Risk Management or Risk Shifting?

Popular academic theory meets real-world pension plan investment strategy.
Academic research has suggested that companies can deal with risk in one of two ways — risk management or risk shifting. In theory, the approach chosen depends on an organization's financial strength, and could have a direct impact on investments and asset allocation.

Under the risk-management theory, an organization balances risk and return to ensure there is sufficient cash flow to meet objectives. Risk shifting, on the other hand, holds that a company facing financial distress or potential bankruptcy might adopt a more aggressive stance and invest in riskier assets to increase the value of shareholders' equity.

To explore the prevalence of these approaches, Joshua D. Rauh, assistant professor of finance at the University of Chicago Graduate School of Business, studied the behavior of corporate defined benefit plan sponsors.

In his resulting research paper, “Risk Shifting versus Risk Management: Investment Policy in Corporate Pension Plans,” Rauh concludes the advantages of risk management outweigh the benefits of risk shifting, even for distressed companies. “The incentives to manage risk and avoid bankruptcy, debt overhang or other underinvestment problems related to financial constraints serve as a constraint on speculation,” he says.

“A CFO or treasurer is responsible for the pension plan, but that is just one of many balance sheet items,” Dykstra says. “Theoretically, the ‘put’ of the PBGC is there, but it doesn’t enter into the thought process. The reason is that the only way you put [pension liabilities] to the government is if the company fails. You would have to file for bankruptcy and there would be much more pain to the organization as a whole. You would basically wipe out your shareholders. It’s a case of winning the battle but losing the war.”

In his previous role as a chief investment officer at United Airlines, Dykstra says the goal was to maintain the pension plan at 100% to 110% funded status to protect against volatile investment returns. “Never in any conversations was there discussion that the PBGC was a safety net in case we fail,” he says.

Theory vs. Reality
Risk shifting is widely taught in corporate finance courses, but few examples exist in the real world. Still, some researchers have argued the U.S. Pension Benefit Guaranty Corporation (PBGC), which insures private-sector defined benefit plans, makes it easier to adopt a risk-shifting approach.

Both Rauh and Dave Dykstra, head of Investment Program Solutions at Northern Trust, note, however, that there is a clear difference between textbook theory and the real world of pension plan risk management.

Checks and Balances
Natural checks and balances act as a restraint on how far a typical pension plan can stray from prudent investment practices. Financial reporting standards set by the Financial Accounting Standards Board (FASB) — for example, FAS Statement 158 — require public companies to disclose their plans' funded status on their balance sheet.

“Well, due to recent changes in both funding and accounting rules, plan sponsors are increasingly concerned with managing the volatility of their plan’s funded status,” says

―Joshua D. Rauh, assistant professor of finance at the University of Chicago Graduate School of Business—
Ken Lining, a pension consultant with Buck Consultants, which specializes in human resources solutions. “They don’t want that funded position bouncing around because it now appears on the balance sheet.”

Lining also notes that well-defined guidelines help dictate pension fund investment policies. These typically are established by plan fiduciaries or trustees who could double as the pension committee of the company’s board of directors. “Generally, there is an investment policy established to provide guidelines on asset allocation and a contribution policy developed to fund plans in an orderly manner within the parameters of the law.”

How Strong is the Company?
Dykstra says it’s a fallacy to think it’s possible to separate an organization from its pension plan in assessing risk. “The pension plan is only as strong as the funding entity that supports it,” he says. Even in the case of the so-called “perfect storm” of the early 2000s, when invested assets lost money and interest rates dropped, causing estimated liabilities to rise, a financially healthy organization could weather that storm.

“It might have had to fund more than it originally planned, but a healthy organization can work its way out of that problem.

Financial strength gives the organization the ability to work through the issues. The company has the flexibility to enhance funding or wait out the market volatility issues, such as negative short-term returns or lower interest rates, and restore balance to the plan,” Dykstra adds. “But for a business that is already on shaky ground, the convergence of external financial pressures can create a crisis point.”

The airline industry in the early 2000s was a good example. Because of declining assets and rising liabilities, “the typical airline pension plan dropped from being 120% funded in the late 1990s to just 85% funded a few years later,” he says. “The airlines faced higher labor costs, enriched benefits and then 9/11 hit.” That led to dramatically lower air traffic, higher fuel costs and, eventually, airline bankruptcies.

Troubled Companies Have Few Options
When the underlying entity reaches a financial crisis point, it can no longer meet any of its obligations — pension funding, lease payments or debt obligations. The organization seeks to avoid bankruptcy, but what are its options? Faced with a situation in which risk shifting might theoretically make sense, in the real world an organization that is struggling through a wide-ranging financial crisis may see no advantage in increasing the odds of its failure.

The True Risk Shift: DB to DC

The term “risk shifting” is one that has been used in different contexts. A more common application of this term is to describe the process many companies go through when shifting from a defined benefit (DB) plan structure to a defined contribution (DC) plan.

Companies can shift the risk or responsibility associated with its DB plan to its employees through augmenting an existing DC plan and freezing the DB plan, or creating a DC plan for the first time.

In the old DB paradigm, the employer bore the risks associated with pensions, namely the ability to accumulate enough funds to provide employees with a lifelong, predetermined retirement income. But with employers facing rising benefits costs, and new accounting rules requiring a pension plan’s funded status on the balance sheet, many employers are reevaluating their DB plans. As a result, plan sponsors are leaning more heavily toward DC plans where plan participants bear more of the risks.

A Watson Wyatt Worldwide report, “Retirement Plan Design: Past, Present and Future,” found a steady shift in emphasis toward DC plans during the past 10 years. Among the 300 employers surveyed, 40% had switched to a DC plan as their main retirement vehicle since 1996. During the same time period, 22% of sponsors closed their DB plan to new employees, 17% froze their benefit accruals and another 1% terminated their plan.

“We are witnessing this happening in many cases, with plan sponsors locking, and in some cases both locking and freezing, their DB plans,” says Ken Lining, a pension consultant with Buck Consultants. “Plan sponsors are de-emphasizing these traditional DB plans and increasing the emphasis on DC plans. This change in focus effectively shifts the risks for investment performance, for longevity and for inflation from the pension plan sponsor to the employees.”
"As CFO, I have to review all my options," Dykstra says. "If I cut my employee benefits and salaries in half, I’ll lose my employees. If I fail to pay my aircraft leases or other debt payments, I won’t have airplanes and I’ll go out of business. Quite simply, the CFO doesn’t sit there and say, ‘I’m going to take more risk in my portfolio because I have this put with the PBGC.’"

Instead, Dykstra explains a CFO looks at pension obligations and investments and considers the impact on cash flow from both a best-case and worst-case scenario.

Lining adds that it’s misleading to assume that companies or industries that have received well-publicized government support — such as the airline industry — do so to cheat the system. “Although it’s not as well popularized in reports of bailouts of high-profile bankruptcies, in several cases where the PBGC has assumed pension liabilities in exchange for plan assets, some employees have received less than the full value of the benefits that they actually earned.”

For example, in the case of United Airlines, the company had pension obligations of up to $125,000 a year for senior pilots. The PBGC, however, provided a maximum of $45,000 in annual benefits, with a limit of $28,000 per year for those who retired at age 60.

Assess the Big Picture

To resolve the problems many pension plans face, Dykstra recommends doing a full evaluation of employee benefits.

- How strategically important is each benefit to the organization in terms of attracting and retaining good employees?
- Is the benefit structure correct? This will determine the cost of doing business.
- Are there other benefit programs that meet the organization’s strategic initiatives in a more efficient manner?

“There is no free lunch,” Dykstra says. “If a CFO has a benefit funding shortfall, ultimately he or she must resolve it just like any imbalance, either by bringing in more revenue, cutting expenses or a bit of both.”