

A Valuable Option

Understanding the pension risk transfer market



From left: Russ Proctor, Marty Menin, Jennifer Haid, Adam Berk

Although the funded status of many defined benefit (DB) plans is improving, some plan sponsors find that the administration, costs and volatility of these plans is too much for their company to bear. Whether a plan is frozen or active, the concept of pension risk transfer (PRT) has caught on here in the U.S. To discuss this market and its trends, Alison Cooke Mintzer, editor-in-chief of PLANSPONSOR and PLANADVISER, spoke with Pacific Life Insurance Company and Ernst & Young about their recently completed research paper on pension risk solutions, titled “Charting the Course: A framework to evaluate pension de-risking strategies.” She sat down with Russ Proctor and Marty Menin, both directors of institutional sales at Pacific Life; Jennifer Haid, a consultant in the insurance and actuarial advisory practice of Ernst & Young; and Adam Berk, who leads the human capital actuarial services at Ernst & Young. They shared their ideas on what plan sponsors need to know about the pension risk transfer market and how it could affect their plans in 2014 and beyond.

PS: From your perspective, what is driving the conversation today about pension risk transfer?

Proctor: Plans are much better funded now than they were in the recent past, so as they start to approach full funding again, that’s really encouraging a lot of them to start looking at solutions to take action and preserve that funded status.

Also, I think there’s been so much volatility over the past five years—plans that were 100% funded in 2008 quickly dropped below 80% and are now finally clawing their way back to 100% funded (Source: Milliman 100 Pension Funding Index, December 2013). Many plans are more focused now on trying to preserve that funded status and do not want it to drop again, as we’ve seen happen so many times in the past.

In addition, the continued changes in pension plan regulation, such as the recent increases in Pension Benefit Guaranty Corp. (PBGC) premiums, are causing plan sponsors to de-risk their plans and begin to move the liability off the balance sheet.

Many pension plans have already closed the plan to new entrants or fully frozen benefit accruals for

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all participants. This dramatically shortens the investment horizon for the plan. These plans are now focusing their investment decisions a lot more on pension risk transfer and de-risking the plans.

Finally, chief financial officers (CFOs) and other executives are now focusing on the impact of funded status volatility on their plan contributions and balance sheet. They understand better than ever that the size of the pension liability compared to the size of their company can have a significant effect on their overall risk profile.

Berk: I would also note that there have been a few landmark transactions in the jumbo market that have paved the way for innovative and customized solutions, not only for larger organizations but for the mid-market as well. For example, we've seen more insurers and asset managers develop pension-specific solutions to meet some of the growing demand.

Pension plan sponsors are in relatively good shape today, and it's much easier to address pension risk when you're already in a strong position. So now is a great time, while plan sponsors are in that position of strength, to take action and address some of their pension risk.

PS: The GM and Verizon deals got quite a bit of attention, and rightly so, but what influence do you think those deals had or are having on the broader market?

Berk: When it comes to true innovation, nobody wants to be the first to act, but everyone is willing to be the second. These initial jumbo transactions created the blueprint for other organizations. Prior to these larger deals, we didn't see much pension risk transfer activity in the United States outside of the more traditional termination funding arrangements.

Menin: These jumbo transactions raised awareness across the whole marketplace. We are hearing from companies like investment banks, small and large actuarial firms and other firms that have not focused on these issues before. They are all asking us about pricing and process, and even bringing some cases to the marketplace.

That awareness has required us here at Pacific Life to become more consultative across all of these firms, because everyone's approaching it from a different perspective. Some people are asking, "How do you place these deals?" Some are asking, "What new products are you building?" Others ask, "What does my client need to do first?"

So, what used to be more or less a binary marketplace of either terminating the plan or keeping the plan has really changed. A plan sponsor's perspective now is, "I'm trying to de-risk, to get to the point of termination, but there's a lot of time between now and then. I want to understand what I need to do in the meantime and how I go about it."

PS: For plan sponsors that are developing these de-risking strategies, what are the most important things to think about or consider as they move forward?

Haid: First, there are some key questions that the sponsor needs to ask: "What is my ultimate objective? What tools are available to get me there? What risks am I exposing the business to, and can I afford those risks?"

Second, the analysis should not have a foregone conclusion. The objective should be stated in terms of a set of measurable outcomes—for example, reducing volatility of expense or minimizing required contributions—that allows each option to be weighed against the others in an unbiased way.

We think that framing the question this way allows the CFO to evaluate a broad range of alternatives against the company's objectives, constraints and other priorities. We wrote this research paper to demonstrate how to compare alternatives in a way that makes the decision-making process more straightforward.

PS: What were the key findings of your analysis? Did anything surprise you?

Haid: The first thing we found, perhaps unsurprisingly, was that there's no one-size-fits-all approach; a CFO looking to terminate the plan quickly may have a different strategy than one with a longer time horizon. Secondly, the effectiveness of the strategy depends on the CFO's objectives and on the attributes of the plan—things like the demographic profile and the funded status—and on the CFO's expectations of the future economic environment. And last, it's a function of our current economic environment that many five-year economic forecasts anticipate an increasing interest-rate environment; and in that environment all of the strategies we looked at achieved full funding with a reasonable level of certainty.

So we're telling our clients that now is a good time to act to protect their funded status, to evaluate their alternatives, and to get a strategy in place so they are well-positioned the next time the market turns.

Proctor: I don't think that we were surprised by any of the results. We certainly expected the insurance products would perform well in volatile economic scenarios, and the research and analytics supported that.

Just the fact that new insurance products are available to the market is very valuable. For example, we offer a buy-in product and an Insured LDI (liability-driven investing) solution.

From left: Adam Berk, Jennifer Haid, Marty Menin, Russ Proctor



We've seen from our clients—with Insured LDI, for example—how it's performed during the volatile market over the last couple of years, and how it's been able to stabilize the funded status no matter how dramatic the market is in terms of interest rates or stock market changes. That's something we've known, but it's nice to see it confirmed in the detailed analytics that Ernst & Young prepared.

Again, with the increasing-rate scenario, it's nice to see that all of the strategies performed fairly well. We also saw that the insured products actually looked a little better than the traditional LDI product because of the longer interest-rate duration in the traditional LDI structure that was modeled, so we thought that was interesting.

PS: Looking ahead, what does the PRT landscape look like?

Menin: From 2012 to 2013, aside from those jumbo transactions, there was about a 65% increase in transaction volume. Clearly, momentum is picking up in this marketplace, and it's going to drive product innovation. These new products give plan sponsors more tools to help solve these pension risk issues and, hopefully, develop better strategies to manage the risk and the financial implications of their pension plans.

Berk: If I were to describe it in one word, I would say “more.” We believe there could be more innovation, more customization, and that we'll see more educated and savvier CFOs, and more transaction activities. We think that there will be more innovation on the supplier side; suppliers will continue to react to plan sponsor demand and will work with CFOs to develop the customized solutions that work for them.

PS: Although the deals with GM and Verizon were quite large, is the risk transfer concept valuable for small and mid-sized defined benefit plans?

Berk: The mid-market benefited from what the jumbo players started in 2012. Those initial transactions paved the way from a legislative perspective and from a strategy perspective. They demonstrated the levers providers can use to customize solutions, and now the small and mid-market sees more opportunity and choice.

Menin: The risk transfer concept is very valuable, perhaps even more so, because the small and mid-market plan sponsor has not had access to the same sophisticated investment strategies that are available to larger plans. That's the reason we developed our Insured LDI solution—it simplifies the LDI process and makes it very

easy to understand how it works.

Haid: One of the things that came out of the large transactions was an increased interest on behalf of plan sponsors, in all markets, in de-risking strategies—and an increase in demand for customized solutions. We're seeing the creation of strategies that focus specifically on the mid-market and bring some of the creative thinking we saw on the large transactions to smaller and mid-level transactions.

PS: If so many more products are going to be coming to market, would it be the wise thing to wait and see what comes out to see what options are available down the road?

Berk: Plan sponsors need to ask themselves, “What's the right timing for me in order to de-risk?” We've seen a lot of innovation and product activity in the U.S., so now is a great time to at least develop the strategy and have a plan for what the optimal economic environment is to de-risk. Performing the analysis sooner rather than later may show that doing something now is better than waiting and maintaining the current strategy.

Proctor: I think we have a broad range of products available now to help solve the plan sponsor's needs. I see

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the customization more in applying the products that we have in different ways and using a mixture of the tools available.

Menin: And let's say a plan sponsor decides to wait. Between now and whatever they do next, the issue of volatility is still there. Our products are designed to help them stabilize their funded status between now and then.

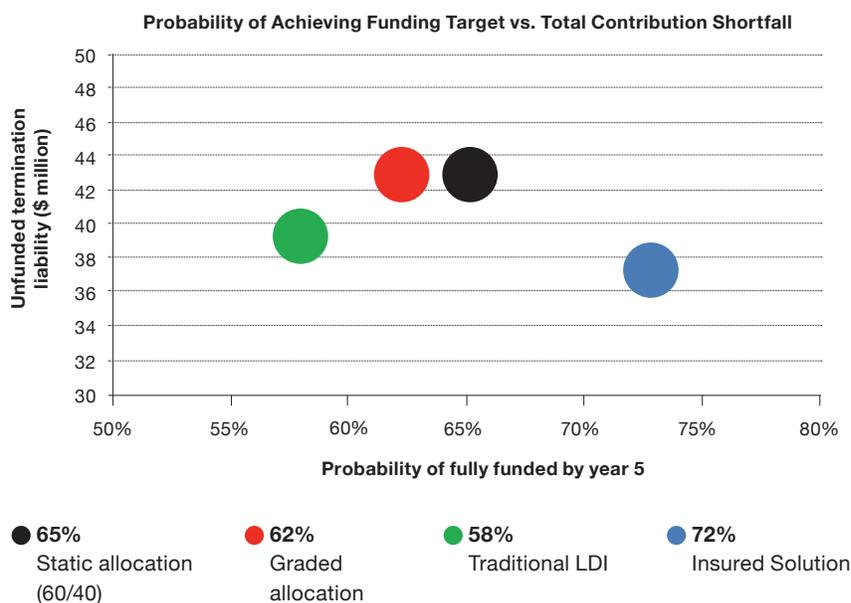
Berk: We have included one of the graphs from the research paper to help illustrate how currently available strategies might be evaluated in the context of a plan sponsor's specific objectives.

An example: A CFO's goal is plan termination in five years. The CFO's objective is to choose an investment strategy such that there is a high probability that plan assets will be equal to the termination premium without needing to contribute more to the trust than what has already been budgeted.

We chose to look at a cross section of the de-risking solutions that are available today. A full description of the data, assumptions, methods and results can be found in the full version of the research paper.

In order to evaluate the strategies, we can look at the data in terms of the CFO's specific objective and constraints. In the following chart, the probability of the sample plan being fully funded on a termination basis by the end of the fifth year (x-axis) is plotted against the average remaining shortfall for those scenarios in which available assets are insufficient to meet the termination premium in the most costly 5% of outcomes (y-axis).

In this case, for this simply stated objective, the strategy that best achieves the objective appears to be the insured solution. This is the result we might expect since the CFO in this example is focused on mitigating the



risk of a large contribution in scenarios with bad financial outcomes.

Should the CFO's objective be different—for example, minimizing cash contributions or managing volatility in net income—there are other strategies, found in the research paper, which may better meet these competing objectives. For this reason, CFOs need to clearly articulate each objective and, to the extent possible, prioritize desired results.

PS: Are there plans for which this is not a great fit?

Menin: Actually, these pension risk solutions are helpful for all plan sponsors, whether their DB plan is ongoing, closed and/or frozen, or in the process of termination. Pension risk management is an issue for CFOs now more than ever—and these solutions work for plans of all sizes and at all points along the de-risking spectrum.

Haid: We advocate a knowledgeable look at your risk profile so you can make impartial and informed decisions. We want our clients to concentrate on looking at the different

solutions that are available to them in the context of how each can help achieve their risk management goals.

Berk: There are more choices for plan sponsors than ever, and we believe it's important to understand the advantages and disadvantages of each. We hope our research will provide a useful set of tools that plan sponsors can use to understand their options. Some plan sponsors may find current strategies will continue to meet their needs and new strategies are not a great fit. That said, all plan sponsors can benefit by looking at their options—some may be surprised by the benefits of new and innovative solutions. ■

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