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Pension Settlement Strategies

The Derisking Market Grows Apace

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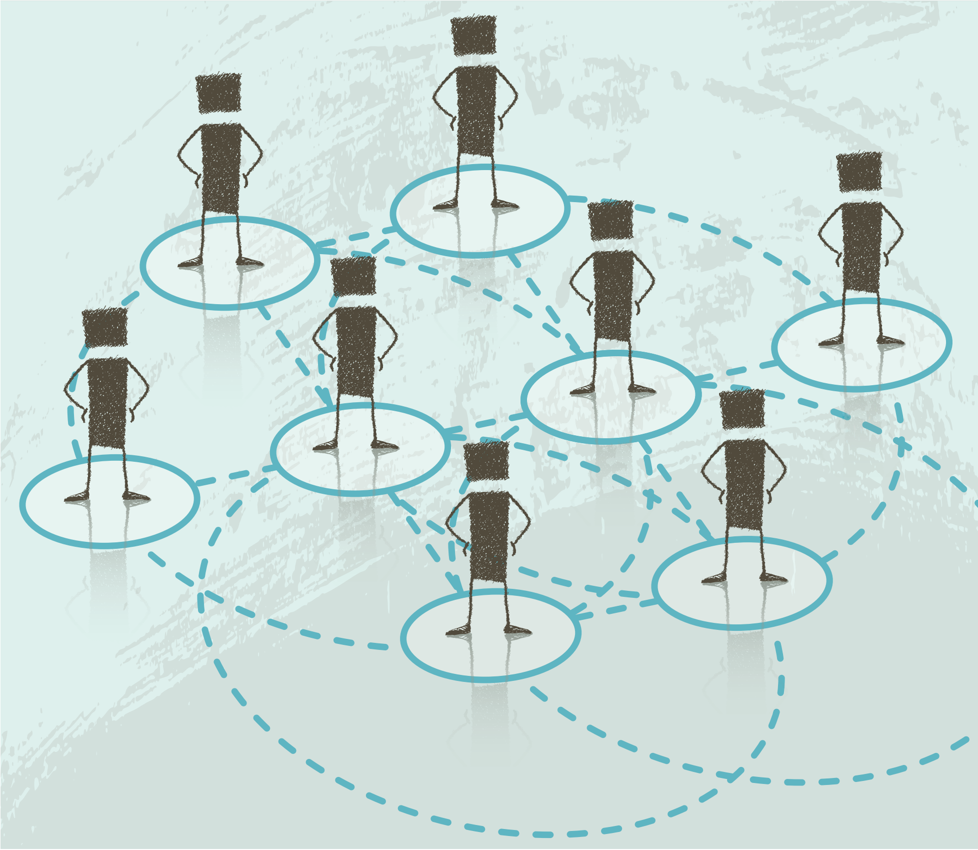

Pension Risk Transfer Comes of Age

When it comes to pension derisking and risk transfer, the pace is picking up. At the same time, it is becoming a more nuanced landscape with a variety of solutions and permutations of solutions available to plan sponsors seeking to change the risk profile of their defined benefit pension plan.

It is perhaps best to think of pension derisking as a continuum, with liability driven investing strategies applied to open plans at one end and full pension risk transfer to an insurer at the other. In between comes closing and freezing of plans, hibernation, buy-ins, partial risk transfer through buyout and lump sums. The nuance comes from the fact that each of these solutions might be a step along a journey, or they may be applied in combination, or indeed a company may stop anywhere along the way. What is clear is that companies have more options than ever when considering derisking — and more challenges in terms of figuring out the right route.

These challenges aren't curtailing activity. A study last year by Aon Hewitt found that 44% of the 248 DB plans surveyed intend to reduce their number of participants through settlement strategies, with 47% initiating a lump sum window in 2015. Equally, more than one-third adjusted their plan's investments to better match the fund's liabilities last year.

INCREASED FOCUS

There has been a significant increase in risk transfer strategies as well. "We say that the total pension risk transfer market in the U.S. of $4 billion in 2013 roughly doubled to $8 billion in 2014," says Wayne Daniel, Senior Vice President and Head of U.S. Pensions at MetLife. "My expectation is that it will continue to grow, so we could see $10 billion-plus per year for the next few years."

The reasons for this pickup in both activity and concentrated interest are many. "Plan sponsors are looking at their plans for a combination of reasons," says MetLife's Daniel. "You've got the sustained low interest-rate environment. You've got the continued market uncertainty. You have the increases in Pension Benefit Guaranty Corp. (PBGC) premiums. You have the new mortality assumptions published by the Society of Actuaries. All of these pressures on the financial impact of the plan on the companies' balance sheets are leading the plan sponsor to holistically evaluate the plan. That in turn is leading to an increased focus on pension risk transfer strategies."

DB pension plans add risk to corporate balance sheets at a time when the benefits may no longer be so apparent. "Pension liabilities are legacy liabilities for corporations because they are not using them to attract and retain talent," says Scott Kaplan, Senior Vice President, Head of Pension Risk Transfer, Prudential Retirement. "Plans are often frozen and discontinued, so the nature of the liability itself is changing. It's a non-core operation for the plan sponsor. It is also becoming more expensive to run a plan because of increased PBGC premiums."

"The underfunded size of the pension is debt, from a corporate finance point of

Defined benefit plan sponsors are becoming serious about derisking, using not just LDI but also strategies that remove liabilities from the balance sheet

view — and that's how the rating agencies view it," continues Kaplan. "However, there is a growing view within companies from CEOs and CFOs that pension debt is a riskier form of debt than traditional debt because pension debt has additional volatility if the underlying assets and liabilities are not well-matched. So there's a premium associated with managing that risk and companies are weighing up this risk alongside others."

These pressures are becoming a more convincing reason to pursue change. "More and more, the DB pension plan is no longer a strategic part of an employer's total compensation package with their employees," says Ari Jacobs, Senior Partner and Global Retirement Solutions Leader at Aon Hewitt. "So the plan is more of a burden. Combine that with the regulatory changes, increased PBGC premiums, new mortality tables and the low interest-rate environment, that's the reason for an increased focus on pension settlement solutions."

Few corporate managers can forget the recent rollercoaster in DB plan funded status. "We see increased stakeholder concerns around financial statement volatility in earnings and cash flow," says Prudential Retirement's Kaplan. "There is increased transparency around this, but what that shows is that these plans are managed very differently than the way an insurance company would handle these liabilities. Twice since the year 2000 DB plans have seen funded status deteriorate over 30% in market downturns as a result of a mismatch between the liabilities and assets. CFOs and boards don't want to see that occur again."

These statistics are also in the public eye. "The status of a company's pension fund is in the public domain, more so, every year," says Jess Yawitz, Ph.D., Chairman & CEO at NISA Investment Advisors. "It's in the accounting, the financial statements, the funded status and even to some degree the breakdown of the asset allocation. So the management of the pension fund is more visible to stakeholders, employees, rating agencies — everyone concerned about the company. As a result, there's interest in measuring and managing the associated risks."

IMMEDIATE IMPACT

"There are several options," continues NISA's Yawitz. "One is LDI. One is selling off the liability to an insurance company. One is offering lump sum payments to the participants. There are similarities and differences here."

A development that has weighed on the minds of many plan sponsors is the update to the mortality tables issued by the Society of Actuaries. "The new mortality tables are having some impact on the market," says MetLife's Daniel. "The immediate impact is that the reported pension liabilities for the average plan are expected to increase by 5% to 7%. This is adding to the pressure on plan sponsors, leading them to evaluate and possibly consider transferring some or all of their liabilities out of the plan."

It often comes down to a matter of cost. "With the new mortality tables, the pricing for annuities looks better relative to your liability," says Aon Hewitt's Jacobs. "Your liability has just gone up and the insurers have effectively been using the new mortality tables for some time, so their pricing hasn't changed by as much, but the gap has closed."

Although it isn't a requirement, most auditors seem to have pressed companies to use the new mortality tables when calculating funded status. "From the data we see in 10-K filings, most companies have made an adjustment to their reported funded status on the basis of the new mortality tables," says NISA's Yawitz. "We roughly estimate that they have taken about a 5% hit on the reported funded status as a result. That has the immediate effect of moving those people on a glidepath of derisking a bit further away from their next step. It is important to remember that while this is a sudden change to their accounting funded status, these mortality improvements have been impacting true economic funded status for a long time already."

PORTION OF THE LIABILITIES

As pension derisking in all forms has become a hotter topic, the shape of the market for solutions has also evolved. It was never a case of one deal and you're done. It's rarely possible, save with very small plans, to transfer all the liabilities of a plan to an insurance company in one go. It is possible to hibernate — manage by matching the assets and liabilities of the plan closely for an extended period of time — an entire plan, but eventually terminate or defease those liabilities. Typically, this is done with a combination of lump sum payments and buyouts for different groups of employees — retirees, term vesteds, etc.

"In the largest plans, buyouts usually only take a portion of the liability, usually 30% to 50% — and it's the shortest-dated liabilities, the retirees," says NISA's Yawitz. "There's logic as to why the retirees are preferred by insurance companies. They are much easier to hedge for a whole host of finance and market reasons. Longevity risks, too, are less scary because it's a more mature population. The portion that's gone is the least volatile from an interest-rate risk and longevity risk perspective."

With the increase in plans looking to transfer risk, insurance companies have

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become choosier as to what risks they want to acquire. “Insurance companies are becoming much more selective in the transactions that they will bid on,” says Aon Hewitt’s Jacobs. “This is either because they don’t like certain risks involved, or in some cases, because they are just overrun with business. It may be a large transaction that has just closed and they are focusing on making sure it is implemented well.”

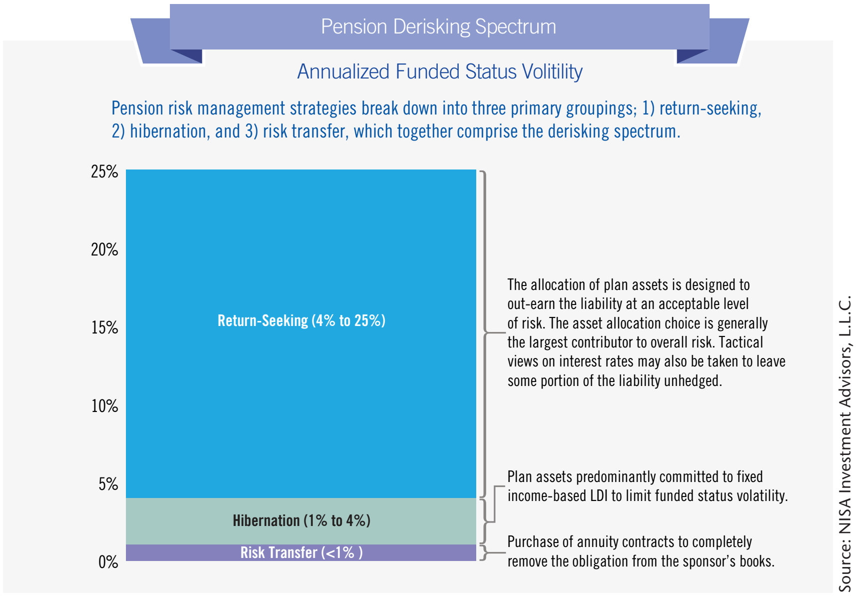
“There’s considerable capacity within the insurance market with the ability to transact tens of billions of dollars in any particular year,” says MetLife’s Daniel. “We don’t foresee any financial constraints in the near term, at least. However, we do sometimes find that when there are a number of transactions in the market at the same time, a sequencing needs to occur because not every transaction can occur on the same day of the same year.”

“Insurance companies are subject to stringent regulations and capital requirements, so the capacity is not infinite,” says Prudential Retirement’s Kaplan. “What worries us more is the capacity for long-dated fixed income. What could make these transactions more expensive in the future is the price and availability of long-dated corporate bonds because these are the instruments that insurance companies use to match these liabilities.”

POTENTIAL SCARCITY

“The scarcity of long-dated bonds isn’t staring us in the face,” says Prudential Retirement’s Kaplan. “I don’t know when but at some point in the future, there’s likely to be increased demand as rates rise and everyone is fully funded, so no company is going to want to sit on this liability. That’s the point at which I think the appetite for corporate bonds might exceed the capacity. I don’t think it would create insurance capacity concerns. But it could impact the potential pricing of these transactions because bonds will be more expensive.”

It does seem to be a bit of a buyers’ market. “I see two ways that insurance companies are limiting their businesses,” says Aon Hewitt’s Jacobs. “First, they are choosing the type of risks they want. Some like retirees. Some like deferreds. Second, a lack of resources and manpower can mean that an insurance company simply won’t bid on a transaction, even though several months ago they would have wanted that exact risk. They may say, ‘We’re not bidding for three months now.’”



“We see a steady deal flow coming to market year in, year out over the next few years, if not the next decade or two,” says MetLife’s Daniel. “If all of the plans contemplating this come to market at once, then it could be a challenge.”

“The pension risk transfer business is still a relatively small part of insurance operations,” says Aon Hewitt’s Jacobs. “Which means that the pricing and implementation is still developing. If an insurance company is going through a few of these transactions at the same time, they might not have the capacity to add others in the next month or two.”

“We have seen new entrants into the market, so that’s been good,” says Aon Hewitt’s Jacobs. “But those new entrants are being appropriately picky as to what they bid on. So solutions are becoming more varied, more complex to put together. The differences are subtle. They’re less likely to impact participants in most cases as much as they are going to impact the ability of companies to execute a transaction.”

SPLIT DEALS

One change that makes a pension risk transfer transaction a bit more complicated for the company, but is helping to ease any bottlenecks in deal flow, is the advent of the two-insurer deals. “There was a deal earlier this year that was split between two insurers, though the typical pension risk transfer transaction involves only one insurer,” says MetLife’s Daniel. “Dealing with one insurer to pay out everyone’s annuity 100% is certainly easier than dealing with two or three to pay out 50% or 33.3%, but it can be done. It does diversify risk, but there is some associated expense.”

“When a transaction is split between more than one insurer, what I have seen is that one insurance company is the lead administrator, so pensioners get only one check,” says Prudential Retirement’s Kaplan. “But the obligation is backed 50-50 by each of the insurers. They aren’t backing each other’s obligations, but are responsible severally for the portion of the obligation they have agreed to assume.”

“There was a big split deal earlier this year at Kimberly-Clark,” says Aon Hewitt’s Jacobs. “The primary advantage of a split deal is that you get to enhance the protections under the state guarantee association system by having individuals split their benefits. I think we will see a lot more discussion around multiple insurers and will see more creativity as to how deals get split. Some insurers would rather do split deals now.”

“For the company, there could be economic value to a split deal,” says Aon Hewitt’s Jacobs. “If they can get other players involved, they may create competitive pressures.”

“For the individual, he will receive two insurance certificates — one from each insurer — but most likely he will receive a single check,” says Aon Hewitt’s Jacobs. “So one insurer will handle the administration, with the other one sending a bulk

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The derisking choice isn't just as simple as keeping or selling the liabilities.

Weighing the Options

The process offers a range of opportunities — and challenges

The mechanics of pension settlement or its near cousin, derisking, are complex. Plan sponsors are well-advised to weigh all their options before making what in some cases can be an irrevocable decision. "First, you need to think about the difference between derisking your plan and settling your plan," says Ari Jacobs, Senior Partner and Global Retirement Solutions Leader at Aon Hewitt. "Derisking is about trying to manage either the growth of your liability and/or the mismatch between your assets and liabilities. You can do that through many different investment solutions such as freezing or closing your plan, or ones that allow you to manage the difference between your assets and liabilities."

"Settling your plan is different," continues Jacobs. "That's taking liabilities off your books through a very clear decision and process. In the U.S., it's done in two ways: either through lump sums or annuities. Lump sums can be offered individually to participants in the plan or a group annuity contract can effectively transfer the liabilities to an insurance company. Lump sums and annuities can be combined for different populations, different timelines, different groups, and so on, to settle liabilities."

"The most common pension settlement strategy is a buyout, which involves transferring the liability to an insurance company and extinguishing it," says Scott Kaplan, Senior Vice President, Head of Pension Risk Transfer, Prudential Retirement. "There are buy-in solutions as well, though these are less common in the U.S. and more widely used in the U.K. Here a sponsor purchases an annuity contract and holds it as an asset of the plan where it perfectly matches the liabilities. It's not an actual settlement, but it is like a buyout from a risk-reduction perspective."

DISCRETE AND IRREVERSIBLE

Risk reduction can take several forms and depends on the goal of the company. "Lump sum payments and selling off the liability to an insurance company are both very discrete and irreversible events in comparison to LDI," says Jess Yawitz, Ph.D., Chairman & CEO at NISA Investment Advisors. "You can reverse out of LDI if you so wish, because you are still managing those assets."

Often lump sums are used as part of a larger strategy that may have the ultimate goal of full settlement. "Typically, we see a lump sum exercise as part of an overall plan derisking strategy, which may include pension risk transfer," says Wayne Daniel, Senior Vice President and Head of U.S. Pensions at MetLife. "We advise the plan that if they're going to undertake a lump sum exercise, they should do so prior to bringing a pension risk transfer transaction to the insurance market."

The use of lump sums is becoming broader. "Plans are using lump sums for retirees somewhat more frequently," says Aon Hewitt's Jacobs. "It is more common to use them for term vesteds, but companies are beginning to get more comfortable with the idea that they don't need to get a private-letter ruling from the IRS."

It is an area that is seeing more interest from regulators. "Lump sums and the information that a plan participant should be given in order to make an informed decision is an ongoing area of debate," says MetLife's Daniel. "The ERISA Advisory Council have had some testimony in the past and in 2013, Joshua Gotbaum of the Pension Benefit Guaranty Corp. (PBGC) testified that in his view, the main danger of derisking was that lump sums were offered, as he didn't feel that they were generally in the consumers' best interest. This was the then-head of the PBGC talking."

For the part of the plan that cannot necessarily be settled at the moment or perhaps that the company does not want to offload, LDI continues to be a viable, and, in some cases, a preferable alternative. "LDI has flexibility and is frankly simpler to implement than the tedious process of going through a buyout transaction," says David Eichhorn, Managing Director, Investment Strategies at NISA Investment Advisors. "Both have the same motivational goal of reducing risk, but LDI has a lot of additional flexibility and expediency vs. some other solutions."

OFF INTO THE SUNSET

There is no right answer here. "An LDI strategy allows the assets and liabilities to move in lock step, and that's part of a derisking strategy," says MetLife's Daniel. "Other techniques like pension buyout — transferring risks to an insurance company — transfer mortality risk, longevity risk, expense risk, early retirement risk, as well as market and investment risks. A pension buy-in is another example of a pension risk transfer, which is a flexible contract allowing the use of a group annuity contract as a plan asset. It's usually a step towards a buyout."

It may be that termination or settlement is the goal for some companies, but it needn't be. "The phrase 'liability driven investing' has been used for years in a very broad way," says NISA's Eichhorn. "At NISA, we have always had a more focused description that it is managing interest-rate risk to reduce funded status risk. Hibernation is a more complete implementation of LDI. At that point, a large portion of the risk assets is gone. It doesn't have to be all of them, but 80% to 90% bonds is the general area. You may not be down to zero, but you've designed most of your assets to ride off into the sunset with your liabilities."

When considering the difference between settling and derisking a plan, plan sponsors doing a cost-benefit analysis need to understand how all the costs impact over time. "The biggest thing to remember when you are settling a liability is that you are settling not just the present value of the benefit payments, but also all of the other requirements and obligations associated with holding that plan — PBGC premiums, administrative fees, investment fees and everything else associated with running a plan," says Aon Hewitt's Jacobs. "It's all that is not commonly included in a standard actuarial liability or a PBGC calculation. We might call it the fully loaded value or the economic liability. Once you know that, you can more effectively compare the cost of settling or continuing to hold the liability."

"There is a difference in the economics of continuing to own the liability and selling it to an insurance company," says NISA's Yawitz. "It's true that paying the PBGC premium creates a drag on the pension side economically speaking, but the more fully funded you are, the lower that drag is. On the other side, insurance companies have capital requirements that mean that they have to set aside more than what is required to defease the liability. So that's a burden and a cost on the insurance side."

The state of the funded status has a significant impact on how the economics play out. "If your plan is 90% funded, then to make a pension transfer solution work, you will need to fully fund that plan up to its economic liability because effectively, that is what an insurance company is going to charge to assume that liability," says Prudential Retirement's Kaplan. "Relative to the liability that companies are carrying on their books, there may need to be an additional top-up because of the recent update to the mortality tables."

GROWING CLOSER

For those considering a settlement strategy, these new mortality tables can be good news. "The insurance company premium will largely depend on the difference between the company's accounting liability and its view of mortality compared to that of the insurer," says Prudential Retirement's Kaplan. "Because company auditors and accountants have been encouraging companies to update their view of mortality, the difference between these two views is growing closer."

"To help you understand whether settlement is the right decision, you need to understand the real impact on your expected cash flow into the plan," says Aon Hewitt's Jacobs. "If the plan is underfunded or not grossly overfunded, there is cash that will need to be put into the plan over the next months and years. If you go through a settlement, particularly one of a notable size, that will change the expected cash contributions, potentially in the very near term and maybe over a 10-year horizon."

"Hibernation is an investment solution for the whole plan," says NISA's Eichhorn. "You can hibernate at 90% funded; it just means you're going to contribute the last 10% or so via a contribution schedule that's set out by the regulations, generally 10 years or so. The nice thing is that you have the retirees, the term vested and the actives — though these are probably frozen for a plan that's in hibernation mode. Since many key metrics are based on percent funded status, for example, required contributions, keeping the more

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PENSION RISK TRANSFER

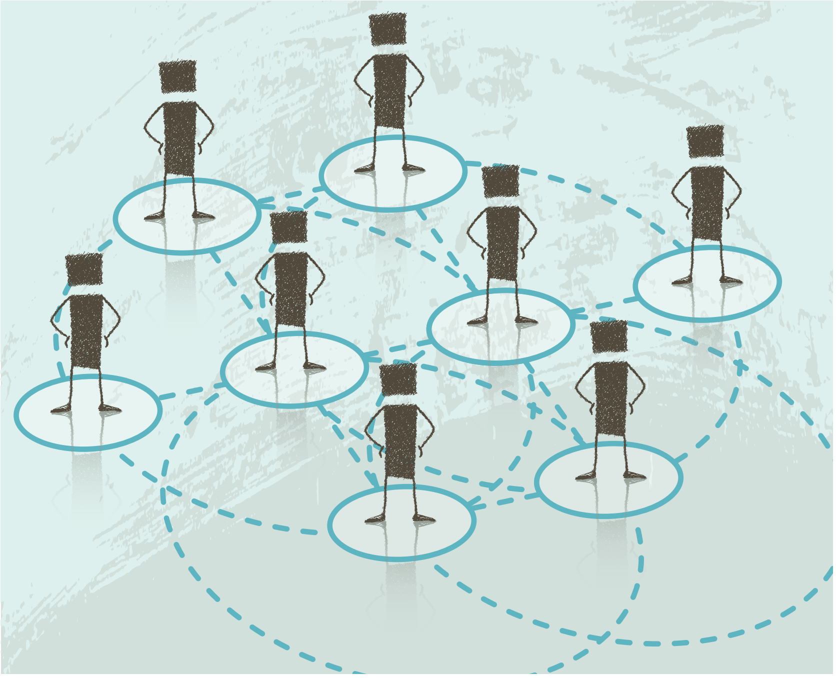
Preparing for Settlement

Plan sponsors must follow a prescribed route to complete a pension risk transfer solution. Understanding the process makes the decision to proceed — or not — easier

A pension derisking or settlement solution — either whole or in part — is a serious decision. Depending on the choice of route, it can be irrevocable. And it can also be seriously time-consuming. Therefore, it makes sense to understand the process fully before embarkation. "The first big step in readying a plan for pension transfer is focusing on getting the data pristine," says Scott Kaplan, Senior Vice President, Head of Pension Risk Transfer, Prudential Retirement. "Typically, this is no small task. The next phase is what I would describe as the feasibility assessment — developing the initial transaction strategy and data — to ensure that the request for information to an insurance company will get you the information you need to get a sense of pricing. At this point, you get to evaluate whether you want to do an in-kind asset transfer vs. cash, and have a back-and-forth with a number of insurance companies to understand the feasibility of the transaction you are contemplating. The third phase involves finalizing the details of transaction strategy and execution. The general timeline is from three to four months to, on the long end, 18 months."

Other insurers agree. "I would categorize derisking into three broad categories," says Wayne Daniel, Senior Vice President and Head of U.S. Pensions at MetLife. "First is preparation. Good data is important to running a lump sum exercise or the decision to approach the insurance market. The plan sponsor needs to look at the implications for the plan, the affordability, the funded status — broadly speaking, a cost-benefit analysis. Then there's the critical decision phase with the settlor decision, which is closely tied to affordability. Finally, there's the fiduciary decision, in terms of making any irrevocable decisions for the plan and the plan participant."

The importance of good data can't be overemphasized. "Part of a successful derisking transaction involves having clean data," says MetLife's Daniel. "By that



we mean that the plan has very good information on its active participants, current retirees and term vesteds. Where we often see the most problematic, incomplete or out-of-date data is in the term vesteds, because these participants are no longer employees. This is the group that is often offered a lump sum in advance of a derisking transaction."

It can be amazing how much data retrieval or updating is required. "The most important readiness factor is making sure that the data on plan participants is up-to-date, accurate and well-documented," says Ari Jacobs, Senior Partner and Global Retirement Solutions Leader at Aon Hewitt. "Similarly, it's good for the company to have reviewed all of its plan documents to ensure that whatever strategy they may be considering is possible. You may also want to spend some time looking at your assets and ensuring that you have the right liquidity or asset mix."

All of this review is useful for whatever strategy the company chooses to pursue. "Companies need to consider the full extent of the steps they need to take upfront in terms of data, understanding the liabilities and the assets," says MetLife's Daniel. "All that work translates into costs, which has a financial impact. There may be actuarial and consulting costs around that activity. The plan sponsor should identify an acceptable budget."

This preparation will make it possible for a company to move more quickly than others when the time is right, which may become more of an issue in years to come. "Companies need to monitor the pension risk transfer market so that when it makes sense for the plan to transact, they are ready to make the decision, execute the transaction and transfer the assets," says MetLife's Daniel.

It may be that after all this work, that settlement is not the right avenue to pursue. In that case, keeping the assets and hibernating them with a view to perhaps settling the plan in the future is another possibility. But again, plan sponsors need to understand what's involved. "Hibernation is not a buy and hold strategy," says David Eichhorn, Managing Director, Investment Strategies at NISA Investment Advisors. "It is one that has reduced risk dramatically, but still requires maintenance and management to keep the strategy on track."

On the positive side, it is possible in this situation to make up some shortfall that a plan may still have in its funding status. "Hibernation involves active management," says Jess Yawitz, Ph.D., Chairman & CEO at NISA Investment Advisors. "If one is managing against the long duration benchmark that has corporate bonds and long Treasuries in it, there may not be room for duration guessing. But there is certainly room for credit decisions and creating alpha. The tools may be limited, but it can enhance the quality of the solution if active management is enabled for most, if not all, of the fixed income securities."

Should the company decide to settle, they will need to work through a well-trod path of procedures. "The plan sponsor needs to understand the financial impact of a pension risk transfer transaction on the company," says MetLife's Daniel. "And they need to obtain any necessary approvals both within the plan and the governance structure of the plan, and the company and the board."

Interestingly, as companies move through this process, it is becoming clearer that pensions aren't the same as other corporate debt. "Companies should consider where the pension obligations sit inside their capital structure," says Prudential Retirement's Kaplan. "In some recent corporate bankruptcies, the pension plan has fared better than debt holders. When the company comes out of bankruptcy, the pension plan has been maintained at 100%. So there's a growing body of evidence that suggests that it is more senior in the capital structure than other debt. So effectively, the discount rate that you would apply to the pension liability is lower than the other debt you are holding on your balance sheet. So if you can get rid of the pension plan at a reasonable cost relative to what you think that obligation is worth from a corporate finance perspective, it may be attractive for you to do so, particularly because it seems to be quite senior in the capital structure."

Of course, the funded status of the plan has an immense impact on whether or not a pension transfer solution is even possible. "Affordability is a critical aspect of contemplating any pension risk transfer transaction," says MetLife's Daniel. "Obviously an overfunded plan can more easily afford a transaction than an underfunded one. So that is one reason why there is an increased focus on monitoring the funded status of a plan and aligning the assets to the liabilities, so that the funded status is stabilized. There can be a plan produced to increase the funded status and eventually move towards being able to afford a transaction."

Insurance companies like to point out that the new mortality tables make the premiums paid for group annuities look cheaper. Others disagree. "The reported funded status that takes account of the new mortality tables makes the liability look closer to a potential buyout price, but economically, nothing has changed," says NISA's Eichhorn.

Nevertheless, "the better funded a plan is, the more financial flexibility it has and the more readily it can choose when to transact," says MetLife's Daniel. "I think we're seeing an increasing focus on becoming better funded, and the more sophisticated corporate executives understand that. This kind of transaction is often driven by Treasury and finance with a corporate finance management objective."

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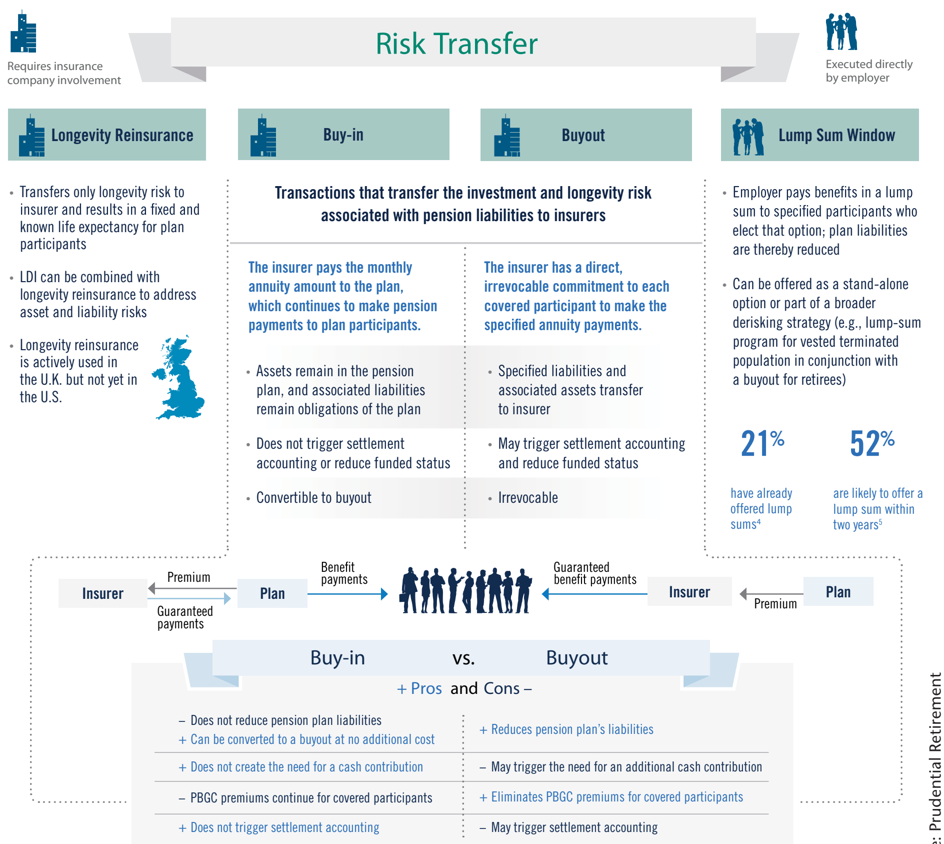

[4] Prudential and CFO Research, "Managing Financial Risk in Retirement and Benefits Programs," p. 6, July, 2014. Survey respondents include senior finance executives.
[5] Ibid.

Should You Hire an Independent Fiduciary?

Fiduciary considerations are a big part of the settlement conversation, whether or not an independent fiduciary is used

In any pension risk transfer transaction, there are two major stakeholders: the pension plan sponsor and the beneficiaries. These two groups may have conflicting interests. In recognition of this situation, the regulations surrounding these transactions, known as U.S. Department of Labor's Interpretive Bulletin 95-1, offer the option of hiring an independent fiduciary to represent the interests of the beneficiaries. It is not a requirement, so when should a plan sponsor consider this option?

"First, the standing fiduciary — usually the plan sponsor — needs to make a decision as to whether they feel comfortable that they can make a decision for the sole benefit for the plan participants without having any conflict with its corporate or other roles," says Ari Jacobs, Senior Partner and Global Retirement Solutions Leader at Aon Hewitt. "If they are not comfortable, then they can hire an independent fiduciary to provide a party that is singularly focused on plan participants and not potentially conflicted by having a dual focus."

It isn't just a question of resolving conflicts. "There is intensive work involved in assessing a transfer transaction," says Scott Kaplan, Senior Vice President, Head of Pension Risk Transfer, Prudential Retirement. "So whether you use an independent fiduciary depends on whether the company has the resources to handle the fiduciary issues or wishes to outsource. There are a number of independent fiduciaries that have been through several of these transactions, so they are experienced at conducting an objective, thorough and analytical search for annuity providers that can meet the plan participants' needs and are insurance companies with the creditworthiness, administration capability and claim-paying ability required."

WEIGHING INSURERS

Hiring an independent fiduciary can be pricey. "Size matters, certainly, in the choice of hiring an independent fiduciary," says Aon Hewitt's Jacobs. "But the concept is that you want to make sure that for a big decision, if you feel that the named fiduciary is not able to make that decision for the plan participants, it's wise to go out and hire an independent one to serve in that capacity."

The complexity of the process means it may make practical sense to hire an independent fiduciary. Choosing an insurer partner involves processes and skills that a company is unlikely to have in-house. One key decision that both the plan sponsor and the fiduciary need to make is the choice of insurer in a pension risk transfer transaction. "There is a set of guidelines for plans working with insurance companies as annuity providers," says Aon Hewitt's Jacobs. "They have to ensure that insurers have the right credit rating, the right risk capital available, the right diversification of businesses, know how to run a portfolio, know how to administer and operate these plans, and has a history in this business — or if not a history, has a clear growth strategy and staff to validate their ability to support the business."

The outline of what's required is clear. "The insurance company you choose needs to have financial strength and stability, ample capital depending on the size of the deal — and the availability of that capital," says Prudential Retirement's Kaplan. "You want a company that is highly rated. You need to consider the size of the insurer in relation to the proposed contract. Importantly, you also need to think about the insurer's ability to administer the liabilities flawlessly into the new system as well as its ability to handle the ongoing administration."

"Once an insurance company satisfies the minimum requirements under the U.S. Department of Labor's Interpretive Bulletin 95-1, how do you separate one insurer from another?" says Wayne Daniel, Senior Vice President and Head of U.S. Pensions at MetLife. "Plan sponsors definitely prefer an insurer with relevant experience. How many pension plans has this insurer worked with that are of a similar size or have similar characteristics to my pension plan? I encourage plan sponsors and their advisers to think about scale, not just because size matters, but financial security and risk diversification are important. MetLife currently manages nearly $38 billion of transferred pension liabilities."

"Stability is also important," continues Daniel. "I see this as the ability of an insurance company to survive the peaks and troughs of changes in longevity, changes in interest rates and changes in economic conditions. Finally, financial flexibility and customer centricity is key. Does the insurer have the ability to deal with the plan participants in a way that the plan sponsor, advisers and the fiduciary would want the plan participants to be treated?"

One of the issues that an independent fiduciary must weigh is the long-term safety of the assets. Insurance companies suggest that the transfer of pension liabilities to an insurance company offers the most protection to the pensioners. "There is a valid comparison to be made between the protection offered by the PBGC and state insurance protection," says MetLife's Daniel. "A plan is backstopped firstly by the assets within the plan, then by the plan sponsor, and, should both of those fail, the PBGC. Once the assets and liabilities are transferred to an insurance company, the liabilities are backed by the assets of the insurance company, which is backed by its capital and the regulations around that that an insurer is required to follow. Should an insurance company fail, which is an extremely rare occurrence, then it's backed by the state guarantee associations."

For some, the comparison is made more accurate by considering the funding status of the plan before and after pension risk transfer. "The average pension fund is 80% funded," says Prudential Retirement's Kaplan. "But when it moves to an insurance company, by virtue both of the regulations and the way these transactions work, it needs to be 100%-plus funded on an accounting basis. On top of that, an insurance company is required by regulation to hold reserves and capital against those liabilities. So from the start, the plan is more secure than it was under ERISA. So I would say that pension benefits are exceptionally secure under a guaranteed pension annuity."

"The amounts that are required to be funded under ERISA are much lower than what is required between an insurance company's reserves and capital regime," continues Kaplan. "Ultimately, of course, there is also the insurance backstop in terms of the state guarantee from the associations."

Should the independent fiduciary concur with the plan sponsor, or the plan sponsor holding both roles conclude that pension risk transfer is appropriate, an additional question is where to put the assets in the insurance company. There is a choice between having the assets held within the general account or setting up a separate account. "Each pension plan is unique," says MetLife's Daniel. "This is very relevant for the decision to place a contract into the general account of an insurance company or in a separate account. At MetLife, we can offer both. We typically find that a larger pension plan will be more

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Types of Buyout Transactions

There are three basic types of buyout transactions.

1. Full Buyout

The entire plan is terminated and a group annuity is purchased covering all participants (or all participants who do not elect a lump sum, if one is offered). This requires that the plan be fully funded and the formal plan termination process be followed.

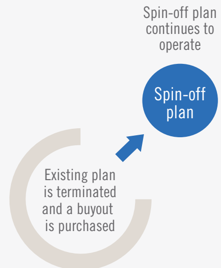
2. Partial Buyout with Lift-out

A group annuity is purchased for a given segment of plan participants, most commonly the retired population. With a partial buyout, the plan remains active. This is the simplest way to initiate a buyout, since the plan does not terminate and the sponsor can decide how much of the liability to transfer to the insurer.

Roughly 50% of private U.S. DB plan liabilities are associated with retirees.[6]

3. Partial Buyout with Spin-off and Termination

A segment of participants, those who are not part of the transaction group, is transferred to a new plan—the spin-off plan. Participants who will be part of the buyout transaction remain in the existing plan. The existing plan is terminated, and once the termination process is complete, a buyout is purchased for all participants (or those who do not elect a lump sum, if one is offered). The new plan will continue to operate in the future on its own. As opposed to a partial buyout with a lift-out, the spin-off approach results in a plan termination. Since PBGC plan termination procedures must be followed, some plan sponsors may feel that this approach affords additional protection from potential employee litigation. Other sponsors may prefer to opt for the relative simplicity of the lift-out approach.



Source: Prudential Retirement

[6] Russell Investments, "Update: Risk Transfer Options for Defined Benefit Plan Sponsors," Russell Research Practice Note, p.3, June 2013.

Weighing The Options, page 9

inert retiree liabilities within plan actually stabilizes funded status volatility."

"To ready a plan for hibernation is really just a decision process," says NISA's Yawitz. "It's just an investment strategy change. It can take time if the portfolio has a large percentage of illiquid assets but is otherwise just a matter of designing the new asset allocation and then reallocating."

"A hibernation or advanced LDI strategy can often be a necessary stepping stone to a buyout," says NISA's Eichhorn. "Sponsors may not like the pricing at the moment, for instance."

Simple cash-flow considerations can't be the main consideration, though. "Cash shouldn't be driving the decision of whether to settle or not," says Aon Hewitt's Jacobs.

But of course, it can be difficult to generalize. "No one pension plan looks like another," says MetLife's Daniel. "Even in the same industry, even similar sized plans — each has a different liability profile, driven by the demographics of their participants and their unique benefit structures. So each plan strategy needs to be customized to the unique circumstances of the plan."

The specific asset allocation of the plan comes into play here as well. "The portion of the liabilities that is sold in a buyout needs to be fully funded at that instant," says NISA's Yawitz. "That can have implications for the liquidity of the assets that are being left behind, in particular, illiquid assets such as private equity or hedge funds."

This isn't as much of a problem when the assets overall are retained. "In a hibernation solution, the idea of having 10% in equity or private equity or another asset class makes sense to us at NISA," says NISA's Yawitz. "It may make sense for an insurance company as well, but the capital charge on that could be quite significant."

Getting rid of just part of the plan also affects how the legacy portion will behave within the corporate financial structure. "If you settle a portion of the liabilities, you want to analyze how a new set of liabilities and assets will change how much cash you will have to put in and when," says Aon Hewitt's Jacobs. "Second, if you are a U.S. company following U.S. GAAP, the transaction will likely have an accounting impact. That will include settlement accounting, which is an immediate hit to the P&L, and a change to your future expense by having a different plan."•

Preparing for Settlement, page 13

In terms of the mechanics of a pension risk transfer solution, perhaps the largest decision is what insurance company or companies to use (see story, page 14). It's a complex and highly regulated process that requires the input of many parties and many fiduciary decisions.

Finally, if the decision is reached that the assets should be transferred to an insurer, plan sponsors will need to engineer the transfer of the assets to the insurers. It can involve liquidating the assets and transferring cash, or sending the portfolio across largely intact. "I think we will see an increase in the use of assets-in-kind to fund pension buyouts," says MetLife's Daniel. "That's because plans have been derisking their asset portfolios and realigning them using LDI strategies. One benefit of this is that when the plan is ready to come to the insurance market, the portfolio is typically a broadly diversified corporate bond portfolio, which is a suitable portfolio for the insurer to hold to back the liabilities."

"Depending on the size of the transaction, we will specify the types of securities and duration profile that we will require for an in-kind portfolio, or even, in certain circumstances, agree on actual securities," says Prudential Retirement's Kaplan.

Cash has its disadvantages for the insurer. "When you receive a premium in cash, typically it may take some time to put the money to work," says Prudential Retirement's Kaplan. "There are risks associated with that, such as changing market conditions. When you accept an asset-in-kind portfolio, you are transferring the premium on one day and you know what the market conditions are. There's no lag."

It can depend on the size of the portfolio. "Some insurers will only accept cash for certain transactions, meaning they don't want to go through the effort of accepting an asset transfer for a particular size of liabilities," says Aon Hewitt's Jacobs. •

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attracted by a separate account because of the additional financial security, but of course that comes with an additional cost."

FAIRLY SEAMLESS

"Transactions are split when the independent fiduciary decides to diversify the credit risk when using a general account solution," says Prudential Retirement's Kaplan. "There's some additional complexity in these transactions upfront for the plan sponsor, but once it's in place, I think it becomes fairly seamless."

There is a cost involved. "We've seen transactions that use the general account as well as those that set up a separate account," says Prudential Retirement's Kaplan. "The key is the size of the contract relative to the size of the insurance company. It's a key fiduciary consideration. Obviously a separate account solution, where the assets are effectively isolated and segregated from the general account, offers a stronger level of protection. There's typically a price associated with that. If an independent fiduciary was concerned about the overall size of the transaction relative to the general account, that it was too large, it might consider splitting the transaction."

"The question of whether to use the general account or set up a separate account is a very individualized one," says Aon Hewitt's Jacobs. "The large majority of transactions still occur in the general account, but the large majority of transactions are very, very small. Above $100 million, that's when you can begin to think about a separate account. For those transactions, the question is being evaluated by all plan sponsors whether or not it is selected."•

WHETHER YOU USE AN INDEPENDENT FIDUCIARY DEPENDS ON WHETHER THE COMPANY HAS THE RESOURCES TO HANDLE THE FIDUCIARY ISSUES OR WISHES TO OUTSOURCE

Comes of Age, page 6

payment to it every month. If something were to happen, the individual would have a claim against each insurer individually. They are not reinsuring each other."

There could be changes afoot in lump sums as well. The window that opened in 2012, thanks to regulatory changes, is still open, but the attractiveness could change in future. "Plans are trying to implement their lump sum windows while the current mortality tables apply and prior to the new mortality tables that will likely apply at some future date," says Aon Hewitt's Jacobs.

"When the new mortality tables begin to apply to lump sums, that will be a big change," continues Jacobs. "It will slow down the lump sum activity."

MEANINGFUL AMOUNTS

Companies considering only transferring some of their pension liabilities need to consider the effect on the remaining assets, liabilities and corporate balance sheet. "If a plan were to sell off a third of the present value of the liability, they may have gotten rid of much less than a third of future funded status risk because they are selling off the shorter, more predictable portion," says NISA's Yawitz.

"In some cases, managing the remaining part of the pension plan could be harder," says David Eichhorn, Managing Director, Investment Strategies at NISA Investment Advisors. "If they have illiquid assets that the insurance company won't take, then they will form a larger part of the remaining assets."

In order to derisk, but not necessarily end up with a more difficult-to-manage plan, it is possible to use a buy-in to defease a portion of the liabilities. "If the plan is significantly underfunded but has a meaningful amount of fixed income already, then they could purchase a group annuity for a portion of the plan, thereby taking some of the risk off the table," says Prudential Retirement's Kaplan. "Whether that was attractive would depend on where our premium is relative to their accounting liability and what impact it could have on the funded status. A buy-in solution wouldn't impact the funded status."

An underfunded plan has fewer options. But it can still derisk. "LDI reduces the effect of interest-rate changes on funded status," says NISA's Yawitz. "If a company wants to move to a less risky funded status, that generally involves long-duration bonds. We view interest-rate risk as uncompensated risk, so companies want less of it. LDI is flexible. Companies can set target levels for funded status and when those targets are hit, the plan can take certain actions to continue to reduce risk."

Although the costs for pension risk transfer and hibernation may be the same over the long term, it is true that hibernation is the cheaper cash-today option. "If a company puts their plan into hibernation mode, they don't view it as a profit-seeking enterprise," says NISA's Yawitz. "If they know that they are able to pay every last liability and have zero dollars left over, they're thrilled. That means the hibernation was a success. An insurance company has to do that and make a profit on top of it to keep their shareholders happy. That's an additional cost that must be baked in."

The interest in hibernation and LDI today is likely a feature of the market environment. "Derisking in general is very driven by markets and funded status," says NISA's Eichhorn. "For several reasons, markets and mortality tables, pension plan funded status has slipped the wrong way. We're 6% or 7% off the high water mark. Activity always picks up when equities are doing well or rates are going up. You'll see more derisking when that happens."

DEFRAYING COSTS

It's also more of an option for a larger company with a larger plan to keep it in-house. "We think that smaller plans may favor buyouts because they have costs that are harder to defray and are unable to invest in the assets that an insurance company can," says NISA's Yawitz. "But for larger plans, hibernation allows them to own a wider variety of assets and spread the cost of managing these assets over many years."

Some lucky plans are still overfunded, even after the mortality table changes and market volatility. "If you have an overfunded plan, you have asymmetric risk because effectively, the overfunded assets may be stranded," says Aon Hewitt's Jacobs. "A company doesn't have great access to these assets. So if you're overfunded, you have more of an incentive to settle and get the liability off your books. If it becomes more overfunded, you don't get a lot of value. If the plan suddenly flips to being underfunded, you may actually have to put cash into the plan."

"We expect that at some point in the U.S. market there may be an emerging appetite for transferring longevity risk discretely to insurance companies," says Prudential Retirement's Kaplan. "It will be those plan sponsors that are fairly sophisticated in their asset management strategy that may wish to retain or hibernate the assets, but cannot hedge the longevity piece. Here they may look to a reinsurance contract to cover longevity. But given the rising cost of PBGC premiums, we think that will be the minority, rather than the majority of plans."

"Longevity risk in the U.S. is lower than it is in other countries, because most pension benefits are not inflation-protected," says Aon Hewitt's Jacobs. "So here longevity protection is purchased through other broader protections like annuities. I think longevity only products will only take shape in the U.S. when the markets for more holistic products become too expensive or too scarce."

"I think the prospects for longevity swaps or reinsurance come down to pricing," says NISA's Eichhorn. "I would like there to be a robust longevity market. Here, sponsors have many different types of risk that they are more concerned about."

"We aren't seeing any demand from our pension clients for longevity swaps," says MetLife's Daniel.

"The S&P 500 is up 2% for the year," says NISA's Yawitz. "Ten-year Treasuries are up 30 basis points and 30-year Treasuries are up 45 basis points for the year. And corporate bond spreads are generally wider for the year. So that's a push on the discount rate that's used to present-value liabilities. So for most plans, their underlying economic funded status has begun to make a comeback from its recent lows. That means that there's enhanced interest in LDI and hibernation."

"I think it's a point worth emphasizing that insurance companies are in the business of assuming risk," says MetLife's Daniel. "The fact that we manage a broad array of different types of risk makes the overall insurance company structure more resilient and more financially flexible than a pension plan. Typically, a pension plan only has certain types of risk and it doesn't have the diversification that a pooled, diversified balance sheet within an insurer does."•

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[1]Based on U.S. Plan Sponsor rankings in *Pensions & Investments,* September 2014. [2]Prudential Retirement, as of 3/31/15. [3]*Pensions & Investments'* 2014 Annual Money Managers Survey, as of 12/31/13. [4]LIMRA Group Annuity Risk Transfer Survey, 1Q 2015. [5]*Pensions & Investments'* 2014 Annual Money Managers Directory, as of 12/31/13. Guarantees are based on the claims-paying ability of the insurance company and are subject to certain limitations, terms and conditions.

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