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TOPICS OF INTEREST

Verus

Developing an end-game strategy for corporate pensions

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Summary

As a plan sponsor's de-risking strategy ultimately bears fruit and the plan approaches full funding, a new phase of the pension management lifecycle brings with it new challenges. Navigating the later stages of the asset-liability journey requires that plan sponsors establish a clear and well-defined view of the end-state. Doing so requires careful consideration of costs (some knowable, some not), risks, and less tangible company-specific considerations. Once this end-state is defined, investment and contribution strategy can be cohesively aligned to maximize the probability of success. With greater flexibility, the probability of a successful outcome increases.

Current market environment

Despite the tumultuous first quarter resulting from the COVID-19 pandemic, the average corporate pension fund ended 2020 in similar financial shape to where it began the year, with a funded ratio of 87%[1], as the strong rebound in equity markets that commenced in April was offset by declining interest rates. While the S&P 500 ended the year up 18.4%, 2020 concluded with the lowest year-end discount rates on record[2]; the combination inflated both assets and liabilities.

Many corporate pension funds are seeking to get off the funded status roller coaster and out of the pension management business. The pension no longer functions as an integral part of the overall employee

compensation and retention strategy for most companies. That combined with the more onerous contribution and mark-to-market requirements introduced by the Pension Protection Act of 2006 have caused the majority of corporate plan sponsors to close their pension funds to new entrants, or freeze their plan entirely. This was an important first step in creating a liability profile that is more manageable, and ultimately putting the sponsor on a path to one day be considering an end-game strategy.

In prior Topics of Interest, Verus has introduced the concept and mechanics of liability-driven investing (LDI)[3]. We have also outlined the methodology used to help clients build successful de-risking glidepaths[4] customized for unique circumstances. This discussion will build off those earlier papers and now focus on the different potential end-game options for plan sponsors and address some of the key considerations to align investment strategy with their ultimate end-game objective.

End Game: pension risk transfer (PRT) or hibernation?

The fundamental end-game decision each plan sponsor needs to make is whether they ultimately want to engage in a pension risk transfer (PRT) and transfer liabilities from their balance sheet to that of a third party via a buy-out annuity or to participants via lump sum payments; or to retain the liabilities and risk on their own balance sheet. Under this approach, plan sponsors can develop a hibernation strategy by constructing a custom LDI portfolio designed to reduce future funded status volatility and potential contribution requirements to levels acceptable to the plan sponsor. In Verus' experience, most plan sponsors are ultimately seeking to transfer their pension risk via buyout annuity, but there are others that desire to retain the risk for reasons we will address below.

As mentioned above, it is important for plan sponsors to consider a variety of factors when determining their ideal end-state. In fact, it is highly likely that different strategies may be suitable for different subsets of plan participants and each strategy's attractiveness often depends on current market conditions. Therefore, to the extent feasible, plan sponsors will benefit by maintaining a degree of flexibility when evaluating end-game strategies.

Below we will address some of the key factors to consider for each strategy, including benefits, risks, and investment implications.

Risk transfer strategies

The most common end-game strategy, and the natural starting point for discussion, is a risk transfer. As mentioned above, the primary risk transfer strategies are:

- Lump sum payments
- Buy-out annuities (partial or total)

LUMP SUM PAYMENTS

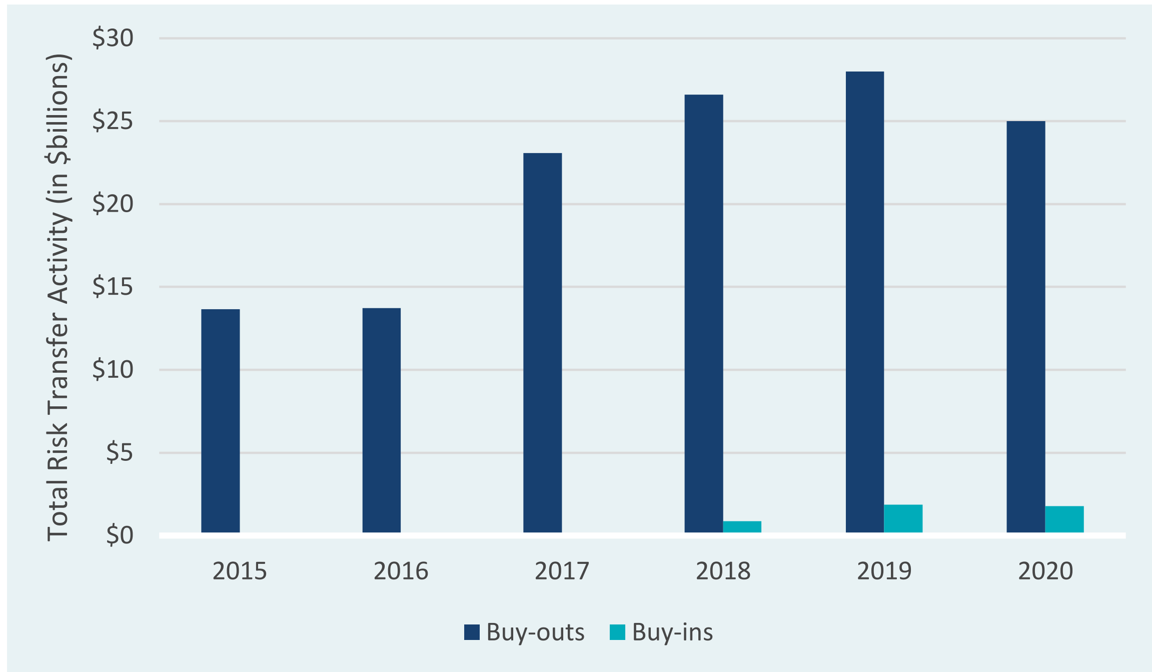
Lump sum payments have been frequently used by plan sponsors as an intermediate step to reduce plan liabilities and costs. They have been used almost exclusively with term-vested employees and are an attractive way of "cleaning up" the participant ledger and removing participants with small pension balances, an action that became especially compelling with the dramatic increase in fixed PBGC premiums that has made these small balance accounts prohibitively expensive to maintain in the plan.

A plan sponsor can periodically offer lump sum payments to select groups of participants. Typically, they will work with an actuarial firm to identify the appropriate groups to target, to craft an offer and then to solicit and collect participant responses. This process generally takes 4-8 months to complete.

BUYOUT ANNUITIES

Buyout annuities became more prevalent following the global financial crisis and their popularity has continued to increase, with transaction volume averaging approximately $25 billion per year over the past four years.

EXHIBIT A: RISK TRANSFER TRANSACTION VOLUME IN US



Source: Secure Retirement Institute

Most of the above activity represents partial buyouts, but a number of plan sponsors have completed total buyouts, effectively removing themselves from the pension management business.

Buyout annuities are usually most cost-effective for current retiree populations with shorter durations, but they can also be utilized with term-vested and active employees with frozen pensions. Buyouts can become more expensive when the liability is not as well defined, such as with pensioners who are still accruing benefits or with plans that offer lump sum payments instead of, or in addition to, a monthly annuity. Cash balance pension plans typically have a lump sum feature (and other attributes) that make them more expensive to include in a buyout annuity transaction.

The appeal of the buyout annuity is that upon completion, the assets and liabilities covered by the annuity are transferred off the plan sponsor's balance sheet and onto that of the insurer. The insurer then bears all the risk (investment, longevity, etc.) associated with funding the benefit payments associated with these liabilities going forward. In addition, the plan is no longer responsible for escalating PBGC premiums for the transferred pensioners, no longer bears the investment and administrative costs of managing the assets and making benefit payments and is not subject to future regulatory changes that may impact future contribution requirements and/or financial statements.

Completing a buyout annuity process is complex and time consuming. The process can take from 12-24 months and most plan sponsors engage various "experts" - including legal counsel, independent fiduciary, actuary, transition manager and annuity placement specialists - to guide the process and ensure they are conducting their fiduciary duty (as outlined in Department of Labor Bulletin 95-1) throughout.

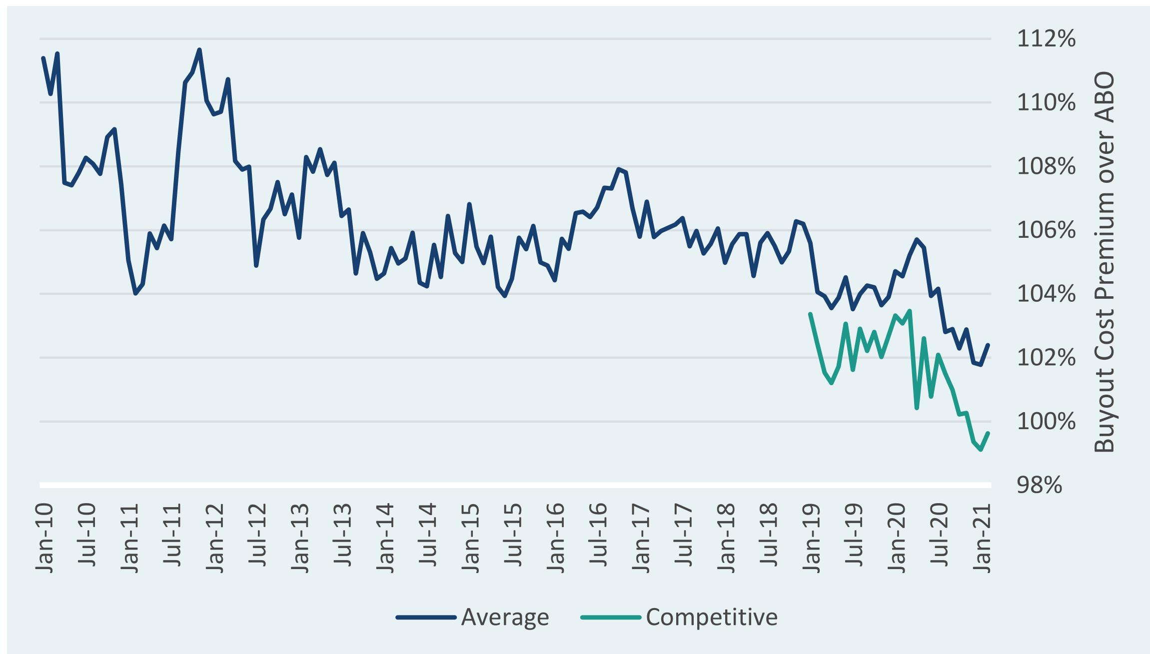
One important consideration is that a full or partial buyout annuity will also require settlement accounting, which can have a meaningful impact on a corporation's financial statements. Depending on the expected impact, the desire to avoid settlement accounting may be one factor that would lead a plan sponsor to opt to retain the plan liabilities on the balance sheet and consider hibernation strategies instead.

ASSESSING THE COST OF A BUYOUT ANNUITY

One of the first steps (and most time-consuming) to complete is "cleaning up" the actuarial data of the population to be included in the buyout annuity. This step can range from cleaning up participant data to conducting a custom mortality study and is essential to ensure that the insurers' bids are accurate and reflective of the plan sponsor's expectations.

As the graph below indicates, the cost of buyout annuities has been steadily declining over the past 10 years as more insurers enter the market.

EXHIBIT B: BUYOUT COSTS DECREASING



Source: Milliman Pension Buyout Index

When soliciting competitive bids for a buyout annuity, pricing can vary widely from insurer to insurer and transaction to transaction. Actual pricing will depend on:

- Deal size
- Insurer demand (can vary throughout the year)
- Participant demographics
- Cash or assets-in-kind transaction

When evaluating the cost of the buyout versus the cost of maintaining the liabilities on the balance sheet, it is important to consider all costs – PBGC premiums, investment and administrative costs and risks – investment, longevity and regulatory risk – associated with maintaining the plan.

PRT'S IMPACT ON FUNDED STATUS

The attractiveness of a pension risk transfer (for both lump sums and buyouts) will also depend on the current funded status of the plan. If the plan is underfunded, a lump sum offering or partial buyout annuity will serve to reduce the funded status of the remaining assets and liabilities, requiring the remaining assets to work harder and potentially increasing future contribution requirements. The table below illustrates the impact on a well-funded plan versus a less well-funded plan.

EXHIBIT C: PRT & FUNDED STATUS

	Pre-transfer	Partial Risk Transfer	Post-transfer	Decline in Funded Ratio
Well funded Plan:				
Assets	$95	(25)	70	
Liabilities	$100	(25)	75	
Funding Ratio	**95%**		**93%**	**-2%**
Poorly funded plan:				
Assets	$70	(25)	45	
Liabilities	$100	(25)	75	
Funding Ratio	**70%**		**60%**	**-10%**

INVESTMENT IMPLICATIONS OF PRT

As a plan sponsor approaches the point where they are considering a PRT, it is important to ensure that the portfolio is structured appropriately and has sufficient liquidity to fund lump sum benefit payments, or to transfer cash or securities in exchange for the buyout annuity. There will also need to be enough liquidity to reposition the remaining assets to the desired asset allocation policy.

For large buyout annuities, better pricing is often offered if a plan sponsor can transfer assets in-kind to the insurer. These assets would generally consist of investment grade corporate bonds and U.S. Treasuries that meet the insurer's portfolio requirements. They will typically provide a list of bond characteristics and/or names that they would accept and the plan sponsor would then work with existing investment managers to construct a portfolio of securities that could be used for the in-kind transaction. If the size of the buyout is significant, it may make sense to engage a third-party transition manager to handle the restructuring to minimize costs and potential market impact.

For pensions that have held legacy investments in illiquid asset classes like private equity or real estate, it is important to prepare to wind down these exposures well in advance of an anticipated PRT of significant size. For instance, in the Exhibit C example for the well-funded plan, a 20% allocation to illiquid investments pre-transfer would become a 27% allocation post-transfer, due to the reduced denominator. A de-risking glidepath will generally provide a mechanism to gradually reduce these exposures as funded status approaches 100%.

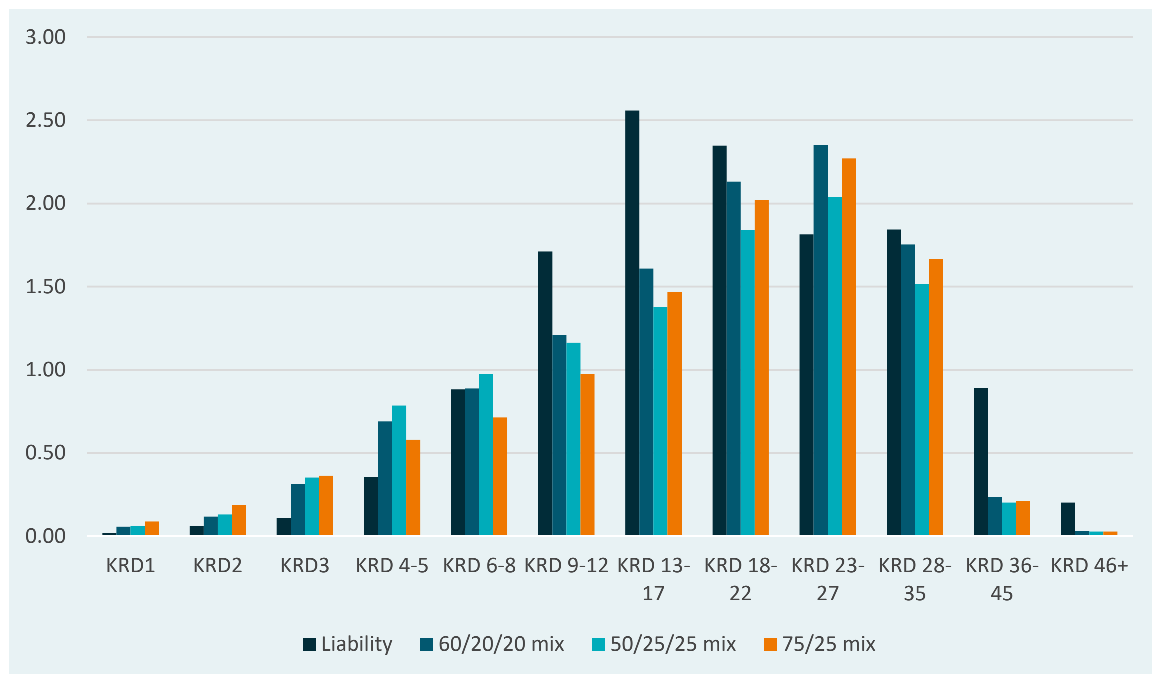
Hibernation

Many plan sponsors may prefer hibernation strategies to pension risk transfer strategies for reasons ranging from potential lower cost, paternalism, or desire to avoid settlement charges (in the short-run or long-run). The appropriate hibernation strategy will differ from plan sponsor to plan sponsor based on their objectives and risk tolerance. For purposes of our discussion below, we will assume that the plan has reached 100% funded on a projected benefit obligation (PBO) basis.

THE CUSTOM BENCHMARK

Creating a custom liability benchmark is the initial step in building a hibernation strategy, if not already considered during the de-risking glidepath. This benchmark can take on many forms depending on the nature of the liabilities and the amount of funded status volatility a plan sponsor is willing to withstand. Benchmarks may be built from the bottom-up with fixed income securities that match the key-rate duration profile of the plan's benefit payment stream, or they may consist of public fixed income benchmarks that are weighted in a manner that reflects the key-rate duration profile (as illustrated in Exhibit D below). While matching the duration profile is the primary measure, other characteristics that are considered are credit quality, sector allocation and individual position size.

EXHIBIT D: CUSTOMIZED LIABILITY BENCHMARKS – EXAMPLE OF MARKET INDEX BLENDS VS. LIABILITY



It is important to note, there are certain risks embedded in the liabilities that cannot be hedged with a fixed income portfolio:

- The first is longevity risk. Excluding the potential impact of COVID-19, the trend for participant longevity has been steadily increasing. Over time, this could cause growth in liabilities to outpace the returns of a custom fixed income liability benchmark.

- The second is credit migration. Pension liabilities are discounted using AA corporate bond yields (and these bonds are often selected based on highest yields). Because of the limited number of AA issuers, it would not be practical to hold a "AA-only" portfolio. It would be overly concentrated. Therefore, the custom fixed income index will take credit

risk relative to the AA discount rate to ensure appropriate diversification. More important, if a bond that makes up the AA discount rate for the liabilities gets downgraded, it is replaced in the discount curve, but if the plan sponsor owns it in the liability hedge portfolio, they suffer the negative return due to the downgrade. Over time, it is estimated that this "credit migration" can result in meaningful deterioration in funded status, all else equal.

Because of these hedging issues, as well as to incorporate the impact of investment and administrative expenses, many hibernation strategies will still include a small (5-10%) allocation to return-seeking assets. While this introduces some additional funded status volatility, it provides the potential to earn excess returns that would help mitigate longevity risk and credit migration.

CUSTOM HIBERNATION PORTFOLIO STRATEGIES

From a portfolio construction standpoint, hibernation portfolios can be passively or actively managed. Active strategies may offer a greater chance of success since active management may help mitigate credit migration risk and any alpha generated would help offset longevity risk and cover costs.

Another strategy that is growing in popularity is a buy-and-maintain strategy. As the name implies, this is not simply a buy-and-hold strategy, but it is not fully active either. The goal for this type of portfolio is to purchase high-quality fixed income securities that closely match the characteristics of the custom liability benchmark, but management would be limited to monitoring credit quality and periodic adjustments to reflect changes in the liabilities. In this manner, investment management and transaction costs are minimized, and funded status volatility remains low. There is minimal opportunity for alpha, but there may be better credit protection than a purely passive portfolio.

Regardless of portfolio strategy – passive, active, or buy-and-maintain, the primary goal of hibernation strategies is to limit funded status volatility and generate cash flows sufficient to meet monthly benefit obligations.

Plan sponsors that have adopted a de-risking glidepath typically begin building custom liability hedging portfolios when they reach a funded status trigger point that pushes the liability-hedging allocation somewhere above 70%. (Building a highly customized liability-hedging portfolio prior to this point is an exercise in over-engineering since the bulk of funded status volatility will be driven by the return-seeking allocation.) This allocation can then be further customized as the portfolio approaches the hibernation stage.

A plan sponsor may want to adopt a hibernation strategy as an interim step in advance of a buy-out annuity. The good news is that if a plan sponsor later opts to do a buy-out annuity after adopting a hibernation strategy, the portfolio should not require a significant amount of restructuring to prepare it for an in-kind transfer to an insurance company.

USE OF BUY-IN ANNUITIES

One component of a hibernation strategy that has been utilized in the U.K. and is beginning to gain some traction in the U.S. is the buy-in annuity. In January 2021, Lockheed Martin announced that it had purchased an $800 million buy-in annuity to cover certain employees.

A buy-in annuity is priced similarly to a buy-out annuity, and like a buy-out annuity, the buy-in annuity provider is responsible for funding all future benefit payments made to those participants covered, with one notable difference - the plan sponsor still retains responsibility for administering the benefit payments to participants.

This structure results in some potential advantages over a buy-out annuity:

1. The buy-in annuity becomes an asset of the plan - therefore, there is no negative impact to funded status or future contribution requirements for underfunded plans.

2. There is no settlement accounting required.

3. Often, the buy-in annuity can be converted to a buy-out annuity in the future at no additional cost.

Unlike the buy-out annuity, the owner of a buy-in annuity will still be responsible for PBGC premiums and other administrative costs. Despite this obvious negative, the buy-in annuity could start to become a more integral part of hibernation strategies in the U.S.

Conclusion

Year-to-date, through March 2021, it is estimated that the average funded status of U.S. corporate pension plans has increased by roughly 8%[5], as continued strong equity markets have been accompanied by rising discount rates, especially benefiting those plans with lower interest rate hedge ratios. While we can undoubtedly expect further volatility across rates, credit spreads and equity markets, many plan sponsors may already find themselves in a position to execute on their end-game strategy. For others still seeking to close a funding deficit, now may be the perfect time to begin developing an end-game strategy and ensuring that investment portfolios are aligned to that end.

This Topics of Interest paper was designed to provide you a high-level overview of the various end-game strategies available to pension plan sponsors. Any one of these strategies is a major undertaking and usually involves input across a wide range of internal stakeholders and outside advisors. As always, planning is the key to success, whichever approach is decided to be the correct one.

Notes & Disclosures

1 *Willis Towers Watson, January 4, 2021. "Willis Towers Watson examined pension plan data for 366 Fortune 1000 companies that sponsor U.S. defined benefit pension plans and have a December fiscal-year-end date. Results indicate that the aggregate pension funded status is estimated to be 87% at the end of 2020, unchanged from 87% at the end of 2019."*

2 *Milliman Pension Funding Index, January 8, 2021. "The Milliman 100 discount rates fell 74 basis points to 2.46% at the end of 2020 from 3.20% at the end of 2019. The discount rate at year-end 2020 was the lowest year-end discount rate and second lowest monthly discount overall that has been recorded in the 20-year history of the Milliman 100 Pension Funding Index (PFI)."*

3 *Please refer to: "A Practical Understanding of LDI" (May 2019) https://www.verusinvestments.com/a-practical-understanding-of-ldi/*

4 *Please refer to "LDI Glidepath Creation" (June 2019) https://www.verusinvestments.com/ldi-glide-path-creation/*

5 *Milliman Pension Funding Index, April, 2021.*

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