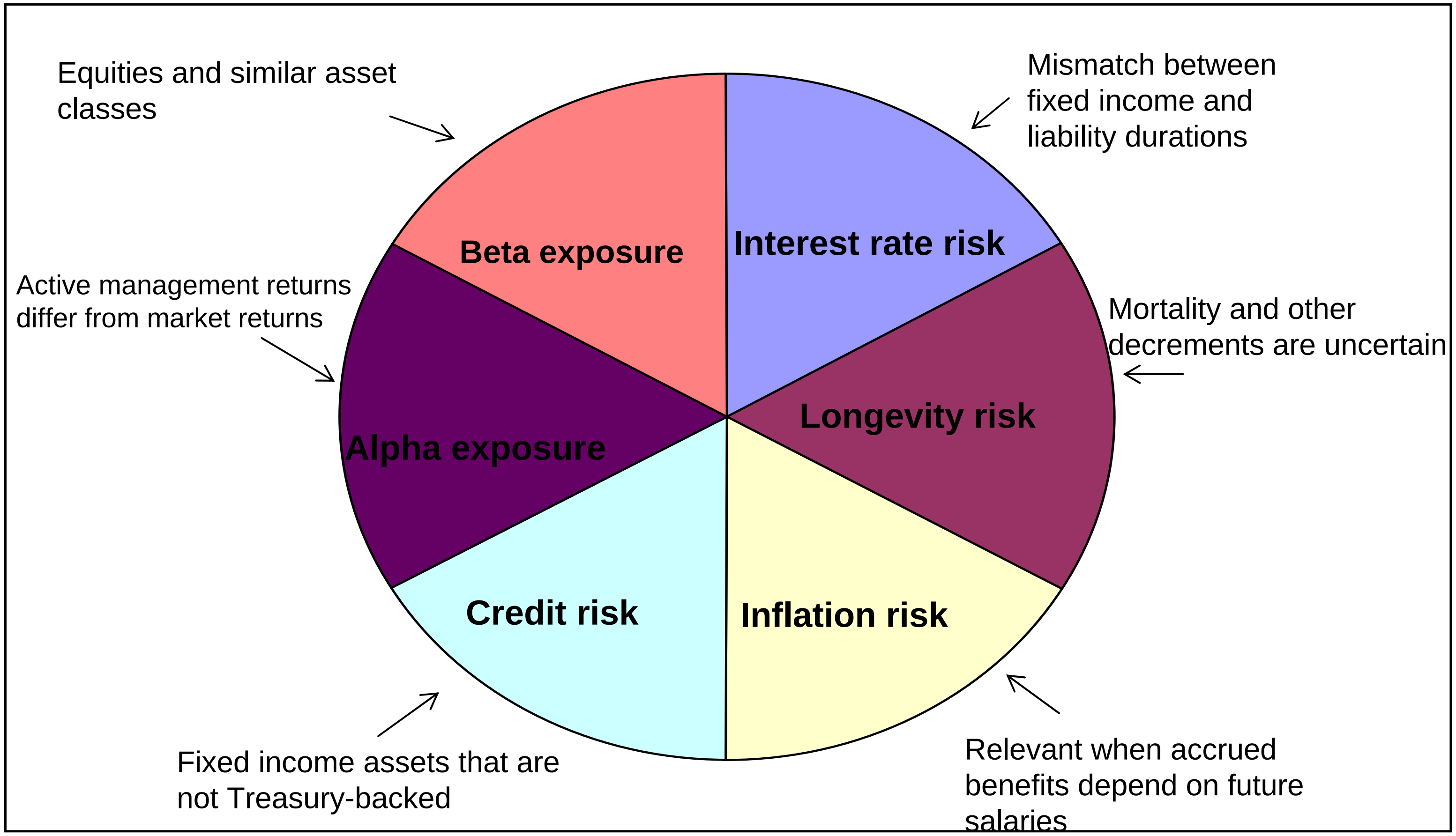
# The fiduciary's job is unchanged: aggregate risk management




- **Risk-taking is permissible because investment policy must mesh with the sponsor's funding policy**



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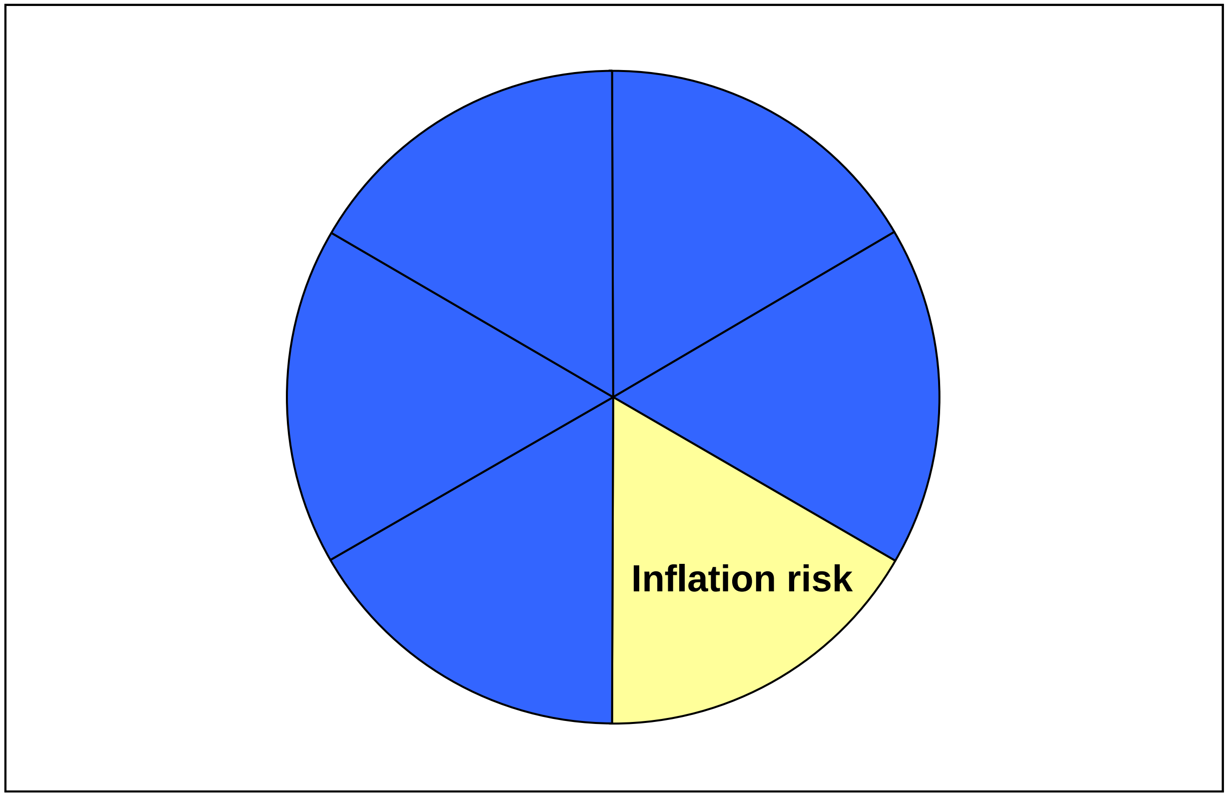
# Inflation risk




- **Typically left to benefit design and funding rather than investment policy**

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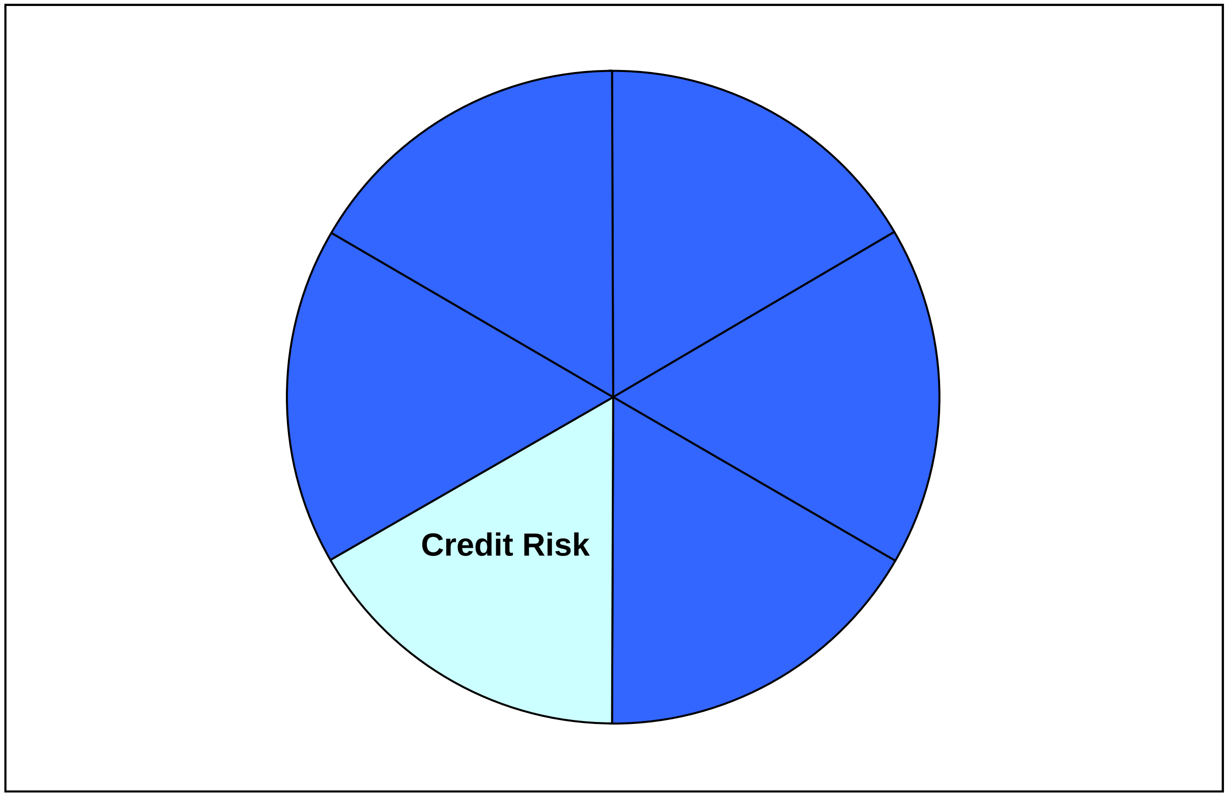
# Credit risk




- Still seen as low risk, with a likely reward

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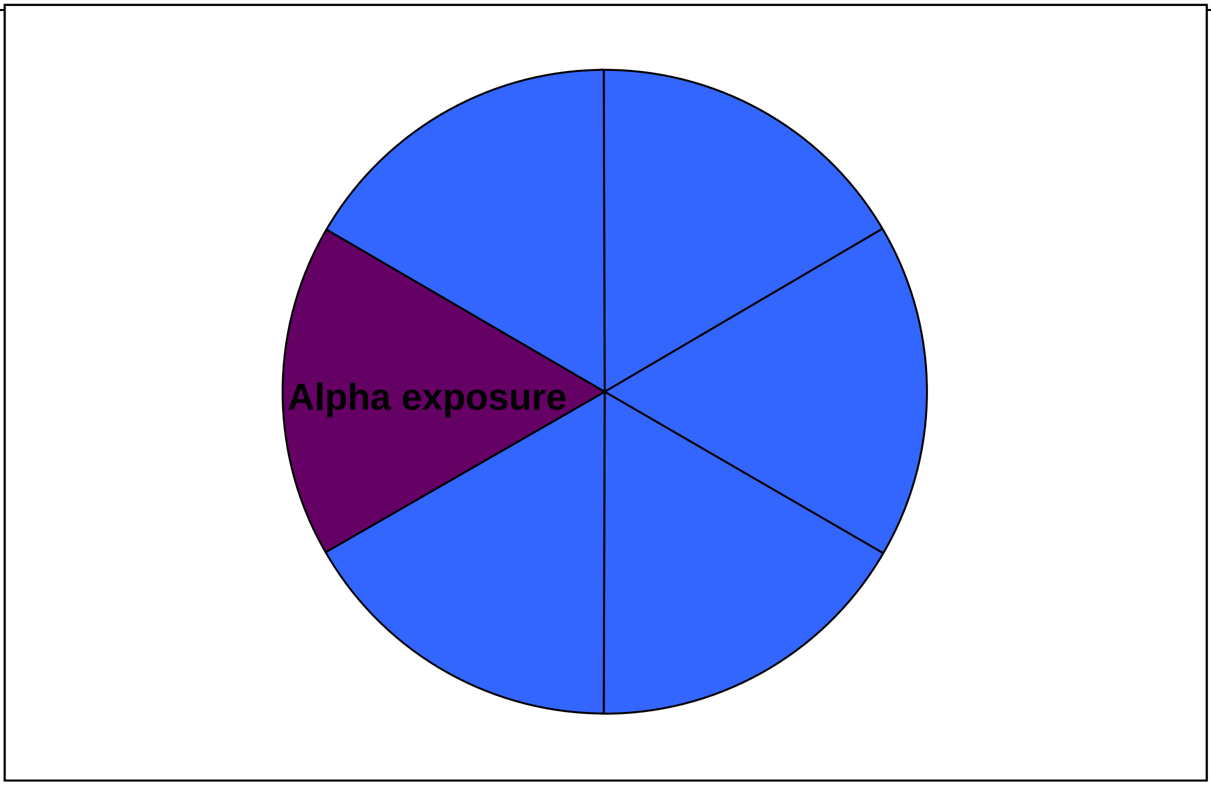
# Alpha exposure




- Still a belief by the majority that they are better than average
- New sources: hedge funds, 130/30
- Diversifying into illiquid asset classes
- Getting divorced from beta sources

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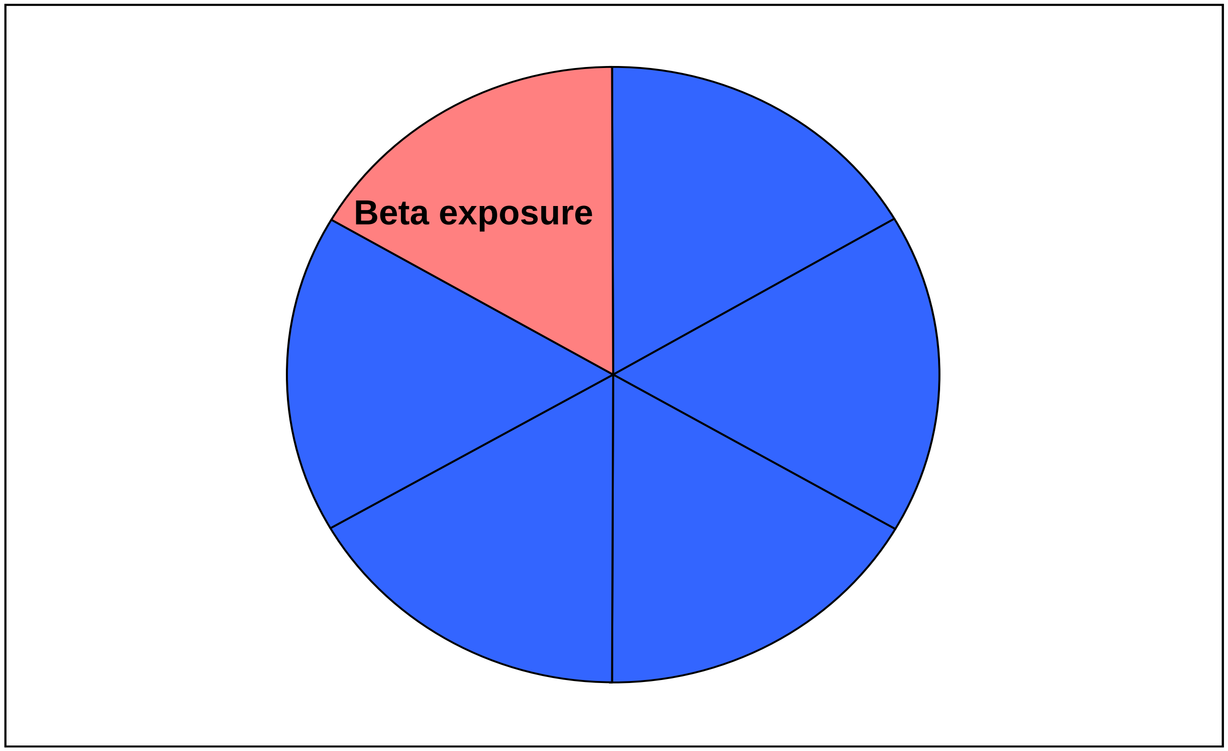
# Beta exposure




- "How much" is becoming more important, based on funding volatility and corporate finance considerations
- Diversifying the sources to make it more reliable

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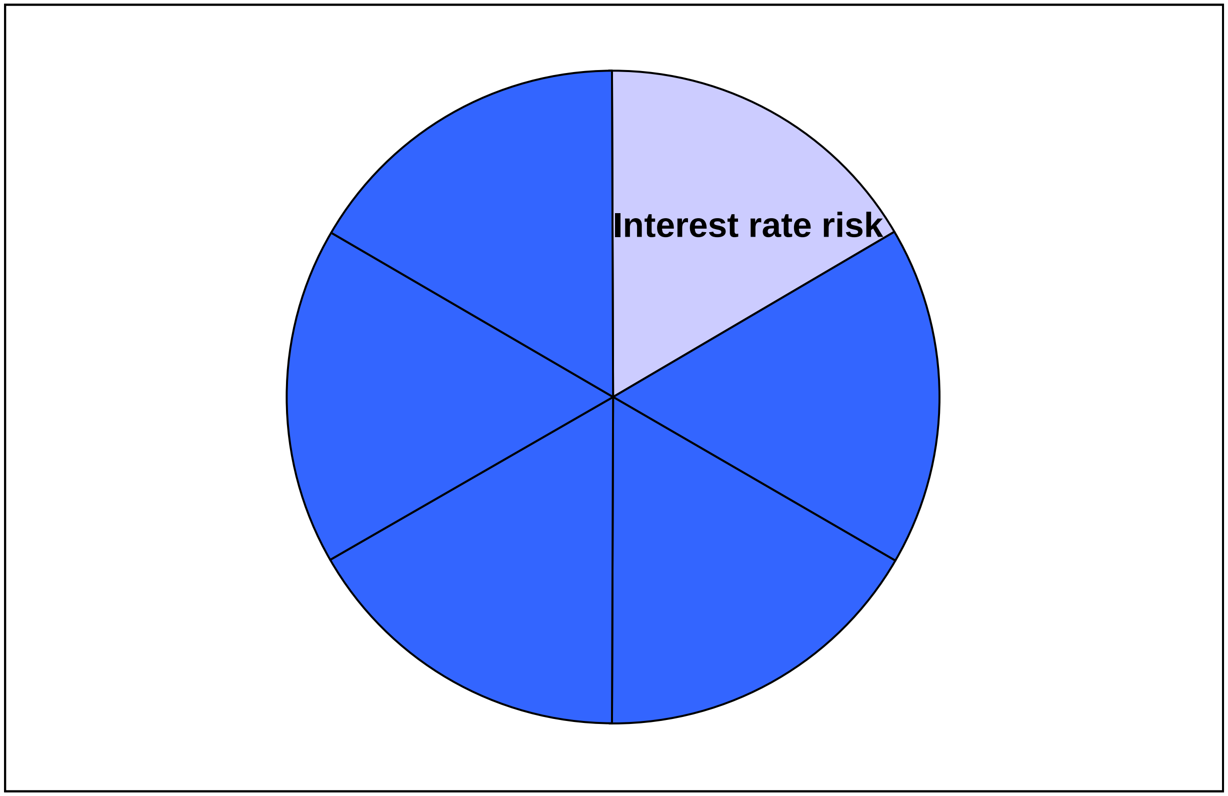
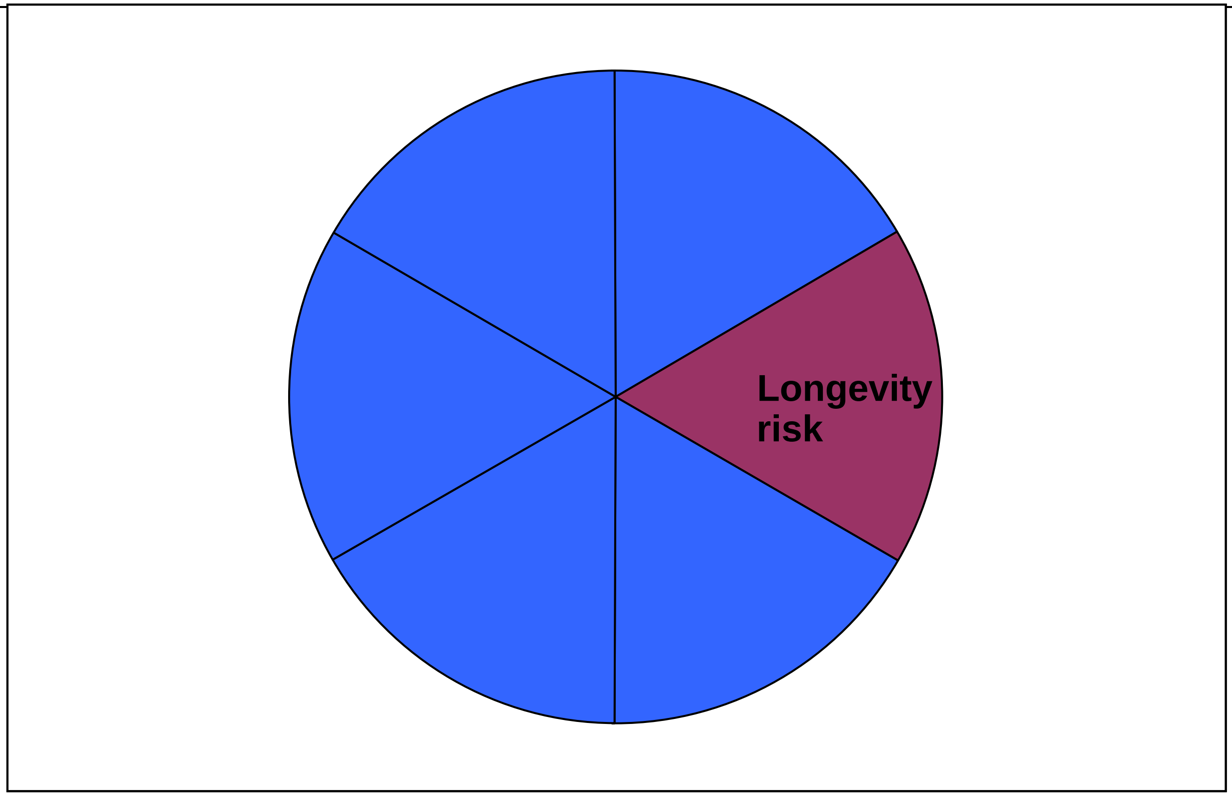
# Interest rate risk




- **Significance finally exposed**
- **Why take it strategically, in the absence of an expected reward?**
  - **But tactical considerations dominate the timing of moving out**

# Longevity risk




- Still under-appreciated
- Still considered too expensive to annuitize
- Look for an explosion of creativity

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# The corporate finance angle

- DB is like an operating division
  - How big, relative to main-line operations?
  - How big, relative to competitors?
- Can it become a source of competitive advantage?
  - Yes, take more pension fund (PF) risk
  - Yes, take less PF risk and transfer the shed risk to main-line operations or balance sheet leverage
  - No, mimic competitors to deny them a competitive advantage
- A tough balancing act for fiduciaries (as always!)



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# A necessary change is evolving: how to judge progress

- **Relative to "big picture" objectives**
  - **"We're on course" is desirable verdict**
- **Aggregate focus is more important than bottom-up manager or asset focus for reporting**
- **"League tables" are irrelevant (except for alpha or "mimic competitors")**




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