BEST PRACTICES: MANAGING RISK IN CORPORATE VEBA AND SERP PLANS

Mike Valchine, CAIA, CIPM, Senior Consultant

The Challenge

Retirement plans known as "other post-employment benefit" (OPEB) plans are governed by different rules and requirements than traditional pension plans. For instance, unlike traditional defined benefit (DB) plans, there is no penalty for not funding OPEB plans and no forced contributions if the plan is underfunded. At NEPC, we believe it is necessary to look at the total benefit package holistically. To this end, OPEB plans deserve the same strategic review from an asset allocation perspective as their more traditional brethren. Thus, an evaluation of funded OPEB plans may be warranted to gauge whether the risk and return of the current portfolio is still aligned with the plan's needs and objectives. This paper discusses our framework for helping plan sponsors assess and enhance allocation strategy.

Background

Many corporate plan sponsors tend to focus heavily on managing risk in defined benefit pension plans, that is, traditional pension plans offering monthly payments on retirement. This focus is understandable given these plans are typically large in asset size, can have an outsized financial impact on the organization and plan participants, and require greater administrative effort. With the push towards Liability Driven Investing (LDI) underway in many pension plans, sponsors may begin to shift their focus to risk management for other post-employment benefit plans. OPEB plans comprise benefits, for instance medical assistance and life insurance, which go beyond the benefits of traditional defined benefit plans. Other post-employment benefits can also include supplemental tax-sheltered deferred compensation, typically awarded to highly-paid senior management on retirement.

Exhibit 1: Pensions vs. OPEB

Pensions vs. OPEB			
	Pension Plans	**VEBAs**	**SERP**
ERISA Governance	Yes	Yes, generally	No
Minimum funding requirements	Yes	No	No
Penalties for underfunding	Yes	No	No
Participant benefit security	Higher	Lower	Lower
Income stmt impact (exp)	Yes	Yes	Yes
Balance sheet impact (funded status)	Yes	Yes	Yes
Volatility impact on financials	Higher	Lower	Lower
Benefits if overfunded	Reduce contributions Risk transfers	Reduce or eliminate contributions	May be able to recover portion of excess funding
Ability to effectively hedge liability	Yes	Less certain	Yes
Taxable	No	May be subject to UBTI (unrelated business taxable income)	Yes

Source: NEPC Corporate Pension Team

OPEB plans share some key similarities with traditional DB pension plans (Exhibit 1); there are also some important differences. While there are many types of OPEB plans, Exhibit 1 highlights two of the more prevalent types: voluntary employees beneficiary association (VEBA) and supplemental executive retirement plans (SERP). VEBA provides life, accident, medical and similar benefits. SERP provides benefits above and beyond those covered in other retirement plans to key company employees, such as chief executives.

Asset allocation for OPEB

Typically, a more straightforward asset allocation strategy is used for OPEB plans compared with DB programs. This is because OPEB plans have a smaller asset base and carry a relatively lower financial impact; they also have fewer issues around administrative capacity.

Historically, many OPEB plans were invested similarly to DB pension plans since both were focused on meeting a return target, had long-term investment horizons, and economies of scale could be gained. However, as pension plans migrated to liability-driven strategies, a more detailed review of whether to mirror this pension strategy may be required. Most OPEBs we have encountered tend to employ a more traditional total return or capital preservation-oriented investment strategy.

A total return approach is commonly used for VEBA plans supporting retiree medical benefits, given there are no-minimum funding requirements, no penalties for underfunding and the typical fast pace of liability growth due to inflationary medical costs. Further supporting a total-return approach in VEBAs: company assets will be used to pay benefits upon the depletion of trust assets. The goal may be to ensure that trust assets last as long as possible by seeking a high return. Total return allocations often include equity indexing and core bonds or municipal bonds, depending on tax circumstances.

A capital preservation approach is also common for well-funded SERP or VEBA plans. In this case, the risk profile generally ranges from cash to core bonds and may include tax-minimizing or tax-aware strategies.

NEPC's Approach

A Framework for Assessing Strategy

At NEPC, we believe in tailoring our proposed solutions to each client's unique objectives, while helping plan sponsors evaluate OPEB allocations and asset allocation in general. Determining ob-

Exhibit 2: Questions to Assess Asset Allocation Strategy

Plan Characteristics	Risk/Return Implications		
	Higher	Moderate	Lower
Is the plan open, closed or frozen?	Open	Closed	Frozen
How well funded is the plan?	Meaningfully underfunded	Reasonably well funded	Fully funded to overfunded
Participant breakdown	Mostly actives	Actives approaching retirement	Mostly retirees in pay status
What is the expected liquidity profile of the plan?	Net cash inflows	Inflows offset outflows	Large net cash outflows
Liability duration	Long	Medium	Short
Expected return compared to breakeven (required) return	Lower	Similar	Higher
Plan Objectives	**Risk/Return Implications**		
	Higher	Moderate	Lower
What is the ultimate objective?	Remain open	Close or freeze	Terminate
What is your risk tolerance?	High	Moderate	Low
What is your funded status goal?	No additional funding	Reasonably well funded	Maintain fully funded to overfunded position
What is your goal for the assets?	Optimize return at current risk level	Reduce risk at current return return level	Reduce risk/return profile

Source: NEPC Corporate Pension Team

jectives and risk tolerance are often the most difficult parts of the process, given the numerous competing forces at play. NEPC uses a highly customized, collaborative approach. This includes not only proposing solutions, but also helping our clients better define the issues at hand.

The most straightforward questions are often the most difficult to answer. We find that a basic framework can lead to robust discussions among investment committees, which can draw focus on plan objectives and overall risk tolerance (Exhibit 2).

After receiving inputs from our clients, we review asset allocation while examining the issues from numerous angles. Traditional mean variance analysis, while informative, focuses on baseline outcomes. We consider different risk allocations and undertake economic scenario analysis so clients can assess their comfort level with the current portfolio and potential combinations in different economic environments. This may enhance the current allocation or take it in a different direction.

Enhancing Current OPEB Plan Allocations

Generally, traditional equity and fixed-income securities make sense as core holdings in most institutional portfolios. NEPC has embraced further diversification into non-core strategies. Whether the goal is to seek returns or reduce risk, we believe that appropriately sized and funded non-core strategies can add value to traditional portfolios. After a long run of US core asset dominance, now may be an ideal time to evaluate non-core assets. Lower expected returns from US core assets, especially core bonds, makes meeting return objectives difficult.

Now, the diversification achieved in traditional defined benefit plans can be implemented in smaller vehicles such as OPEB plans. Many flexible, diversifying strategies that NEPC has long advocated are now available to plans of much smaller asset sizes and in investment vehicles that are easier to administer such as mutual funds.

Strategies, for instance, global asset allocation, risk parity, multi-sector fixed income and absolute return can help add stability to a total return portfolio that is biased towards US equity risk. Additionally, access to non-US equity diversification has improved. NEPC supports globally diversified portfolios, including those holding international developed and emerging market equities.

Capital preservation strategies may benefit by incorporating allocations to absolute-return fixed-income holdings or by including muni-crossover policies that can invest opportunistically in taxable bonds. To the extent that gradually stepping out on the risk/return spectrum makes sense, absolute return strategies can be more readily accessed in investor-friendly vehicles.

Applying Lessons of Pension Risk Management to OPEB

For pension plans that are de-risking, we may recommend a strategy that balances returns with hedging liabilities. Given that the end goal for many pension plan sponsors is to exit their plans, the aim is to reduce risk as a plan's funded status improves over time. A balance between seeking returns and hedging liabilities can help reduce volatility and address competing objectives. To the extent that plans are well funded or sponsors are unable or unwilling to accept high volatility, incorporating strategies typically used in pension de-risking may make sense.

OPEB liabilities are valued the same way as a DB pension plan's liabilities, and they often have a similar amount of interest rate risk. As with traditional pension plans, funded status is reported on the balance sheet, which can lead to greater volatility than desired if the allocation is not focused on liability. Long-duration fixed income addresses interest rate risk and, depending on the allocation size and funding source, may not adversely impact expected returns. Long duration is also a powerful diversifier, providing protection in deflationary and flight-to-safety environments. Diversifying strategies, as mentioned earlier, can complement equities in the return-seeking portfolio, further stabilizing the total portfolio.

Health VEBAs and Medical Cost Inflation

Many VEBAs are faced with risks related to interest rates and inflationary medical costs, with the latter expected to have a bigger impact on a plan's financials. Medical cost inflation, on average, consistently has a 2% premium over the Consumer Price Index (CPI) for the last 45 years, according to the Bureau of Labor statistics. In general, we believe a good hedge for medical cost inflation does not exist in the capital markets. Hedging becomes more difficult as the risk is only realized when the actuary changes the assumption for medical costs, which may lead to a timing mismatch with the asset performance. While difficult to find an exact hedge, strategies that seek to achieve a return above CPI or those serving as a natural inflation hedge may be appropriate. We believe investments in private markets will likely provide investors the best chance at earning attractive premiums over CPI; for example, direct lending strategies, with their high-coupon income and appreciation potential, may help keep pace with medical cost inflation.

OPEB and Taxes

The taxable nature of some VEBA plans—typically for non-union employees—and of SERPs may appear to call for low turnover indexed equity and municipal bond strategies. While these may be appropriate core holdings in taxable OPEB plans, NEPC suggests a focus on earning superior risk-adjusted returns rather than tax avoidance or tax minimization. An overreliance on tax minimization strategies may lead to inadequate diversification or misalignment with a plan's overall risk and return objectives.

Conclusion

We believe plan sponsors should take a fresh look at their OPEB plan allocations. OPEB plans should benefit from a more robust strategic review as is often applied to traditional pension plans.

Disclaimers and Disclosures

- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.

- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

- This report contains summary information regarding the approaches described herein but is not a complete description of the research that supports these approaches. This analysis does not constitute a recommendation to implement any of the aforementioned approaches.