CFO Insights
Shedding pension risk

Over the past few years, many defined benefit (DB) plan sponsors have worked to reduce balance-sheet exposure to pension liabilities through a variety of de-risking strategies, including plan redesign, (for example, plan closures or freezes), in-plan strategies such as liability-driven investing (LDI), and pension risk transfer (PRT) strategies, such as voluntary lump-sum offerings and annuity buyouts.

In fact, about 63% of CFOs who report having pension plans have utilized at least one aggressive de-risking tactic, according to the Q1 2016 *CFO Signals*™ report—up from 45% in Q4 2014.[1] Moreover, the attractiveness of reducing retirement risks has contributed to increased use of voluntary lump-sum payouts for terminated employees (52% of CFOs reported this activity, up from 42% in Q4 2014), and outright plan terminations, which require annuity buyouts, have risen as well (to 23% from 17% in Q4 2014).[2] See Figure 1.

But as frequent as de-risking activity has been, there are several factors suggesting it may accelerate this year. For example, recent regulatory changes[3] that will raise the total cost of existing US DB pension plans for many organizations may encourage plan sponsors to move forward with or consider new de-risking strategies. Meanwhile, the perceived cost of annuity buyouts has come down over the last few years as companies have reflected the new mortality tables in their financial statements, and many CFOs continue to wrestle with the balance-sheet volatility of pension liabilities.

As management and boards become increasingly motivated to de-risk their DB plans, leading practices are emerging to help them sort through the complexity of the process and address concerns of various stakeholders. In this issue of *CFO Insights*, we will consider some of those practices and offer insights into effective de-risking strategies.

Regulatory changes spur action

There are several new regulations spurring companies to consider de-risking. A two-year budget deal[4] signed in November increased the premiums that plan sponsors pay to the Pension Benefit Guaranty Corporation (PBGC) by more than 20%. PBGC premiums are fairly significant and have often been an impetus to offer lump-sum payout programs to former employees. By allowing plan participants to take a one-time, lump-sum payout in lieu of future annuity payments, plan sponsors are able to shrink the number of former employees vested in their plans, which can reduce the total PBGC premium and eliminate pension risk for those participants.

Another driver of pension risk transfer is the impact of updated mortality tables on plan liabilities. Released in 2014, new tables[5] indicate that US longevity is increasing faster than previously expected. The resulting change to pension calculations was reflected in year-end 2014 financial statements for most companies and increased corporate pension liabilities by between 5% and 8% based on Deloitte's experience with affected companies.

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However, the mortality tables used to determine pension funding requirements and to make lump-sum calculations won't be updated significantly until at least January 1, 2017.[6] Given the lag time, many companies are working to complete their lump-sum programs before then to help contain the costs of these programs. Deloitte estimates that roughly two-thirds of companies with pension liabilities have executed terminated-vested (TV) lump-sum programs to date.

Another regulatory change affecting lump-sums came in July when the IRS issued a Notice[7] that effectively disallows new retiree lump-sum programs. The Notice stipulates that unless plan sponsors meet one of a few explicit exceptions afforded to programs that were already in process, the programs will be prohibited. This regulatory change limits the options plan sponsors have to de-risk liabilities for the retiree portions of their plans, causing sponsors to consider plan terminations or partial plan annuity purchases to further de-risk.

Current and emerging strategies

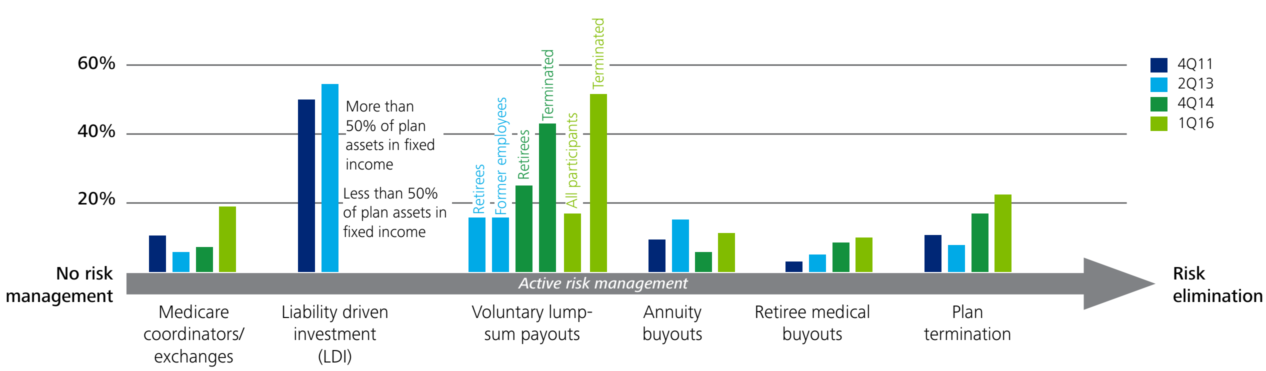
As attractive opportunities to offer lump-sum programs dwindle, many companies are focusing on other strategies, such as purchasing annuities and implementing more comprehensive LDI approaches. It is not an "either-or" choice between LDI and annuity buyouts, however. LDI strategies are about reducing the risk of volatile financial results by changing the plan's investment strategy to be more in line with the plan's liabilities. This is often undertaken as a so-called glide path, whereby volatility is gradually reduced as the plan's funding position improves. An LDI strategy can be used whether or not a plan sponsor ultimately decides to use annuities to remove risks and expenses permanently.

The changes impacting DB plans also have prompted some companies to look more closely at the long-term cost of plan sponsorship. When viewed over the lifetime of a DB plan, the full cost of plan maintenance is significant—typically 5% to 10% of the liability on a present value basis, based on recent research.[8] These maintenance costs can be eliminated for the participants covered by an annuity purchase.

But annuity buyouts typically require a well-funded plan. Poorly funded plans generally are not good candidates unless sponsors are prepared to make significant contributions. That is why plan sponsors will often adopt an LDI strategy until the plan is sufficiently funded to purchase annuities.

Figure 1. Aggressive pension de-risking strategies on the rise

Percent of CFOs citing past use or intended use (within a year) of each strategy (n=69-81)



Source: North American CFO Signals, Q1 2016, US CFO Program, Deloitte LLP

Capacity issues could increase costs

As more organizations aim toward annuity buyouts, they could face obstacles if de-risking activity continues to accelerate. In 2015, annuity buyout sales topped $13.6 billion across more than 300 transactions. Annual buyout sales have eclipsed $10 billion only one other time (in 2012).[9] A heightened level of activity could lead to capacity issues as well as human resource shortages at insurers and advisers that help execute annuity buyouts.

Consider that every time an insurer issues a contract, it must use some of its capital to support that contract, and annuity buyouts tend to be large contracts. In addition, potential changes to risk-based capital standards issued by the National Association of Insurance Commissioners (NAIC) are being studied. The NAIC standards[10] tie the amount of capital insurance companies must hold to the quality of bonds on their balance sheet, and the adjustments to the standards that are being considered could cause insurers to invest in higher-rated, lower-yielding bonds or to demand a higher profit spread, either of which would make annuity buyouts more expensive.

Human capital resource constraints also may impact an organization's plans to de-risk. With elevated recent activity, many insurance companies and advisers are starting to feel the crunch of not having the number of experienced employees needed to take on the increasing number of buyout transactions. Insurers are being more selective in choosing whether or not to bid on annuity buyout transactions, often citing resource constraints. That could lead to higher transaction costs if constraints persist.

Weighing the cost of annuity buyouts

Before changes to mortality tables for accounting purposes, annuity buyouts appeared relatively expensive compared with their accounting carrying value. Now, however, many companies have started to realize they can settle large portions of their pension liabilities at a cost not much higher than the current balance-sheet liability. And when that cost is compared with the present value of all future plan maintenance costs (not to mention the removal of significant risk), annuity buyouts often look attractive.

Based on Deloitte's experience, the buyout premium for retirees is generally about 3% to 6% above the plan's accounting liability. The premium is generally higher for active and terminated vested participants, so many plan sponsors have focused on annuity buyouts for retirees in the near-term. If the insurance capacity issues begin to impact pricing, the premium relative to accounting valuations could rise higher for all participant segments.

There is a difference of opinion about valuation comparisons. Some stakeholders say it is not appropriate to compare the buyout cost with the accounting value, which is calculated by discounting the plan's projected benefit payments using a yield curve based on AA-rated bonds. Rather, the buyout should be compared with a risk-free rate because virtually all risks to the plan sponsor are eliminated for those liabilities transferred via an annuity buyout.

Virtually is the operative word, however. As long as the plan sponsor executes its fiduciary responsibility properly in conjunction with the Department of Labor (DoL) Interpretive Bulletin 95-1, the sponsor should have no residual liability, even if the selected insurer—which might coincidentally hold AA ratings—becomes insolvent and plan participants lose some benefit value. According to Penbridge Advisors, annuity buyout costs are currently approximately 8% lower than the cost would be using a Treasury curve as a proxy for the risk-free rate.[11] It is therefore not surprising that an emerging leading practice, used in many recent large buyout transactions, is the enlisting by the plan sponsor of an independent fiduciary to ensure that the annuity is selected in accordance with DoL guidelines.

There is general agreement, however, that the AA-rated curve may be appropriate for plan maintenance because even under the most conservative LDI strategy, the sponsor continues to assume at least credit risk.

Implementing effective strategies

As executives consider the impact of regulatory and market changes, and weigh various organizational objectives, decision-making around de-risking strategies can be challenging. About two-thirds of CFOs with pension plans cite impediments in de-risking their obligations, including waiting for higher interest rates to reduce de-risking costs and the fact that they are not well-enough funded[12] (see Figure 2). The goal is to figure out what should be done, if anything, and when.

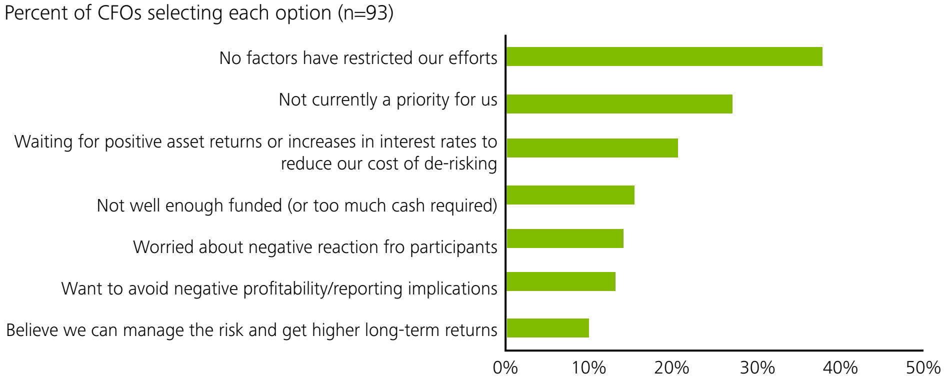
There are several leading practices that plan sponsors can adopt to develop and implement effective strategies:

- Involve stakeholders from HR, finance, and treasury to ensure that varying perspectives are considered.
- Understand the scope and materiality of the pension plan to the overall organization, which may have changed over time.
- Review ongoing plan governance activities to help improve the decision-making process around pension de-risking.

Once the financial and risk reduction trade-offs are understood and intangible considerations, such as management's time, are evaluated, plan sponsors often are better-positioned to compare the identified benefits of transferring plan risk to managing pension risk on their balance sheets. In the end, the appropriate strategies vary from company to company. As a pension plan's risk profile evolves over time, sponsors should understand and evaluate the full range of pension de-risking alternatives.

It is important to establish a clear action plan and an ongoing monitoring structure to help execute in a cost-effective way while reducing overall risk once the objectives are set. Pension risk transfer transactions, in particular, can be highly complex and impact the organization's people, finances, and reputation in significant ways. Careful planning and communication have never been more important.

Figure 2. Factors restricting de-risking efforts
Percent of CFOs selecting each option (n=93)



Source: North American CFO Signals, Q1 2016, US CFO Program, Deloitte LLP

Endnotes

[1] North American CFO Signals, Q1 2016, US CFO Program, Deloitte LLP.

[2] North American CFO Signals, Q1 2016, US CFO Program, Deloitte LLP.

[3] House Bipartisan Budget Act of 2015, Pub. L. No. 114-74, Title V: Pensions.

[4] House Bipartisan Budget Act of 2015, Pub. L. No. 114-74.

[5] Society of Actuaries, RP-2014 Mortality Tables, October 2014 (Updated November 2014).

[6] Internal Revenue Service, Notice 2015-53—Updated Static Mortality Tables for Defined Benefit Pension Plans for 2016.

[7] Internal Revenue Service, Notice 2015-49—Title IV, Use of Lump Sum Payments to Replace Lifetime Income Being Received By Retirees Under Defined Benefit Pension, Title IV. Effective Date, July 27, 2015.

[8] Estimates based on Penbridge Defined Benefit Expense Survey, 2014-2015.

[9] LIMRA Secure Retirement Institute, U.S. Group Annuity Risk Transfer Survey, Fourth Quarter, 2015.

[10] National Association of Insurance Commissioners Model Laws Regulations and Guidelines, Risk-Based Capital (RBC) Model Act, III-312-1, 1st Quarter, 2015.

[11] Estimates based on Penbridge Pension Risk Transfer Index, March 2016.

[12] North American CFO Signals, Q1 2016, US CFO Program, Deloitte LLP.

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