

Regional Hospital makes strategic decision to fund pension plan using long-term assets

THE ORGANIZATION

A regional hospital providing a wide array of services, employing over 200 physicians and 1,600 clinical and administrative personnel. Management oversees multiple asset pools, including a long-term investment account, a frozen pension plan, and a foundation - just under \$200 million in all. The pension plan represents about half of the total investible assets.

Challenges

An underfunded pension plan was creating multiple problems for the hospital. While asset returns for the plan had been very good since the global financial crisis, interest rates had dropped significantly, causing plan liabilities to grow rapidly. The resulting drop in funded status led to unexpected required contributions to the plan, causing management concern about possible impact to the hospital's credit rating.

Managing the underfunded plan had also become quite expensive, with PBGC1 premiums set to increase over the next few years. While the investment committee was hopeful that interest rates would rise in the future, causing some of the balance sheet liability to disappear, they decided to evaluate making a large contribution as a way to a) shore up the funding of the plan, and b) allow them to begin a pension de-risking strategy.

A strategic solution

The finance committee sought Russell's recommendations on how to best make this large contribution. In particular they wanted advice on:

1. How large should the contribution be?
2. What assets should the committee sell to transfer into the pension plan?
3. How should the committee allocate the contribution once it is in the plan?
4. When should the committee make this contribution?

PENSION FUNDING PROBLEMS

- › *Declining funded status (despite achieving asset return targets)*
- › *Unexpected required pension contributions*
- › *Potential negative impact to hospital credit rating and debt covenants*
- › *Increasing PBGC premiums*

This hospital and longtime Russell Investments client was able to quickly rebound from the global financial crisis of 2008. Operating revenue had steadily increased over the past few years and the hospital enjoyed more days of cash on hand than many others in their peer group. While the hospital was an early adopter of a liability driven investing (LDI) approach, the plan still maintained about 60% of their pension portfolio in equities, as the plan had yet to reach the funding status levels that the committee had established as the triggers for reducing exposure to market risk.

Russell Investments helped the committee realize that making a lump sum contribution created a good opportunity to revisit the hospital's entire investment strategy—an exercise that would provide clear answers to the committee's questions and position their total investment program for the future. After conducting an asset/liability study, Russell recommended the implementation of a dynamic de-risking strategy for the pension plan called Liability Responsive Asset Allocation (LRAA).

Under the LRAA schedule Russell Investments developed, the plan's liability hedge ratio target and allocation to fixed income increases as funded status improves, given that the plan has less incentive to take interest rate risk. However, since the liabilities are only partially hedged, any unexpected rise in interest rates would still benefit the plan and improve funded status. The schedule below shows the fixed income allocation for the pension assets (with the remainder allocated to return seeking strategies) and an interest rate hedge ratio target at each funded status.

| FUNDED STATUS | FIXED INCOME ALLOCATION (% OF TOTAL ASSETS) | HEDGE RATIO TARGET |
|---------------|--|--------------------|
| <70% | 40% | 28% |
| 75% | 45% | 34% |
| 80% | 50% | 40% |
| 85% | 55% | 47% |
| 90% | 60% | 54% |
| 95% | 65% | 62% |
| 100% | 70% | 70% |
| 105% | 75% | 79% |
| >110% | 80% | 88% |

Using this approach lowered the expected pension contributions in adverse market scenarios, helping address the committee's concerns regarding their ability to make pension contributions in a market downturn that would also negatively impact long-term assets and the overall financial health of the hospital.

The large allocation to fixed income also had the benefit of positioning the plan for a risk transfer strategy if the sponsor decided to transfer the pension liabilities to an insurance company in the future. The hospital decided to adopt this revised asset allocation strategy and incorporated it into their investment policy statement.

Specific answers to the committee's funding questions

In our role as co-fiduciary, Russell Investments worked closely with the hospital's investment committee, finance committee, and the plan's actuary to answer each of the following questions:

1. HOW LARGE SHOULD THE CONTRIBUTION BE?

Russell Investments advised the client to put enough assets into the plan to reach the next funded status trigger on their LRAA schedule. This would reduce the hospital's days of cash on hand to a level more in line with their peer group and still provide for ongoing financial flexibility. To materially impact the amount of PBGC premiums payable, the contribution had to be of significant size. The finance committee approved a contribution that increased the plan's funded status from 64% to nearly 76%, and reduced the assets of the long-term pool by 11%.

TARGET DURATION LDI FUNDS

Russell's Target Duration LDI funds are a series of six funds with targeted durations ranging from 6 to 16 years. This series of funds provides a close representation of U.S. corporate pension liability behavior by intentionally targeting specific duration exposures and deliberately managing credit exposure and default risk.

The building block approach of these funds enabled Russell Investments to tailor a solution to match the specific liability profile of the hospital's pension plan.

2. WHAT ASSETS SHOULD THE COMMITTEE SELL TO TRANSFER INTO THE PENSION PLAN?

The finance committee was particularly concerned about realizing losses in their long-term assets since any realized losses would flow through to the hospital's financials, with potentially negative impacts on their credit rating and debt covenants. Russell Investments conducted a thorough analysis and concluded that a pro-rata liquidation of assets in the long-term asset pool would lead to a realized gain and would not impact the hospitals' credit rating or debt covenants. This pro-rata withdrawal approach had the added benefit of maintaining the overall risk and return profile of the long-term pool.

3. HOW SHOULD THE COMMITTEE ALLOCATE THE CONTRIBUTION ONCE IT IS IN THE PLAN?

With a large enough contribution to impact funded status and reach a different threshold on the LRAA schedule, an increased hedge ratio and allocation to fixed income was called for. Russell Investments recommended that the committee invest almost all of the contribution in Russell Target Duration Fixed Income funds.

Using the Target Duration LDI funds enabled Russell to effectively match the duration, convexity and curve coverage of the liabilities while achieving the desired target hedge ratio, enabling the client to "lock-in" the funded status gain from the contribution. Ultimately, the contribution lowered the plan's overall interest rate risk without increasing the overall portfolio's market/equity risk.

Investing directly in the Target Duration LDI funds also helped reduce transaction costs, avoiding a two-step process of first investing pro-rata and then moving to the new allocation outlined by the LRAA schedule.

4. WHEN SHOULD THE COMMITTEE MAKE THIS CONTRIBUTION?

The committee considered two strategies regarding the timing of the contribution: dollar cost averaging over several months vs. making the entire contribution at once. After a careful evaluation of the advantages and disadvantages of both approaches, Russell Investments recommended that the investment committee make the contribution all at once in order to reduce the interest rate risk as quickly as possible.

RESULTS

By implementing three key changes, the hospital was able to reduce the likelihood and frequency of future unexpected pension contributions, along with their potential negative impact on the overall financial health of the hospital.

- › Making a one-time contribution from long-term assets took significant risk off the table and reduced future PBGC premiums.
- › Adopting an LRAA schedule helped further reduce expected contributions by approximately 3%.
- › Incorporating the Russell LDI Target Duration Fixed Income funds enabled a better match between the pension assets and liabilities.

ABOUT RUSSELL INVESTMENTS

Russell Investments has helped hospitals and healthcare system clients navigate challenges and meet goals since 1983. We work with each of our clients to fully understand their asset pools and unique investment needs. The comprehensive fiduciary solutions we design for our clients are tailored to meet each organization's specific goals and incorporate our award winning advice, investment strategy and implementation.

FOR MORE INFORMATION:

Call Russell Investments at **855-739-7979** or
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