PARTIAL RISK TRANSFER

Sponsors of defined benefit (DB) plans are generally aware that annuities must be provided for or offered to plan participants in the event that the plan terminates. Those annuities — which by definition are offered only through insurance companies — guarantee the benefits that have been earned by each participant under the plan. Many plan sponsors may not be aware that group annuity-based products can also play a valuable role in managing pension risk in ongoing active and frozen plans.

Given the volatility in funding levels, accounting expense and contribution levels that plans have experienced since 2006, many plan sponsors are considering the merits of moving to an investment strategy that better matches the plan's liabilities and assets once their plan becomes adequately funded as a way to lessen such volatility. A Partial Risk Transfer can mitigate more risk than an immunization strategy such as a traditional Liability Driven Investment (LDI) program at a competitive cost, factoring in the costs and risks of both approaches.

This edition of Topics in Pension Risk Management presents the major considerations for plan sponsors including a Partial Risk Transfer in their pension plan management strategy, and is designed to assist plan sponsors in understanding their options. It also covers some of the planning aspects involved in a Partial Risk Transfer.

WHAT IS PARTIAL RISK TRANSFER?

> For the purpose of this paper, Partial Risk Transfer is defined as the removal of a portion of the assets and liabilities from a DB plan by “settling” them with an insurance company through the purchase of a group annuity contract. The authors note that this concept is only one type of group annuity contract-based pension risk reduction method. Other solutions, while also group annuity contract-based, are beyond the focus of this paper.

> Speaking generally, any portion of a DB plan’s liability that can be identified and measured is a candidate for Partial Risk Transfer. In actual practice, the most common application of the strategy is for liabilities associated with current retirees, current terminated and vested participants, or participants associated with nonconforming plans such as those inherited through merger/acquisition activity.

WHAT ARE THE BENEFITS OF PARTIAL RISK TRANSFER?

> Provides hedge for the liabilities that are transferred. While it’s possible to mitigate most investment and interest rate risk by assembling a high-quality bond portfolio whose cash flows roughly match the anticipated plan payments, it can be expensive and labor intensive. In addition, the success of utilizing such a portfolio depends on investment market
behavior, the specific securities selected for the portfolio, and the precision with which the plan’s liability cash flows have been estimated. In contrast, the settlement of liabilities for a defined block of participants will completely remove investment risk and interest rate risk, actuarial risks such as longevity, and behavioral risks such as early retirement election; these risks can only be effectively mitigated through an insurance-based solution.

> Reduces the plan’s asset-based and administrative fees and eliminates PBGC premiums for the annuitized participants. These fees can easily amount to 1% per annum or more of invested assets, plus the direct costs of cutting checks, tax forms, benefit calculations, and PBGC premiums of $42 (for 2013 plan year) or more per participant. A comprehensive cost and benefit analysis of a Partial Risk Transfer should always include a reasonable present value of the future stream of these expenses.

> Reduces the size and risk of the plan. Actions that reduce the balance sheet risk of a company at a reasonable price should generally be viewed favorably by the market or other financial stakeholders. Reducing the size of the DB plan is often particularly important for plans whose unfunded liabilities are significant relative to metrics such as the plan sponsor’s market capitalization.

WHAT ARE THE POTENTIAL DRAWBACKS OF PARTIAL RISK TRANSFER?

> Settling liabilities may appear costly relative to the plan’s accounting or funding liability. This is primarily due to the more realistic assumptions that must be made when an insurer irrevocably assumes the risks of what is often a multi-decade obligation for a “one-time” amount. The “price differential” is primarily captured by the difference between discount rates used for accounting and funding purposes, and the “net” rate used by the insurer (the plan sponsor’s discount rate can be considered a “gross” rate, i.e., it ignores future expenses and risks while the insurer’s “net” rate reflects all future expenses and risk charges). The “net” rate is driven by several factors including the available rate of return to the insurer on an appropriately high-quality, cash flow/dollar duration-matched portfolio with limited optionality.

A second factor is that insurer pricing reflects charges for asset and liability risks, profits, and expenses (ongoing investment and administration services). In addition, more realistic assumptions, such as those used for mortality, also affect premium estimates. The Pension Protection Act (PPA) has required adoption of mortality and interest rate (prior to MAP-21) assumptions that are much closer to the assumptions used by insurers, significantly reducing the differential between the two measures seen several years ago. Also, heavily subsidized early retirement benefits increase risk — and cost. A relatively small difference between the assumed retirement age used by the plan’s actuary and that used by the insurance company pricing actuary can cause the insurer’s estimate to be several percentages higher than the plan actuary’s.

> Any settlement will require the realization of a proportional amount of the plan’s accumulated actuarial gain or loss (plus the gain or loss associated with “mark to market” of the liability settled) in the income statement. This recognition is merely the accelerated realization of an accrued gain or loss that would otherwise have been amortized over time; however, plan sponsors should expect that the recognition will impact their quarterly income statement. The financial effect of a settlement should be estimated in advance and, if material, management of publicly traded companies might consider communicating this impact to their analysts.

> Partial Risk Transfer will affect the funded status of the remaining plan assets and liabilities, as well as the future GAAP expense. In most instances, an underfunded plan will become even more underfunded and vice versa. Oversimplifying this, if a sponsor has a plan with $100 of liabilities and $90 of assets, and settles half the liability for $50, the remaining $40 has to fund $50 of liabilities — a decrease in the funded ratio from 90% to 80%. Thus, doing a risk transfer on a significantly underfunded plan can have negative effects. On the other hand, Partial Risk Transfer can be remarkably beneficial if, for example, a somewhat overfunded plan wishes to increase its overfunded level to enable it to pay retiree medical premiums under IRC Section 420. Additionally, a review of the impact of the remaining assets
and liabilities on the annual GAAP expense should be performed. The magnitude, as well as the direction of the impact, will depend on several factors, including the price of the Partial Risk Transfer relative to the Projected Benefit Obligation of those benefits, as well as the difference between the expected return on plan assets and discount rate assumptions.

**WHAT LIABILITIES ARE CANDIDATES FOR A PARTIAL RISK TRANSFER STRATEGY?**

This will vary based on the situation of the plan sponsor. One of the advantages of Partial Risk Transfers is that they are very flexible, and can be tailored to fit a particular plan sponsor’s objectives. While risk transfers may be structured in a wide variety of ways, some potential approaches are outlined below.

> Retiree groups are often an initial focus. They are generally among the easiest for carriers to underwrite, and the typically shorter duration (about 9 years, compared with 14 or more for active lives) makes it easier to construct a portfolio that will match anticipated cash flows. Given the participants’ ages, there is less likelihood of significant unanticipated longevity increases. And, of course, with retirees there’s no early retirement risk. Thus premiums for these liabilities are frequently the closest in line with the plan actuary’s liability estimate (i.e., the accounting liability or funding liability in the absence of MAP-21). For plan sponsors, focusing on those who are already retired and generally in pay status also often makes intuitive sense. These liabilities are therefore frequently the first ones settled.

> Plan sponsors ought not overlook considering their terminated vested liabilities as excellent candidates for Partial Risk Transfer. These liabilities can also be settled, especially if the plan does not carry significant early retirement benefit subsidies that may make this approach appear less “competitive” with the plan actuary’s liability estimate. In either case, as benefit liabilities for terminated vested participants are of a longer duration than a current retiree group alone, considering the two populations together may result in “stretching” the duration of the combined liability resulting in a more attractive relative price for the overall liability.

> Larger plans may have concerns about particular “tail risks” they wish to protect against. Examples might be a sudden increase in early retirements, or longevity increases far greater than had been anticipated (as have occurred in the UK). It may be possible to tailor a Partial Risk Transfer transaction to address such plan-specific risks; for example, it might be beneficial for a plan sponsor to transfer all benefits payable to retirees past age 85 — and only those benefits, effectively re-shaping the overall plan’s duration and providing cash flow certainty for the plan’s tail risk.

**WHAT HURDLES EXIST TO A PARTIAL RISK TRANSFER, AND HOW DO I ADDRESS THEM?**

> As soon as serious consideration is being given to a Partial Risk Transfer, plan sponsors should arrange to obtain premium estimates from insurance companies. If an insurer’s estimate is deemed acceptable, and a Partial Risk Transfer will be done without delay, consideration should be given to implementing an immunization strategy to preserve the plan’s current funded status while the risk transfer is implemented. If it is determined that a Partial Risk Transfer is not currently feasible, the plan sponsor should work with the insurer to model the impact of interest rate changes or other variables on the premium to understand the conditions under which a risk transfer might become economically feasible for the plan.

> Approvals should be sought from internal stakeholders such as Finance, Human Resources, and Legal well before the Partial Risk Transfer is implemented to avoid any “last-minute issues.” Finance needs to be involved as there may be financial statement impacts as well as an impact on funding levels and contributions. Legal should opine on the appropriateness of the due diligence review being performed. Human Resources will have several issues to deal with, for example in terms of notifications to affected participants, and may have specific needs that may be accommodated. The key is to get input from affected parties as early as possible.
> Documenting the prudence of the selection of the insurer is important. In many instances, the plan’s Investment 
Committee or similar body has responsibility for decisions involving the use or application of plan assets, such as a 
Partial Risk Transfer. The decision to implement a Partial Risk Transfer is generally deemed a settlor function and may 
reside with finance. However, the choice of the insurer with which to implement a Partial Risk Transfer is a fiduciary 
decision. Sufficient time should be allowed for a due diligence review of the insurer.

> Since Partial Risk Transfers require the use of plan assets, fiduciary responsibility is involved, as with any plan-related 
investment decision. Fiduciary duty entails acting in the best interest of the plan participants, following a reasonable 
process and documenting that process. When purchasing annuities, plan sponsors benefit from the guidance provided 
by the U.S. Department of Labor in their Interpretive Bulletin (IB) 95-1, generally referred to as the “Safest Available 
Annuity Provider” standard. Most consultants and ERISA counsel feel that following the protocol set forth in the 
Interpretive Bulletin — and documenting the process — helps sponsors meet their responsibilities.

> Plan sponsors should be prepared to react quickly if an unusual scenario makes a Partial Risk Transfer particularly 
attractive. The steps outlined above should help plan sponsors prepare, so that they are best positioned to act on 
favorable pricing or market conditions when they arise.

> PLEASE CONTACT YOUR METLIFE REPRESENTATIVE OR CALL 1-888-217-1858 IF YOU WOULD LIKE TO DISCUSS 
THESE IDEAS IN GREATER DEPTH.

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.

1 © METLIFE, INC.