RISK MITIGATION THROUGH ANNUITIES: HOLDING A GROUP ANNUITY AS A PLAN ASSET

The effects of recent financial market volatility, together with ongoing regulatory changes, have heightened plan sponsors’ awareness of the various risks associated with their defined benefit pension plans. Historically, investment strategies have focused on the asset side of the balance sheet, with “risk” defined in terms of asset performance relative to a benchmark, such as the Barclays Aggregate Bond Index or the S&P 500. However, the Pension Protection Act (PPA) and revised Financial Accounting Standards (FAS 158) have compelled plan sponsors to focus on the funded status of their plans—or stated another way, assets in the context of the plan’s liabilities.

One effective way to mitigate funded status volatility and other risks, while ensuring that ongoing cash flow requirements are met, may involve the use of group annuity contracts as plan assets. Such a strategy, known as a “buy-in” in the U.K., can provide a cash flow guarantee to the plan without an irrevocable risk transfer.

FROM PARTIAL RISK TRANSFER TO AN ANNUITY AS A PLAN ASSET (BUY-IN)

Much has been written about Liability Driven Investing (LDI) as a way of immunizing defined benefit plan sponsors against balance sheet volatility. While LDI can provide protection against interest rate changes, its contribution to overall risk protection is limited. Risks such as mortality and early retirement remain, and can substantially impact funded status.

Annuities can be used in different ways to mitigate risks, such as:
> Investment, interest rate, mortality and early retirement risks;
> The need for liquidity to meet benefit payments; and
> Funded status, balance sheet and earnings volatility.

One method of moderating risk is shrinking the size of a plan and its associated risks through the use of Partial Risk Transfer. This involves transferring a portion of assets and liabilities to an insurance company. With this partial settlement, the plan no longer bears the obligation to pay benefits to participants covered in the group annuity contract.

As noted, an alternative method, known as a “buy-in,” has been used in the United Kingdom. U.S. insurers have adapted the concept for use with U.S. defined benefit plans to conform to the accounting rules and pension regulatory structure.
In these transactions, a pension plan purchases a group annuity contract to cover a defined group of participants, similar in concept to Partial Risk Transfer. A crucial difference, however, is that with this alternative method, while plan assets are used to purchase the contract, the annuity contract is held as an asset of the plan. In this case, the insurer’s obligation is to the plan and not the participants. Unlike a Partial Risk Transfer, the size of the plan is unchanged, since neither assets nor liabilities have been transferred. When held as a plan asset, this type of group annuity contract reduces rather than transfers risk, and effectively functions as a distinct asset class for a pension plan manager.

**HOW AN ANNUITY AS A PLAN ASSET WORKS**

- The plan makes a single premium payment to an insurance company to cover the future benefit payments of a selected group of plan participants. In turn, the insurance company issues a group annuity contract to the plan.
- The insurance company makes a monthly bulk payment to the plan, representing the monthly benefit amounts for those covered by the contract.
- There is no relationship between the insurance company and the plan participants; the plan continues to make the benefit payments to the participants and retains the liability for these benefits.
- As the contract can be discontinued under specific circumstances, the liability has not been irrevocably transferred to the carrier.

**ANNUITY AS A PLAN ASSET STRUCTURE**

![Diagram of Annuity as a Plan Asset Structure]

The annuity retains the immunization advantages of a Partial Risk Transfer. The annuity contract will pay all benefits to the plan for the specified group of participants, so it immunizes the plan against investment, mortality, early retirement and cash flow risk for these lives. Additionally, since the insurance company obligations are essentially the same whether the annuity contract is held as a plan asset or under the Partial Risk Transfer approach (with the exception of administrative costs), pricing for both will be similar. However, the discontinuance option when the annuity contract is held as a plan asset may increase its cost modestly compared to the Partial Risk Transfer approach. In a Partial Risk Transfer, the assets and related liabilities irrevocably leave the plan, which may affect the funded status of the remaining plan; in an Annuity as a Plan Asset structure, the contract value is included as a plan asset, leaving the plan’s funded status essentially unchanged.

**FINANCIAL CONSIDERATIONS AND THE NEED FOR FURTHER CONSULTATION**

Outlined below are accounting and funding considerations associated with the Annuity as a Plan Asset structure. As always, but particularly as this is a new concept in the U.S., plan sponsors should consult with their actuarial, accounting and legal advisors for specific advice.
Accounting:
U.S. GAAP requires immediate gain or loss recognition if a transaction “…(a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a pension benefit obligation and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement.” As noted earlier, under the contract, the plan continues to be responsible for payments to the plan’s participants, and the contract provides that the sponsor may discontinue the contract. As such, we believe that a properly designed arrangement would not meet the requirements necessary for FAS 88 settlement accounting, and its related effects on financial statements.

Changes in interest rates over time will impact the plan’s liabilities and the value of the contract. For accounting purposes the value of the liability may be set equal to the contract value of the annuity contract. Although both are based on long-term, high-quality yields, differences may exist between the contract value and the funding liability value as calculated under PPA. As with any plan asset or liability, plan sponsors should consult with their accounting advisors to determine the values for financial reporting purposes.

Funding:
Since the assets and liabilities remain in the plan, the funded status of the plan should not change upon purchase of the annuity contract. Assets are being allocated to an insurance contract, rather than leaving the plan. This is in contrast to a Partial Risk Transfer in which assets are distributed from the plan and funded status is impacted. For example, assume a liability value of $125:

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<thead>
<tr>
<th>Before the Annuity as a Plan Asset Transaction</th>
<th>After the Annuity as a Plan Asset Transaction</th>
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<tbody>
<tr>
<td>Equity</td>
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<tr>
<td>Fixed Income</td>
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<tr>
<td>Annuity Contract</td>
<td>Annuity Contract†</td>
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<tr>
<td>Other</td>
<td>Other</td>
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<tr>
<td>Total Assets</td>
<td>Total Assets</td>
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<tr>
<td>Funded Status</td>
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Note: In the example above, the annuity contract is funded through a reallocation of equity, fixed income and other investments. An annuity contract can be funded through a reallocation of such assets and/or new contributions.

Since the plan retains the obligation to pay all benefits to plan participants, PBGC protection continues, as do PBGC premiums. Additionally, the plan continues to administer the participant data and benefits, so administrative expenses continue as well.
ADDITIONAL ISSUES AN ANNUITY AS A PLAN ASSET TRANSACTION CAN INTRODUCE

> This approach is still new in the U.S., so it may require significant review by advisors, which may raise cost and timing issues.

> While the contract may be viewed as a fixed-income alternative for calculating the plan’s asset allocation and expected return on assets, sponsors should be aware that it is not a “liquid” asset. Therefore, the annuity contract purchase should be viewed as a long-term allocation decision.

WHEN MIGHT A PLAN SPONSOR WANT TO INITIATE A PARTIAL RISK TRANSFER FOLLOWING AN ANNUITY AS A PLAN ASSET TRANSACTION?

> At some future date, a plan sponsor may be inclined to settle liabilities which are covered by the annuity contract (and/or other plan liabilities) if certain conditions evolve, such as:

  – Plan funding level improves; or
  – The sponsor’s ability to absorb settlement accounting improves.

> When the plan sponsor initiates a settlement with the insurance company, the following typically occurs:

  – The insurer issues certificates;
  – Liabilities and assets are transferred from the plan to the insurer, as applicable;
  – If the sponsor wants the insurer to assume responsibility for administration of those participant benefits, an administrative charge is assessed;
  – Settlement accounting occurs; and
  – The size and the risk of the plan are permanently reduced.

SUMMARY

Pension risk management for defined benefit plans continues to evolve with new solutions. The primary objective of a pension plan is to secure benefits and provide retirement income for plan participants. Most plan sponsors are seeking cost-effective ways to mitigate risk and annuitization can provide a complete hedge for covered liabilities. The Annuity as a Plan Asset approach may provide a plan with cost-effective risk mitigation and preserve maximum sponsor flexibility in ongoing plan management.

Like most group annuity contracts, MetLife group annuities contain certain exclusions, limitations, reductions of benefits and terms for keeping them in force. A MetLife group representative can provide costs and complete details.

Please contact your MetLife representative or call 1-888-217-1858 if you would like to discuss these ideas in greater depth.

1 Immunization: A technique of investing in bonds such that the portfolio’s target return is protected against interest rate fluctuations. Changes in returns at which cash flows can be reinvested are offset by changes in the value of the securities in the portfolio.

2 Various investment strategies are commonly accessed through group annuity contracts issued to qualified plans, in which case the group annuity contracts are plan assets. Similarly, a group annuity contract is issued to and owned by the plan, but is structured to provide a defined and guaranteed set of cash flows to the plan in return for a specific premium paid to the insurance company. This paper distinguishes this arrangement from a Partial Risk Transfer, in which a portion of the plan’s obligations are settled, in which case the group annuity contract serves to remove obligations from the plan and as such is not a plan asset.


4 MetLife does not give accounting advice. Each plan sponsor should consult its own advisors with regard to valuation.