Retiree Carve Outs - The What’s, Why’s and How’s of Pension Plan Annuity Purchases – Part 2

This article is our second in a series that discusses why pension plan sponsors are turning back to an old idea, Annuity Purchases, in order to control costs and lower risks. In our last article we addressed the risks, and costs, pension plans pose to their sponsors and how annuity purchases are being used to mitigate risk and costs for those plans. In this article we discuss annuity purchases and the reasons sponsors are utilizing them. We also address the specifics around why so many plan sponsors are purchasing annuities, how to analyze whether an annuity purchase makes sense, and what a good candidate for an annuity purchase looks like. Our third article will address the process of annuity purchases and ways to optimize your results.

Why plan sponsors are purchasing annuities now

As mentioned above, pension plan annuity purchases are not new. Any plan sponsor that has ever gone through a plan termination has most likely gone through an annuity purchase as well. It was common decades ago for sponsors to routinely purchase annuities when their participants retired. In the future, plan sponsors that go through plan termination will also eventually select an insurer to purchase annuities from for their participants. Annuity purchases, particularly for retirees only, are back in vogue; the chart below shows the annual group annuity risk transfer sales ($ in millions) since 1986. The chart highlights the rapid growth in annuity placements over the past few years.

Starting in 2012, large plan sponsors began to analyze the cost of keeping retirees in their pension plans. Two companies in particular, GM and Verizon, decided that it made sense to purchase annuities for a subset of their retiree participants (they represent the large spike in 2012 in the chart above). These two annuity purchases were somewhat of a watershed moment for the annuity market. Awareness and confidence in annuitization strategies improved, and

1 LIMRA Group Annuity Risk Transfer Survey
several insurers subsequently entered the annuity market in the hope of securing further transactions. Those two 'jumbo' transactions still hold the records in terms of size, but in recent years there have been a steady stream of large annuitizations from other large companies including Motorola (2014, $4.2bn), Philips (2015, $1.5bn), Kimberly Clark (2016, $2.5bn), PPG (2016, $1.6bn), and The Hartford (2017, $1.6bn).

Beginning in 2015, many sponsors took note of the recent large annuity purchases and started to analyze their own situations. From there, a large number of average-size plan sponsors began to purchase annuities for parts of their retiree populations.

There are three primary drivers that have caused plan sponsors to go through the annuity purchase process:

1. **Rising PBGC premium costs** – As discussed in our first article, rising PBGC costs have made risk transfers appealing to plan sponsors. The cost of maintaining participants in a pension plan, especially those with small annual benefits, is increasingly expensive. It is simply cheaper to have insurance companies manage these benefits.

2. **Balance sheet consistency** – Historically, annuity purchases were seen as cost prohibitive with annuities costing anywhere from 10% - 20% above the balance sheet liability. However, in recent years companies incorporated the new mortality tables from the Society of Actuaries (SOA) issued in 2014. Balance sheet liabilities are now more in line with the annuity purchase cost. The reasons for the disparity in the past was largely driven by the fact that insurers tended to know and understand the true life expectancy of pension plan participants better than what the prevailing mortality tables showed. The prior best estimate mortality tables were released in 2000. With the release in 2014 of the RP-2014 mortality tables from the SOA, the new best estimate tables reflect what the insurers knew all along. Once companies incorporated these tables into their balance sheet liabilities, the difference in the annuity purchase price and the balance sheet liability was minimized.

3. **Pension risk management** – As discussed in our first article, plan sponsors have realized that reducing the number of participants in the plan, and their associated liability, reduced their overall pension risk exposure.

**How to analyze whether an annuity purchase makes sense**

Buying annuities for some or all retirees will make sense for most mid and large-size plan sponsors. A number of factors should be considered when analyzing whether or not an annuity purchase makes sense for a plan sponsor.

- **Number of retirees:** The first thing plan sponsors will want to consider is how many retirees they have and take inventory of the distribution of those retirees by benefit amount.

- **Distribution of retirees:** From our experience, the percentage of retirees with small annual benefits can be anywhere from 33% to 85%. “Small” is subjective based on the specific plan’s situation, but under $4,000 in annual benefits is clearly small and based on our experience many plan sponsors will find a meaningful number of retirees in this category.

- **Funded status:** The plan’s funded status is an important factor in determining whether to implement an annuity purchase. There are three aspects to consider:
  - **AFTAP:** The plan’s Adjusted Funding Target Attainment Percentage (AFTAP) has to be over 80% in order to go through an annuity purchase. If a plan’s AFTAP is less than 80%, then a contribution will need to be made to get the AFTAP to 80% before proceeding with the annuity placement. Plans frozen before September 1, 2005, are not subject to this restriction. Most plans’ AFTAPs are currently well above 80%.
• **PBGC funded status:** If a plan’s unfunded PBGC liability is such that the plan is subject to the variable rate premium cap, then it is more compelling to execute an annuity purchase.

• **Liquidity requirements:** Although uncommon, plan sponsors will want to make sure that they have sufficient assets after an annuity purchase transaction to meet liquidity requirements under the minimum funding rules.
  
  ▪ **Frozen plans and timing for termination:** Frozen plans that are within a few years of being sufficiently funded, so as to terminate the plan, may want to wait until termination to go through the annuity purchase process.

Once it is clear that an annuity purchase makes sense, the next step is to analyze the effect that different levels of purchases will have. This analysis will help the plan sponsor draw the line on the size of their annuity purchase. Typically these lines are drawn at a certain level of benefit payments (e.g. all retirees with payments less than $10,000/year).

1. **Short term cash implications** – One consideration for plan sponsors when drawing the line is the trade-off between increased short term contributions and decreased PBGC premiums. Based on the way that actuaries are required to calculate liabilities for cash funding purposes, an annuity purchase will increase the funding deficit for determining minimum required contributions. The savings on PBGC premiums for retirees with benefits above a certain level (roughly $4,000/year, depending on the demographics of the plan) will be less than the amortization of this additional deficit and will result in an acceleration of future contributions. How much of an increase will largely be determined by where the line is drawn for the level of benefits included in the annuity purchase. This acceleration is merely a timing issue, and over time, the cash outlay to the plan will be reduced by the savings in PBGC premiums. Also, from a timing standpoint, sponsors enacting an annuity purchase now who are paying the minimum required contribution most likely won’t start to see the contribution increases hit for 18 months to two years because of the way that the minimum funding rules work.

2. **Balance sheet implication** – For companies that have adopted the up-to-date mortality tables and use market rates for determining their discount rate, there will be little-to-no change in the dollar amount of funded status. For underfunded plans, the funded percentages will more than likely decrease. In 2016, many of the retiree carve-outs that we were involved with actually resulted in funded status improvements!

3. **Pension expense** – For the income statement, conducting an annuity purchase may result in settlement accounting. Under US GAAP, if the annuity purchase is more than the annual service cost plus interest cost, companies are required to recognize an additional expense. The additional expense equals the proportion of the balance sheet liabilities that are settled multiplied the accumulated losses sitting in AOCI. Under international accounting standards, the difference in the annuity purchase price and the settled liability is recognized as an expense or income amount.

**What is the profile of a plan that should consider an annuity purchase?**

In analyzing whether or not an annuity purchase makes sense, there are several criteria to look at. The criteria include:

▪ Pension plans with a large number of retirees
▪ Retiree groups with a high concentration of small annual benefits
▪ Plans that are subject to the PBGC variable rate premium cap
▪ Sponsors that can absorb the increase in short-term contributions
Companies that value their balance sheet liabilities using up-to-date mortality tables and discount rates based on high quality corporate bond yields.

So who should steer away from an annuity purchase? One group, is plan sponsors that are within 2-3 years of beginning the plan termination process. Even though there would be short term cost savings, when the plan goes through termination you will want a mix of in-pay retirees along with active and vested terminated participants to get good pricing. It becomes increasingly harder to get good pricing (or even to get insurers to bid at all) when there are only deferred annuities involved (i.e., active and vested terminated annuities).

Also, some plans that have permanent lump sum features that allow newly terminated participants to cashout their benefit may also not be good candidates. This is because participants with small benefits tend to take their lump sum distribution immediately. The plan is left with a smaller proportion of retirees, and the retirees they do have tend to have bigger annual benefits.

Severely underfunded plans are also not great candidates. In order to purchase annuities they need to make sure that their AFTAP is over 80% which can be challenging if cash is already constrained.

Lastly, companies that use aggressive balance sheet assumptions may not be good candidates. These are companies that use discount rates that are higher than what high quality corporate bond yields would suggest, or they use dated mortality tables. The reason for this is that an annuity purchase would most likely not be neutral and the company would see an increase in their overall balance sheet liability. Depending on the company, this may or may not be problematic.

Conclusion
Annuity purchases are becoming more commonplace among all sizes of pension plans. Between rising PBGC premium costs, alignment of annuity purchase prices with balance sheet liabilities, and overall pension risk management, implementing an annuity purchase is a de-risking strategy that all sponsors should be evaluating.

The next article in our series will look at the process plan sponsors need to go through to meet their fiduciary duty in selecting an appropriate insurer to transfer their pension obligations to.

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