hooker & holcombe

Pension Risk Transfer – optimizing the approach to private plans during a low interest rate environment

According to the Federal Reserve, pension plans, in aggregate, represent almost $10 trillion dollars in assets. Due to the shifting nature of work, over a decade of suppressed interest rates and new rules for valuing liabilities, these plans are more challenging to manage than they were years ago. Retirement plans have also shifted from defined benefit (pension) to defined contribution (401k) plans, with only an estimated 5% of corporate pension plans having been bought out to date. Pension risk transfers allow some companies to reduce some or all of the pension plan's liability and risk by offering lump-sum distributions to inactive participants or by purchasing annuities from insurance companies to provide participants' promised benefits.

Even with a well-funded plan, the sponsor may still need to contribute funds in order to achieve the projected funds needed to meet its plan obligations. This leaves many plan sponsors facing an important question – *should I de-risk by transferring some or all of our pension liability to another party?*

What is a Pension Risk Transfer?

A pension risk transfer reduces some or all of the pension plan's liability and risk by offering lump-sum distributions to inactive participants or by purchasing annuities from an insurance company.

It's never too early to start planning for a pension risk transfer, but this can be especially true when interest rates are at record lows. Savvy plan sponsors know the markets can quickly turn and they need to be prepared to recognize the right time to buy annuities for retirees.

If you're a plan sponsor, consider the following advantages (and disadvantages) of this effective strategy.

Advantages

Reduced PBGC premium – By purchasing annuities, companies with pension plans below the PBGC variable premium cap can realize savings per retiree. By focusing on retirees with small benefits, plan sponsors could maximize savings and help manage the cost of the pension risk transfer. There will also be a reduction in the overall PBGC per participant premium.

Supply and demand – Today, insurance companies have capacity to buy retiree annuities. Will this level of capacity continue if interest rates rise and more pension plans start looking to sell? After all, supply and demand has taught us if there is a large group of plan sponsors wanting to execute pension risk transfers, the premium may not be as attractive when compared to the economic cost of retirees' liability. Could a spike in low interest rates reduce pricing competitiveness?

Economic Savings – When considering the purchase of an annuity, plan sponsors should remember to focus on the full "economic cost" of running a plan, not just the accounting liability. A plan's full "economic cost" is the accounting liability plus the PBGC premium, investment, and administrative costs. The cost of the annuity will generally be determined based on high quality fixed income investments, administration and investment costs until the last participant death, a conservative mortality assumption and estimated profit. The elimination of the volatility in the plan may be more valuable than the additional upfront cost for an annuity.

H&H annuity savings – Insurance companies can be competitive with their retiree annuity premiums because they have experience predicting mortality for retirees and there are fewer unknowns. Many actuarial or annuity transfer firms charge a commission or fee based on a percentage of the annuity purchase. *This is where H&H can add additional value:*

we do not charge commission on the purchase of the annuity. Our services are based on hourly rates to cover the cost of the vendor search, preparation and delivery of the plan information to the interested insurance companies, solicitation of annuity quotes and recommendation of a provider. The total cost of these services is usually significantly lower than paying a commission.

There are also disadvantages of pension risk transfer, but it's still worth a second look.

An increase in Minimum Required Contributions – Although a retiree pension risk transfer can increase the minimum required contribution of a plan due to differences in assumptions, the contributions are typically viewed as an acceleration of future contributions. Additionally, the loss realized due to the difference between the insurance premium paid and the liabilities released is amortized and paid over the next seven plan years. However, as the minimum required interest rates drop, future contributions will increase if the retirees remain in the plan.

The triggering of Settlement Accounting – A significant retiree pension risk transfer may trigger settlement accounting for a pension plan, resulting in a one-time charge to the income statement. Obstacles could arise depending on the sensitivity of one-time charges for a particular company. However, a settlement that is "below-the-line" cost under accounting rules can make the settlement less of an issue for most companies. Should settlements prove to be an obstacle for your organization, executing multiple smaller pension risk transfers with lower premiums over a number of fiscal years can help with managing settlement costs.

Funding status is below the required 80% – It's a hard rule: Annuities cannot be purchased and full lump sums cannot be paid from a plan that is not 80% funded on a PPA interest rate relief basis unless the plan sponsor makes some immediate funding to the plan. Keep in mind that most annuity purchases or lump sum payments will lower the funded percentage of the plan. However, since the 80% funded status threshold is determined based on a smoothed interest basis, the funded status may be more than 80% even in this low interest rate environment.

Be prepared. Even in a historically-low interest rate environment, plan sponsors should be ready to buy annuities by getting their data ready.

Interest rates continue to remain low, and it makes sense to monitor them to remain informed. Plan sponsors should be ready to buy annuities by getting their data ready, finding missing participants, updating contact information, and setting a targeted annuity premium. Once the target is met, they will be ready to move more quickly to execute the pension risk transfer.

To get started, we recommend having an actuary perform a financial analysis to determine the impact of a pension risk transfer on your plan. Armed with this financial information, most plan sponsors can be ready to move quickly and recognize the right time to buy annuities for their retirees.