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Pension Risk Transfer Solutions

BY GEOFF DIETRICH

Adding guarantees to the defined benefit fixed income conversation.

Pension risk transfer (PRT) is a term that is quietly incubating within the U.S. pension marketplace. A close cousin of terminal funding (a term which may be more readily familiar to asset-liability practitioners), pension risk transfer involves the use of institutional annuity products to reduce and/or eliminate pension risks.

PRT solutions are differentiated from terminal funding in that their utilization is not relegated to being part of a plan termination process. Rather, PRT solutions are a new guaranteed asset

HIGH LEVEL IMPACT OF PARTIAL ANNUITY BUY-OUT ON REMAINING PENSION PLAN

Annuities Less Attractive	Retiree Obligations Annuitized*/ Total Pension Obligations					
Annuities More Attractive	60%	50%	40%	30%	20%	10%
Pension Plan Funded Status % Pre Annuity Purchase	Pension Plan Funded Status %: Post Annuity Purchase					
70%	10.0%	30.0%	43.3%	52.9%	60.0%	65.6%
75%	22.5%	40.0%	51.7%	60.0%	66.3%	71.1%
80%	35.0%	50.0%	60.0%	67.1.9%	72.5%	76.7%
85%	47.5%	60.0%	68.3%	74.3%	78.8%	82.2%
90%	60.0%	70.0%	76.7%	82.9%	85.0%	87.8%
95%	72.5%	80.0%	85.5%	88.6%	91.3%	93.3%
100%	85.0%	90.0%	93.3%	95.7%	97.5%	98.9%
105%	97.5%	100.0%	101.7%	102.9%	103.8%	104.4%
110%	110.0%	110.0%	110.0%	110.0%	110.0%	110.0%

* Annuitization assumes retired life liabilities are settled at 110% of accounting liability value

class for pension sponsors to consider as they evaluate their overall fixed income investment portfolio. The objective of this article is to provide a high-level outline of the pension risk transfer solution spectrum, and challenge pension stakeholders to consider the utility of these products as part of the fixed income universe of pension investments.

TAILORED ANNUITY BUY-OUTS

Annuity buy-outs are the classic product used to support the terminal funding needs of pension sponsors who are terminating their pension programs. Buy-outs are viewed as the product that most frozen pension plan sponsors want but few can afford. But is this really the case?

Recent history has led the buy-out annuity product to be primarily deployed in conjunction with a plan termination. This "all or nothing" approach to settling plan liabilities may not be optimal, especially in light of the emerging best practice of dynamic asset allocation, where fixed income allocations are increased as funded status rises to phase in the interest rate hedge.

I believe the same wisdom should apply when thinking about how to settle the pension liabilities. By tailoring or calibrating the annuity purchase, working in close collaboration with the consulting actuary, a plan sponsor can mitigate any negative impacts (funding, accounting or PPA restrictions) and overcome the inertia of waiting to settle all liabilities as part of a plan termination.

The chart illustrates how a plan's ability to "afford" annuitization is to some degree a function of its funded status and the proportion of plan liabilities it annuitizes. Thus, for plans funded in excess of 90% it is likely that they may be able to comfortably afford to annuitize some portion of their plan liabilities. This strategy concentrates on annuitizing retiree liabilities that can be most efficiently priced by insurers (typically less than 110% of GAAP liability value) and reducing the plan's cash flow/ benefit payment expense burden. For plans which may be waiting for rates to eventually rise, this approach may be preferable to an alternative settlement approach of issuing voluntary lump sums to terminated vested participants, in that a future rise in interest rates will have a more dramatic liability reduction impact on the long-duration liabilities associated with younger terminated vested participants.

BUY-IN ANNUITIES

Buy-in annuities are a relatively new approach to pension

> "Buy-in annuities are a relatively new approach to pension annuitization that has recently crossed the pond from the U.K."

annuitization that has recently crossed the pond from the U.K., where pension buy-ins are a multi-billion dollar annual marketplace. The U.S. witnessed its first buy-in transaction in May 2011.

Buy-in annuities are contracts that are held by the plan as an investment where the obligation of the insurance company is to issue monthly, life-contingent payments to the trust in bulk. The plan trust then issues payments directly to its pensioners. Like buy-outs, this approach is most effective when covering retiree obligations that are most efficiently priced by the institutional insurance marketplace.

The primary advantage of a buy-in annuity is that it avoids the funding status and accounting impact that would be otherwise associated with a buy-out annuity for an underfunded plan. Thus, a sponsor can engage a custom solution that provides a precise hedge against the plan liabilities, which, in turn, require monthly cash flow to issue benefit payments. This is a particularly attractive benefit for many pension sponsors who may not have the scale to access customized fixed income investment strategies from separate institutional account money managers. Too many pension sponsors are funding benefit payments by selling invested assets in an ad-hoc manner to meet monthly cash flow needs. A buy-in annuity contract provides a turnkey benefit payment financing investment.

When considering a buy-in, it is particularly important to collaborate with the sponsor and its advisors to understand issues related to the contract valuation, revocability and monitoring of the insurance company's financial strength. This new pension risk management tool is a useful solution that sponsors should investigate as they look to de-risk their plans.

INVESTMENT CONTRACTS

While each of the PRT solutions described above involve life-contingent, mortality-based guarantees, investment contracts offer a more pure play on leveraging an insurance company's fixed income investment capabilities. Insurance companies can structure an investment contract in a variety of different ways. Some carriers offer fixed crediting rate products that may fit nicely as a component of a larger more diversified fixed income portfolio. Other carriers can structure a contract to cover expected monthly plan cash flows for a defined period of years (*i.e.,* two to five years). This approach allows a plan sponsor to essentially purchase a bond-like investment that is designed specifically to defease its unique expected pension cash flows.

A new PRT product based on investment contracts has recently come to market that is designed to be a turnkey, bundled LDI solution. This investment contract guarantees that a plan's expected cash flows will be valued equal to the prevailing rate of the same pension discount curve the plan uses to value its liabilities. This approach essentially allows a plan sponsor to invest in a contract (asset) whose value is equal to the liability. That is a powerful proposition for sponsors interested in de-risking their plan and increasing allocations to fixed income to protect their funded status.

The primary advantage of using investment contracts as a PRT solution is that the terms can be customized to cover as few or as many cash flows as the sponsor is comfortable with. While an investment contract approach does not provide protection against mortality risk, it does allow a sponsor to diversify its fixed income investment by employing a guarantee. Additionally, an investment contract based approach to PRT allows a sponsor to engage an institutional insurer in a relationship in advance of more fully annuitizing its liabilities via a buy-out or buy-in solution. The advantage of being an existing client of an institutional insurance provider can potentially be a significant factor when it comes time for that carrier to evaluate its annuity pricing for a plan's liabilities. Based upon our

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experience, we believe that in certain instances this "existing client effect" could result in a cost savings of 1-2%.

A FULL SPECTRUM OF GUARANTEED FIXED INCOME PRODUCTS

The customized insured pension solutions detailed above are all similar to each other in that they are all built on a guaranteed group annuity contract chassis and leverage the fixed income investment capabilities of some of the largest fixed income asset managers. That said, the array of different solutions allows for a consultative approach in which PRT can be discussed with pension clients in a product-agnostic way.

PRT solutions can be delivered at all points on the fixed income yield curve, offering an effective alternative to short, intermediate, core or long-duration fixed income funds (see chart). The customization offered in these products may be particularly attractive to mid-sized plan sponsors who typically rely on mutual and collective funds, which are more benchmark-driven and are not customized to the specific cash flow needs of the pension plan.

CONCLUSION

Pension risk transfer solutions come in many different shapes and sizes, but all employ powerful financial guarantees backed by the some of the largest, best-capitalized life insurance companies. The ability to customize the PRT structure to employ an optimal mix of covered guaranteed cash flows (based upon investment and funding objectives) provides pension sponsors with a compelling alternative to traditional fixed income mutual or collective funds.

While the benefits of PRT solutions are clear to professionals who have experience working with these institutional insurance products, the fact is that these products are not part of the broader pension investment conversation, which relies on more traditional market valued (non-guaranteed) investment products. This fact presents both a challenge and an opportunity for the PRT market and its products. PC

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