For sponsors of defined-benefit pension plans, market volatility and the global interest rate environment have been causing headaches for years. As a plan’s liability discount rate falls, the present value of its projected stream of future benefit payments rises. Thus, the global financial crisis, which dropped the effective federal funds rate from over 5 percent in 2007 to 0.25 percent by early 2009, also wreaked havoc with plans’ funded status. Pensions for which total asset value was higher than liabilities’ value just before the crisis saw their funded status fall to below 80 percent within a year.

Although funded status rebounded in recent years, funding concerns intensified in October 2014, when an update to the Society of Actuaries mortality tables extended by two years the life expectancy of Americans who reach age 65. This good news for retirees further increases plan liabilities. To top off the situation, the premiums that plan sponsors must pay to the Pension Benefit Guaranty Corporation (PBGC) have repeatedly increased over the past decade.

On every front, the costs of offering employees a defined-benefit pension plan continue to grow. Many companies are responding by shifting employees away from these traditional retirement plans.

“Corporations are shying away from making further defined-benefit promises,” explains Wayne Daniel, senior vice president and head of U.S. Pensions for MetLife. “The true cost of these promises has come out, and employers would prefer to have a fixed cost in terms of percentage of payroll. This is driving the trend toward offering defined-contribution plans.”

However, the move from defined-benefit to defined-contribution is not a panacea. It reduces a pension plan’s liability on the corporate balance sheet and makes corporate payouts predictable, but it also removes employees’ assurance of income in retirement. Market volatility leads to swings in 401(k) asset balances, and investment decisions fall to employees, most of whom have little experience in managing such assets.
“As with other types of employee benefits, there's been a fundamental shift in retirement plans toward employers providing the tools and resources to enable their employees to make decisions for themselves. And with that comes great responsibility,” says Timothy Brown, senior vice president and head of Life and Income Funding Solutions for MetLife.

The picture has been complicated by regulatory reforms for money market funds. Although stable value funds are the primary capital preservation option in most defined-contribution plans’ lineups, money market funds have also been included as a fixed income option. But the reforms, which take effect in October 2016, will mean that some money market funds will no longer offer a stable net asset value (NAV), and others will add redemption fees and liquidity gates that make them less attractive. It’s one more layer of complexity that participants in a defined-contribution plan will have to navigate.

Today’s economic and regulatory environment, along with retirement programs’ increasing costs, have brought to a head questions about a company’s optimal benefit strategy. Some organizations’ retirement plans still stand up under close scrutiny—but few companies today can afford not to evaluate whether they need to make changes.

“Many plan sponsors that have not taken action now feel compelled to do a real reassessment of their plan, in light of the macroeconomic environment and changing expectations of the workforce,” says Robin Lenna, executive vice president and head of MetLife Corporate Benefit Funding, the company’s institutional retirement business. “They’re deciding whether they need to take action.”

EVALUATING OPTIONS FOR DEFINED-BENEFIT PENSION DE-RISKING

Sponsors of defined-benefit pension plans who decide they do need to take action have several options. Collectively, these options are known as pension “de-risking” strategies. They range from a fairly low-impact change in the plan’s investment approach to a transfer of all pension liabilities to a third-party insurer.

At one end of the spectrum is liability-driven investment (LDI). The goal of liability-driven investment is to align the risk profile of a pension plan's asset portfolio with the plan's liabilities, so market trends that increase a plan's liabilities simultaneously increase the plan's asset value. LDI can be very helpful in mitigating interest rate risk, for example, but many of the current threats to plan funded status are outside the reach of an LDI strategy.

One step further down the spectrum is a pension “buy-in,” a defined-benefit pension plan’s purchase of a group annuity to hold as a plan asset. Owning an annuity can be an effective way to mitigate potential volatility in fund status because the annuity’s value is stable. It also helps a company guarantee that plan participants will have a certain level of income in retirement, as the annuity will provide a regular cash flow into the plan.

For plan sponsors that prefer to fully remove all their pension liabilities from their balance sheet, a pension “buyout” may be the best option. One type of pension buyout involves the plan sponsor offering participants a lump-sum payout in exchange for elimination of their future pension benefits. The company may open a three- or six-month window during which participants must decide whether they’d prefer to receive the future pension cash flow upon retirement, or receive a single payment in the immediate term instead. The smaller the benefit due to a particular participant, the more likely he or she is to take this type of buyout.

A lump-sum buyout can seem very attractive to plan sponsors because it transfers all risk from the plan to the individual. However, there is ongoing debate about whether this approach to de-risking is in the best interests of the plan participants. Like shifting to a defined-contribution model, offering a lump-sum buyout cancels the defined-benefit plan’s retirement income guarantee and allows the participant’s retirement security to be dictated by the whims of the market.

In July 2015, the Internal Revenue Service (IRS) announced in Notice 2015-49 that it intends to prohibit defined-benefit plans from replacing any annuity they are currently
paying with a lump-sum payment or other accelerated form of distribution. In other words, once the IRS has enacted its proposed regulatory changes, lump-sum buyouts will not be an option for current retirees.

An alternative to the lump-sum buyout is the transfer of defined-benefit pension liabilities to an insurance company through a well-established procedure known as a pension buyout. Pension buyouts usually involve the purchase of an annuity contract that transfers to the insurer all the risks around markets, investments, longevity and mortality, and changes in plan expenses. In exchange the insurer receives a lump-sum payment of either cash or assets in kind, or some combination of the two.

“This approach allows the plan sponsor to remove the volatile and expensive pension liabilities from its balance sheet, while at the same time it ensures that plan benefits are properly protected for current and future retirees,” says Daniel. “More important, when the plan sponsor chooses a large and stable insurance company for a pension buyout, it’s ensuring a secure retirement income for plan participants. Individual participants are not responsible for building an asset portfolio that will generate adequate income. From participants’ perspective, the only thing that changes is the entity their payments come from.”

Because the purpose of a pension buyout is to ensure a steady flow of income to the plan’s retirees, selection of the right insurance partner is key. U.S. Labor Department interpretive bulletin 2059.95-1 provides guidelines on the criteria that an insurance company must meet before it can take on responsibility for a defined-benefit pension’s distributions.

“Financial strength ratings are very important,” says Rhea Adler, senior vice president and CFO of MetLife’s Corporate Benefit Funding group. “One of the major points in Bulletin 95-1 is financial strength ratings; generally, AA is the minimum. The bulletin also provides specific requirements around an insurer’s portfolio diversification, size, and mix of business lines.”

It’s a crucial decision, but completing a de-risking transaction with the right insurance partner may actually protect employee benefits better than leaving them in a defined-benefit plan. Transferring a plan to an insurance carrier means participants’ future pension cash flows will be backed by the full protection of the insurer and, if needed, the appropriate State Guaranty Association.

“MetLife believes that the transfer of responsibility for pension benefits to a highly rated insurance carrier provides participants as much, if not greater, protection than their traditional reliance on plan sponsors and the PBGC,” Lenna says.

According to MetLife’s 2015 Pension Risk Transfer Poll, among plan sponsors who would most likely transfer pension risk to an insurer via an annuity buyout, 57 percent are considering doing so in the next two years. That percentage rises to 63 percent for plans with defined-benefit plan assets of $250 million to $499 million and 77 percent for plans with defined-benefit assets of $500 million to $1 billion.

A final de-risking option that is currently very popular among U.S.-based pension plan sponsors is the partial risk transfer. In a partial risk transfer, the plan sponsor either offers a lump-sum buyout or transfers risk to a third party for one segment of plan participants, such as current retirees, while leaving the plan intact for the rest of the participant population. Both active and
frozen defined-benefit plans are eligible for partial risk transfers.

What should plan sponsors be doing today?
The total accumulated value of legacy assets and liabilities within defined-benefit plans in U.S.-based private sector businesses exceeds $3 trillion, and only a small proportion of these plans has yet been de-risked. In the wake of ongoing regulatory and market changes, every defined-benefit pension plan sponsor should reconsider whether the current structure of the plan will continue to make sense into the future.

Pension risk transfers typically take several years to complete. They require an assortment of analyses of plan assets and liabilities. And many companies find, once they start the de-risking process, that they have inadequate data on plan participants or on some other crucial element of plan accounting.

For that reason, a corporate treasury team that is evaluating pension de-risking options would be wise to get the human resources function involved, to help ensure that the company has a properly cleansed version of all the data it will need if it does move forward with a risk transfer deal. Even those organizations that are not yet ready to finalize a transaction will benefit from developing a trustworthy source of data on which to base future plan management decisions.

“I encourage corporate treasurers to actively participate in the formulation of a pension risk management strategy within the corporation,” Daniel says. “I would also recommend actively engaging with advisers to prepare, so that when pension risk transfer is affordable and makes sense for the plan, the plan sponsor is in a position to take advantage of the opportunity.”

ENSURING SUCCESSFUL OUTCOMES FOR DEFINED-CONTRIBUTION PLANS

Whether or not it previously offered a defined-benefit pension plan, a company that provides a defined-contribution plan is putting the burden of ensuring retirement security entirely on the shoulders of its employees.

“Employees are exposed to market risks, inflation risks, and longevity risks,” Lenna says. “Longevity risk, the risk of living longer than expected, is the greatest risk an individual faces in retirement. It amplifies both market and inflation risks because it means individuals will be exposed to these other types of risks over a longer time. Consequently, mind-sets need to shift from a focus solely on retirement savings to producing retirement income in order to guarantee employees a financially secure future.”

The most important step a defined-contribution plan sponsor can take to help ensure a financially secure future for plan participants is to offer the right mix of investment choices. In fact, the recent Supreme Court decision in Tibble v. Edison International established that a plan sponsor has a fiduciary duty not only to offer investment options that will help participants meet their retirement goals at a reasonable cost, but also to regularly review the plan’s investment lineup.

“When reviewing Tibble, the first consideration for corporate treasurers and plan sponsors is whether the current investment lineup optimizes participant value and offers investment choices appropriate for all stages of a participant’s career,” says Tom Schuster, vice president and head of Stable Value and Investment Products for MetLife. “A sponsor’s review must be informed by external developments—e.g., five years of zero money market returns and the likelihood that money market reforms will depress future money market returns below historical norms, even when rates rise.”

To that end, many defined-contribution plan sponsors are considering replacing their plan’s money market funds with stable value funds. Like money funds, stable value funds are designed to protect principal, but stable value funds were created exclusively for the defined-contribution marketplace. They recognize tax and plan restrictions to construct a principal preservation option with higher-yielding investments further

“MetLife has been a leader in the stable value market since the very beginning of defined contribution plans. We introduced the first separate account wrap product in 1989, and last year we introduced a non-participating separate account product which combines the insulation properties of a separate account offering with the guarantee of a general account product. Understanding stable value is in our DNA.”

—Tom Schuster, vice president and head of Stable Value And Investment Products, MetLife
out the yield curve than money market regulations allow. MetLife recently evaluated the performance of its stable value contracts over the past 10 years and found annualized returns of 3.38 percent, versus just 1.29 percent for money funds over the same period. What this means is that $100 invested in the typical MetLife stable value contract a decade ago would be worth approximately $140 today, whereas the same amount of money invested in the typical money market fund would be worth $114. Taking into consideration inflation, the MetLife stable value offerings outperformed inflation by an average of about 1.25 percent per year, while the money funds actually eroded purchasing power at an average rate of 0.75 percent per year.

“A money market fund is really a retail product,” Schuster explains. “Defined-contribution plan participants who utilize money market funds are forgoing return in exchange for retail liquidity they don’t need. Since we are confident that any expert comparison of stable value versus money market would convincingly demonstrate the superiority of stable value in a plan setting, corporate ERISA counsel and corporate treasurers need to be aware that failure to reconsider the role of money market could subject the plan to increased litigation exposure. In one recent settlement, $29 million was allocated to a claim that the stable value option had too much in money market instruments. Additionally, the unanimous decision in Tibble v. Edison increases the likelihood that plan sponsors with money market as the sole capital preservation fund in their lineups could be exposed to increased litigation risk.”

Retirement income for defined-contribution participants.

Even employees who make the best possible choices in their defined-contribution portfolio will face a challenge in retirement: how to draw down the defined-contribution account balance without running out of money prematurely.

“Many employers are looking to rebalance, providing retirees with a guaranteed income while helping them retain flexibility and save enough for retirement,” Brown says. “Their focus was previously on how to convince employees to save enough during their working career, but they’re now starting to recognize that it’s important to arm plan participants with the right drawdown strategies, to help them make their savings last.”

Retirees have a couple of options for drawing down the balances on their defined-contribution plans. One is a systematic withdrawal program (SWiP), in which the individual decides how much to remove each year. This approach provides a great deal of flexibility, but it does not mitigate the risk that an individual will outlive his or her savings.

Experts often recommend that retirees withdraw 4 percent of their savings each year, but that may not be smart given the current interest rate environment. If the value of plan assets is rising more slowly than the historic average, the standard 4 percent per year might wipe out a defined-contribution plan balance years sooner than expected. Even as interest rates rise, some retirees live longer than others; the average will never be a guaranteed outcome for a specific individual.

One way around this harsh reality is to purchase an income annuity that will produce a certain level of guaranteed income in retirement. Some defined-contribution plan sponsors are introducing institutional income annuities as an option within their plans. The annuities aren’t investment options, but they offer the option to have a steady level of income flowing from an insurer during retirement.

“If they have the choice of an income annuity within their defined-contribution plan, employees can place some of their savings into a layer that provides a predictable income,” Brown says. “It’s not an all-or-nothing proposition. Plan participants who want flexibility can use a SWiP to withdraw some or all of their savings. Participants who want predictability can put some or all of their account balance into an annuity. Or participants can take advantage of both options to generate both secure income and access to their funds. Offering
both options enables participants to find their own balance between the right level of income and access to their funds."

A variation on the annuity theme is the qualifying longevity annuity contract (QLAC), a deferred income annuity that provides regularly scheduled payments starting at some point in the future—for example, when the plan participant reaches age 80 or 85—and continuing until either the death of the plan participant or the deaths of both the participant and his or her spouse. QLACs were brought into existence by a July 2014 U.S. Treasury decision that altered defined-contribution plans’ minimum-distribution rules. Now participants can use a QLAC to defer distributions on the lesser of $125,000 or 25 percent of the account balance.

“In light of the shift away from defined-benefit pensions, many defined-contribution plans are evolving from savings plans to retirement income plans,” Lenna says. “There’s a recognition that defined-contribution plans need to provide more effective outcomes for plan participants. One of those outcomes should be lifelong income for the participant.”

Offering an immediate income annuity and a QLAC as two options within a defined-contribution plan lets participants choose the level of retirement income predictability they need. Those who want immediate income can select that annuity. Those who want more flexibility can utilize a SWiP strategy but also purchase a QLAC to protect against the tail risk of outliving their investments.

Of course, just as with a pension buyout, the income assurance of any annuity contract is only as stable as the insurer from which the contract is purchased.

“Plan sponsors should work with insurance companies that have maintained strong financial ratings through all economic conditions,” Adler says. “MetLife is definitely one of those companies. Our financial strength ratings, combined with our reputation as a market leader and our customer experience, make us a trusted adviser to defined-contribution plan sponsors.”

Employee education is crucial.

Providing the right mix of investment and income options in a defined-contribution plan is clearly crucial, but plan sponsors shouldn’t overlook the importance of properly educating employees about those options. One best practice is to make clear to participants what level of income they can expect in retirement based on their specific defined-contribution account balance. Some companies include this information on every account statement. Another best practice is to keep decisions as simple as possible.

“Information overload with a lot of different choices can cause paralysis and inaction in many people,” Brown says. “The key to education is to simplify information so that all your plan participants can understand and make a decision. You want individuals to choose a course of action, rather than getting bogged down weighing too many options.”

FUNDING FOR POST-RETIREMENT BENEFITS

Many companies sweeten employment packages by offering non-qualified benefits such as life insurance, deferred compensation, supplemental executive retirement plans, and post-retirement medical benefits. These benefits may help attract top talent in the short term, but they create a financial dilemma for the longer run.

Non-qualified benefits do not have to be funded as the liabilities are incurred. However, these benefits are very difficult to eliminate from a human resources perspective, so finance managers should consider strategies to mitigate this liability. Companies could almost always find another use for their excess cash, but funding non-qualified benefits often makes sense.

“As the treasury and risk folks are looking at the most efficient use of capital, they need to keep in mind that this isn’t just about the internal rate of return,” Brown says. “With retiree life insurance, for example, the older your covered population gets, the more your liabilities increase because you know the claims are coming. So you have to treat funding very differently when you’re dealing with retiree life insurance than when you’re dealing with a pension
plan. It makes sense to look at the long-term outlay of costs and the opportunity to mitigate future costs, either by funding them or by transferring the risk to an insurer."

Some companies use company-owned life insurance (COLI) to create a tax efficient asset on their books for non-qualified benefit liabilities. Essentially, these businesses are purchasing cash-value life insurance policies on a segment of their top employees where they have insurable interest, then using the cash value and the death benefits to informally fund their non-qualified benefit programs. The Pension Protection Act of 2006 codified best practices for use of COLI in recognition of the important role they play in financing these liabilities.

While COLI works well for informally funding an array of non-qualified benefits, other options for efficiently funding or transferring liabilities specifically related to post-retirement group term life insurance exist. MetLife offers employers options well suited to managing these specific liabilities. First are life insurance funding accounts, which are a flexible, tax-efficient means of pre-funding the cost of retiree life insurance. Second are guaranteed life insurance funding accounts, which are similar to a pension buyout in that the insurer guarantees future payments in exchange for an up-front lump sum. Although the concepts are similar to pension funding, Brown warns that non-qualified benefits generally require their own cash flow analysis. “Some companies just put in place the same investment strategy they have for their pension plan,” he says. “That’s a mistake. Those cash flows are fundamentally different. It’s invaluable to work with a carrier with specialized expertise that can point out the opportunities and explain what the options are.”

**LOOKING FORWARD**

As financial markets and the regulatory environment continue to evolve, sponsors of pension and other retirement plans need to regularly re-evaluate the efficiency and effectiveness of their programs.

One area in which regulatory change is on the horizon is the definition of fiduciary responsibility. The U.S. Labor Department is proposing a new definition, which would extend fiduciary duty to anyone who provides investment management recommendations or appraisals to employee benefit plans. “This will have implications for the retirement space overall,” Brown says. “Depending on how the final regulations come out, this rule could have the impact of limiting the amount of information and education that is available to participants because those who would otherwise provide advice might be concerned about taking on fiduciary responsibilities. There’s a chance this will impact the way defined-contribution plan sponsors provide information to their participants.”

Regulatory hurdles to including income annuities within defined-contribution plans will likely continue to diminish. “There have been a number of regulatory barriers—both actual and perceived—that have limited plan sponsors from making institutional income annuities widely available,” Brown says. “Over the past few years, federal regulators have begun providing clarity on these issues, which enables more and more plan sponsors to include annuities in their plans.”

Litigation will likely continue to motivate defined-contribution plan sponsors to move away from money market funds and into stable value funds built explicitly to meet their participants’ needs. Future rule changes may also make de-risking an increasingly attractive option for defined-benefit pensions.

“There’s increased focus in the Obama administration on lifetime income,” Lenna says. “Along with the rest of the industry, MetLife is working with policymakers to help them strengthen the retirement system without weakening the protections provided by ERISA.”

Staying abreast of all these issues is a crucial responsibility for today’s corporate treasurer. Staying in the dark is not safe, as inaction increases litigation risk. Market forces and the macroeconomic environment will continue to raise the complexity of retirement investment decisions, and plan participants will expect increasing levels of transparency and decision-making support.

“In all the businesses that MetLife Corporate Benefit Funding is in, financial strength ratings are very important. These deals are committed for many, many years; some are basically evergreen contracts. So there’s a lot to be said for partnering with a company that has stellar ratings, and MetLife fares very well in that regard.”

—Rhea Adler, senior vice president and CFO of MetLife’s Corporate Benefit Funding group
Companies need to regularly reconsider whether they’re providing the right options, tools, information, and education to the participants in their benefit plans. And treasury and finance managers—who have ultimate responsibility for managing plans’ assets and liabilities, and mitigating their impact on the corporate balance sheet—need to play a key role in these analyses.

“At the end of the day, it’s the treasurer or CFO who has to make the important decisions around management of the corporate pension plan,” Adler says. “They have the right perspective to consider what’s best for employees and what’s best for the company too. It’s a daunting task, but it’s the treasurer and CFO who must ultimately make the decision on how to proceed with retirement benefit programs.”

Why Partner with MetLife for Corporate Benefit Funding?

In the corporate benefit funding arena, knowledge and trust are priceless. Plan sponsors need an adviser to help them understand the implications their decisions will have for plan participants. They also need complete confidence that if they transfer responsibility for employee benefits to a third party, the obligation will be fulfilled.

“It’s great to have a lot of features and options in your retirement benefit plans,” says Robin Lenna, executive vice president and head of MetLife Corporate Benefit Funding, “but you want to make sure they’re with a carrier that’s going to be around for a long time. Some retirement benefits won’t be paid for 20, 30, or 40 years, or more. A multifaceted retirement product line isn’t going to be worth much if the company that was guaranteeing it ceases to exist.”

RELIABILITY. This is where MetLife shines. It was the first insurer to offer a group annuity in the 1920s and, more recently, the first to offer institutional qualifying longevity annuity contracts (QLACs) and separate account guaranteed insurance contracts (GICs).

After almost a century of innovation in the retirement space, the Corporate Benefit Funding group has historically accounted for around 20 percent of MetLife’s total operating earnings.

“We are first or second in market share in almost every market we serve,” says Rhea Adler, senior vice president and CFO of MetLife’s Corporate Benefit Funding group. “We have been in many of these markets for more than 50 years. We have the financial strength of MetLife behind our business, and we have a breadth of experience that enables us to really understand the needs of a particular plan sponsor, treasurer, or CFO.”

Moreover, says Tom Schuster, vice president and head of Stable Value and Investment Products for MetLife, “our history proves that MetLife will provide retirement solutions when it’s easy to be in a market and when it’s difficult. We’ve earned the trust of plan sponsors by staying in our markets through all economic cycles.”

For example, following the 2008 economic crisis, wrap capacity for stable value contracts became very limited. Many banks exited the market, and many insurance providers scaled back their offerings. MetLife, on the other hand, provided $30 billion worth of wrap coverage during that challenging time. “When times are difficult and it’s not easy to be in a market because of the dislocations that are occurring, partners that understand and are committed to the market will provide the coverage to stabilize the market. That’s exactly what MetLife did,” Schuster adds.

SIZE. In addition, the scope of the Corporate Benefit Funding business—managing over $190 billion in assets and making annuity distributions to more than 600,000 people annually—enables MetLife to diversify risk in a way that smaller insurers can’t.

“Whether it’s individual participants at a defined-contribution level, or a defined-benefit plan, or even in the non-qualified market, we can diversify risks across geographic lines, across ages, and across product lines, such as life insurance and annuities,” says Tim Brown, senior vice president and head of Life and Income Funding Solutions for MetLife. “We can mitigate financial risks over a very, very large pool.”

REPUTATION. Finally, because MetLife is a household name, partnering with MetLife may simplify a plan sponsor’s task of selling a change to plan participants.

“MetLife is one of the carriers with great brand recognition, and that helps participants feel good about the fact that their employer is providing a retirement solution from a strong, reputable, trustworthy company,” Brown says.

“It’s important for plan sponsors, treasurers, and CFOs to understand the depth of our experience and our constancy in these markets,” Adler concludes. “We have strong financial ratings, and our breadth of experience is unparalleled.”