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Minding your own business

Transferring pension risk so you can focus on what you do best

Imagine that your organization had a line of business that was completely unprofitable. While it may have made some strategic sense at one point, now it's just diverting resources from your core business. Its costs are volatile and tend to be highest at the times when your organization can least afford it. The market sees it as debt and it pulls down your credit rating and the perception of your business as a whole. *What would you do?*

You'd take steps to divest the business. As soon as you could.

What if that under-performing line of business was your pension plan?

Some organizations have pension obligations that make up a significant proportion of their total market capitalization. The volatility can create uncertainty for the whole organization. Human and financial capital are used to support the plan, which adds little to no value. In essence, the organization develops a pension insurance business that it is ill-equipped to manage.

All defined benefit pension plans (DB plans) inherently carry pension risk. While an open DB plan can be an important compensation tool, an employer needs to weigh its plan's value against the current, and increasing, risk to which it exposes the organization. Further, the legacy obligation to individuals who have already left or retired is really nothing but dead weight to the company.

Many sponsors are under the misconception that because they either *closed* their plan to new entrants or *froze* future benefit accruals they have adequately reduced their risk. The reality is that their plan is still subject to significant volatility, all while providing the company none of the talent attraction and retention value that an open, unfrozen plan can provide. Closed and frozen DB plans have become the corporate orphans of their sponsoring employers.

The best response for plans at any stage may be de-risking through pension risk transfer strategies, in which the risk associated with a given group of the DB plan members is transferred to an insurer. These transactions can be large and complex. Like any other deal, the divestiture of this unprofitable legacy "pension insurance" business should be carried out using the same rigour and discipline as an M&A project.

What follows is a discussion of pension risk: how to recognize, address, and transfer it, and how to overcome the organizational roadblocks that make pension risk transfer a challenge.

What is pension risk?

In a traditional DB plan, the members are promised a specified retirement benefit. Regardless of the cost, the plan must honour the promised payments from the day each member retires until the day they die.

This means there has to be enough money in the plan to pay for those benefits, no matter what the market does and no matter how long each member lives.

And that's where things get risky.

That obligation subjects the employer to pension risk, which shows up as volatility in:

- Cash contributions: the employer's actual cash outlay to support the plan—a regulatory matter
- Pension expense: the expense claimed against the employer's earnings—an accounting matter
- The plan's funded position: the plan's assets compared to its obligations

There are two key drivers of pension risk: longevity risk and investment risk.

- Longevity risk: the risk that the members will live beyond the plan's life-expectancy assumptions, increasing the plan's total obligation to its members.
- Investment risk, which has asset and interest rate components:
  - Asset risk: the risk that the pension assets will suffer losses or grow at a slower rate than anticipated, reducing the plan's funded status.
  - Interest rate risk: the risk that changes in the prevailing interest rates will impact the valuation of the plan's obligation as well as the value of the plan's actual investments.

Pension risk is nothing like the typical business risks that an employer faces. To be successful, an organization should focus on what it does best, whether that's engineering, manufacturing, finance, service, retail, or something else entirely. **Most employers don't specialize in managing pension risk—nor should they.**

Life insurance companies, on the other hand, are in the business of managing pension risks, and have spent years researching, managing, and modelling them. And in recent years they've become increasingly interested and competitive in assuming these risks for a price.

Pension de-risking reduces a plan's volatility and the resources dedicated to managing the plan—allowing the employer to "mind its own business" and focus on what it does best.

Pension de-risking strategies

There are three broad categories of pension de-risking actions.

Plan design changes	Liability-driven investing	Pension risk transfer
Making fundamental changes to the plan provisions, altering benefit entitlements and coverage/eligibility	Moving to an investment strategy whose objective is to ensure that assets and liabilities change in the same way/rate	Transferring elements of pension risk to a third party through specific financial transactions

1. Making changes to the plan design, such as closing a DB plan to new members or freezing future accruals, is an important initial step to de-risking. It “stops the bleeding” by *curtailing the growth*, and associated risk, of the plan’s obligations. However, under Canadian legislation, reducing or eliminating accrued pension benefits in most DB plans is essentially impossible.[1] So, plan design changes are really only a first step.

2. Liability-driven investing (LDI) is an effective tool to control pension deficits. By refocusing investment decisions to match assets as closely as possible with future liabilities (rather than choosing potentially riskier investments in an effort to simply maximize growth), organizations take a more careful, deliberate approach to investing for the plan. However, LDI alone cannot eliminate risk as it does not directly address or reduce pension obligations.

3. Pension risk transfer (PRT) involves transferring risk to another party through a financial transaction. Pension risk is directly linked to the size of pension obligations, so companies with larger plans are naturally subject to greater risk than those with smaller pension obligations.[i] **The only way to materially reduce pension liabilities and eliminate risk to your organization is to transfer some or all of your pension risk to an insurer.**

[1] The ultimate de-risking plan-design strategy is to wind up or terminate the plan. For various reasons, employers in Canada have typically not wound up DB Plans unless required by applicable legislation.

Here we will focus on larger-scale PRT strategies, where risk is transferred out of the plan to an insurance company through an annuity purchase or a longevity swap.

These strategies are not "either/or" propositions. As an employer, you can implement a combination of these tools to move your pension program to your desired risk composition, whether your goal is long-term sustainability or fully hedged risk.

Annuity purchase

There are two categories of annuity purchases.

- **Buy-out annuities:** a pension plan pays a lump sum premium to an insurance company to transfer all of the pension risk for a group of retirees. The retirees' pensions are then paid directly by the insurer, which also takes on all administration and communication requirements of the plan *(see Figure 1)*. Essentially, the insurer takes the balance-sheet obligation, as well as all the administrative burden, off the employer's hands.
  - While buy-outs are effective at transferring risk from a plan, there are some financial considerations beyond the purchase price:
  - Depending on the employer's accounting basis, a buy-out could trigger an accounting settlement. In particular, this can be an issue for an employer that reports under US financial accounting standards and has significant gains or losses that will be recognized upon settlement.
  - Depending on the jurisdiction, pension legislation may require a top-up contribution to a buy-out. For example, in Ontario the regulator has set a limit on the amount of benefits that can be transferred from an underfunded plan. Once that limit is exceeded, the employer is required to make an additional contribution.
- **Buy-in annuities:** While the pension risk is transferred to the insurer in exchange for a lump sum premium, like a buy-out, here the plan sponsor continues to pay pensions to members directly as before *(see Figure 2)*. For accounting and regulatory purposes, the buy-in transaction is treated as a perfectly hedged "investment" in the plan. Conceptually, the funds are incorporated into the pension fund (rather transferring the liability out of the plan, as in a buy-out). An annuity buy-in generally does not trigger an accounting settlement or require any additional contributions from the sponsor.

A buy-in annuity can generally be converted to a buy-out contract on the sponsor's request without paying an additional premium. The employer can strategically wait to convert to a buy-out (and turn the plan administration over to the insurer) until financial considerations change (e.g., when an accounting settlement is no longer a concern or the plan's funded position improves to the point that no additional contribution is required).

Longevity swap

Where the employer wants to eliminate longevity risk but is comfortable retaining the interest rate risk and investment decisions for the plan, they can explore a longevity swap, which protects against increasing member lifespans. The plan pays fixed monthly payments to the insurer based on agreed-upon longevity assumptions; in exchange, the insurer makes monthly payments to the employer based on the actual mortality of the group *(see Figure 3)*. The longevity risk on the covered group is totally eliminated, and longevity swaps generally do not trigger settlement accounting or regulatory contributions.

Figure 1: Annuity buy-out

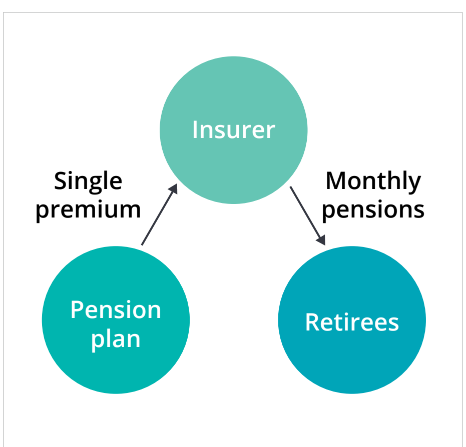


Figure 2: Annuity buy-in

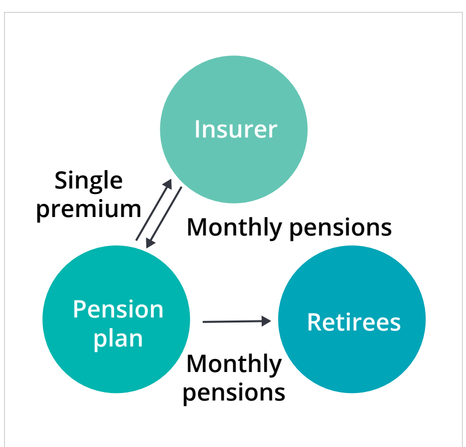
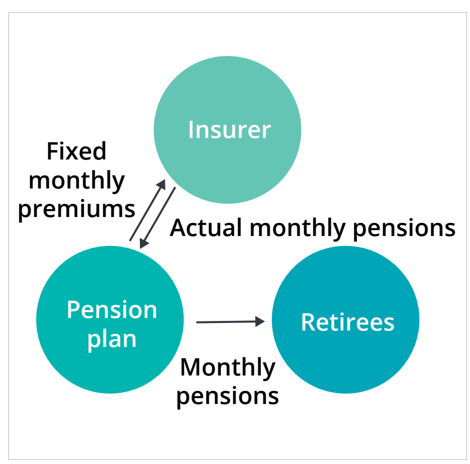


Figure 3: Longevity swap



The de-risking paradox

There's an interesting, and unfortunate, paradox in pension de-risking decisions: the *desire* to de-risk and the *ability* to de-risk generally move in opposite directions.[ii]

When the plan is well-funded, required plan contributions may be relatively low or even non-existent. So, despite the fact that de-risking would be quite easy at this point (requiring little or no injection of cash to purchase annuities from an insurer), there's very little immediate pressure to do so. Pension risk is not on anyone's mind, and there's even a tendency to expect positive conditions to continue.

On the other hand, when the plan's funded position is worse, higher contributions are required, which affect the employer's cash flow. Suddenly the plan starts getting more attention. "We have to *do something about the plan!*" the finance team cries. But "doing something" when the plan's funded position is weak can require additional cash and organizational resources at a time in the business cycle when both are in short supply.

An example

Let's take, for example, a typical plan during the three-year valuation cycle from January 1, 2014, to January 1, 2017.[2]

ACME Manufacturing has an Ontario-registered DB plan. In 2014, solvency discount rates are around 3.5%. As at January 1, 2014, the plan has:

- Assets of $140 million
- Solvency liabilities of $150 million (pensioners make up about 50% of the total liabilities)
- A solvency deficit of $10 million
- Annual solvency deficit payments[3] of $2 million starting in 2014

Two million dollars is a small enough contribution not to draw any attention. Nobody is yelling that they need to "do something about the plan!" Nobody considers de-risking. Everyone's happy.

Over the next three years, asset returns are good. However, solvency discount rates decrease to around 2.7%, causing the plan's funded position to deteriorate.

As at January 1, 2017, the plan has:

- Assets of $165 million
- Solvency liabilities of $200 million
- A solvency deficit of $35 million
- Annual solvency deficit payments of $9 million

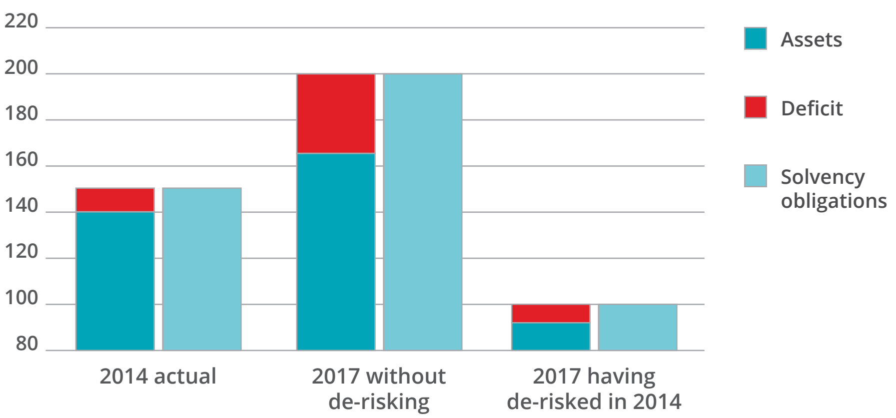
Had somebody at ACME taken a strategic de-risking approach back in 2014, convincing the company to purchase buy-out[4] annuities, its January 1, 2017, valuation could have looked like this:

- Assets of $92 million
- Solvency liabilities of $100 million
- A solvency deficit of $8 million
- Annual solvency deficit payments of $3 million

The lesson is clear: it can be extremely valuable to be proactive in de-risking before times get tough.

Factors that negatively affect DB plans (such as bear markets and low interest rates) tend to be the same factors that adversely affect the business, so low plan funding and the resultant high pension contributions often coincide with low points in the overall business cycle.

Figure 4: ACME pension positions at 2014 and 2017 ($ million)



2 Under the Ontario Pension Benefits Act regulations in effect at the time of publishing.

3 Assume no deferral of deficit payments.

4 Had a buy-in annuity purchase been done, equivalent amounts representing the premium would be reflected in both the assets and the liabilities, however the solvency deficit and resulting deficit payments would be as shown.

Legal issues in de-risking

Issues with annuity buy-outs: Being resolved

Until recently, annuity buy-outs were generally not used except on plan wind-up. Pension legislation did not discharge plan administrators of their responsibility on an annuity buy-out. This left a concern that in the albeit unlikely event that the insurance company became unable to pay the annuities to members,[5] the administrator could suddenly be liable for them once again. This "boomerang risk," i.e., the risk of liability for continued payment of pensions that the employer thought it had settled, was deemed too, well, risky.

That problem is being resolved. Several jurisdictions—Alberta, British Columbia, Quebec, and federal—have amended their pension standards legislation to discharge the administrator[6], assuming the annuity buy-out meets certain conditions. Ontario has announced plans to amend its legislation to provide a full statutory discharge as well.[iii]

Conflicting roles

It is important to note that a business may have two distinct, and sometimes competing, roles with respect to a pension plan.[7] One is the **sponsor**, which is primarily concerned with what's good for the business. The other is the **administrator**, which must act in the best interest of plan members. The two hats (even if worn by the same person) are very different. The administrator is responsible for upholding a certain standard of care under applicable pension standards legislation and at common law—but the employer is not.

In deciding on and implementing a PRT, the sponsor is likely most interested in *low-cost* annuities, while the administrator is most concerned with the *quality* of the annuities. The PRT strategy is determined by the administrator, so when the company is playing both sponsor and administrator roles, there can be some conflict. The plan terms, the funding agreement, and the statement of investment policies and procedures should be reviewed for any barriers to implementing a PRT and appropriate action taken to address any limitations.

It's also important to eliminate potential conflicts of interest (both perceived and real) involving ongoing vendors and consultants. A perceived conflict could exist wherever a provider stands to gain from choosing a specific alternative. The ongoing pension service vendors and consultants' compensation model is tied to the plan's size and life span. This is in direct conflict with the goal of PRT, which is to shrink the liabilities. The best way to eliminate any such perception is to engage a fully independent advisor to help you devise your PRT strategy.

For annuity buy-ins, both the federal and Ontario regulators have released policy statements that treat an annuity buy-in as an investment of the pension fund. Yet annuities are unlike other investments because there is no expectation of gain. That unusual financial profile means that the administrator needs to take extra caution in a PRT. The permanent nature of most PRT transactions makes it very important for employers to work with an independent advisor, who has no other role in the plan, to advise on and review any PRT transaction.

5 To the extent that the benefits are not paid by Assuris (a non-profit organization that protects policyholders in the event that a life insurer becomes insolvent).

6 Or, in the case of Quebec, to provide that payment under the annuity policy constitutes final payment.

7 Assuming the pension plan is not a "multi-employer pension plan."

De-risking in Canada to date

For life insurance and reinsurance companies, longevity and mortality risks are core competencies. Longevity risk can offer a potential diversification benefit to existing mortality risk, and PRT liabilities are much less risky than some of these companies' other blocks of life insurance business.[iv]

This risk exposure, along with the more natural alignment of competencies of insurance companies, has encouraged a heightened interest and greater activity in the PRT market.

De-risking strategies have grown in prominence in Canada in recent years. Canadian annuity purchases averaged around $1 billion annually for a decade leading up to 2012 but exceeded $2 billion in each of the four subsequent years, with a record $2.7 billion in 2016[v] *(see Figure 5)*. Early estimates suggest that 2017 annuity purchases may top $3.0 billion. Still, as a proportion of DB liabilities, de-risking strategies have not been as popular in Canada as in the US and the UK *(see Figure 6)*; some experts suggest that Canadian sponsors are as many as five to ten years behind its UK peers. This suggests we will likely see an increase in the number and complexity of such strategies among Canadian plan sponsors in coming years.

Recent transactions like Loblaw's purchase of $350 million of annuities for inflation-linked pensions or the $530 million annuity buy-in deal that combined the DB plans of two unrelated plan sponsors to achieve optimal pricing are proof that there are innovative de-risking solutions out there for employers willing to consider them.

Figure 5: Total Canadian annual annuity purchase premiums ($ million)

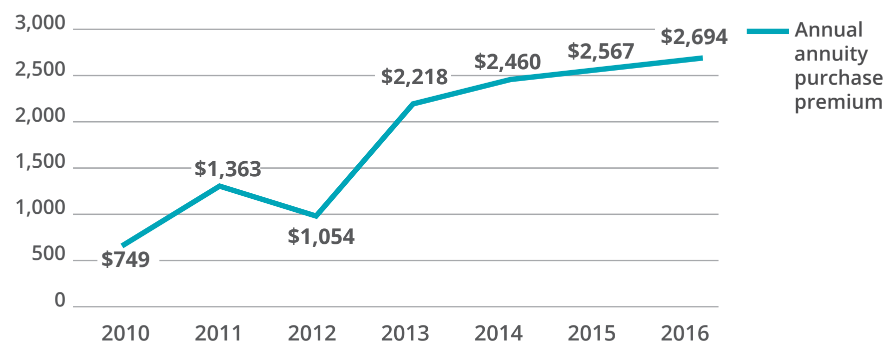
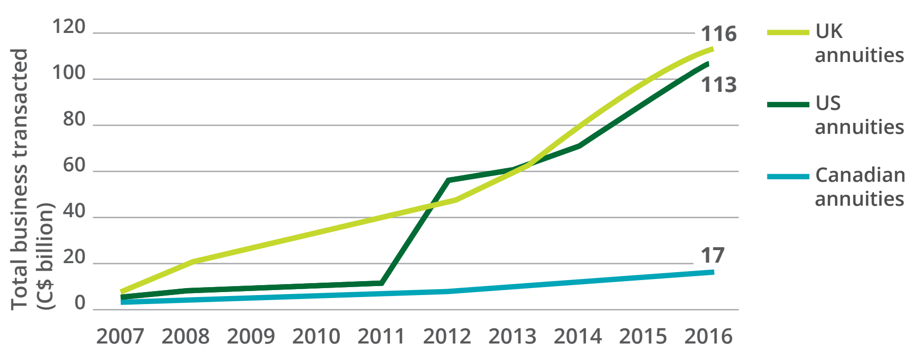


Figure 6: Growth of de-risking strategies in Canada, the UK, and the US[vi]



Don’t wait to talk to your advisor about de-risking

Too often employers merely react to the symptoms, such as increased contributions, rather than proactively trying to address the underlying disease, pension risk.

If pension de-risking is not currently an imperative goal of your business, it likely should be. Pension risk management is indeed a significant challenge for organizations. But DB pension risk can constrain cash flow and limit your ability to invest in your business; how it is addressed is key to maintaining financial stability and meeting your fiduciary duties.

And, as with any significant business decision, it’s important to remove any bias from the process, whether actual or perceived. When contemplating a major transaction like a merger or an acquisition, you would protect your business from potential biases and conflicts of interest internally through ethical walls and externally through independent consultants. Similar safeguards should be put in place as you establish a strategy to reduce and ultimately eliminate pension risk. It’s critical that you work with an independent advisor, who has no other role in your plan, to help you make smart de-risking decisions, free from internal or external biases.

After all, your company’s, and your members’, future is at stake.

Endnotes

[i] Elinore Hoover et al., “Time to Risk Transfer: De-Risking Corporate Pension Plans,” Citi Corporate and Investment Banking report, September 2014. http://pensionrisk.prudential.com/pdfs/time-to-risk transfer-de-risking-corporate-pension-plans.pdf

[ii] Gavin Benjamin, “Desire versus ability: the psychology of pension risk management,” Benefits Canada, April 14, 2016. http://www.benefitscanada.com/pensions/other-pensions/desire-versus-ability-the-psychology-of-pension-risk-management-79732

[iii] Ontario Ministry of Finance, May 19, 2017.

[iv] Brian O’Neill, “Fighting Inertia,” *The Actuary Magazine*, February/March 2017. www.theactuarymagazine.org/fighting-inertia/

[v] Mercer Global Pension Buyout Index, March 2017. https://www.mercer.ca/content/dam/mercer/attachments/north-america/canada/ca-2017-mercer-global-pension-buyout-index-march-en.pdf

[vi] Lane Clark & Peacock 2016, LIMRA Secure Retirement Institute 2017, Willis Towers Watson Global Pensions Asset Study 2017, and Sun Life estimates. Exchange rates at December 31, 2016.

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