Relatively strong U.S. equity markets over the past year have been countered by a continued low interest rate environment, causing pension liabilities to skyrocket and pension plan sponsors to contribute substantial amounts of cash to their plans. Many plan sponsors are seeking risk reduction strategies that might help to reduce their pension liabilities and gain better control over the impact that the pension is having on overall corporate finances.

While several large U.S. corporations made news headlines in 2012 for their steps in reducing pension liabilities through annuitization with an insurance provider or lump sum payments to participants, these options pose some challenges for the market at large. According to the SEI Pension Management Research Panel's January poll, plan sponsors are considering the following risk reduction strategies in 2013:

- 63% Liability driven investing
- 47% Lump sum payments
- 31% Closing/freezing accruals
- 16% Plan termination
- 14% Annuitization

This commentary provides an overview of the benefits and challenges that plan sponsors face in implementing annuitization options and lump sum payments to decrease risk. Two separate summaries will follow to provide additional information on the process of plan termination, as well as implementing an effective liability driven investing (LDI) strategy for a closer liability match and reduced tracking error.

What are pension buy-ins and buy-outs? What should plan sponsors consider when exploring annuitization through an insurance provider?

In the world of pensions, the term “annuitization” is used most often to describe a portion of the plan liability being sold to an insurance company, also commonly known as a pension buy-out. In this model, the plan sponsor effectively sheds liability risk, which then resides with the insurance provider. Another less common form of annuitization is a pension buy-in, where certain liability cash flows are guaranteed by an insurance company, but the contract or agreement remains an asset of the plan.

Today’s pension buy-outs and buy-ins are not new and have been around in differing forms in the U.S. and globally for many years. Generally speaking, plans look to annuitize retirees or pensioners in payment status. However, it is possible to include other groups such as terminated vested participants, although this typically increases the overall cost.

Before making the decision to annuitize pension liabilities, there are several factors that plan sponsors need to consider, with the most basic being the Employee Retirement Income Security Act (ERISA) considerations and the ultimate cost. First, annuity purchases must satisfy the ERISA “safest available” rules in order for the plan sponsor to meet its fiduciary responsibility in transferring the liability. Therefore, it is prudent to follow the Department of Labor interpretive bulletin 95-1 when selecting an insurance provider.
Second, plan sponsors should also consider the cost—both the cost of purchasing the contract and the accounting costs that may be included. The cost to purchase the annuity contract includes 100% of the value of the liability being annuitized, as well as an additional premium for factors such as mortality risk, the interest rate environment, re-investment risk and administrative costs. It is not uncommon to see premiums of 15-25% over the liability value, depending on the population and other considerations.

Considering that the majority (70%) of plans responding to the Pension Management Research Panel's recent poll are between 70% and 90% funded, the premium required for a pension buy-out transaction would likely be an expensive risk reduction strategy to undertake. These transactions can also have significant impacts on corporate balance sheets. From a corporate finance perspective, organizations should also consider the view credit rating agencies may have with regard to the potential impact.

Buy-ins were initially viewed as a more favorable solution as they defer any potential accounting impacts, while still immunizing a specific set of cash flows. However, risks with a buy-in may include a comparable high initial price tag, along with the potential for additional costs and due diligence required to transition to a buy-out at a later date or at plan termination. A pension buy-in may also pose possible tracking risks to the liability, and negative impacts on any current LDI strategy.

What are lump sum payments? What should plan sponsors consider when exploring this option for terminated vested participants?

Plan sponsors looking to shed risk may consider offering terminated vested participants the option of receiving a one-time lump sum payment in lieu of or in addition to life annuity payments. By accepting lump sum payments from their pension plans, retirees take on fiduciary responsibility for managing the assets paid to them and plan sponsors shed the associated fiduciary and liability risk.

In considering lump sum payments, plan sponsors should evaluate the overall cost and whether the option would improve plan funded status and move the plan further along the glidepath. Lump sum payment rates are generally determined once per year using interest rates based on corporate bonds. Depending on the current funded status of the plan, lump sum payments may or may not improve funded status, based on the difference between the lump sum rate and the discount rate versus the plan funded status. For example, the liability would need to be 125% of the lump sum payment for an 80% funded plan to increase funded status.

Some plan sponsors may view a lump sum payment as a more affordable alternative to purchasing an annuity. By offering a lump sum payment, plan sponsors could potentially reduce the number of retirees for whom they are obligated to pay Pension Benefit Guaranty Corporation (PBGC) premiums and ongoing administrative costs. However, in the current historically low interest rate environment, lump sum payments may also be an expensive option, as low interest rates equate to higher cash values. Plan sponsors should also consider the disruption in asset allocations due to cash outflows, especially for plans with illiquid asset classes in their portfolios.

Pension plan sponsors should thoroughly explore the full cost of offering a lump sum payment. In many cases, the cost of calculating the benefit alone can be well over $100 per participant. It is best practice to conduct a full break-even analysis that includes all costs and savings factored by the estimated terminated vested participant acceptance rate for the lump sum payment to determine whether this strategy has worthwhile benefits to the plan in the current investment environment.
Conclusion
Choosing the most effective approach to reduce pension liabilities and risk is clearly a complex decision. The main benefit of annuitization and lump sum payments is the decrease in plan sponsor liability, although maybe not entirely in the case of a buy-in.

These strategies should be evaluated on a plan by plan basis. At this time, we believe the environment does not make these strategies attractive for most pension plans. The selection and implementation process is long and complicated. Settlement accounting is still required. And, most significantly, the expense can be a significant premium to the liability value.

We believe the current environment provides plan sponsors with better options for managing the plan risk, with the use of custom and actively managed LDI programs and dynamic glidepath management, eventually getting the pension plan to a funded level or environment of lower termination costs.

The Pension Management Research Panel, sponsored by SEI’s Institutional Group, conducts industry research in an effort to provide members with current best practices and strategies for the investment management of pension plans.

For the Pension Management Research Panel’s 2013 Outlook Poll Summary or additional information, please contact SEI at SEIResearch@seic.com or 1-866-680-8027.

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