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Supplanting Cash in Annuity Buyouts: Asset-in-Kind Transfers Move toward Mainstream

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After years of economic and financial challenges, defined-benefit (DB) plans—once viewed as the bedrock of America’s retirement system—have lost ground. Stubbornly underfunded despite new contributions and actions to actively manage investment risk relative to plan liabilities, DB plans can constrain business results by siphoning off capital that might otherwise be used for business growth. Not surprisingly, nearly half (45%) of large plan sponsors have taken proactive steps to prepare for an eventual pension risk transfer (PRT). There are many paths to pension de-risking, each with unique merits, limitations, and implications. This article focuses on the annuity buyout, and more specifically, on the practice of using assets-in-kind (AIK), rather than cash, to fund this approach.

ANNUITIZATION: A SIGN OF THE TIMES

In an annuity buyout, all or a portion of the plan’s liabilities, and by definition, all risks associated with those liabilities, are permanently and irrevocably transferred from the plan sponsor to an insurance company. As a PRT strategy, annuitization has gained traction in recent years. In 2015, annuity buyout transactions topped $13.7 billion across 300 transactions and eclipsed $10 billion for the second time in four years. In view of recent regulatory changes limiting lump-sum window programs to those not yet receiving pension income and longer life expectancies that could increase pension liabilities by 7% to 10% or more, interest in removing these liabilities through plan termination or retiree “lift-out” is expected to remain strong.

INSURER-FRIENDLY PORTFOLIOS ARE REPLACING CASH IN MORE ANNUITY BUYOUTS

Premium payment in an annuity buyout has traditionally been made with cash generated by the sponsor liquidating the DB plan’s assets. The insurer would, in turn, use that cash to purchase investment assets to hold against the liabilities for which it has assumed responsibility. In the case of an AIK transfer, however, the premium for the annuity is paid by transferring ownership of some or all of the plan’s eligible assets to the insurance company; in the latter, minimal, if any, liquidation of plan assets takes place, and most or all of the deal is executed with AIK. An AIK transfer is possible when assets held by a DB plan are generally consistent with those the insurer would deem suitable for its portfolio, pursuant to regulatory requirements and internal risk management practices.

In-kind transfers have been commonplace in the United Kingdom for more than
a decade. Introduced into the American PRT market in 2012, early AIK transactions involved jumbo deals, as smaller transactions were too time-consuming to justify the effort. At the time, plan sponsors often sought to transfer shorter, more predictable portions of a pension plan’s liabilities such as those associated with current retirees, and insurers likewise sought associated assets, which could leave plan sponsors with the task of repositioning the remaining portfolio’s illiquid assets to match the retained liabilities. Difficulties arose as sponsors became unwilling to part with liquid assets when that would result in the plan’s remaining portfolio containing a higher proportion of illiquid assets.

As the American AIK market evolved, insurers gained experience and bandwidth to handle these increasingly popular transactions. Today, a handful of insurance companies will work with smaller-sized plans (e.g., $100 million+), and some have even become more flexible in the types of assets they will accept in-kind for the pension buyout premium. Holdings that once were considered illiquid may now qualify as “asset-friendly” in an AIK transfer—including alternative investments, such as hedge funds and private equity.

BENEFITS OF AN AIK TRANSFER

An AIK transfer may be the preferred approach in an annuity buyout as it bypasses several of the challenges and friction costs inherent in all-cash transactions, such as funding delay and transaction costs discussed below:

- Large cash transactions create risk for insurance companies, as time may be needed in order to put that money to work. An AIK transfer ensures that the funds underlying a transaction are immediately invested, avoiding the “cash lag” (funding delay) in terms of time or spread lost during the interim funding period.
- By eliminating the need to liquidate significant portions of plan assets, which can introduce a “drag” on portfolio returns or yields pre-closing, sponsors can reduce potential asset–liability management (ALM) mismatches during the transition period. Moreover, since PRT premiums are based on market conditions, as interest rates and credit spreads change, so, too, will the price—and potential affordability—of the transaction. In addition, comprehensive ALM monitoring as the transfer date approaches will help to ensure the deal is consummated, whether transacted in AIK, cash, or a combination of both.
- If a plan holds securities that the insurance company finds appealing, an in-kind transfer can minimize or eliminate for both parties the transaction costs that would otherwise result from the sale or purchase of any assets. Transition services are available to assist plan sponsors in preparing a portfolio prior to a PRT. Such a service can facilitate a portfolio’s AIK readiness and minimize the time and cost of asset repositioning.
- To the extent that the insurer is willing to accept a plan’s illiquid assets, an AIK approach eliminates the need for the sponsor to risk a loss on such sales due to disadvantageous timing triggered by a need to dispose of those assets prior to the transfer. In addition, such assets may be difficult to replace if scarce, and may be very attractive to match or hedge portions of the liabilities.

IMPACT OF AN AIK TRANSFER ON TRANSACTION PRICING

The impact of an AIK transfer on transaction pricing depends on several factors, including asset classes in the portfolio; the spread/yield on assets; and the liability profile, such as size and duration. To the extent the buyout premium payment is made in the form of AIK with a positive spread to the U.S. Treasury curve, the impact to the insurer’s spread loss during the funding period may be mitigated—resulting in a more attractive yield for the insurer, and potentially, a more attractive premium for the plan sponsor. For example, assets with minimal or no spread, such as U.S. Treasury securities, will offer no pricing benefit versus a 100% cash transaction. Conversely, an AIK mix that closely aligns with an insurer’s target portfolio, or an AIK mix that provides a material spread during the interim funding period, can result in a price improvement in the plan’s favor.

PREPARING PLAN ASSETS FOR A BUYOUT

Plan sponsors can take a number of measures to position their asset portfolios for an efficient AIK transfer to an insurance company, with minimal ALM risk and cost. In order to set the stage for an optimal transfer, it may be beneficial to consider how insurance companies approach an AIK transfer.
Working with the plan sponsor, the insurance company will identify the types of securities and duration profile sought for the in-kind portfolio. There may be instances when the insurer and the sponsor agree on specific securities eligible for the transfer. In selecting suitable assets, the insurer will evaluate the actual holdings within each asset class with regard to duration, credit quality, and liquidity, among other considerations. Exhibit 1 shows the asset classes that insurance companies may typically accept.

- **Fixed Income**: Insurance companies are generally willing to accept public fixed-income assets that provide a reasonable ALM fit to liabilities, have larger issuance sizes, or are part of established benchmark indexes, subject to the insurer’s credit quality parameters. These assets may include public corporate bonds, structured assets (such as asset-backed securities [ABS], commercial mortgage-backed securities [CMBS], residential mortgage-backed securities [RMBS]), municipal bonds, and U.S. government securities.

- **Privately Sourced Fixed Income**: Although pension plans may not commonly hold certain privately sourced fixed-income assets such as commercial mortgages, private placement debt, or agricultural mortgages, these classes may be readily accepted by insurance companies because they more commonly invest in such asset types.

- **Alternative Assets and Real Estate Equity**: As noted earlier, a few of the larger insurers may be willing to accept certain classes of alternative investments, including hedge funds and private equity. Among other considerations, the proportion of these assets as part of the broader AIK mix will depend on the insurer’s assessment of the characteristics (duration/cash flow profile) of the pension liability.

Assets generally not preferred in an AIK transfer include public equity, public fixed-income assets with low outstanding amounts or inactive secondary markets, highly illiquid assets of poor/questionable quality, alternative assets that are of lower quality, lesser known/smaller positions spread across multiple managers, older private equity vintages (prior to 2006), and direct investments that are not part of a diversified investment partnership.

**VALUATION OF ASSETS**

A critical step in the AIK process for pension buyouts is the agreement on a valuation source for the various assets transferred. There are a number of methods for valuing a portfolio and, beyond that, specific approaches for valuing different components within the portfolio. Since each insurance company involved in the bidding process may have its own approach, managing this part of the AIK process can be challenging for plan sponsors and their asset managers. Discussions with insurers should begin early in the process so there is sufficient time to review the plan’s asset portfolio, negotiate terms, and agree on a mutually acceptable valuation methodology.

The precise length of time associated with the entire AIK process is highly dependent on deal specifics and is composed of multiple steps, as shown in Exhibit 2.

1. **Identify Assets.** The first step in the portfolio review process is to communicate to the insurance company the potential universe of assets available for the AIK transfer. For publicly traded assets, this information would include asset identifiers/CUSIPs, durations, and par amounts. For private assets, including private equity and hedge funds, this information would cover relevant fund details.
material deal documentation, and information on commitments and liquidation rights.

2. **Review Assets for Credit Quality, Liquidity, and ALM.** The insurance company will conduct a thorough due diligence process on both the public and private portions of the AIK mix. As part of that review, the asset profile will be evaluated through a number of lenses, including credit, liquidity, and ALM, to determine the appropriateness of the AIK transfer versus the liability and potential impact, if any, on the buyout premium. There may be some assets in the pension plan portfolio that the insurer is not prepared to accept as part of the AIK transfer (so these would need to be sold and delivered as cash or other acceptable assets). A further portion of the plan’s assets, although eligible for the AIK transfer based on the insurer’s criteria, may be repositioned by the insurer post-closing.

3. **Discuss Results and Select AIK Assets.** Once the initial review is conducted, the insurer will discuss in detail the results of the due diligence exercise and work closely with the sponsor, generally in consultation with its investment managers, to agree on an appropriate AIK portfolio as premium payment. Agreement must also be reached relating to the purchase and sale of any private assets involved in the AIK transfer, including compliance with any rights of first refusal or other transfer restrictions relating to such assets. Agreement must also be reached on how to allow for any trading within the plan portfolio, in the ordinary course of managing the plan assets, and also for dealing with any downgrades or credit default events within the AIK portfolio.

4. **Agree on Valuation Source(s), Methodology, and Timing.** Among other specifics, the insurance company and plan sponsor must agree on valuation source(s), methodology, and timing. It may be helpful to have a dry-run valuation of the AIK assets pre-closing, so that any discrepancies can be managed.

5. **Exchange Custodial Bank Information.** The insurance company will provide the necessary custodial bank information to the plan sponsor to ensure a smooth transition of the AIK at transaction closing.

6. **Transfer Assets.** With regard to the transfer of private assets involved in the AIK transfer (such as private equity or hedge funds), the insurer and plan sponsor may also need to negotiate transfer agreements with, and obtain consent from, third parties such as general partners.

**CONCLUSION**

For plans working to transfer liabilities through annuitization, the ability to use plan assets instead of cash for premium payment may be an attractive option. Sponsors can work with their consultants to seek insurance companies with the resources to help them fully understand the merits and limitations of an AIK approach, as well as the capacity and desire to take on their plan’s assets and liabilities should a decision be made to move forward. Even if a PRT isn’t imminent, but is being contemplated for some time in the future, action may need to be taken in order to optimize results of the AIK transfer.

**ENDNOTES**

1. See MetLife’s 2015 Pension Risk Transfer Poll.

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