Pension De-Risking Strategies – Latest Developments and Trends

June 30, 2015
# Speakers

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Agenda

Latest Trends – Phil Parker

Annuity Purchases and Buyouts – Tom Sablak

Implications of the GAO Report – Tonya Manning
Latest Trends
Background

Defined benefit plan sponsors have been considering and implementing de-risking investment strategies in the wake of interest rate and market turbulence over the last 20 years.

- As plans begin to return to being fully funded again, sponsors may want to consider permanent risk transfer options, including administrative and design alternatives.

- Over the past 3 years, interest in one such option has escalated — offering terminated vested participants, and in some cases retirees, a payout through lump sum windows.

- Terminated vested lump sum offerings, which may include retirees, were very prevalent in 2014 and activity is continuing to remain high into 2015.

- Take rates generally range from 40% to 70%
Pension Plan De-Risking Approaches

Offer Participants Lump Sums
- Participants must elect to receive a lump sum
- Normal form of benefit must be offered as well
- Settle liability directly with participants for an amount close to accounting liabilities

Purchase Group Annuities
- Plan sponsors can elect to transfer pension liability to high quality insurance carrier
- Premiums can exceed accounting liabilities by 10 - 30%
- U.S. insurers' capacity raises some concern

Retain Liabilities and Manage Risk More Closely
- Plan payments typically expected to continue for 80+ years
- Sponsors have structured long term LDI strategies to mitigate pension cost and funded level volatility
- Certain demographic risk transfer products may proliferate
Considerations

Why are some plan sponsors choosing to offer a lump sum window while others are not? Factors influencing decisions about executing a Lump Sum window vary by plan and by company:

- Plan structure – open, closed and frozen pension plans
- Cost/benefit to execute window
- Investment management considerations
- Employer perspectives on paying lump sums or early annuities
- Accounting considerations
- Effect on the funding of the plan
- Future of the plan
- Employee’s ability to make an informed decision
- Limited one time windows versus a permanent lump sum option
Pros & Cons

Key advantages

- Reduced administrative costs - most notably plan administration and PBGC premiums that are scheduled to increase considerably
- Pending change in 417(e) and IRS Funding mortality tables likely to take effect in 2016 or 2017 will increase both liabilities and lump sum costs significantly
- Permanent reduction in the size of pension obligations
- Reduction in overall balance sheet risk
- Accelerates participant access to retirement assets
- Favorable interest rate environment

Disadvantages

- Short-term cost of administering the window
- Potential settlement charge
- Potential decrease in funding percentage
- Participants may not be able to manage retirement income appropriately
- May require negotiation with unions to include union plans
## Considerations: PBGC Premiums

<table>
<thead>
<tr>
<th>Year</th>
<th>Flat Rate (previous law)</th>
<th>New Law Flat Rate</th>
<th>Variable rate per $1000 of underfunding (previous law)</th>
<th>New Law Variable Rate</th>
<th>Variable rate cap (previous law)</th>
<th>New Law Variable Rate Cap</th>
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</thead>
<tbody>
<tr>
<td>2013</td>
<td>$42</td>
<td>Same</td>
<td>$9 indexed ($9)</td>
<td>Same</td>
<td>$400</td>
<td>Same</td>
</tr>
<tr>
<td>2014</td>
<td>$49</td>
<td>Same</td>
<td>2013 rate indexed + $4 ($14)</td>
<td>Same</td>
<td>$400 indexed ($412)</td>
<td>Same</td>
</tr>
<tr>
<td>2015</td>
<td>$49 indexed</td>
<td>$57</td>
<td>2014 rate indexed + $5 (at least $19)</td>
<td>2014 rate indexed + $10 (at least $24)</td>
<td>$400 indexed (at least $412)</td>
<td>Same</td>
</tr>
<tr>
<td>2016</td>
<td>$49 indexed</td>
<td>$64</td>
<td>2015 rate indexed (at least $19)</td>
<td>2015 rate indexed (at least $29)</td>
<td>$400 indexed (at least $412)</td>
<td>$500</td>
</tr>
<tr>
<td>2017</td>
<td>$49 indexed</td>
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<td>2015 rate indexed (at least $29)</td>
<td>$400 indexed (at least $412)</td>
<td>$500 indexed</td>
</tr>
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</table>

### Payment Level

<table>
<thead>
<tr>
<th>Payment Level</th>
<th>Currently In Payment</th>
<th>2016 PBGC Savings</th>
<th>Future PBGC Savings</th>
<th>Deferred</th>
<th>2016 PBGC Savings</th>
<th>Future PBGC Savings</th>
<th>Estimated Total Future Savings</th>
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<tbody>
<tr>
<td>&lt;$5,000</td>
<td>254</td>
<td>16,243</td>
<td>324,864</td>
<td>1,395</td>
<td>89,280</td>
<td>1,116,000</td>
<td>1,440,864</td>
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<tr>
<td>&lt;$10,000</td>
<td>1,050</td>
<td>67,200</td>
<td>1,344,000</td>
<td>2,659</td>
<td>170,150</td>
<td>2,977,632</td>
<td>4,321,632</td>
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<tr>
<td>&lt;$25,000</td>
<td>1,853</td>
<td>118,579</td>
<td>2,371,584</td>
<td>3,547</td>
<td>226,982</td>
<td>4,147,680</td>
<td>6,519,264</td>
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Note – assumes 60% of window participants elect the lump sum
## Considerations: Avoid Settlement Charge

### Example – Targeted Sequential Lump Sum Windows

<table>
<thead>
<tr>
<th>Group 1: Lump Sum &lt;$60,000</th>
<th>Count</th>
<th>FAP Lump Sum</th>
<th>Cash Balance</th>
<th>Total Lump Sum</th>
<th>PBO Liability</th>
<th>Funding Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,037</td>
<td>$18.4M</td>
<td>$2.6M</td>
<td>$21.0M</td>
<td>$24.4M</td>
<td>$15.3M</td>
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<tr>
<td>Group 2: Lump Sum &lt;$100,000</td>
<td>97</td>
<td>$7.2M</td>
<td>$0.1M</td>
<td>$7.3M</td>
<td>$8.6M</td>
<td>$5.3M</td>
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<tr>
<td>Group 3: Unlimited Lump Sum</td>
<td>225</td>
<td>$28.1M</td>
<td>$1.6M</td>
<td>$29.7M</td>
<td>$34.0M</td>
<td>$22.6M</td>
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Service Cost + Interest Cost approximately $18.0M
New mortality was already adopted for 12/31/2014 YED
IRS likely to increase lump sums by 2016 or 2017
Every employer is different. For some, settlement is the driving force behind decisions for others it’s not a consideration at all.
Trends Workflow

**Step 1**
Identification of Terminated/Vested Target Participant Pool
- Key Target Criteria Based on Company Goal: risk mitigation, PBGC premium reduction, phased termination of the Plan, etc.

**Step 2**
Calculation of Annuity/Lump Sum Payment Amount
- Accrued benefits are verified/calculated, Plan amendments adopted, optional forms of payment calculated, demographic data collected

**Step 3**
Administer Lump Sum Window
- 1. Address/death verification
- 2. Communication: draft supporting communications
- 3. Compose, print and mail
- 4. Call center support all calls recorded and tracked to completion
- 5. Web Site: decision support tools, online election, document warehouse
- 6. Weekly funding report

**Step 4**
Participants Mail Back (or elect on-line) Election Materials
- Review and follow up with participants as needed

**Step 5**
Incoming Responses Are Scanned & Imaged
- All incoming mail is stored electronically and indexed; images provided to client at end of project

**Step 6**
Payment File Is Provided
- Trustee and Plan administrator receive electronic file of employee elections and payment information

**Step 7**
Confirmation Letter (Optional)
- Election letter/statement is mailed to participants:
  - Confirmation of election
  - Notification of payment amount/start date

Take Rates: Online Elections, Targeted Education, Consistent Reminders, Multimedia
Trends Timeline

- Kickoff meeting
- Draft communications
- Address search
- Data reach out

Announcement postcard → Decision kit → Reminders*

1 week

Election period opens

Month 3 - Month 4

Month 5 - Month 6

Month 7

Call center training

Launch website

Final follow-up correspondence for incomplete responses

*Reminders include post cards and can include phone calls or emails
Trends: Going Online

Web portal incorporated into existing DBA, or stand alone, to provide a centralized source of materials and election gathering.

67% of employees making elections did so online
Plans offering online elections tended to have higher take rates
Trends: Take Rates

Take Rate by Age
Trends: Take Rates

Take Rate by Lump Sum Amount

![Bar graph showing the take rate by lump sum amount. The x-axis represents lump sum amounts ranging from 0 to 30,000, and the y-axis shows the take rate. The graph indicates a decrease in take rate as the lump sum amount increases.]
Trends

What else is going on with TV Lump Sum windows?

• Targeted Sequential Lump Sum Windows
• Phase #2 - Plan Termination
• Employers coming out of benefit restrictions
• Reminder campaigns
• Plan Choice/Window, Spin Off and Termination
• The media portrayal of de-risking, especially TV & Retiree Lump Sum windows
• Increased scrutiny
Annuity Purchases and Buyouts
Annuity purchases and buyouts: an overview

Many names: “buyout”, “partial risk transfer”, “carve-out”, “lift-out”

What is a “buyout”? 

- Single premium group annuity (SPGA) contract purchased for a segment of a pension plan’s population
  - Typically involves retirees in payment status, but may also include terminated vested participants
- Involves the complete and permanent transfer of liability (and related administration) from a pension plan to an annuity provider without a full plan termination
- While the plan sponsor holds the SPGA contract, certificates are issued to each individual
- Transaction does not require participant consent or election
Retiree buyouts – why the interest?

Market data

U.S. SPGA Sales and Estimated Indicative Annuity Purchase Rates

Estimated Annuity Purchase Interest Rates (retirees): presenter’s calculations reflecting year-end annuity purchase rates for retirees in payment status based on indicative rates furnished by an insurance company.
Retiree buyouts – why the interest?

“De-risking” strategies reduce the size of pension obligations and therefore reduce funded status and balance sheet volatility in general.

Reflection of longevity improvements in actuarial calculations has narrowed the gap between GAAP liability and insurer premiums.

“Upon closing the annuitization with Prudential based on current market conditions and other estimates, the plan will transfer about $3.1 billion of assets to Prudential in payment for Prudential’s group annuity contract covering about 30,000 retirees with a PBO liability of about $3.1 billion … we’re settling the retiree obligation with Prudential approximately at par, which is unprecedented.”

- Rob O'Keef, Motorola Solutions, Inc. Corporate Vice President and Treasurer on a pension update conference call with analysts, September 25, 2014
Retiree buyouts – considerations

Key advantages

• Financial – Reduction in balance sheet liability
• Risk-transfer – Investment, interest rate, and longevity risks are transferred to an insurance company
• Administration – Reduction in PBGC premiums and ongoing plan administration costs
• Speed – Annuity purchase transaction can be quick and focused
• Control – Sponsor selects target population, drives timetable, and makes “go / no-go” decision

Key considerations

• Financial – Settlement accounting may apply and additional funding contributions may be required to maintain funded status
• Opportunity cost – Plan’s investible asset base shrinks
• Compliance/legal – Selection of an annuity provider is a fiduciary decision, and PBGC protection is replaced with state guaranty association coverage
• Communications – Participant groups have challenged buyout transactions so communication strategy is important
Process and sample timeline

**Pre-Transaction Preparation (1-3 months*)**
- Identify stakeholders and select advisors
- Assess feasibility and financial impact
- Identify/address potential risks
- Set price and action targets
- Prepare census data
- Draft communications
- Structure transaction portfolio
- Collect and analyze preliminary quotes
- Review financial strength and administration capabilities of potential annuity providers

**Post-Transaction Implementation (2+ months*)**
- Finalize data
- Transition administration to selected annuity provider
- Send communications to participants
- Review and finalize SPGA contract
- Negotiate post-closing adjustments
- Confirm delivery of annuity certificates
- Document process and transaction

**Annuity purchase transaction (can be 1-2 weeks*)**
- Final quotes
- Select insurer
- Sign agreement
- Pay premium

*Note: actual timing and steps are case-specific and may be different than shown above.*
Cash vs. Assets-In-Kind (AIK)

**Cash transactions (smaller cases)**

Plan assets prior to transaction:
- U.S. Equities
- Non-U.S. Equities
- Fixed Income
- Real Estate
- Alternatives
- Cash

Plan assets post-transaction

Plan assets prior to transaction:
- U.S. Equities
- Non-U.S. Equities
- Fixed Income
- Real Estate
- Alternatives
- Cash

Cash for annuity purchase

**AIK transactions (larger cases)**

Plan assets prior to transaction:
- U.S. Equities
- Non-U.S. Equities
- **Fixed Income**
- Real Estate
- Alternatives
- Cash

Plan assets post-transaction

Transaction portfolio for annuity purchase

**AIK Planning Issues:**
- Cost/benefit analysis
- Valuation/liquidity of assets
- Timing
- Sufficient liquidity in remaining portfolio

**Insurance Company**

Hypothetical investment portfolio:
- Bonds (Investment grade)
- Mortgage Loans
- Private Placements
- Bonds (< Investment Grade)
- Mortgage-Backed Securities
- Other
Retiree buyouts – fiduciary activities

Decision to buy out retirees is a sponsor (aka, “settlor”) activity but buyouts involve several fiduciary decisions:

• Selection of annuity provider (Department of Labor’s Interpretive Bulletin 95-1 provides important guidance)
• Use / allocation of assets related to buyout
• Adequacy of funding after transaction
• Reasonableness of fees incurred for buyout transactions paid by the pension trust
• Structure: in-house fiduciary vs. independent fiduciary vs. independent advisors

Highlights of DOL’s IB 95-1
• Contains the “safest annuity available standard”
• Fiduciaries should consider:
  − Insurer’s investment portfolio
  − Size of insurer vs. size of contract
  − Insurer’s capital and surplus
  − Insurer’s lines of business
  − Structure of contract including any guarantees
  − Availability of protection from state guaranty associations
• Ability of insurer to administer current and future benefit payments can also be taken into account
• Unless they possess necessary expertise to evaluate these criteria, “fiduciaries would need to obtain the advice of a qualified independent expert”
Retiree buyouts – compliance considerations

Buyouts are likely to receive increased attention from regulators

- Department of Labor’s ERISA Advisory Council:
  - 2013 Recommendations: Confirm that scope of DOL IB 95-1 includes buyouts; clarify guidance regarding consequences of breach of fiduciary duty when selecting an annuity provider
  - 2015 Recommendations (forthcoming): Communications and disclosures to participants

- National Council of Insurance Legislators (NCOIL)
  - 2014 Proposed Pension De-Risking Model Act: State insurance commissioner approval of all buyouts, required supplemental protections (e.g., reinsurance) for all transactions, mandatory disclosures to participants, opt-out opportunities, etc.

- Pension Benefit Guaranty Corporation (PBGC)
  - Participated in the ERISA Advisory Council hearings
  - 2015 Premium Filings: PBGC asks for data related to “risk transfer activity” (item 18)
Incentives for plan sponsors:
• Reduce financial volatility
• Reduce administrative burden and costs
• Address changing regulations
• Ability to select lookback interest rate
• Reduce oversized plan liabilities
• Ability to target specific groups of participants

Disincentives for plan sponsors:
• Administrative costs
• Adverse selection
• Sizeable immediate payments
• Interest rate uncertainty
• Foregone potential returns
Highlights of key factors participants need to know

1. What benefit options are available
2. How the lump sum is calculated
3. Relative value of benefit options
4. Positive and negative ramifications of a lump sum
5. Tax implications
6. Loss of PBGC protection
7. Instructions for accepting or rejecting the offer
8. Contacts for follow-up questions
How the report may affect your decision to de-risk

Recommendations to DOL and Treasury may signal increased regulatory guidance:

• DOL should:
  - Require plan sponsors to notify them when conducting TVLS window
  - Coordinate with IRS & PBGC to clarify and provide guidance on information to be provided to participants

• Treasury should:
  - Review relative value regulations
  - Review lookback rule
  - Establish process and timeline for updating mortality tables

Focus on Participant Education

• Consider costs for useful communication and education in overall window expenses

• Model participant materials in light of GAO's eight key factors

• Set realistic expectations for a take rate. A lump sum may not be the right choice for many participants
Questions

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