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Transferring Risk

Jump-started by two huge deals, the US pension risk transfer market has taken off.

by Angelo John Lewis

Four years before the two mammoth multibillion-dollar U.S. pension risk transfer deals that transformed the industry, Robert Goldbloom had a sense that 2012 was the year the market for pension risk transfer would begin to take off.

Then a senior vice president at AIG, Goldbloom knew that key legislation and an IRS ruling would spur plan sponsors to remove unwanted pension obligations from their books by offering lump sums to pension plan participants and in many cases follow that with a group annuity contract (or "buyout") from an insurance company. "I had a sense back in 2008 that 2012 was going to be the year that this market would take off. For one thing, it became more favorable to pay lump sums. You could foresee hundreds of billions being lumped out," said Goldbloom, now co-founder and principal of Penbridge Advisors, which consults with defined benefit sponsors about pension risk transfer.

A provision of the 2006 Pension Protection Act provision made it cheaper for private sector employers to wait until 2012 when favorable lump sum rates were scheduled to be fully phased in. For plan sponsors considering a full buyout with an insurance company, a good strategy was to wait until that year and then offer lump sums before initiating a buyout.

Also in 2008, the IRS issued Revenue Ruling 2008-45, which essentially made it impossible for sponsors to transfer their unfunded pension obligations to a third party that would assume the role of plan sponsor. Some investment banks had considered becoming active in the "plan sponsor business," according to Goldbloom. Although it didn't say so explicitly, the ruling made it clear that the only avenues for plan sponsors to remove pension liabilities from their books was through lump sums or an annuity contract issued by a life insurance company.

Lump sums and/or buyouts were employed as part of the two largest pension risk transfer transactions in U.S. history, both of which occurred in 2012 and involved Prudential Insurance Company of America. That year, General Motors paid Prudential $25.1 billion for a group annuity for employees who did not

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Key Points

The Source: Although pension risk know-how developed in the U.K., big-ticket transactions have shifted the spotlight to the United States.

The Incentives: Increased fixed costs for maintaining pension plans and recently implemented Society of Actuaries mortality tables have given some plan sponsors the motivation to begin pension risk transfer.

The Unknown: Long anticipated rises in interest rates can either increase plan sponsors' incentives to do PRT or cause them to keep their plans as rising rates will reduce the size of plan liabilities.

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accept or were not offered a lump sum. Verizon paid the insurer $7.5 billion for a group annuity for 41,000 of its retirees.

About a dozen insurers are now active in the buyout market, ranging from those who seek smaller deals to those pursuing multibillion-dollar transactions. Prudential, AIG, MassMutual, MetLife, Pacific Life, Principal Life Insurance Company, Mutual of Omaha, and OneAmerica are among the companies that are involved in this space.

"All the time I worked at AIG, each year had $1 billion to $3 billion total in deals. Now, we're seeing more big deals. Before, it was mostly small companies getting rid of nuisance plans or maybe it was in conjunction with an M&A and the acquirer saying, 'we don't want your pension plan—get rid of it.'" Goldbloom said.

On the highest end of the market is Prudential Financial Inc., which toward the end of 2014 was managing the pension benefits of nearly 2 million participants at more than 5,700 companies, according to a Best's Briefing, *U.S. Pension Risk Transfer Market Heated Up in 2014* (Dec. 19, 2014).

"There has been a broad transformation in the U.S. pension market in the sense that many plan sponsors don't look to defined benefit programs as their primary source of delivering retirement benefits to their participants."

Matt Herrmann,
Towers Watson

"There's an expectation that with market conditions being favorable in the U.S. there is a good likelihood that interest rates will rise, so plan sponsors want to be positioned to take advantage of that opportunity."

Sean Brennan,
Mercer

"Although the GM and Verizon transactions didn't emerge until 2012, Prudential recognized this opportunity early and began building the infrastructure and capitalizing for this business back in 2006," said Prudential's Scott Kaplan, senior vice president and head of pension risk transfer.

One company pursuing smaller deals is OneAmerica (American United Life Insurance Company) which last year re-entered the pension risk transfer market after an absence of 20 years. The company's buyout annuity product last year generated $51 million in sales premium.

According to Andy Wilkinson, OneAmerica vice president and managing principal, his company targets group annuity premium deals that are less than $50 million. "That's our target, although we have the capacity to do more," he said.

Wilkinson described the pension risk transfer market as an "intermediary-run market," in which third-party firms vet both plan sponsors and insurers to determine potential matches.

"They perform a valuable service for us because, if we're working with them, we know that they've thoroughly vetted the clients. One of the issues with plan sponsors is that they sometimes don't have enough money to do a pension risk transfer. So, we don't want to burn a lot of calories on opportunities that are not going to happen. Also, they do a fair amount of scrubbing of the data and the bid package, so that there aren't any surprises after the fact," Wilkinson said.

According to Goldbloom, some third parties are firms with actuarial capabilities, such as Aon Hewitt, Towers Watson, Deloitte or Mercer. These companies provide actuarial services to current plans and may be instructed by their clients that they wish to terminate their plans.

"These companies don't necessarily go around and encourage plan sponsors to terminate because they'll then lose the golden goose as the actuary because of their revenue from providing the actuarial valuation and other support services. But if a plan sponsor does decide that they definitely want to terminate, they can help them do that," Goldbloom said.

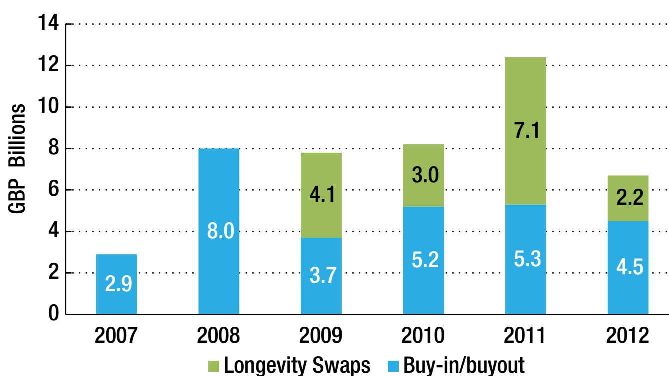
Mercer, the global human resource and financial services consulting organization, advises organizations involved in pension risk transfer.

Sean Brennan, a partner in Mercer's financial strategy group and the company's U.S. lead buyout strategist, described his company's role in facilitating these transactions:

"Quite a few plan sponsors agree in principle that lump sums or annuity buyouts make sense. But, then it's also a matter of getting them to do so at the optimal time and taking the optimal approach for them. We'll do all the calculations required, help the company put in place a really robust communications process and work with the company to understand the financial implications of the timing. On the annuity buyout front, we engage with insurance companies, negotiate on price and support the corporate and fiduciary decision-making around which insurer to ultimately select," he said.

There are also about a dozen annuity placement

specialists who focus on smaller companies involved in pension risk transfer, a busy area of the sector. "They tend to do placements on the smaller end, certainly under $100 million. The medium-size case is around $10 million. Half of the deals getting done are maybe less than $10 million," Goldbloom said.



Source: Hymans Robertson

Changing Plans

The phenomena of pension risk transfer in the U.S. comes at a time when private sector employers are de-emphasizing defined benefit plans in favor of defined contribution plans, which shift the primary responsibilities of retirement savings to employees. According to the Employee Benefit Research Institute, 62% of employees that had retirement plans in 1979 had defined benefit plans, versus 7% in 2010. The same period saw the rise of defined contribution plans among employees that had retirement plans from 16% to 69%.

"At the highest level, there has been a broad transformation in the U.S. pension market in the sense that many plan sponsors don't look to define benefit programs as their primary source of delivering

Pension Risk Transfer: Buy-Ins and Longevity Swaps

Although annuity buyouts are the preferred form of pension risk transfer in the United States, plan sponsors can utilize two additional strategies to de-risk plans: buy-ins and longevity swaps.

With a buy-in, insurers agree to pay sponsor pension payments, although beneficiaries still remain on a company's books. Buy-ins have the advantage of avoiding the one-time settlement charges that occur with buyouts and also allow the sponsor to hedge longevity and interest rates. The sponsor is still responsible for ongoing expenses such as administrative fees and Pension Benefit Guaranty Corporation premiums.

"Some people think of buy-ins as the perfect LDI [liability driven investment] strategy because it not only hedges your interest rate risk, it hedges your mortality risk, but you don't put it outside of the plan, so it doesn't cause a settlement. Although that's something that a couple of people in the U.S. have tried, it hasn't really taken off," said Timothy J. Geddes, a director, in Deloitte Consulting's human capital practice.

"In the U.S., usually when you begin to have the conversation about pension risk, decision-makers usually come to the conclusion that if I'm going to enter into a significant transaction I would like to be out of this liability and that means a buyout," said Scott Kaplan, Prudential senior vice president, head of pension risk transfer. "Doing a buy-in doesn't eliminate the PBGC liability from your book, so it doesn't eliminate the premium, it just acts as an asset of the plan, but it has the same risk reduction implications."

According to a Mercer white paper, *Briefing on Buy-in Annuity Contracts*, a buy-in might serve as an interim step. "Sponsors may therefore consider a buy-in as a shorter-term solution—an intermediate step on the path to a buyout," the white paper said.

In a longevity swap, the pension transfers the risk of paying for its pensioners living longer than expected to a counterparty, such as an investment bank or insurance company, in return for an agreed stream of payments.

In March, BCE Inc. announced a deal with Sun Life Financial Inc., in which the latter would insure approximately $4 billion in pension liabilities for current retirees in the Bell Canada Pension Plan. According to press reports, that transaction was the first longevity swap conducted outside of the U.K., where the practice is relatively common.

"A key difference in the U.K. and U.S. market is that many U.K. pension liabilities are inflation adjusted, so when you think about the impact of someone living longer that tends to have much bigger impact in the U.K. than here. On the corporate side in the U.S., most pensions of any size are not inflation-adjusted, so it's not as big of a deal," said Mike Moran, Goldman Sachs Asset Management's chief pension strategist.

"One of the motivations for some risk transfer in the U.S. has been tied to the higher cost of the plan through higher premiums that have to be paid to the PBGC. As the participant premium goes higher, I as a sponsor will have an incentive to try to move that participant off my books and buying an annuity is one of the ways to do that. If I do a buy-in or a longevity swap, I still have that participant on my books. So while it is a tool in the toolbox for pensions risk management, it doesn't remove that participant from my pension rolls," Moran said.

retirement benefits to their participants," said Matt Herrmann, senior consultant at Towers Watson and leader of the organization's retirement risk management group. "A number of organizations have either frozen or closed plans that ultimately are just not consistent with managing their ongoing business. Or they're concerned about controlling the size of ongoing plans and are looking for answers that allow them to continue to manage inactive ongoing plans, but with controlled growth relative to the size of their obligations."

"If [pension sponsors] can find it at the right price, I think [they'll] look to transfers to reduce their pension risk and to focus on their business."

Timothy J. Geddes, Deloitte

"All the time I worked at AIG, each year had $1 billion to $3 billion total in deals. Now, we're seeing more big deals."

Robert Goldbloom, Penbridge Advisors

Costs Matter

For managers of the estimated $3.2 trillion that remain in the private pension plans, maintaining these plans has grown increasingly expensive.

According to a 2014 analysis conducted by Deloitte for the Society of Actuaries, fixed costs for maintaining pension plans through Pension Benefit Guaranty Corporation flat rate premiums will nearly double. Premiums for unfunded vested benefits are scheduled to more than triple from 2012 to 2016. The PBGC is the government agency that insures the benefits of private defined-benefit plans and charges fees from plan sponsors.

"The cost of these plans is moving higher," said Mike Moran, Goldman Sachs Asset Management's chief pension strategist. "The premiums that the PBGC charges pension plans have been rising notably in the past few years. That's giving plan sponsors the incentive to get participants off their books and risk transfer is a way to do that."

An additional driver of activity is the impact of the 2014 Society of Actuaries Mortality Tables, which documented that people were living longer than noted in previous society calculations.

Longer lives, according to the Deloitte white paper, will increase U.S. GAAP obligations. "Mark-to-market accounting approaches will require plans to immediately reflect plan gains or losses, increasing the pension plan volatility on both the balance sheet and income statement. All of these may spur a company to engage in pension risk transfer."

"We have seen estimates in the 4% to 8% range from implementation of new mortality tables. Additionally, low interest rates have driven an increase in liabilities and within the insurance industry we have seen the impact from the new mortality tables and rising interest rates to be roughly equivalent over the last year," said Rosemarie Mirabella, an A.M. Best Co. assistant vice president.

"The example I would use is that if you had $100 of GAAP liability on your balance sheet and the insurer said that they were going to charge you $110 at a 10% premium, many plan sponsors would say that was too expensive," Moran said. "Now with the mortality changes, my $100 in liability grows to $105. The insurance company is still charging $110 because they are using their own mortality assumptions."

The UK's Situation

Neither of these factors—increased accounting transparency nor longer mortality projections—are news to U.K. plan sponsors or insurers, who for a variety of reasons have had a robust pension risk transfer market long before the practice took hold in the United States.

"If mortality or longevity experience is required to be reflected more regularly, plan sponsors may

Selected US and UK Pensions – Risk Transfer Deals (2010-2013)

Company	Provider	Value	Deal Type	Date
Verizon (U.S.)	Prudential	USD 7.5B	Buyout	Oct. 2012
General Motors (U.S.)	Prudential	USD 29B	Buyout & Lump sum	June 2012
Ford (U.S.) *	N/A	Up to USD 18B	Lump sum	April 2012
SPX Corporation (U.S.)	Mass Mutual	USD 625M	Buyout	Nov. 2013
EMI (U.K.)	PIC	GBP 1.5B	Buyout	July 2013
BAE Systems (U.K.)	L&G	GBP 3.2B	Longevity swap	Jan. 2013
Tate & Lyle (U.K.)	L&G	GBP 347M	Buy-in	Dec. 2012
Rolls Royce (U.K.)	Deutsche Bank	GBP 3B	Longevity swap	Nov. 2011
British Airways (U.K.)	Rothesay Life	GBP 1.3B	Buy-in	June 2010
British Airways (U.K.)	Rothesay Life	GBP 1.3B	Longevity swap	Dec. 2011

* Ford transaction was a lump sum offer to participants only, not a pension risk transfer.
Source: A.M. Best data and research

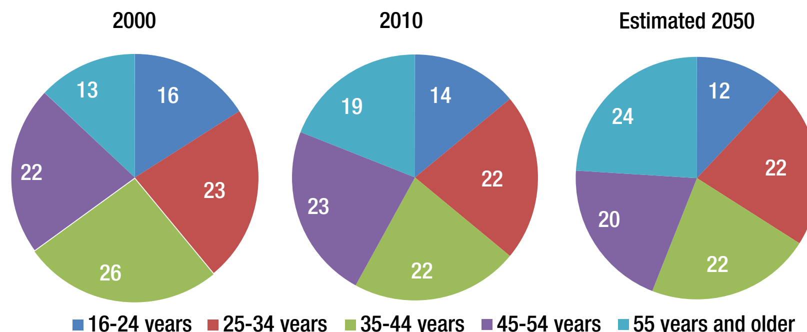
experience more periodic increases in their liability. And if we move toward mark-to-market accounting, the effect of these increases will be required to be recognized immediately," said Jennifer Haid in the article, *Longer Lives, Bigger Issues* in the September 2014 issue of *Best's Review*.

According to Haid, then a manager of EY's Financial Service's Office, frequently issued longevity updates and the ubiquity of mark-to-market accounting meant that U.K. sponsors were able to see increasing plan liabilities immediately.

"The business started in the U.K.—this is really a U.K. technology—which began to be transferred over to

US Pensions – Labor Force by Age (2000-2050E*)

An aging population will comprise a larger part of the workforce as individuals struggle to save for retirement.



*Estimated
Source: U.S. Department of Labor

Anatomy of a Deal

In September 2014, Motorola Solutions Inc. announced that it completed what was at the time the third-largest pension risk transfer deal in history.

As a result of the transaction, which included lump-sum payments to beneficiaries and the purchase of a group annuity, the Illinois-based company reduced its ongoing U.S. pension obligations by $4.2 billion. Prudential Insurance Company of America agreed to pay and administer future benefits to approximately 30,000 retirees.

Behind the headlines of the deal was a flurry of activity that involved an annuity committee, advisers to the annuity committee, an independent fiduciary, law firms and annuity market experts, said Robert Goldbloom, principal and co-founder of Penbridge Advisors, the firm that helped the annuity committee preform its fiduciary responsibilities.

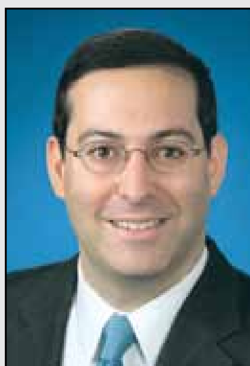
For large deals like the Motorola transaction "investment bankers are often involved advising the plan sponsor whether to do a buyout transaction or not, depending on factors such as the impact on the firm's financial position or how shareholders might react. Then, after a decision is made to do a buyout, a fiduciary structure needs to be put in place," Goldbloom said.

In the case of Motorola, the company appointed an annuity committee whose job was to choose an independent fiduciary to decide which annuity to choose.

"Having the ultimate decision made by a fiduciary who is independent of the plan sponsor is the clearest way to avoid the possibility of a conflict of interest. The fiduciary decision as to what annuity contract and what provider to pick was based on guidance that has been laid out in the Department of Labor's Interpretive Bulletin 95-1," Goldbloom said.

"There are a lot of logistics that have to be coordinated on a deal like Motorola's, which involved a $3 billion buy-out. The last couple of months before the placement were particularly intense," Goldbloom said.

A parallel process on jumbo-sized deals involves moving the investments from the pension plan's balance sheet to the insurer's, as larger transactions tend to involve a transfer of assets rather than cash. "A significant part of the process is for plan sponsors to take investment advice on how to shape the plan's asset portfolio so that it is easily acceptable by the insurer with minimal market risk," said Goldbloom.



Jared Klyman

"What may not get as much attention, but is also relevant, is the size of the invested assets transferred to the insurer from the plan sponsor as part of a deal. Generally speaking, the larger the size of the transfer assets, the less of a risk premium that the insurance company will charge, because there is less exposure to changes in market yields before transferred cash can be invested," said Jared Klyman, Goldman Sachs Asset Management's head of insurance strategy for North America.

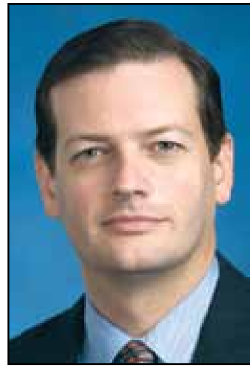
If the transaction involves the insurer buying assets to back the transferred liabilities, the insurer will charge more for this service.

"And there's a risk because it takes them a bit of time to actually buy those assets, and during that amount of time the insurer loses investment income. And also there's a risk that yields will fall between the time when the cash comes in and when the purchases are made," Klyman said.

the U.S. after 2009," said Robert Goodman, head of Goldman Sachs Asset Management's global insurance relationships. "The defined benefit size in the U.K. is about $1.9 trillion, while in the U.S. it's on the order of $3 trillion. When you consider the fact that the U.K. is a small percentage of the U.S. in terms of population, you can see that defined benefit plans as a percentage of overall demographics were more significant in the U.K. and that's frankly where this technology began."

The pension risk transfer market is an "intermediary-run market" in which third-party firms vet both planned sponsors and insurers.

Andy Wilkinson,
OneAmerica



"It's not easy to hang out a shingle and say I see a lot of risk transfer and I'm going to start an insurance company and do it. There are specific rules that the plan sponsor must satisfy when picking that annuity provider."

Mike Moran,
Goldman Sachs Asset Management

The Beginning of a Trend

Although the megadeals of 2012 marked an uptick in the U.S. pension risk transfer market, some believe the phenomenon is still in its infancy.

"One thing that has held back some activity in some of this market over the last number of years has been the relatively low level of funding. So if we think about funded status of these plans, given the low interest environment of the last several years, many plans were funded in the low average 80 percentile," Moran said.

"If I'm going to effectuate one of these transactions and if I'm going to pay for it out of plan assets, if I'm underfunded, then by definition I can't annuitize the entire plan without making a contribution to get back to fully funded or get above fully funded to pay for that premium to the insurance company," he said.

"From late 2008 onward, sponsors have faced a steep climb, as depressed equities hampered pension plan assets while declining interest rates drive significant increases in plan liabilities," according to a 2014 Mercer white paper, *Time to Act on Pension Risk*. "U.S. corporate pensions hit a low point at the end of July 2012, with plans sponsored by S&P 1500 organizations at only 69.5% funded, equating to an aggregate deficient of $689 billion."

The good news for those insurers looking for an uptick in U.S. pension risk funding activity is that the economy has steadily improved, leading to the increases in plans' funding status.

"In 2013, plan sponsors began to see a light at the end of the tunnel as double-digit equity returns and rising interest rates resulted in significant improvements in funded status for most pension plans. In fact, Mercer estimates that as of December 31, 2013, the aggregate funded status of defined benefit plans sponsored by companies in the S&P 1500 was at nearly 95%, with 31% of plans over 100% funded," the Mercer report concluded.

"I think there's an expectation that with market conditions being favorable in the U.S. there is a good likelihood that interest rates will rise, so plan sponsors want to be positioned to take advantage of that opportunity," said Brennan.

Business Opportunities

With plan sponsors either considering or on the verge of engaging in pension risk transfer activity, there's a growing cadre of insurers lined up ready to assist them.

"I think there's an interesting dance and an interesting balance going on right now, where insurance companies are looking for adequate compensation for the risk that they're taking over the long term and plan sponsors are looking for a fair deal to offload liabilities. I don't know that it's certainly skewed in the favor of either of the plan sponsors or the insurers in the current marketplace," Herrmann said.

In order to participate in the PRT market, insurers must meet plan sponsors' fiduciary requirements as outlined in the Department of Labor's Interpretive Bulletin 95-1. These rules require sponsors to choose the safest annuity provider, as measured by factors that include the insurer's level of capital, the diversity of its investment portfolio and the size of the transaction versus the size of the insurer, Moran said.

"From a capacity issue, it's just not easy to hang out a shingle and say I see a lot of risk transfer and I'm going to start an insurance company and do it. There are specific rules that the plan sponsor must satisfy when picking that annuity provider," Moran said.

"The other thing that is important to note is the economics of doing this business for an insurance company are not superb. In other words, this tends to be a very aggressively priced business. You're going basically for size rather than absolute margin. And therefore it's going to be something that can be most competitively addressed by people that already have a lot of scale," Goodman added.

A Growing Market

The U.S. pension risk transfer market has evolved considerably in the past five years, with the biggest change being the advent of jumbo-size deals and the complexities that go along with them.

Since the Verizon and General Motors transactions, other sizable transactions include Kimberly-Clarke Corporation's 2015 purchase of group annuity contracts from Massachusetts Mutual Life Insurance Co. and Prudential Insurance Co. of America for about 21,000 U.S. retirees; and Motorola Solutions Inc.'s 2014 transfer of pension obligations for 30,000 retirees to Prudential.

A key element of these large deals involves transfers of assets-in-kind to insurance companies, rather than cash.

"Until 2012, every deal was done for cash. Now with these bigger deals, it's going to involve assets-in-kind as this is a lot more efficient. A big part of this process is reviewing investment portfolios. The insurance company is going to review them and there needs to be an agreement on how all these assets are going to be valued and how interest rate risks are going to be hedged at various points in the transaction," Goldbloom said.

"Those in-kind transfers tend to be transfers of fixed income securities, primarily because insurance companies are very comfortable holding these types of assets. But that doesn't help to address the problem of having a set of assets that are illiquid because they are in hedge funds, private equity partnerships or other illiquid forms. Those are very difficult to price and difficult to sell. That onus is still on the sponsor to make that happen in the transaction," said Timothy J. Geddes, a director with Deloitte Consulting's human capital practice.

In addition to asset-in-kind transfers, some large deals involve the insurer setting up separate accounts for the supporting assets.

"The economics of doing this business for an insurance company are not superb. In other words, this tends to be a very aggressively priced business. You're going basically for size rather than absolute margin."

Robert Goodman,
Goldman Sachs Asset Management

"A separate account might be set up on large transactions, such as those over $1 billion. The separate account assets are available to pay benefits directly to participants in the unlikely event that the insurance company is unable to pay. This is an added layer of protection which often comes with an extra cost," Wilkinson said.

"These have been around for a while, but they are not much used until you get into really big cases. Separate accounts are a safety issue," Goldbloom said.

Although most observers believe the U.S. market for pension risk transfers will grow, there is little consensus on when that growth might occur.

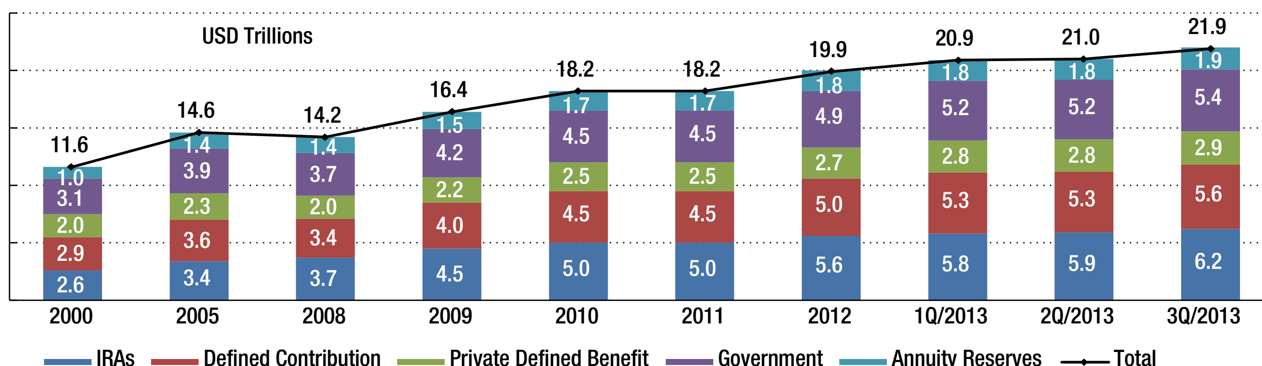
Waiting For a Change

A long-anticipated move by the Federal Reserve to raise interest rates can impact this activity, Mirabella said.

"From an insurer perspective, if interest rates were to rise, it becomes more desirable to do deals because portfolio yields rise and you're better able to support the liabilities. If you're a plan sponsor, however, rising interest rates lessen your incentive because they're reducing the present value of your liabilities and improving your funding status. Company-specific factors will drive your decision," she said.

"I personally think [pension risk transfer] will become more and more popular. If they can find it at the right price, I think people will look to transfers to reduce their pension risk and to focus on their business. I think this is a very real trend and I would expect that we will see more and more of these transactions. It will clearly be choppy, because some of the deals are huge. But I do think this will continue to accelerate as we go forward," Geddes said. BR

US Pensions – Total Retirement Assets by Plan Type (2000-3Q / 2013)



Note: Totals may not add due to rounding. IRA totals for 2011 through 3Q/2013 are estimates.
Source: ICI Research (*www.ici.org*)