PERSPECTIVES

SOLVENCY – THE FINAL FRONTIER?

February 2022

Full funding is finally in reach for most plans which are now closed or frozen to new benefit accrual. This is an historic milestone after almost two decades of deficits volatility since the early 2000s. While a very welcome victory lap may be in order, plan sponsor´s should not be complacent in recognizing this moment in time and move to prepare for the next two (or more) decades ahead. This should, in our view, involve moving “Beyond LDI” and managing accounting funded status volatility (and LDI strategies) and towards adopting a solvency framework seeking to mitigate all future sources of funding shortfall and cash contribution risk.

Plans can move “beyond LDI” & accounting funded status volatility metrics towards a solvency-orientated framework

Are we there yet?

The goal of an LDI strategy is to reduce the volatility of assets to liabilities i.e., funded status. It typically achieved through an asset dedication strategy, implemented by allocating to “return-seeking” and “liability matching” asset buckets. Funded status risk is controlled by establishing and managing towards target hedge ratios, including for interest rate duration, key rates and credit spread sensitivities.

Table: Milliman Top 100, Corporate Pension Funding Study

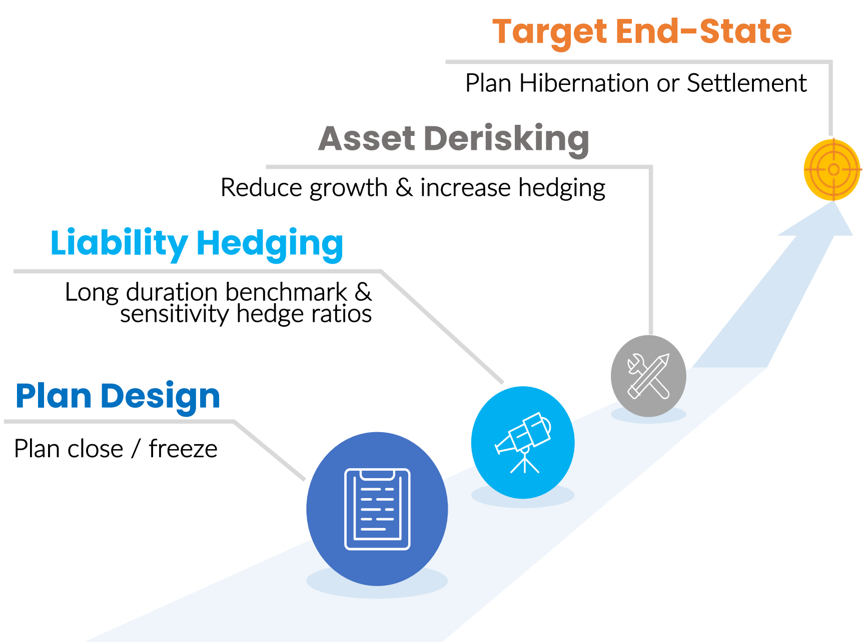
Year End	2000	2002	2007	2008	2012	2013	2014	2017	2021
Funded Status	123%	82%	106%	79%	77%	88%	82%	86%	99.6%

This level of funding is significant as, in addition to touching full funding for accrued obligations, it makes it possible for plans to effectively “lock-in” a fully funded level by securing the future liability cash flows at a high degree of confidence and with a residual robust level of buffer capital. Different strategies can be pursued depending on the status of the plan, for example:

- **Fully frozen** plans, with no further benefit accrual, can seek to “immunize” liabilities and protect against the risk of future contributions and/or move to a buy-out and/or plan termination;
- **Closed plans**, on the path to being frozen, but still accruing new liabilities, can move most (if not all of the way) towards the desired target end-date, strategically moving the plan into a run-off mode; while
- **Open plans** can use the gains to increase hedging allocations thus reducing future cost and deficit volatility.

Levels of funding make it possible for plans to effectively “lock-in” a fully funded level by securing the future liability cash flows at a high degree of confidence

The De-risking Playbook



With the average Funded Status reaching an estimated 99.6% as at end of November, achieving the target end-state is finally in sight. Plan Sponsors are now positioned to take the final step to implement their Target End-State portfolio.

We have LDI strategy, can we simply extend this?

LDI strategies have been a critical tool to help Plan Sponsor´s manage funded status risk since the GFC. However, now that full funding in in sight, we believe that plans should look to put accounting objectives in the rear-view mirror and move towards a more economic solvency orientated framework (please also see our separate paper titled "Beyond LDI"). This approach aims to protect the target long-term outcome through the more efficient allocation of risk and return.

Plans should look to put accounting objectives in the rear-view mirror

A solvency-orientated strategy is different to LDI and hibernation strategies for two primary reasons:

- **STRATEGIC OBJECTIVE:** The strategic goal of an LDI or hibernation strategy, as they exist in the market today, is to minimize funding status volatility (or tracking error) and managed on an accounting PBO liability basis. By contrast, a solvency framework seeks to minimize economic shortfall risk and is managed relative to projected liability cash flows. It will therefore lead to a different portfolio construction and residual level of risk.

- **COST & RISK MANAGEMENT:** LDI and hibernation strategies are predicated on duration matching sensitivity hedging e.g., interest rate and credit spread ratios and are typically implemented using custom liability indices. This is an effective strategy to manage accounting volatility on the journey to full funding but is unlikely to be the most cost or risk efficient way to defease economic liabilities. In a solvency-orientated framework, risk management is more holistic and is defined as anything that can impair the objective of fully funding the future projected liability cash flows. Managing risk is a more optimal way can also allow the liabilities to be defeased at a lower projected funding cost.

Summary takeaway: Why consider a Solvency framework?

The reason to consider adopting a solvency solution is that it can represent a superior and often lower-cost investment and risk management solution. This is because the more direct and holistic approach to managing shortfall can address the inefficiencies of LDI strategies It is particularly suitable for Plan Sponsor´s reaching the later stages of their de-risking journey plan, providing greater comfort and certainty of achieving the long-term liability defeasance objective.

Adopting a solvency framework can lead to a superior investment & risk management solution

Author: **Kevin McLaughlin**, Founder **Renuaa Risk Management Advisors LLC**
kevin.mclaughlin@renuaa.com | www.reunaa.com

How can RENUAA uniquely help you?

Renuaa´s mission is to help Plan Sponsor´s and Fiduciaries to address the long-term affordability and sustainability of pensions and savings programs. To meet this aim, we believe it is important to achieve an alignment among all stakeholders with a clear specification of the risk management objective. Our strategic advice and services are firmly grounded in the disciplines of corporate finance and financial economics. Importantly, this gives us an ability to distinguish between actuarial funding costs and true economic costs of capital, allowing us to design more efficient liability risk management programs. We have developed a unique solvency solution and set of tools to allow Plan Sponsor´s and fiduciaries of mature pension plans to optimize their approach to managing shortfall risk in the decumulation phase. History has shown us that holistically addressing governance, financial strategy and risk management practices are too important to ignore, as getting it wrong can have a detrimental impact on the long-term cost and viability of the pension program.

Disclaimer

"This article is not intended as investment advice and has been writing without taking into consideration the specific needs, objectives, constraints, or other considerations of any individual investor. Information regarding investment solutions and services are interned for institutional investors only and provided solely to include information about our investment philosophy, our strategies and to be able to contact us for further information. Individual investors are not to act upon information without seeking the service of a professional accountant, attorney and/or financial advisor. Presentation of this information is not intended to create, and receipt does not constitute, a client relationship. Renuaa does not accept any liability for any loss or damage arising out of the use of all or part the information presented including any inadequacy, inaccuracy or omission contained herein. Any U.S. federal (or other) tax information contained in this website is not intended as advice nor to be used for the purpose of avoiding penalties under U.S. federal tax law. The information in this paper is not available to be copied or disclosed, in whole or in part, without the prior written consent of Renuaa.