DE-RISKING Your Pension Plan

More employers are ditching pension liabilities by transferring funds to annuities or offering lump-sum payments.

By Joanne Sammer

When General Motors (GM) announced in 2012 that it would ask its retirees to either convert their pensions into an insurance annuity or take a lump-sum payment in lieu of a monthly check, reactions from those affected ranged from gratitude to outrage. While some plan participants appreciated the opportunity to manage that money on their own—and believed they were the best ones to do so—others felt they were getting the short end of the stick by potentially losing out on healthy interest accruals, according to press accounts.

While retirees' views may have varied when it came to such so-called de-risking of traditional defined benefit pension plans, GM officials were confident that the move would strengthen the company overall by erasing more than $25 billion of its enormous pension burden. And if imitation is any indication of success, de-risking appears to be a viable business strategy. The list of companies that have since completed similar transactions reads like a Who's Who of blue-chip corporations: Ford, Verizon, Motorola, Bristol-Myers Squibb and many others of all sizes. ›

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The pension de-risking movement shows no signs of easing anytime soon. In 2012, initial annuity activity totaled nearly $36 billion due to jumbo annuity deals by Ford and GM, according to the LIMRA Secure Retirement Institute. These deals totaled $3.8 billion in 2013 from 217 transfers and $8.5 billion in 2014 from 277 transactions. The second quarter of 2015 saw a new record with $3.8 billion in transfers, followed by $3.2 billion in transfers in the third quarter. That was the first time more than $3 billion in activity was recorded in consecutive quarters.

Data on lump-sum payouts is harder to come by, but an analysis by Aon Hewitt found that 70 plans offered lump sums totaling more than $8 billion to approximately 290,000 participants in 2014. Fifty-eight percent of plan participants elected to take deals, with payouts totaling more than $4 billion.

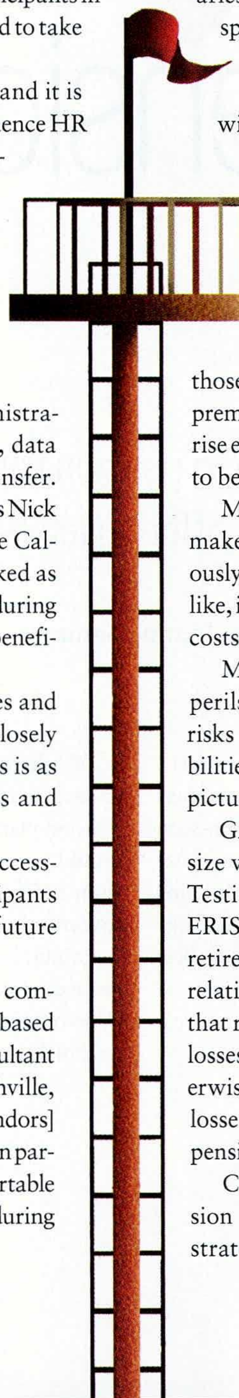
The decision to de-risk is a complicated one, and it is often driven by a company's CFO. How much influence HR executives can have likely depends on their relationship with the finance department. But given that these deals can leave retirees and employees feeling alienated and confused, it's critical for HR to insert itself in the process. Indeed, deciding to de-risk provides a good opportunity for HR to partner with finance and work through the details of these transactions together.

HR can also play a key role during the administrative phase of any de-risking efforts. For example, data exchange is a crucial component of an annuity transfer. "The records need to be scrubbed and updated," says Nick Botticelli, pension investment specialist with Hirtle Callaghan in West Conshohocken, Pa., who also worked as executive director of global investments at Verizon during that company's pension de-risking initiative. "The beneficiary data needs to be verified."

That means ensuring that HR has the resources and bandwidth necessary to monitor progress, work closely with vendors, and generally make sure the process is as seamless as possible for both current employees and retirees.

In addition, clear communication is vital to a successful transition. That includes letting current participants know what to expect and who to contact with future problems or concerns.

"HR must make sure participant information is complete and comprehensive and benefit calculations are based on quality data," says Tom Swain, an actuarial consultant with Bryan, Pendleton, Swats & McAllister in Nashville, Tenn. Beyond that, "HR professionals can help [vendors] understand the general financial education level of plan participants, which is critical for participants to be comfortable in making decisions and taking action, for example, during a lump-sum window."



What's Driving De-Risking?

At their core, de-risking strategies are another example of companies trying to save money by getting out of the defined benefit pension plan business. The number of these traditional plans has declined from more than 103,000 in 1975 to about 44,000 in 2013 as more companies close, freeze and ultimately terminate their plans.

The costs of maintaining pensions have become too unwieldy for many employers. For one reason, people are living longer. That increases the number of payments pension plans pay out over the course of beneficiaries' lifetimes. The Society of Actuaries recently updated mortality tables to reflect longer life spans. While that data is not expected to be adopted by the IRS for pension plan liability calculations until 2017 at the earliest, it looms large. "These new assumptions will increase pension plan obligations by 4 to 8 percent on average," Botticelli says.

In addition, the premium payments that employers with traditional pension plans must make to insure their plans with the federal Pension Benefit Guaranty Corporation (PBGC) continue to grow. Flat-rate per-participant premiums have increased steadily, with payments in 2016 more than double those paid in 2006. The 2015 Bipartisan Budget Act increased premiums from $57 in 2015 to $64 in 2016. The premium will rise each year until 2019, when it will reach $80 and will begin to be indexed for inflation.

Moreover, contributions that companies will be required to make to traditional defined benefit pension plans are notoriously difficult to foretell. And if there is one thing CFOs don't like, it is unpredictable expenses. Larger-than-anticipated plan costs strain a company's cash flow.

Many businesses are simply worried about the financial perils of their plans. "De-risking strategies are all about the risks and accounting treatment of pension plan assets and liabilities and their impact on the organization's larger financial picture," Swain says.

GM, for instance, concluded that the company's current size was dwarfed by its long-term pension plan obligations. Testifying in 2013 before the U.S. Department of Labor's ERISA Advisory Council, Preston Crabill, GM's director of retirement and profit-sharing plans, said, "Although GM had relatively well-funded pension plans, it faced the annual risk that relatively small changes in interest rates or plan actuarial losses (through unexpectedly lower investment returns or otherwise) would create large and disproportionate balance sheet losses and significant funding obligations to its defined benefit pension plans."

Current accounting rules require companies to show pension plan liabilities on their balance sheets, and de-risking strategies focus on removing as many of those obligations

De-Risking Options

Lump-Sum Payouts

Features

- These payouts must provide the current dollar value of participants' vested benefits from the pension plan.
- The company's offer has to be voluntarily accepted by the beneficiary and is generally targeted to former employees who are fully vested in their pension benefits but not yet old enough to collect them.
- People who accept the deal can roll over the money into another retirement account or take it as a taxable distribution.
- The IRS no longer allows employers to offer lump-sum payouts to retirees who are already receiving retirement benefits from the plan.

Costs

- A lump-sum strategy is generally less costly to implement than an annuity transfer.
- Plans can offer lump sums even if they are underfunded.

Annuity Transfers

Features

- Employers make a deal with an annuity provider, usually an insurance company, to transfer a certain amount of plan assets, plus pay additional fees, in return for monthly payments to plan beneficiaries when they retire.
- Participant consent is not required.
- Retirees' monthly payments are the same as they would be under the plan, but they are made by the insurer and are not guaranteed by the federal Pension Benefit Guaranty Corporation.
- Employers must choose their providers carefully with documented due diligence under the guidance of an independent plan fiduciary.

Costs

- Annuity transfers often involve additional contributions to fully fund plan liabilities. "The insurer will want anywhere from 106 to 110 percent of the liability," says Nick Botticelli, pension investment specialist with Hirtle Callaghan.
- The U.S. Department of Labor requires plan sponsors to follow certain guidelines to identify the safest available annuity. Note that the safest one will not necessarily offer the most competitive price.

Investments

Features

- Employers can also adopt investment-related strategies. For example, liability-driven investing, also known as LDI, attempts to match returns to plan obligations.
- These tactics are generally outside of HR's purview, but they can be used in conjunction with other de-risking strategies. "It is not uncommon for plan sponsors to pay lump sums to a certain number of participants while simultaneously changing investment policy to better match liabilities," says Matt McDaniel, defined benefit risk leader for Mercer.

Costs

- LDI can be cost-effective for employers. "Continuing a pension plan in its current form and managing the funded status through plan design changes or the investment policy is often the least expensive option over time," says Tom Swain, an actuarial consultant with Bryan, Pendleton, Swats & McAllister.
- In this case, the employer is essentially self-insuring the annuities the plan offers.
- With no profit margin involved, those annuities will be less expensive than those purchased from a third party.

as possible. Ford, an early pioneer in the movement, managed to eliminate a reported $4.2 billion in pension liabilities with its offer of lump-sum payouts for some 90,000 retirees. GM offloaded nearly $30 billion through an annuity transfer.

Too Big to Fail?

What about the risks to participants? After all, these deals do not eliminate risk; they simply transfer it to another party. In a lump-sum buyout, risk passes solely to plan participants, who must then manage the money themselves, deciding whether to roll it over into another retirement plan and how to invest it. They assume the hazards involved in those decisions and the consequences of the money not lasting their lifetimes.

Pension de-risking could heat up if the markets do well and pension plans' funded status increases.

Annuity transfers bring a different set of issues. After a transfer, beneficiaries will receive a monthly payment from the insurance company instead of the pension plan. However, these annuities are not backed by the PBGC. So, if the insurer goes bankrupt or is otherwise unable to meet its obligations, these annuities would be covered by state guaranty associations up to a certain amount. The rules and coverage specifications, including any caps on coverage, vary by state.

The chances that an insurance company will fail are low because the industry is so heavily regulated. That said, given the ongoing frequency and size of annuity deals, the risks that providers are taking on continues to grow.

At the same time, current traditional defined benefit pension plans are hardly free of peril themselves. In some cases, retirees may make out better if plan assets are transferred. "If you work for a company that has a very poor credit rating and is in some form of financial distress, you might have a much more secure benefit if your annuity is bought out by an insurer," says Matt McDaniel, defined benefit risk leader for Mercer in Philadelphia. Insurance companies are likely to be "monitored more closely than a private pension plan, on more secure financial footing, and, to be honest, much more experienced in managing these types of liabilities and obligations."

Moreover, employers can build in extra protections in an annuity transfer. For example, they can require a provider to establish a separate account for transferred funds. "Those assets are segregated and cannot be grabbed by general creditors in case of an emergency," says Ari Jacobs, global retirement solutions leader with Aon Hewitt in Norwalk, Conn.

The Long Game

There is usually no urgent reason for companies to offer a lump-sum buyout or undertake an annuity transfer. Companies generally just want to remove pension obligations from their balance sheets in the interest of their long-term financial health. A business facing bankruptcy or a significantly underfunded pension plan would not be a good candidate for de-risking. A transfer to an insurance company often requires a payment equaling up to 110 percent of plan liabilities, and a lump-sum offer could drain an underfunded plan if too many participants select that option.

That's why the decision of whether to pursue an annuity transfer, a lump-sum payout offer or both should be driven by your company's particular goals. The only way to remove all pension plan liabilities from the balance sheet is through an annuity transfer. A lump-sum offer can help reduce those obligations but will only make a dent overall if the population eligible for the payouts is limited to vested participants who have not yet reached retirement age.

While the underlying reasons for pension risk transfer strategies may be sound, companies should go into the process with their eyes open. These deals are complicated and time-consuming. "There are a lot of complex issues that need to be thought through, and none of these solutions is a universal one-size-fits-all approach," says Matt Hermann, North America leader of the retirement risk management group at Towers Watson in St. Louis. ›

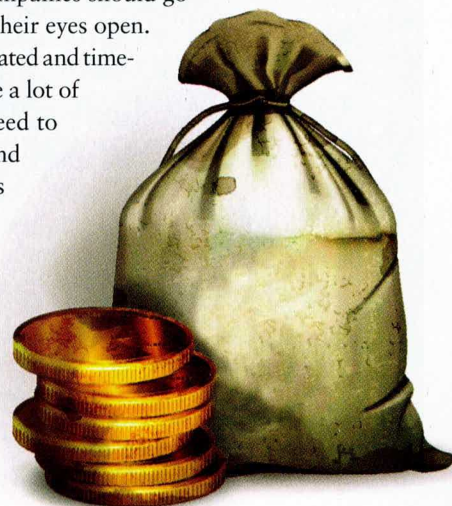


IMAGE BY SHUTTERSTOCK

De-risking has also caught the attention of regulators. In July 2015, the IRS effectively banned employers from offering lump-sum buyouts to plan beneficiaries who are already retired—which is the approach Ford took. This action by the U.S. government shows that such practices are on its regulatory radar screens.

What's Next?

So what can benefits professionals look forward to in the next few years?

Pension de-risking could heat up if the financial markets perform well and pension plans' funded status increases. That would put businesses in a better position to implement these tactics. "Companies are looking at de-risking strategies now because financial market performance has been strong in recent years, improving the funded status of many plans," Swain notes.

In a survey of 213 finance executives in organizations with defined benefit plans, conducted by benefit consultants Mercer and CFO Research, 49 percent of CFOs said they were likely or very likely to undertake lump-sum transactions in 2015 and in 2016. Annuity transfers, which often come with additional costs and require a certain level of pension plan funding, are somewhat less popular, with 36 percent of CFOs saying this type of transaction was likely or very likely in 2015 or 2016.

Although de-risking has gathered momentum, all of this activity still amounts to less than 5 percent of the U.S. corporate defined benefit pension marketplace, according to Herrmann. "We are still in the early stages of this game."

If anything could drive more activity, it would be a hike in interest rates, which would also lead to a rise in pension plan funding levels. Better-funded plans could more readily pursue de-risking, particularly annuity transfers. "[Higher interest rates] would likely generate a transformational amount of activity," Herrmann says. It would also create new challenges and opportunities for HR. Will it be worth the de-risk? HR

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