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Why Corporate Pension Plans Are Considering **Their Derisking Options**

Corporate pension plan sponsors are familiar with the Groundhog Day phenomenon. After all, twice in the past 15 years, U.S. corporate defined benefit pension plans have lost over 30% of funded status in market downturns. If you've been there before, you certainly don't want to be there again. So the rocketing equity markets of 2013 proved a boon to plan sponsors.

It wasn't just stocks that supported the upward trajectory in funded status. "Since the beginning of 2013, the S&P total return (not annualized) through mid-May was a little over 35%," says Jess Yawitz, Ph.D., Chairman and CEO at NISA Investment Advisors. "The 10-year Treasury, in spite of the fact that it's come down a bit, is 75 basis points higher, and the 30-year Treasury more than 40 basis points higher. So from our clients' perspective, the market has been their friend. That's because higher rates make the liability worth less, while risk assets have performed in excess of expectations, which both lead to improved funded status."

So recently, plan sponsors have gotten double bang for their bucks. But the improved funded status isn't just down to markets. Companies have been pursuing the incremental versions of derisking since before the global financial crisis. "We've lived through a decade of improvements," says Glenn O'Brien, Managing Director, Pension Risk Transfer at Prudential. "Improvements answer the question of how to make the existing pension situation better by some margin. That strategy has dominated the landscape for the past decade. Liability driven investing was an improvement that reduces the amount of volatility experienced by pension funds. Additional cash contributions improved the funded status. The use of hedge funds improved the expected rate of return and the outsourced chief investment officer (OCIO) would attempt to outsource the management of the problems."

Yet again, it's a pivotal moment for companies considering the future of their DB plans. What to do is a big decision and one that will affect the future of many firms in fundamental ways. "The investor narrative is extremely important for companies," says Prudential's O'Brien. "Companies want to be known for allocating capital, resources and talent into their core business. Large legacy annuity obligations are often inconsistent with that message. Having a big pension fund and legacy obligations, often underfunded, can divert capital and cash away from business expansion plans, research and development, or other investments that have both short and long term benefits."

When funded status was last this good, the majority of plan sponsors did little to crystallize the event by derisking. This time the mood is quite different. Today, plan sponsors are investigating their options along the derisking spectrum, from implementing an LDI glidepath through hibernation all the way to pension risk transfer.

INCREASED RISK

It can be expensive to run a DB plan, and the costs – both in cash and risk terms – aren't going down any time soon. "The extreme market volatility and persistently low interest rate environment has increased the risks associated with managing a defined benefit pension plan," says Wayne Daniel, Vice President and Head of U.S. Pensions at MetLife. "Plan sponsors also need to take account of the recent increases in PBGC premiums and the expected adoption of the new mortality tables from the Society of Actuaries. The risks associated with managing a pension plan can impact a variety of corporate performance measures, so we're seeing more companies taking concrete steps to consider derisking their pension plans."

Still, it's that key marker, funded status, that is driving today's activity. And many plans have adopted an LDI approach or glidepath to increase funded status and decrease the associated volatility. "The market environment has afforded clients the opportunity to act and derisk," says David Eichhorn, Managing Director, Investment Strategies at NISA Investment Advisors. "If plan sponsors have a plan in place, they have stuck to it. And depending on where it started, some have actually gotten to the endpoint. Many are still on the journey. Precision is needed as you get closer to that end state and there's a need for a very precise quarterback role – or completion role. We see more interest in those more refined in-plan, endgame strategies."

Once a plan's funded status has reached a certain level, probably north of 90%, then plan sponsors are weighing their options. "The funded status of plans is probably the primary economic factor that causes plan sponsors to think about whether or not they should be defeasing their liabilities," says William E. Ryan III, Chief Fiduciary Officer at Evercore Trust Co. "One of the concerns plan sponsors had last year was the cost they saw associated with GM and Verizon transactions – the additional contributions to the plans that both plan sponsors needed to make to effect the buyouts. But as plan funding status has improved over the last two years, on a termination basis, the need for a plan sponsor to make such contributions is less likely. What looms larger for plan sponsors are the ongoing costs of maintaining the plans, such as PBGC premiums, service provider costs and contribution obligations."

PROJECTED FUTURE EXPOSURE

The choice between whether to keep or transfer the plan is critical to long-term planning and may be beyond the financial, such as the retention of current staff.

There is no one answer. "The major thrust of derisking should be on matching the plan assets to the plan liabilities," says MetLife's Daniel. "This involves understanding not only the current, but also the projected, future exposure of the plan and all of the risks, which involve investment, interest rate and early retirement risks. Of course, it's important to recognize that no two plans – even if they're in the same industry and of similar size – have the same liability profile. So every plan is unique, and the solution for each plan and each plan sponsor needs to be tailored accordingly."

What changes when funding status rises is the need to execute derisking strategies with

With significant plan funded status improvements, companies are looking for ways to maintain these gains – forever

Asking the Right Questions

Any pension risk transfer event involves many players – and it can take a long time. So it helps to think through the steps involved to make sure that the company and the plan are prepared. "We suggest that plan sponsors begin to prepare early for derisking," says Wayne Daniel, Vice President and Head of U.S. Pensions at MetLife. "This is often a multi-year strategy. You need to be able to react promptly so that when the opportunity arises, you're ready to act. The preparation steps we emphasize include understanding and quantifying the costs and the financial impact, identifying a target level of acceptable costs, obtaining the necessary approvals for action from all of the stakeholders, and monitoring the environment so that when an opportunity arises, you are ready to act."

Sponsors should remember it's less about the buying and selling of a product but rather the structuring of a transaction. "We work with sponsors that have assets spread around the capital markets," says Glenn O'Brien, Managing Director, Pension Risk Transfer at Prudential. "So having a good understanding of how to make an efficient transition on the asset side is important and involves a lot of discovery. There's the question of whether or not to use an independent fiduciary. Legal decisions – are you going to spin off and do a partial lift-out of a plan? Communication is a big issue. Obviously you want to communicate to retirees and others, but if you're publicly traded, and want to use capital or cash, you might trigger other disclosures. Data about beneficiaries isn't always as clean as you think it is going to be."

The accountants will need to estimate the impact on the company's cash flow and pension accounting expense. The plan actuary will need to consider how any change in investment strategy or partial settlement will impact the funded status and expected return on assets.

"Firstly, what is the historical experience of the insurance carrier," says MetLife's Daniel. "How many years of experience do they have in managing these transferred pension risks? Secondly, what is their experience in implementing pension risk transfer transactions? Thirdly, what is their long-term commitment to the pensions market?"

That final consideration is important. "This is a business where practice matters," says Prudential's O'Brien.

more precision, whether the ultimate goal is to keep or transfer the assets. "There's an evolving recognition that there is uncompensated risk from not hedging interest rates," says NISA's Yawitz. "Last year is just a continuation of previous years in terms of increased desire to hedge. But corporate pension funds are embracing derisking strategies with more precision."

It's absolutely clear that activity in the pension settlements arena has stepped up this year. "In 2014, we are seeing increasing expressions of interest from plan sponsors in defeasement strategies involving annuities," says Evercore's Ryan. "Plan sponsors have been looking at the performance of their plan and their other obligations. What were theoretical enquiries in 2013 are now transactions that are actively being investigated or are well underway."

Activity isn't limited to risk transfer solutions. "In the last few years, we've had a number of large transactions in the annuity space," says NISA's Eichhorn. "One appealing thing about those transactions is that they are very easy to understand from the outside. They are very direct because they are just a purchase from an insurance company. But we do see plenty of interest in alternatives to annuity buyouts, like hibernation strategies, for example."

REWARDING SHAREHOLDERS

This is fundamentally a matter for the enterprise as a whole. "Pension risk transfer is focused on answering the innovation questions," says Prudential's O'Brien. "Are our shareholders rewarded for retaining the legacy obligations, are our best and brightest people focused on the core business issues, and what do we want to be known for as a company?"

Expect to hear more about pension settlements as the year progresses. "If we continue to see the improvement in funded status, which is projected to increase, then I think we will continue to see a good number of transactions," says MetLife's Daniel. "We've been very pleased with our 2014 activity to date and we see good growth opportunities in the future." ↺

Choosing the **Right Option**– For Company and Plan

The direction of travel in the world of DB pension plans is clear. Companies are interested in gaining control of a liability that can sometimes seem onerous. With full funded status within shouting distance for many plans, a final solution seems within reach. Finality, however, comes in many guises and it pays to consider which option will work best for each plan and each company.

"Many corporate pension plans now have a more precise game plan in terms of derisking," says Jess Yawitz, Ph.D., Chairman and CEO at NISA Investment Advisors. The recent gain in equity markets has allowed some of our clients to move more rapidly than they may have originally expected. They feel more comfortable monetizing the improvement in funded status by reducing their risk assets and increasing their interest rate hedge, with more bonds or interest-rate derivatives."

Pension risk transfer solutions are one end of the derisking continuum. "The solutions available today fall into two categories: annuities and lump sums," says Ari Jacobs, Senior Partner and Global Retirement Solutions Leader at Aon Hewitt. "Lump sums are single payments to individuals and annuities are purchases of the same stream of payments that are then paid by an insurance company rather than by the plan itself. Lump sums are currently popular for terminated vested former employees – folks that haven't started receiving their benefits yet – though lump sums to retirees are also being considered."

ASSETS AND LIABILITIES IN SYNC

Other market participants point out that transfer is not the only derisking possibility. "You can reduce enterprise risk either through annuitization or hibernation," says NISA's Yawitz. "But in some cases, that impact on enterprise or firm risk may effectively be identical. The additional positive to a hibernation strategy is that you don't need to come up with the potentially large buyout cost up front. In some cases that risk reduction without the immediate hit to liquidity or leverage may translate to a notch or two of ratings improvement in hibernation that you wouldn't expect with a buyout."

Most pension plans do consider the hibernation vs. annuitization vs. lump sum question, if only because alongside those that are well along in derisking, there are still a number that haven't started. "A pension plan that has done no derisking, that simply has a traditional allocation of assets and liabilities, can move through a spectrum of derisking activities," says Wayne Daniel, Vice President and Head of U.S. Pensions at MetLife. "You can start with partial derisking, the retirees only using an annuity buy-in – a bulk group annuity that more closely matches some of the liabilities within your plan. That way, the plan still owns all of the assets and liabilities within the plan."

"Then you begin to move towards a full LDI strategy where your assets and liabilities begin to move more in sync as the economic environment changes," continues Daniel. "Your funded status becomes more stable and then ultimately, you can move to full buyout if the plan sponsor so chooses."

The endgame question is interesting, but need not be imminent. "Pursuing a hibernation strategy involves some important decisions," says David Eichhorn, Managing Director, Investment Strategies at NISA Investment Advisors. "Each plan's circumstances are unique – whether it is fully funded or not, whether it has a glidepath, whether it has illiquid assets. Is it partially open, grandfathered or closed? All those issues factor into the question, 'What does endgame mean?' particularly for an in-plan strategy. It could be an annuity purchase, but that may be some years off."

Pursuing LDI to hibernation doesn't preclude a possible risk transfer in the future. "We haven't seen any other mega-transactions since the GM and Verizon deals," says NISA's Eichhorn. "There may be others in the future. But the trend we see is that companies are looking at locking down risk with asset allocation rather than doing annuity transactions."

The affordability of pension transfer solutions continues to be a concern. "Funded status is the most important indicator of the ability to afford a full buyout solution so that all risks, all assets and all liabilities can be transferred and the plan sponsor would therefore have no further

The derisking spectrum is broad, with each potential choice offering different benefits to plan sponsors. Cost and implementation issues must also factor into the decision

ongoing responsibility," says MetLife's Daniel. "The average plan is not in a state to afford a full derisking solution, so partial risk transfer is a consideration for plans that perhaps have a funded status of 80% or 90%. Hopefully, those types of solutions are viewed as steps that enable a plan to eventually reach full buyout at some point in the future."

A FORM OF DEBT

At its heart, pension settlement is a corporate finance decision, and so must be considered in light of the company's overall financial situation. "Right now, a pension deficit looks like a form of debt to interested parties – investors, banks, rating agencies, regulators, participants," says Glenn O'Brien, Managing Director, Pension Risk Transfer at Prudential. "From a corporate finance perspective, why should a company have a variable-rate obligation on the balance sheet associated with what is often a legacy business?"

In the light of enterprise considerations, some market players see a step up in thinking that DB pensions aren't a core component of many corporate strategies. "The corporate finance decision is based on the question of where is the company most rewarded for deploying capital," says Prudential's O'Brien. "The company probably isn't in the business of managing pensions. Is there a financial justification for staying in that business? If not, is there a benefit in moving out of that business? We see that thinking coming through a lot more in the last year."

"To make the right decision, a company first has to evaluate its pension liability on a fully loaded basis – what might be referred to as an economic liability basis," says Aon Hewitt's Jacobs. "That's different from the calculations of liability that are typically used for determining expense, contributions or balance sheet requirements. The economic liability is the true cost of operating the plan, including administrative, actuarial and investment management fees, and PBGC premiums."

This can be significant. "The biggest fundamental difference for plan sponsors to appreciate is that the existing funded status on an accounting basis may be quite different from the full buyout basis required to settle the plan," says MetLife's Daniel. "It's not just today's payments, but all future payments, permanently. This can come as a surprise when the buyout cost is higher than the current accounting cost."

FULL BUYOUT BASIS

It's not a straightforward calculation. "The economics are quite complex because of the number of different costs, benefits and considerations before undertaking any particular transaction," says MetLife's Daniel. "The costs include the total amount of money required to adequately fund the plan on a full buyout basis, which looks at the future projected liabilities under the plan, not necessarily on a current accounting basis that is more of a snapshot."

"The plan sponsor needs to consider foregone investment earnings as a result of reducing the investment risk," continues Daniel. "There may be accelerated recognition in the P&L of accrued gains or losses, so it's important that different stakeholders are involved in understanding these impacts."

In considering the decision from all perspectives, it is necessary to follow it through all the way to the end of the process. "From a corporate finance perspective, the company needs to compare the economic liability to the pricing of lump sum or annuity first," says Aon Hewitt's Jacobs. "Then, if it decides the pricing is favorable, it should next focus on the cash implications of any transaction. If the plan is underfunded, it will likely require the contribution of cash into the plan sooner rather than previously anticipated. The company must also consider the accounting implications, as there may be a settlement accounting charge to the income statement in the year of the settlement."

Crucially the decision-makers need to understand the ramifications of this comparison. "There's a behavioral finance issue here in comparing the economic and accounting liability," says Prudential's O'Brien. "We remind clients often that the accounting is insufficient and that the cash flow needed to service the obligation will be a premium over what they currently disclosed. When clients compare their own premium to keep and maintain the liability compared to the premium to transfer the liability, you see a shift happen in perspective. "

TIMING IS CRUCIAL

This analysis is important for other reasons. There's a common perception that pension risk transfer is, by definition, more expensive than holding the pension plan, in a derisked form on the balance sheet. "We see more and more plan sponsors comparing the true economic cost of pension ownership to the cost of transferring," says Prudential's O'Brien. "When factoring in regulatory expenses and mortality improvements that sponsors will need to recognize, the difference can be very small. We see examples where it will be less expensive for the sponsor to settle the obligation then hold onto it. "

However, straight cost is not the only consideration here. Timing is also crucially important in the corporate finance equation. "If you derisk internally, you have the luxury of spreading required contributions out over time," says NISA's Eichhorn. "And the amount of those contributions is relatively certain because you've derisked. We also think that hibernation is a little bit less expensive even with the ongoing costs that aren't part of a PPA or accounting liability valuation. We see clients interested in hibernation whether they've decided that's their endgame strategy, or whether they just want to be opportunistic in approaching the annuity market later."

A further wrinkle in the keep-or-transfer decision is a source of some confusion. "There is an ongoing debate about whether, from a security perspective, plan participants are better off under a PBGC guarantee than under an insurance company guarantee," says MetLife's Daniel. "First, the PBGC plan pays benefits only to a small percentage of private retirement plan participants. The plan sponsor of the business must go through a bankruptcy proceeding or liquidation. I would point out that, under the modern insurance regulatory regime, there has been no instance of a qualified pension benefit secured through a group annuity contract being paid at less than 100%. So the insurance industry has an absolutely golden record, even

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The Lump Sum Alternative

Lump sums are more popular at the moment because they are less expensive. "Lump sums are a single payment based on a set of interest rates that can be up to one year old," says Ari Jacobs, Senior Partner and Global Retirement Solutions Leader at Aon Hewitt. "It's possible that you can have interest rates that are different from current rates, leading to lower costs. Lump sums are also based on mortality tables that are somewhat dated and therefore offer the opportunity to pay out on a mortality expectation that is different from that used by the insurance companies."

"We know that lump sums won't require the use of the new mortality tables until at least 2016," says Aon Hewitt's Jacobs. "And it may not be until 2017 or later; that will be decided in Washington."

This market anomaly creates a window of opportunity for those companies able to take advantage of the situation. "Companies are weighing the economic cost of using lump sum benefits or annuities in defeasing pension liabilities," says William E. Ryan III, Chief Fiduciary Officer at Evercore Trust Co. "They would be comparing the interest rate costs associated with the payment of a lump sum vs. the purchase price options with respect to purchasing an annuity contract. That's a function both of the performance of the market and the actuarial calculations associated with a particular participant pool."

For many, the decision is even simpler. "If the lump sum or annuity is lower than 100% of the economic liability, then you would say it's a good economic transaction," says Aon Hewitt's Jacobs. "If it's higher than 100%, then the economics need to be looked at more closely. Insurance companies will typically charge a little north of 100% of the economic liability because of their profit, reserve and operational requirements. Lump sums are typically less than 100% because they don't include these expenses."

Lump sums are used for certain sections of the plan participant base. "We expect to see companies devising their strategy around the most efficient options," says Glenn O'Brien, Managing Director, Pension Risk Transfer at Prudential. "For active or soft frozen plans that are large compared to the income statement, this could be choosing to keep the actives, but transferring other groups where insurers are more efficient. In the event of a termination, that might mean lump sums to deferreds. Lump sums are attractive today, given the new mortality tables haven't yet been implemented."

That said, some plan sponsors are wary of offering retirees lump sums. "Retiree lump sums are still uncommon," says Aon Hewitt's Jacobs. "I think you will see more of them. GM and Ford did them in 2012, but they remain uncommon for various reasons. Some organizations feel they need an IRS private-letter ruling to do it. There's a concern about anti-selection costs if those that elect the lump sum are more unhealthy, while those that remain are healthier. Certain organizations don't believe in the idea of offering single-sum payments to individuals who are retired and on a fixed income. And there are many complex communications and administrative challenges associated with retiree lump sums."

"I see incremental, not large, movements in the pension settlement market," says Aon Hewitt's Jacobs. "But the discussion about how to look at your liabilities and the prospect of settling those liabilities is here to stay. I think we will see a lot more lump sums than annuities, as we already are."

during the financial crisis, of actually paying out full benefits."

"When you look at the sponsor and the PBGC next to an insurer and the state insurance side-by-side, I think there's a very, very strong case for the insurance framework," says Prudential's O'Brien. "It's performed incredibly well on behalf of participants. Companies that understand this are comfortable with the insurance company framework and the protections afforded participants in the annuity framework."

It also may be a bit of a tempest in a teapot, in that the issue only arises in certain cases. "The potential fiduciary and financial issues in comparing PBGC protections vs. state insurance guarantee funds, which were raised in the Verizon case, really only come into play in analyzing an annuitization that is not part of a plan termination – a 'lift-out' from an ongoing plan," says William E. Ryan III, Chief Fiduciary Officer at Evercore Trust Co. "Plan terminations effectively put an end to the right by participants to rely on PBGC protections in any event, since ERISA clearly allows plan sponsors to terminate pension plans through the purchase of an annuity."

UPDATED MORTALITY TABLES

Just in case this wasn't complicated enough, the baseline valuation of pension liabilities is set to change soon. "The mortality tables are being updated and will be incorporated in various valuations within the next few years," says NISA's Eichhorn. "These updates will incorporate 14 years of new demographic data and will change the valuation of liabilities meaningfully, easily by 5% or more. It's an improvement in modeling and longevity assumptions, but it's effectively just a marking to market of 14 years of historical experience. It's not new risk." (see page 16)

There's one important caveat that plan sponsors must remember as they seek the holy grail of full funding. While it's important to have a deep understanding of the economic value of the liabilities, there's no added benefit to overshooting a funding goal. "The considerations for an overfunded plan are a bit different from those of an underfunded one," says Aon Hewitt's Jacobs. "With an overfunded plan, there are a number of options available for the extra funding that bring with them significant tax and excise tax considerations. These vary from sharing the overfunding with participants, perhaps through a transfer to a 401(k) plan or paying a heavy 50% excise tax if all assets are returned to the company."

If a plan makes the decision to annuitize, it must devise an implementation strategy, whether fully or partially. This involves many stakeholders and a range of decisions (see box, page 5). First and foremost is the decision of

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PENSION RISK TRANSFER

which insurance partner to choose (see story, page 16, for a discussion of fiduciary responsibility). One element of this choice is the structure of the arrangement.

Most annuitizations are done with a single insurer, but that isn't the only option. "Multiple insurers in a transaction used to be more common," says Prudential's O'Brien. "It's used a lot less today because of the different structural enhancements like separate accounts that can be added onto a transaction. We've seen very large transactions done with single insurers because of the confidence that the structures provide. There's an efficiency to working with a single insurer."

LACK OF DIVERSIFICATION

From a risk perspective, though, is there some merit to spreading a transaction across several insurance companies? "There is some diversification gained by having multiple insurers," says Aon Hewitt's Jacobs. "And you may be able to increase your state insurance protection levels by providing multiple insurance certificates to your participants."

And although the market seems to favor single-insurer annuitizations, that may change in the future. "MetLife has undertaken transactions that involve multiple insurers in the past and we do have in-force contracts where we are a participant alongside other insurance carriers," says MetLife's Daniel. "So in principle, we would entertain that structure. The bulk of transactions today are with a single carrier. For the very large and complex transactions, splitting among insurance carriers may be the right solution. We have had conversations on this topic with other market participants, and for the right transaction, we would share with other carriers."

It's true that there are probably only eight or nine insurers operating in this market, and fewer in the larger end willing to take on large plan annuitizations. This lack of potential diversification does worry some independent fiduciaries. "With relatively few insurers in the market to issue termination annuity contracts, one option to explore (especially for larger plans) is syndication," says Evercore's Ryan. "Particularly for larger plan annuitizations, plan fiduciaries concerned about a narrow choice of annuity providers may investigate whether two or more insurers can effectively 'co-insure' a single plan contract through a syndicate rather than having the entire contract issued by one insurer. While this may broaden the number of insurers who may be able to bid on a particular book of business, and arguably diversifies the risk, this option has its own administrative complexities and costs."

"There are a number of administrative complexities in actually paying a single annuity benefit from multiple insurance carriers and tying multiple contracts into a single integrated structure," says Evercore's Ryan. "And there are relatively few insurers that can handle those complexities."

Once the insurer question is settled, the matter of the deal structuring comes up, namely whether the annuity contract is held under the insurance company's general account or in a separate account. Again, opinions differ. "There are advantages and disadvantages to what are known as insurance company 'general account' contracts, which are issued off the full balance sheet of the insurance company, rather than being supported (in whole or in part) by dedicated separate accounts," says Evercore's Ryan. "Assets held in the general account supporting such contracts are strictly regulated by the insurer's state regulator, but may also be subject to the claims of the insurance company's creditors. An insurance company separate account can be constructed to support a particular plan, but that usually occurs for the largest plan contracts. Otherwise, multiple separate account contracts may be supported by the same separate account, in which assets of multiple plans may be commingled."

OTHER MECHANISMS

To an extent, the choice depends on the assessment of the company and its fiduciary, whether independent or not, representing the interests of the beneficiaries. "Separate accounts offer an extra layer of protection for participants," says Prudential's O'Brien. "We've been doing them for both small and large deals. It's a fiduciary decision as to which structure best serves participants. It can depend on a number of factors that sponsors should consider. We still see and the industry conducts many general account transactions, as well."

"Separate accounts are more ring-fenced," says Evercore's Ryan. "The assets are devoted to either a single annuity contract or a limited universe of contracts, which may provide added financial security in the event of the insurer's insolvency. There are, however, other mechanisms that the insurer may have in effect to protect its obligations to pay, such as state guarantee funds, reinsurance arrangements or derivatives that can be used to backstop the financial obligations for a general account contract.

There is a cost factor here, with a separate account annuity usually being more expensive. Hybrid solutions do exist. "Most insurance companies will say that they issue separate account contracts for relatively small plans, which is absolutely true," says Evercore's Ryan. "However, the separate account contract being issued may not be a dedicated separate account/separate account contract for one plan, which are usually done only for very large plan deposits ($1 billion and up)."

For smaller annuitizations that don't want to use the general account, the alternative may be a pooled separate account contract, where the plan is investing with a number of other plans in a commingled account, each plan being issued their own contract," says Evercore's Ryan. "The assets in pooled separate accounts are ring-fenced from other insurer obligations, but the pooled plan contracts do potentially share investment experience and risk."

Cost is always an element of any decision. "Cost is a factor in choosing an insurer, but it isn't purely a cost factor," says MetLife's Daniel.

> When readying a plan for settlement or risk transfer, all advisors would advocate cleaning up your data. Data issues can significantly complicate any of these transactions

Ease of implementation can also feature. "With respects to the mechanics of an annuity purchase, an all-cash transaction by the plan is generally simpler," says Evercore's Ryan.

"If you look at the publicly available documentation on the GM deal, you can see how involved the process of transferring non-cash assets was," says Evercore's Ryan. "There is both a valuation component with respect to the assets (especially true of plan portfolios that may not have a readily available market price) and a willingness of the insurance company to accept the particular assets being offered. There can be advantages to in-kind transfers (for example, potentially reduced transactional costs), but the appetite for engaging in these types of transactions vary among insurers. In some cases, insurers will be happy to take certain debt obligations if they fill gaps within their own portfolios."

Cash is king in smaller plan annuitizations. "For the vast majority of smaller transactions, a cash transaction is a lot simpler and that continues to be the typical mode of transaction," says MetLife's Daniel. "However, as we get to larger transactions, typically $500 million or more, then in-kind assets become a more important feature. We would then sit down with the plan actuary and the investment profile of the plan to understand the asset mix. Where a plan has been actively employing LDI and aligning their assets towards their liabilities, we can probably

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Evercore Trust Company, N.A., a national trust bank and subsidiary of Evercore (NYSE: EVR), serves America's leading corporations by providing specialized investment management, independent fiduciary and trustee services for employee benefit plans. Assets under administration as of April 30, 2014 are $38.8 billion.

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take more assets in-kind. If there isn't good alignment, we would scale back and request more of the payment in cash."

"For smaller deals, there's usually no difference in price for settling in cash or securities," says Aon Hewitt's Jacobs. "As the deal gets larger, insurance companies may require that the company delivers securities, not just cash. It's typically an economic decision for the plan more than anything else."

IN-KIND ASSET TRANSFERS

But what constitutes small may differ from insurer to insurer. "Cash is the most efficient way to settle smaller transactions," says Prudential's O'Brien. "Just what is small and what is big depends on the size of the insurance company. Smaller insurance companies will be able to put smaller amounts of money to work on a monthly basis. Larger insurance companies will be able to put larger amounts to work. So our threshold of where it is efficient to take on cash is probably higher than others."

Transitioning in-kind assets is obviously a more complicated and time-consuming process. "On the larger end of the market, we think in-kind asset transfers are very efficient and can reduce cost," says Prudential's O'Brien. "Here it is important to work with your insurer early on in the process to design a portfolio that the insurer can take easily in order to reduce or eliminate the lag."

"Some illiquid assets already held in a plan (such as limited partnership interest or other private funds) may require advanced planning to figure out whether it is possible to sell them favorably, or whether they can be used on a sale or exchange basis in the annuity contract," says Evercore's Ryan. "That was done in the General Motors deal, but it takes time."

If the portfolio has been prepared properly in conjunction with the insurer, it can be a win-win situation. "Being able to take more in-kind assets can save transactional costs and is a preferable route where possible," says MetLife's Daniel.

It's all in the preparation. "The larger the annuitization, the more likely it is to have some kind of in-kind transfers," says Evercore's Ryan. "Even in smaller transactions, consultants have been advising plan sponsors to consider implementing an LDI strategy in order to create a portfolio that may be more attractive for an insurer to assume."

An oft-forgotten part of the process is information. A plan isn't ready to transfer until all the beneficiary data is up-to-date. "When readying a plan for settlement or risk transfer, all advisors would advocate cleaning up your data," says Evercore's Ryan. "Make sure you understand not only who your participants are, but what the historic and current benefit formulae and options are, who are their beneficiaries, and do you have current records for their addresses, Social Security numbers, and the like. Data issues can significantly complicate any of these transactions."

With the majority of U.S. DB plans on a derisking trajectory, questions arise about capacity – in the long-duration bond markets and within insurance companies – to support the range of possible solutions. "There has been strong demand for long duration fixed income, from the folks derisking internally and from the annuity market," says NISA's Eichhorn. "There has been plenty of supply out there thanks to new corporate issuance over the last few years, though obviously that could change. But the good news for pension plans is that if the long corporate bond market ever feels too constrained, there are plenty of other ways to remove interest rate risk and even replicate spread exposure."

STEADY FLOW

Bond market capacity is potentially an issue for both pension plans and insurance companies, but with the current vogue for settlement and risk transfer, is there enough insurance capacity? "There are about $3 trillion of accumulated assets and liabilities within the U.S. defined benefit pension system," says MetLife's Daniel. "I feel confident that the insurance industry will be able to meet derisking demand. Of course, if all of those liabilities were trying to derisk this year, there wouldn't be sufficient insurance capacity. I think the best way of thinking about this is that, as a practical matter, it is a multi-year, probably multi-decade process. Over the next one or two decades, I would expect to see a steady amount of derisking activity, year in and year out."

Others are less convinced about the insurance industry's ability to digest the volume of transactions. "There is the capacity question for insurance companies doing annuity transactions," says NISA's Eichhorn. "It's been a market of several billion a year, when you set aside the mega-deals like Verizon and GM. Could the market systematically take down $100 billion a year? Anytime a market spikes up 20 to 30 times, you at least have to ask the capacity question."

More neutral observers see signs that the insurance market may change in the future. "Currently, the capacity in the insurance industry is fine," says Aon Hewitt's Jacobs. "We are seeing a somewhat more selective market in terms of the risks and types of liabilities that insurance companies are willing to acquire."

An insurer disagrees with this assessment. "I see ample insurance capacity for pension risk transfer," says Prudential's O'Brien. "There's a deep market. We want to be a large provider in this market and continue to pursue that goal. We haven't changed our definition of what kinds of transactions we want to do. I think there's more capacity than demand, and don't expect to see that changing for any measurable period of time."

Of course, capacity per se is not the only issue influencing the market for settlements. "The first consideration is that, in order to defease pension liabilities using annuity, the number of vendors selling eligible annuity products is relatively limited. U.S. plans are limited to using U.S.-regulated annuity providers," says Evercore's Ryan. "Further, and depending on the size of the annuitization, the number of U.S. carriers ranges from eight or nine insurers (for smaller contracts) to as few as two to three for larger annuitizations. As you know, some of the larger U.S. insurance companies have already completed very significant transactions. Even if these firms continue to offer the products, the rate at which they may engage new business may slow down eventually as these insurers need some time to absorb these deals."

"With respect to insurer capacity for annuity sales, one concern here is timing," says Ryan. "Two factors that make it more attractive for plan sponsors to consider annuitizations are the improved funding status of these plans (thanks to the performance of the markets) and the impact that rising interest rate adjustments may have on both the plan's portfolios and the cost of lump sums vs. the annuity from the insurer. Annuitization may become cheaper, particularly compared to lump sums as interest rates rise."

For companies that come to the decision that they don't want to be in the pension or asset management business, insurance companies may be the natural home for these liabilities – and assets. "Group annuity contracts are an important element of the overall defined benefit system in the U.S.," says MetLife's Daniel. "I believe that insurance companies are uniquely suited to manage the mix of risks within a defined benefit pension plan because insurers are regulated for long-term solvency. Our core business is the pooling of mortality, longevity, investment, credit and administrative risks. It's our core expertise, so that's why I believe that this complex, illiquid, extremely long duration mix of risks is best managed within a long-term, broadly balanced insurance portfolio."

As the market for pension settlements grows, more companies are identifying benefits from the process. "We see a continued and growing demand for pension risk transfer," says Prudential's O'Brien. "Those that have done a transaction have seen expense reductions, a streamlined investor message and a continued focus on core business issues. The demand side continues to be strong but is correlated to funded status. The pace of adoption is harder to judge. We continue to be bullish and expect the three- to five-year adoption rate to increase." ↺

Longevity Risk: Looking Forward, Not Back

Although it's a relatively small percentage of overall pension risk today, as derisking takes effect, longevity risk will grow in importance

Longevity risk is the potential risk attached to the increasing life expectancy of pension participants, which can eventually translate into higher-than-expected payout ratios for a pension fund. U.S. workers are living longer, a fact that will be made starkly real when the new mortality tables issued by the Society of Actuaries are incorporated into pension actuarial calculations in 2016 or 2017.

But the new mortality tables represent risks that are already apparent. "What is important about longevity is prospective risk, not the catch-up risk represented by the new mortality tables," says David Eichhorn, Managing Director, Investment Strategies at NISA Investment Advisors. "That's harder to quantify, but that's the real risk you hedge in a transaction. We estimate that on an annualized basis, longevity represents about 0.5% in funded status volatility terms. That means a 0.5% change in funded status would be a one standard deviation event in a given year. That's not trivial, but it puts longevity risk in context with equity risk and interest rate risk. It hasn't been addressed directly in the U.S. because there's been bigger fish to fry."

SMALLER THAN OTHER RISKS

That is one view, but others contend that the integration of the catch-up in longevity risk into plan calculation will be jarring. "People talk and write about longevity risk and the volatility around longevity risk being marginal," says Glenn O'Brien, Managing Director, Pension Risk Transfer at Prudential. "So the implication is that companies shouldn't worry about longevity risk. While I agree that longevity volatility is smaller than equity and interest rate volatility, the economic impact of longevity improvements is substantial. We will soon be marking up the estimated $2.5 trillion in U.S. corporate pension liabilities by 7% to 9%. That's a large and important number that is going to directly impact company performance and capital allocation plans."

It's also important to consider the relative size of longevity risk in relation to the larger plan risks that plan sponsors are attempting to mitigate. As plans move down a derisking glidepath and funded status risk drops from 8% or 12% down to 3% or 4% in hibernation, then the relative importance of longevity risk will rise," says Jess Yawitz, Ph.D., Chairman & CEO at NISA Investment Advisors. "That's when we expect more plans will look to hedge longevity. Until then it would be false precision for that to be the first derisking trade."

Whatever the view of its importance, longevity risk exists. So should it be hedged? "We believe that if a risk is uncompensated, then you should go out and hedge it, as long as you can do it in a reasonably cost-effective way," says NISA's Eichhorn. "Longevity swaps would be a way to lay off that risk. But the market is not well developed or cost-effective enough to be attractive at this point."

MARKET COULD PICK UP SPEED

There may not be enough drivers yet to envisage a vibrant market developing anytime soon. "Up until now, longevity-centric solutions have been more active in the U.K. than in the U.S.," says Wayne Daniel, Vice President and Head of U.S. Pensions at MetLife. "One of the key reasons for that is that U.K. pension schemes typically have inflation-linked benefits, and that significantly increases the amount of longevity risk. In the U.S., longevity risk is less high up on the priority list."

Longevity swaps are available in the U.S., at a price. "The new mortality tables may help because it will take some of the sticker shock off the pricing of longevity swaps, which were already using newer projections," says NISA's Eichhorn. "But we think the holdup is the triaging of all the risks that need to be dealt with. Plan sponsors have made other risks higher priorities than longevity, but the longevity swap market could pick up speed as they bring those other risks under control."

It's important not to confuse derisking with pension settlement. "Longevity swaps aren't really a settlement," says Ari Jacobs, Senior Partner and Global Retirement Solutions Leader at Aon Hewitt. "They are just a hedge or a risk reduction against the plan's longevity risk. The plan sponsor still holds onto the liability. All you've done is hedge the risk by making another organization responsible."

"I think that in the U.S., organizations will use annuities or lump sums to manage longevity risk, rather than synthetically through longevity swaps," says Jacobs. "In the U.K., where longevity swaps are more commonly used, pensions are adjusted for cost of living, so over time the cost of mortality is higher. There's more of a need to hedge this risk." ↺

Satisfying Fiduciary Responsibility

When it comes to pension settlements, company plan sponsors may wish to consider hiring an independent fiduciary to represent the interests of plan beneficiaries

One of the first issues a company considering an annuitization as part of the pension derisking process must decide is how to meet its obligations as a fiduciary. "In the U.S., a plan sponsor has both a settlor and a fiduciary role," says Wayne Daniel, Vice President and Head of U.S. Pensions at MetLife. "As a settlor, the plan sponsor has the right to amend the plan. This includes the right to terminate the plan. The plan sponsor is also the primary fiduciary and so has the right to determine how the assets will be invested and how the plan will be managed. When a plan sponsor is proposing a derisking or a partial risk transfer, there is a fiduciary aspect to that decision, including deciding which insurance carrier to retain."

Part of the fiduciary decision involves weighing in on whether the beneficiaries will be best served by risk transfer at that time. "There's a tension between the sponsor's objectives and the fiduciary's requirement to get the safest available annuity," says David Eichhorn, Managing Director, Investment Strategies at NISA Investment Advisors. "And there's only so much capacity for annuities at any one point in time. Derisking first with hibernation and later with annuities allows you to be price sensitive and flexible to the environment changing. For the fiduciary, that may be a real positive, to avoid second-guessing down the road."

SOLVENCY ISSUES

The choice of an insurer for annuitization is guided by the Department of Labor Interpretative Bulletin 95-1. "The factors to be considered include, but are not limited to, the financial strength and solvency of the insurance company," says William E. Ryan III, Chief Fiduciary Officer at Evercore Trust Co. "You look at the risk ratings, the public finance information with respect to the company's solvency, the insurance rating agency information and the various components of the actual contract."

Sometimes it may not be possible for the company to maintain both the settlor and fiduciary roles. "If the named fiduciary responsible for the plan is unable or conflicted out of making a decision on behalf of the participants, then it may make sense to hire an independent fiduciary," says Ari Jacobs, Senior Partner and Global Retirement Solutions Leader at Aon Hewitt. "The role of the fiduciary is to make decisions specifically and solely for the benefit of participants. Corporate officers who are the named fiduciary may feel they are unable to do this independently. They also may not have the expertise in insurance rules and annuity purchases that is required here. Typically, larger deals are more likely to have an independent fiduciary than smaller deals. The context must be, though, that the participants have a clear voice and representation in the process."

DE FACTO DEBT

That said, tensions aside, the company has the right to transfer pension risk. "The decision to buy an annuity is a corporate finance decision," says NISA's Eichhorn. "The choice of annuity providers is a fiduciary decision. The corporate finance decision has to be taken at the highest level, as the transaction may effectively change your leverage ratio or have a big liquidity impact. The company has a pension obligation that is a de facto debt of the organization. It owns lots of equities and other assets against that obligation, but it is still inherently more levered than a company that does not have that debt on the balance sheet. In enterprise terms, a company that derisks by annuity or hibernation reduces enterprise risk. For companies with very large pensions relative to their market cap, this can have a big impact."

It is usually the larger transactions in which an independent fiduciary is engaged. "The plan sponsor company is the settlor and also a fiduciary," says Glenn O'Brien, Managing Director, Pension Risk Transfer at Prudential. "Sometimes, though – and the choice of an insurer in a pension risk transfer is one of those times – it can make sense to bring in an independent fiduciary to make sure the decision isn't second-guessed. In 99% of the transactions, we don't see an independent fiduciary involved, but that 1% where there is one involved may cover 30% of the assets that have been transferred."

"There can be a sound rationale for bringing in an independent fiduciary because it's another set of eyes to evaluate the qualitative aspects of the transaction, as well as the economic ones,"

says O'Brien. "It's usually the larger plans that use an independent fiduciary. The larger the transaction, the more it looks like the divestiture of a business has that complexity."

Fiduciaries always need to consider a range of issues, but the impact of some will be greater, the larger the transaction. "As the fiduciary reviewing the alternatives, you want to make sure that the insurance company can not only make the financial commitment to pay the benefits, but that they also have the administrative wherewithal to make the payments to the right individuals," says Evercore's Ryan. "Questions to consider include whether or not the particular insurer has a good track record in claims processing; do they have a call center that has received many complaints from various state insurance agencies; do they have a very good track record about providing participants information about their benefits; and do they provide insurance certificates to participants on a timely basis and are these accurate? In selecting an insurance carrier, the fiduciary should consider not only the financial strength of the institution, but the administrative strength as well." ↺

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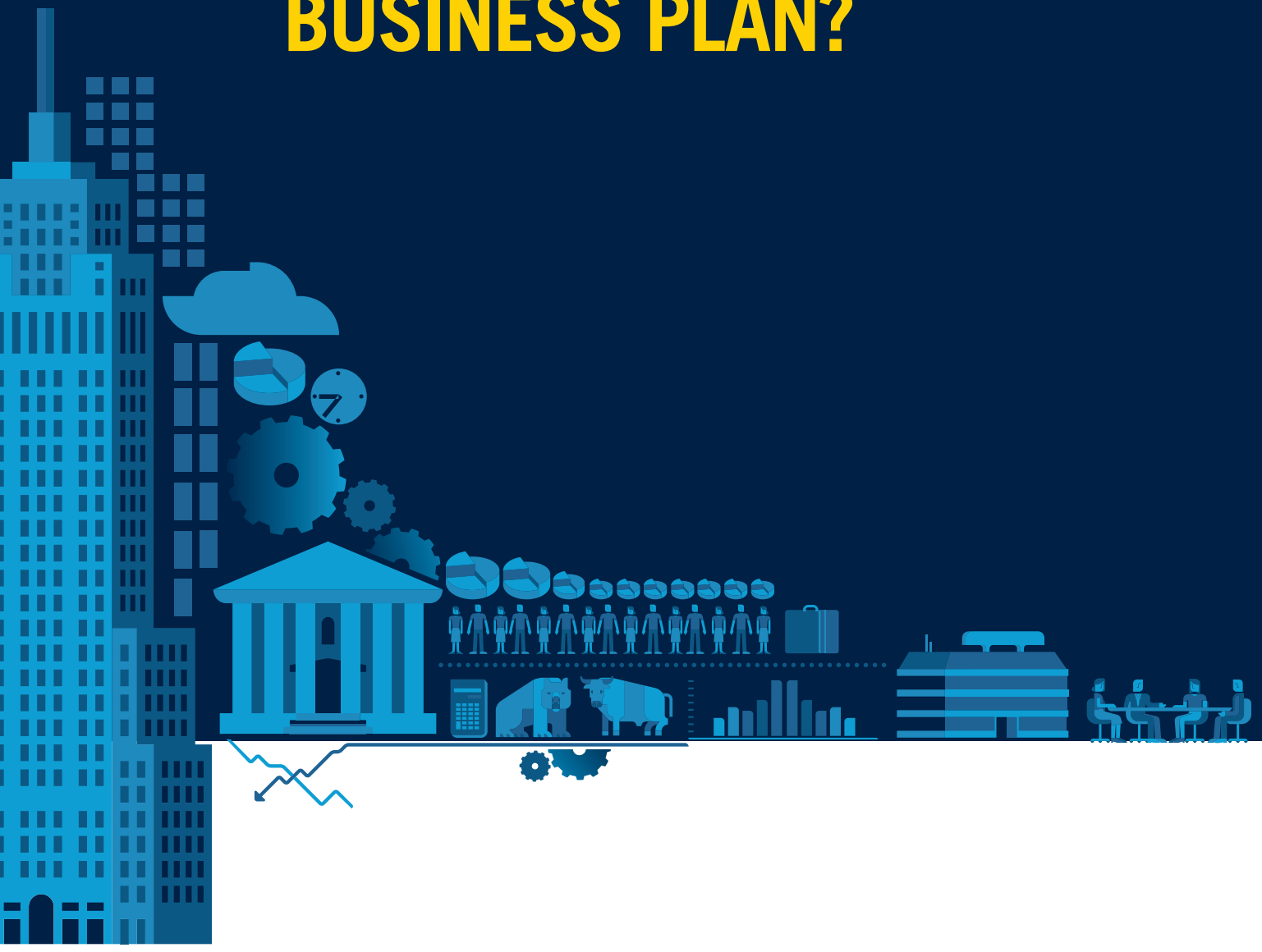

[1]Based on fund sponsor rankings in *Pensions & Investments,* September 2013. [2]*Pensions & Investments* 2013 Annual Money Managers Directory. [3]LIMRA Group Annuity Risk Transfer Survey, 4Q 2013. Guarantees are based on the claims-paying ability of the insurance company and are subject to certain limitations, terms and conditions.

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