Glidepath, Liability Reduction, and Plan Termination

SEI New ways. New answers.®

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SEI's more comprehensive approach to strategy design focuses on three key areas

Corporate Risk Management Approach

- Evaluate organization's risk tolerance
- Incorporate key corporate sensitivities
- Identify plan sponsor goal with regard to pension

Sophisticated A/L Framework

- Match liability in a more sophisticated/highly custom way
- Incorporate funded status, benefit stream, and duration of exposures
- Proprietary modeling and stress testing provide decision support

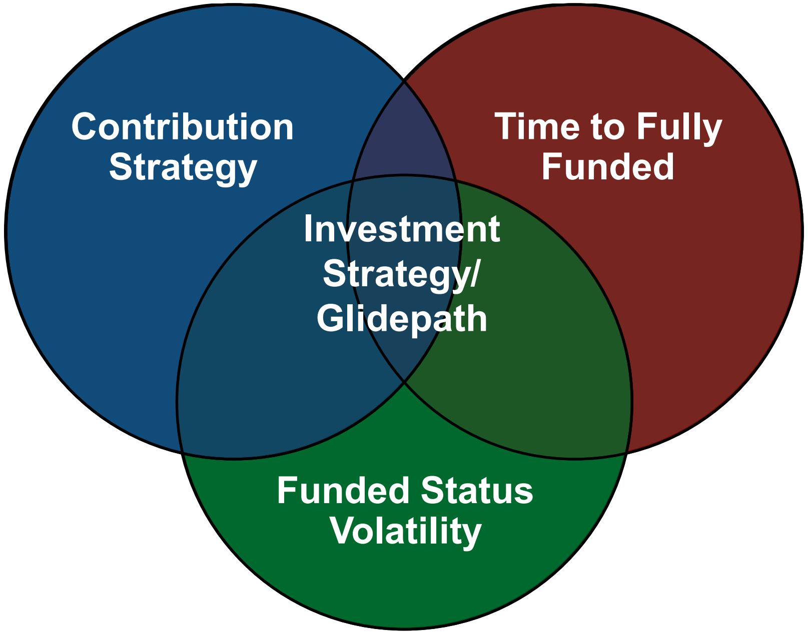
Asset Portfolio Optimization

- Active portfolio design identifies drivers of risk and return
- Allocate managers based on risk and return contribution
- Construct optimal allocation given economic conditions
- Blend of products/funds used to optimize return/meet goal

Multi-level risk management analysis and reporting
Custom goals-based reporting

Setting investment strategy

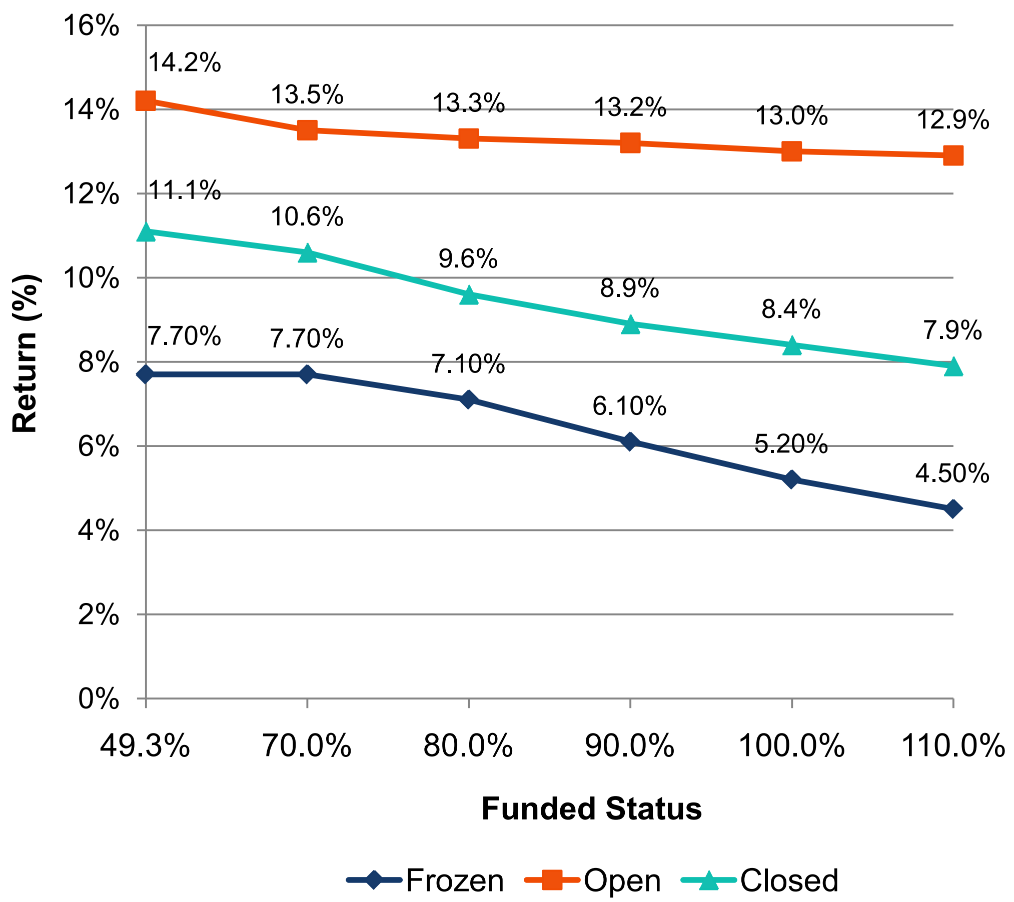
Meeting or exceeding the plan's hurdle rate can be accomplished either through market returns and/or contributions.



- Hurdle rate defined as the rate of return needed on the asset base, with out contributions, to maintain funded status year over year
- In the absence of any recurring contribution strategy to address underfunding, plans need to evaluate the tradeoffs among three major parameters in getting the plan to full funding
- Plans should:
  - Establish a hard threshold for the key parameter
  - Isolate/manage interest rate bets
- Constraints on any two parameters establish the need for equity risk
- Monitor the plan's funded position until the tradeoff suggests no further need to take risk

Glidepath and strategy implications:
Hurdle rate progression and impacts

Hurdle Rate Decomposition	
Service Cost/PBO	3.3%
+ Interest Cost/PBO	+ 5.1%
- Benefit Payouts/PBO	- 5.1%
= Liability Growth Rate	= 3.3%
+ Benefit Payouts/Assets	+ 7.9%
= Hurdle Rate	= 11.1%



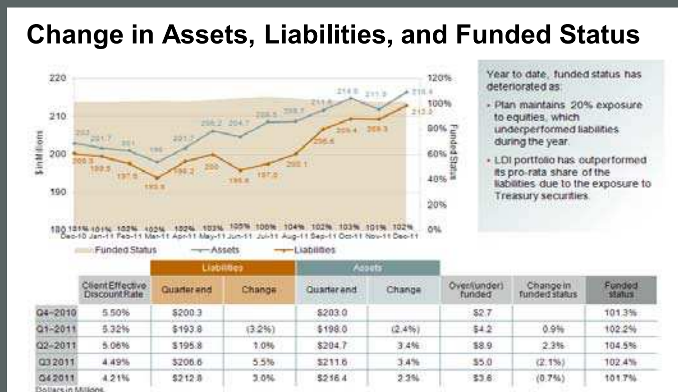
Hypothetical example for illustrative purposes

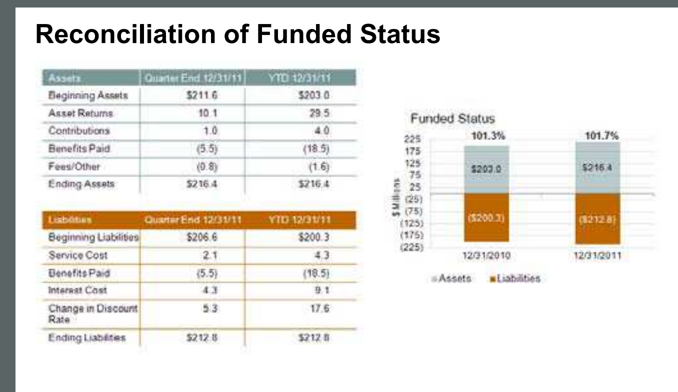
Glidepath, de-risking, asset allocation, and monitoring methodology

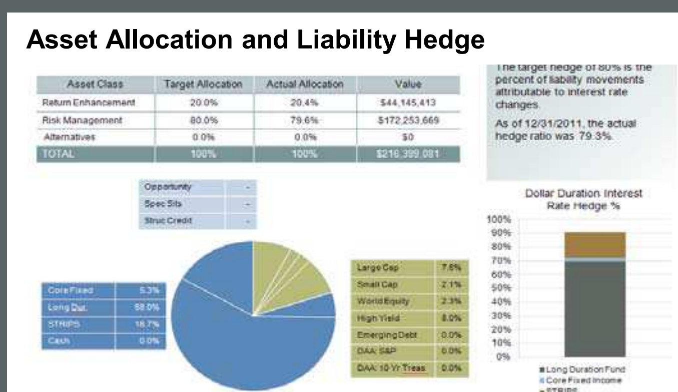
SEI takes an active approach to de-risking, asset allocation, and monitoring

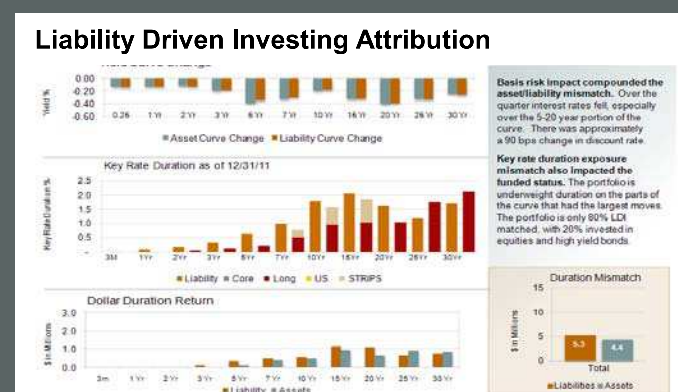
- Setting goals:
  - Goals are expressed in terms of contribution strategy, funded status hurdle rate, corporate priorities (managing cash contributions, funded status volatility and the time frame to become fully funded or endowed), including any enterprise risk considerations
  - The inputs allow SEI to determine the return targets and allocations necessary to achieve the stated goals
- Determining appropriate return target:
  - The target is determined by solving for the annual return required to increase each year's funded ratio by the stated goal
  - Relative size of benefit payments must be considered, as well as the increase in assets expected from contribution requirements
- Setting the allocation:
  - After the goals are established and the return target is set, SEI can determine the allocation that should achieve this return with the lowest amount of surplus volatility and best possible liability hedge

SEI goals-based reporting: Custom, timely reporting to monitor progress against goals









Sample reporting. For illustrative purposes only.

Liability Reduction

Defeasing liabilities – an abbreviated version: Options to shrink one side of the funded status equation

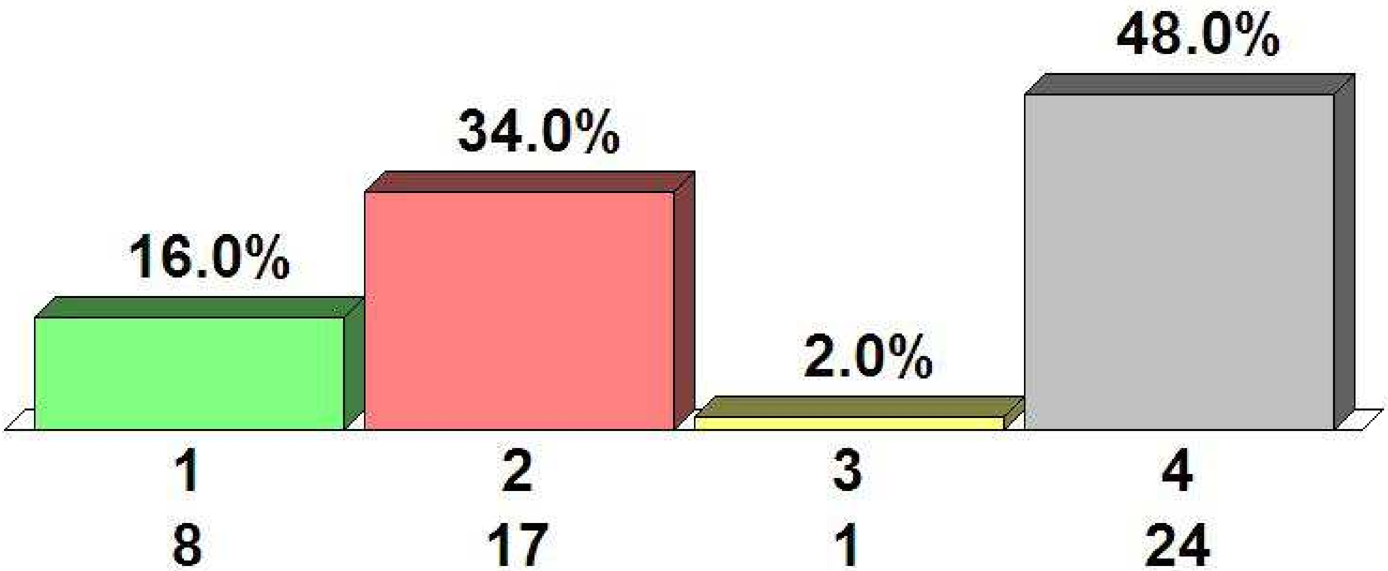
There are three basic and most common ways to defease liabilities (ignoring what Ford and GM did recently), definitionally meaning, completely removing the liability and future responsibility from the plan sponsor

- Terminate plan
- Lump out term vested participants
- Annuitize retirees

Poll Question

In the next 1-3 years, how many of you are considering:

1. **Terminating your plan**
2. **Lump out term vested participants**
3. **Annuitizing retirees**
4. **No changes**

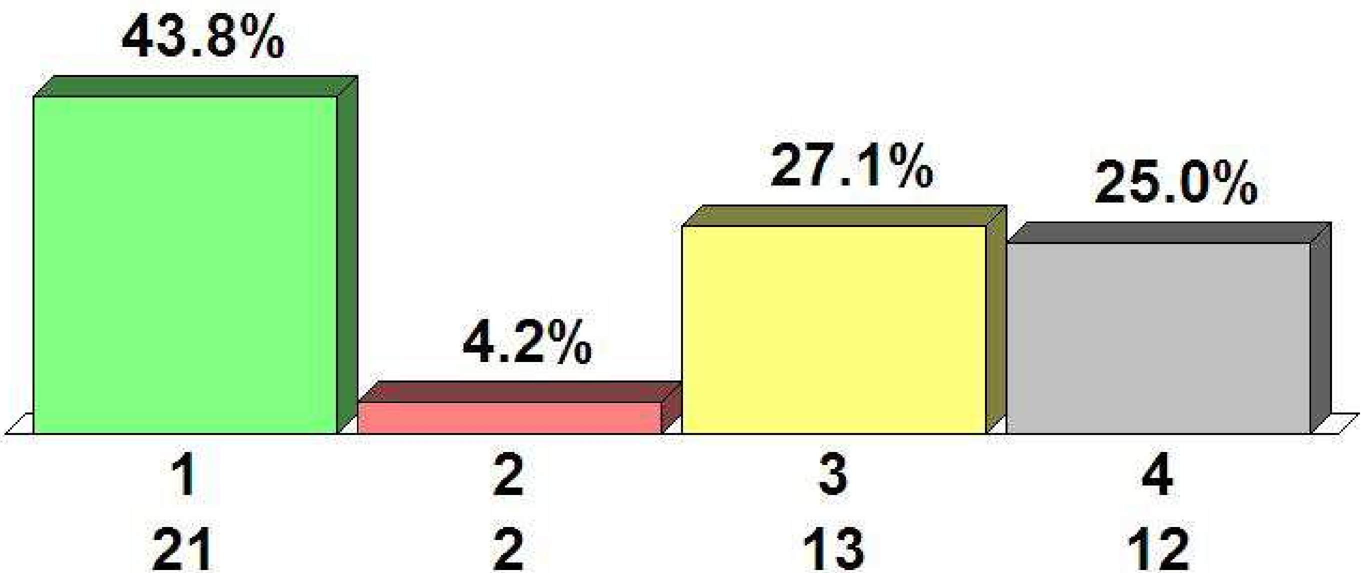


Total: 50

Poll Question

Beyond 3 years, how many of you are considering:

1. **Terminating your plan**
2. **Lump out term vested participants**
3. **Annuitizing retirees**
4. **No changes**

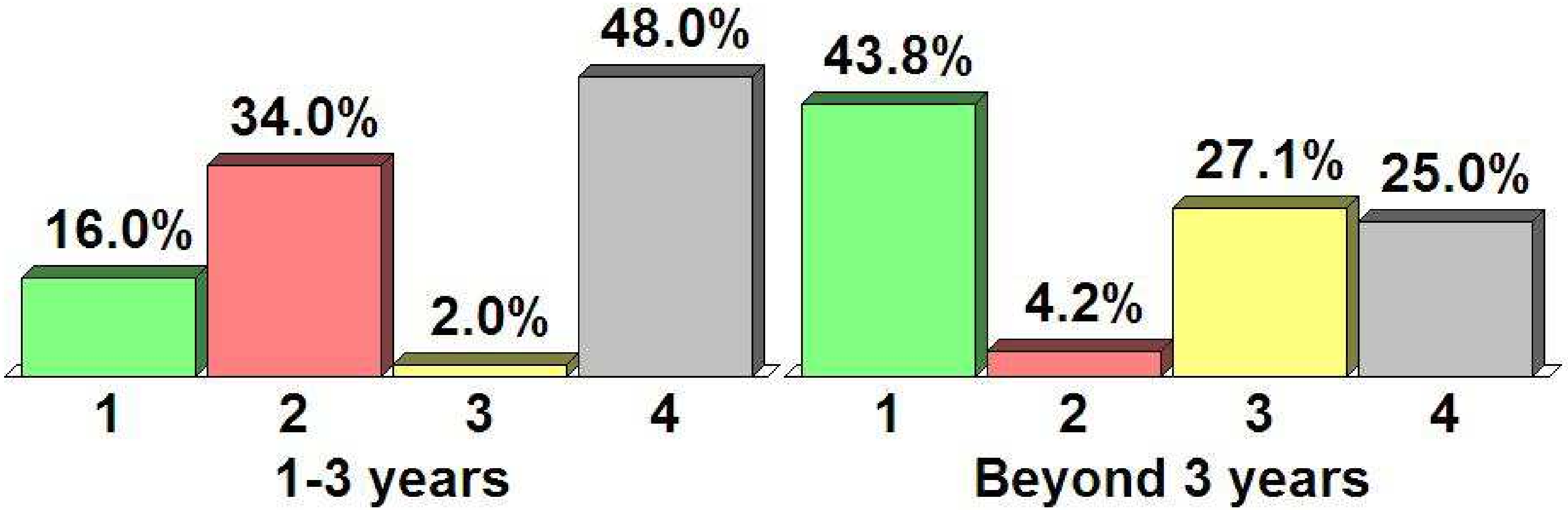


Total: 48

Poll Question

In the next __ years, how many of you are considering:

1. **Terminating your plan**
2. **Lump out term vested participants**
3. **Annuitizing retirees**
4. **No changes**



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California Lawmakers Look to Approve Sweeping Pension Reform
Fox Business, August 2012

Unfunded pension liabilities forcing companies to get creative in managing their risk
BenefitsPro, February 2012

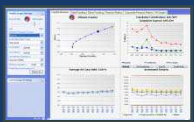
Prudential's GM deal revives annuities
Financial Times, June 2012

Ford's Lump Sum Announcement Could Have Far-Reaching Implications for Plan Sponsors and Participants: Towers Watson
ProgramBusiness.com, April 2012

Termination process:
SEI can help and has recent experience

PLAN SPONSOR EXPERIENCE

INVESTMENTS



Portfolio Modeler

SEI continually monitors plan assets and liabilities to ensure a dynamically aligned investment strategy over time.

COMPLIANCE

- Board adopts amendment to freeze plan*
- Board adopts amendment to terminate plan
- IRS Form 5310: Application for Determination for Terminating Plan
- PBGC Form 500: Standard Termination Notice
- PBGC Form 501: Post-Distribution Certification
- Final Form 5500

ADMINISTRATION

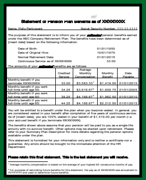
- Calculate frozen accrued benefits
- Data Conversion & Web Calculator set-up

- Request Annuity Bids
- Annuity Provider selected
- Plan Assets distributed

Freeze → **Termination**

COMMUNICATION EVENTS

- 204(h) Notice



- Final Benefit Statement

- Web Calculator Announcement Letter
- Web Calculator available
- Notice of Intent to Terminate & Notice of State Guaranty Association Coverage of Annuities
- Notice to Interested Parties with Cover Letter
- Notice of Plan Benefits

- Distribution Election Kit

- Employee Meetings
- Participants return completed Election Kits
- Lump sums paid
- Notice of Annuity Contract
- Form 1099R

PARTICIPANT EXPERIENCE

Lump sum option for terminated vested participants

- As of 2012, the interest rates that are used for determining lump sum distributions are based on corporate bonds. Generally this has eliminated the additional cost, or difference between the value of the liability and the lump sum value (assuming a fully funded plan and similar yield curve methodologies).
  – Historically, it was generally viewed that a plan could not offer a lump sum to a retiree already in payment status. GM found a creative way to accomplish this, although it was both expensive and a very complicated process. Not generally what a majority of plan sponsors are focused on at this point.
- Generally, plans reset their lump sum rates once per year.
- The current decline in rates, along with the convergence of the discount rate methodology (allowed to use all corporate bonds), has provided an opportunity to offer lump sums at a lower rate than they would be valued at in the liabilities at year end.

Lump sum option for terminated vested participants

- Depending on the funded status of the plan, this may or may not be dilutive to the funded status. This is primarily dependent on the difference between the lump sum rate and the discount rate creates, versus the plans funded status.
  - This analysis is best tested on a plan by plan basis (For example, the liability would need to be 125% of the lump sum value for an 80% funded plan to be accretive)
- The increase in PBGC premiums in MAP-21 make it more costly to retain participants.
- Even though these opportunities exist, we are at historic low interest rates and this can be viewed as an expensive time to offer a lump sum (low interest rates equate to higher cash values).
  - At the same time, many plan sponsors are reluctant to price annuities because of the expense, yet still willing to consider lump sums. Ultimately, they are both expensive in today's market.
- Asset allocation needs to be revisited as the duration of the terminated vested may not be the same as the overall plan.

Lump sum option for terminated vested participants

The primary pros:

- Reduction of the liability at a value higher than the lump sum value
- Reduction of administrative costs including increased PBGC premiums
- Less expensive than purchasing annuities for this group
- Acceleration of glidepath towards termination
- Generally shortens duration for custom LDI implementations

The primary cons:

- Accounting rules require a one time charge to the P&L if the amount of the lump sums exceeds current service cost plus interest costs
- This will be dilutive to MAP-21 funded status
- Asset allocation may be disrupted due to the cash flow out, especially with plans holding illiquid asset classes
- May cause a disruption in custom LDI implementation

Annuitizing retirees: Costly in today's environment and potentially in the future

- Also known as a buy-out, or completely transferring the liability to an insurance company
  - A buy-in also tries to defease the liability but the insurance contract stays as an asset of the plan
- Generally, plans look to annuitize retirees, although it is also possible to include terminated vested (generally increases cost)
  - Annuitizing only the retirees potentially limits the options of placing the terminated vested group with an insurance carrier at a later time
- It is prudent to follow DOL interpretive bulletin 95-1 when selecting a carrier that satisfies the ERISA safest available rules
- It can be an expensive proposition, carrier will charge a premium for:
  - Mortality risk and duration
  - Interest rate and re-investment risk
  - Administrative costs

Annuitizing retirees: Costly in today's environment and potentially in the future

- Not uncommon to see premiums of 15% to 25% depending on the population and other considerations
- Still potentially requires settlement accounting
- Carrier availability and capacity likely to impact pricing in the future
- Moody's current view on annuitization (the GM transaction for example) was neutral from a ratings perspective
  - The financials were carrying a lower liability but the cost to accomplish was higher
- Buy-ins were initially viewed as a favorable solution, as they defer any potential accounting impacts and immunize a specific set of cash flows; however, risks with a buy-in include:
  - Still subject to the initial high price (must set aside more assets than the liability covered)
  - The cost and process to flip to a buy-out (still need to satisfy safest available)
  - The potential tracking risk to the liability
  - Impacts on a custom LDI strategy

Annuitizing retirees: Costly in today's environment and potentially in the future

The primary pros:

- Completely defeases the plan sponsor liability – may or may not be completely true in terms of a buy-in

The primary cons:

- Requires settlement accounting
- Rather long and complicated process
- The expense – anywhere between 115% to 125% of the liability value

Disclosures

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