

Pension Risk Transfer Solutions

Adding Guarantees to the Defined Benefit Pension Fixed Income Conversation

Dietrich
& ASSOCIATES

Pension Risk Transfer (aka PRT) is a term which is quietly incubating within the US 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 class for pension sponsors to consider as they evaluate their overall fixed income investment portfolio. The objective of this paper 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 classical 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 indeed the case?

This “all or nothing” approach to settling plan liabilities may not be optimal...

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. We 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.

...for plans funded in excess of 90%, it is likely that they may be able to comfortably afford to annuitize some portion of their liabilities.

The chart inset below illustrates how a plan’s ability to “afford” annuitization is somewhat of 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 which can be most efficiently priced by insurers (typically ~110% of GAAP liability value) and reduce the plan cash flow/benefit payment expense burden. For plans that may be waiting for rates to eventually rise, this approach may be value-added over 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 long duration liabilities associated with younger terminated vested participants.

High Level Impact of Partial Annuity Buy-out
on Remaining Pension Plan

Annuities Less Attractive	Retiree Obligations Annuitized*/Total Pension Obligations					
	60%	50%	40%	30%	20%	10%
Pension Plan Funded Status %: <i>Pre Annuity Purchase</i>	Pension Plan Funded Status %: <i>Post Annuity Purchase</i>					
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%	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%	85.0%	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

Buy-in Annuities:

This relatively new approach to pension annuitization has recently crossed the pond from the UK where pension buy-ins are a multi-billion dollar annual marketplace. The US witnessed its first buy-in transaction in May of 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 which 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 which 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 institutional separate 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.

A buy-in annuity contract provides a turnkey benefit payment financing investment.

Investment Contracts:

While each of the PRT solutions mentioned 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 which 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. 2-5 years). This approach allows a plan sponsor to essentially purchase a bond-like investment which is designed specifically to defease its unique expected pension cash flows.

A new investment contract based PRT product has recently come to market which 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.

...terms can be customized to cover as few or as many cash flow as the plan sponsor is comfortable with.

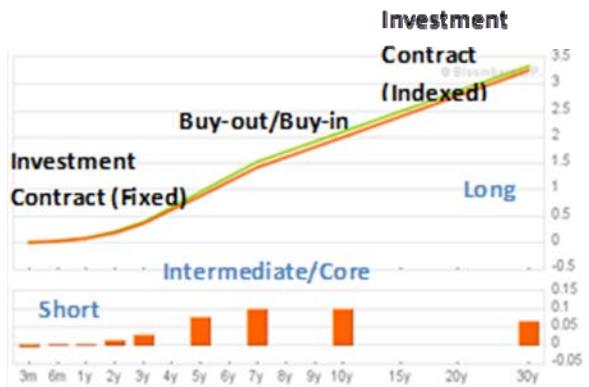
The primary advantage of using investment contracts as a PRT solution is that the terms can be customized to cover as few or as many cash flows as the sponsor is comfortable with. While an investment contract approach does not provide protection against mortality risk, it does allow a sponsor to diversify 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 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 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 above allow for a consultative approach where Pension Risk Transfer 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 illustration). The customization offered in these products may be particularly attractive to mid-market sized plan sponsors who typically rely on mutual and collective funds that are more benchmark driven and not customized to the specific cash flow needs of the pension plan.

PRT Solution Spectrum vs. Fixed Income Yield Curve



About Dietrich & Associates: Dietrich & Associates is the largest institutional group annuity brokerage firm in the US. Throughout the last thirty years, Dietrich & Associates has supported more than 1,600 annuity contract placements totaling more than \$4.5 billion in annuity premium. To find out more, email info@dietrichassociates.com or visit www.dietrichassociates.com.

Conclusion

Pension Risk Transfer solutions come in many different shapes and sizes, but all employ powerful financial guarantees backed by some of the largest, most well 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 Pension Risk Transfer market and its products. Readers of this paper should challenge themselves to consider how they might differentiate themselves and deepen their engagement with other pension stakeholders by seizing the opportunity to more directly investigate Pension Risk Transfer products and their associated guarantees.