

Transferring Pension Plan Risk

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The Pension Protection Act of 2006 (PPA) and Financial Accounting Standard No. 158 both encourage risk mitigation and reduction in the volatility of a pension plan's funded status (fluctuation in the ratio of assets to liabilities) while encouraging plan sponsors to maintain a 100 percent funded pension plan. It is important to manage financial statement liabilities created by employee benefit programs and, when appropriate, to reduce or eliminate such liabilities.

For defined benefit pension plans, plan sponsors can match the cash flows of assets and liabilities to mitigate risk. They can also consider more aggressive funding of the plan to handle the volatility of assets. Alternatively, they can consider the purchase of a group annuity on a block of pension plan liabilities. With the recent extreme volatility in the financial markets, there has been an increased interest in such risk transfer.

Working to decrease risk

Most investment risk and interest rate risk can be alleviated by matching cash flows of an investment portfolio to anticipated plan payments. However, this can be expensive and labor intensive—and it's never perfect. Alternatively, when a company reduces or eliminates its liabilities through a partial or full risk transfer by purchasing a group annuity, investment and interest rate risk are effectively removed. This also removes mortality risk and early retirement risk, which investment immunization strategies struggle to address.

Typically, when a pension plan is partially annuitized, retirees are settled first. The shorter duration of annuity payments makes this group less risky to underwrite. There is less likelihood of unanticipated longevity increases and, since retirees already receive payments, there is no risk of unknown early retirements. For these reasons, insurance companies who sell group annuities aggressively pursue this block of business. Plan sponsors get the benefit of completely removing these liability obligations and associated risks from their books. A single premium is paid and the liability associated with the block is eliminated.

The second most common choice for annuitization would be to settle the block of terminated vested participant liabilities. This

group adds the extra uncertainty of participants taking benefits early. If the plan is subsidized for early retirement (and most are), liabilities increase as participants take early retirement. Annuity pricing actuaries generally add in loads for this extra risk and, so as not to come up short on their premium charge, they may assume many more early retirements than are likely to occur.

Look before you leap

Following are some items to consider when planning either a partial or full risk transfer:

- Participants typically receive a more secure benefit since there is more collateral in the insurance company than there are assets supporting the pension plan.
- For publicly-traded corporations, reducing the size and risk of a plan is generally viewed favorably by the market.
- Settlement will require the realization of a proportional amount of the plan's accumulated actuarial gain or loss in the income statement. This accelerates the realization of the accrued gain or loss that otherwise would have been amortized over time.
- The risk transfer will have an impact on the future Generally Accepted Accounting Principles' (GAAP) expense. The magnitude and direction of the impact will depend on the price of the transfer relative to the Pension Benefit Obligation of the benefits settled and the difference between expected return on assets and the discount rate assumption.
- PPA has forced adoption of mortality tables and interest rates closer to those used by insurance companies to calculate the group annuity premium. Beginning with the 2012 plan year, the interest rate basis will be fully phased in. This means that the liabilities determined in the plan valuation will become more closely aligned with the premiums for the group annuity.
- A partial risk transfer will affect the funded status of the liabilities which remain in the plan. An underfunded plan will become more underfunded. An overfunded plan will become more overfunded. For example, if plan assets are \$90, liabilities are \$100, and a portion of liabilities worth \$50 is settled for \$50, the funded status of the pension plan goes from 90 percent to 80 percent.



- Under PPA, if a plan's Adjusted Funding Target Attainment Percentage (AFTAP)—that's the funded status with adjustments for credit balances and annuity purchases, where applicable—drops below 80 percent, accelerated payments (which include annuity purchases) are restricted.
- Ongoing investment and administration services (cutting checks, tax forms and benefit calculations) are assumed by the insurance company.
- The annuity provider's lines of business and other indications of exposure to liability.
- The structure and guarantees found in the annuity contract.
- The availability of additional protection through state guaranty associations.

Annuity selection

In 1995, the U.S. Department of Labor issued Interpretive Bulletin 95-1, offering guidance in the selection of an annuity provider. Following these guidelines ensures that the plan sponsor is meeting its fiduciary duties and properly considering the interests of plan participants. The Interpretive Bulletin states that a plan fiduciary:

- Should purchase the safest annuity available unless it would be in the interest of plan participants to do otherwise.
- Must conduct an objective, thorough and analytical search to identify and select providers.
- Must evaluate the claims-paying ability and creditworthiness of potential providers but must not rely solely on ratings provided by insurance rating agencies.
- A fiduciary should also consider:
 - The quality and diversification of the annuity provider's investment portfolio.
 - The size of the insurer relative to the proposed contract.
 - The level of the insurer's capital and surplus.

Without the necessary expertise and resources to evaluate such factors, plan sponsors need to obtain the advice of a qualified, independent expert. SilverStone Group has worked with many different types of benefit plans, including complex cash balance plans. With this experience comes the ability to articulate benefits for the annuity provider and interpret the annuity contract wording for accuracy. It is important to develop clear and concise bid specs and provide accurate census data so that insurance underwriters have a complete understanding of the plan.

Choosing an organization with both actuaries and brokers on staff eliminates the need to establish a new relationship and trust of a third party to handle the annuity sale when the time comes to do so. With this combination of expertise, estimates are obtained directly from the annuity providers and compared to actuarial valuation liabilities. Because rates are monitored regularly, cost and benefit analyses of settlement in various interest rate environments position the plan sponsor to act when it is the best time to buy. The focus is on designing the best risk transfer solution for the plan sponsor and the participants.