Pension Risk Transfers – What Every Examiner Should Know

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Pension Risk Transfer ('PRT') is the process of contractually transferring a defined benefit plan's risks from a corporate plan sponsor in order to eliminate or reduce balance sheet risk, longevity risk, investment risk, interest rate risk, and/or other risks

Why do we care?

The most common and natural counterparty to the corporate plan sponsor are insurance companies. As PRT business is a growth area within the insurance industry, a target area of focus in a risk-focused exam related to current or prospective risks, in interim review work or in ongoing regulation should be a fundamental review of the PRT business that exists and the assumptions used in pricing and assessing the adequacy of reserves for PRT business.

Current market participants include not only some of the largest multi-national insurers, but also middle market players as well.

Prudential	Principal	OneAmerica
MetLife	Pacific Life	Mutual of Omaha
New York Life	Athene	Mutual of America
AIG	Securian	CUNA Mutual
MassMutual	Western and Southern	Legal & General America

Life insurance companies are properly equipped to engage in the PRT market given that retirement planning and payouts are a core part of their industry. For some companies, the PRT market is a way to diversify its portfolio, while for others it offers the company a way to apply its annuity expertise in a new way. Some companies enter the market with small tranches at the start (between $5 million to $500 million) so as not to be completely dependent on the business to generate profits.

Over the past seven years, a number of high-profile transactions reveal the strength of the global de-risking trend. These included industry icons such as:

General Motors	Bell Canada
Rolls-Royce	Motorola
Verizon	Fedex
British Telecom	Bristol-Myers

Each of these firms varies in terms of its resources, constraints, strategic goals and definitions of success, so each deal was tailored with features to meet the company's unique needs, and reflects a broad range of transaction sizes, with agreement amounts all the way up to $27.7 billion. These companies are looking to focus on their core business rather than managing pension plans. This will allow them to eliminate ongoing plan expenses, reduce balance sheet volatility and overall reduce risk to the plan sponsor. Often the plan is no longer part of a retirement benefit package for active employees.

PRT Basics

An annuity contract is a promise from an insurer to make a series of periodic payments, usually for a lifetime, in exchange for a single premium. A group annuity contract is a single contract covering a group of people with something in common for a single premium. Common types of PRT annuity contracts are Buy-out, Buy-in and Longevity transfer

Buy-outs are common in the U.S., U.K., and Canada and require the plan to pay a premium to the insurer to settle the liability, with the insurer then covering all investment and longevity risks for annuitants. Buy-outs allow plan sponsors to transfer risk, including investment and longevity risk, to an insurer, which guarantees payments to participants for life; eliminate administrative, actuarial, and investment management expenses, including guaranty corporation premiums; and remove pension liabilities from balance sheets. This solution is ideal for plan sponsors seeking to reduce pension liabilities leading to more predictable and manageable costs going forward.

Pension buy-ins enable sponsors to purchase bulk annuities and hold them as liability matching assets of the plan. This allows pension plans to transfer risk today without the accounting impact of liability settlement charges, and offers additional advantages for underfunded plan sponsors, including maintaining funded status, holding contributions steady and minimizing accounting and funding volatility. Though buy-ins provide plans with the precise amount of income required to make benefit payments for participants' entire lifetimes, this solution is rarely employed in the U.S. because the liability is not settled. It is more commonly implemented in the U.K. for pension funds beginning the plan termination process, or taking steps in a phased de-risking program.

Longevity risk transfer is the fastest-growing solution in the U.K. The products currently available convert an unknown future liability into a fixed liability cash flow by locking in the life expectancy of the plan participants. Large pension funds find it easier to manage an asset portfolio against a liability when the future obligation is fixed and known. After addressing funded status and asset risk concerns, longevity risk transfer can serve as the capstone to a pension hibernation strategy, with the sponsor continuing to manage the plan on its balance sheet, with risks and expenses managed within a tight tolerance. Longevity risk transfer transactions will increasingly be conducted via captive insurance and reinsurance strategies, thus ensuring cost-effective execution.

Safest Available Annuity Requirement

There is applicable regulatory guidance, which dictates how PRT transactions must occur and ensures that the plan participants become policyholders in a safe and orderly fashion as the pension plan assets and liabilities are transferred from the plan sponsor to an insurance company; this is found in Department of Labor (DOL) Interpretive Bulletin 95-1.

DOL 95-1 prescribes several requirements that must be met and on which plan fiduciaries must opine to ensure that the group annuity provided by the PRT insurer can be deemed the "safest available annuity."

In short, the safest available annuity factors that should be considered require a deep-dive look into the bidding insurer's ability to effectively run the business it is assuming as part of the PRT transaction. The factors include:

Quality & diversification of the provider's asset portfolio	Size of the insurer relative to the proposed contract	Level of the insurer's capital and surplus
Lines of business of the annuity provider and other indications of an insurer's exposure to liability	Structure of the annuity contract & guarantees supporting the annuities, such as the use of separate accounts	Availability of additional protection through state guaranty associations and the extent of their guarantees

These, of course, are the same things that we look at to assess and examine the insurance company issuing these products. What this construct effectively does to the PRT market is to help ensure that the pool of PRT providers remains financially strong, profitable, highly rated, reputable and very risk aware. This acts as a natural inhibitor to overly aggressive pricing in the PRT space.

We should not be tempted to think that DOL 95-1 compliance is simply a "cover your tracks" or "check the box" exercise. About one year after a high-profile sponsor's large 2012 PRT transaction closed, there was a class-action lawsuit brought by a group of retirees who questioned the legality of the fact that the checks they used to get from the plan sponsor were now coming from a PRT insurer. The case was thrown out of court, with the primary reason being the lengths to which parties to the transaction went to ensure DOL 95-1 compliance (and the documentation of such compliance).

Recent Trends

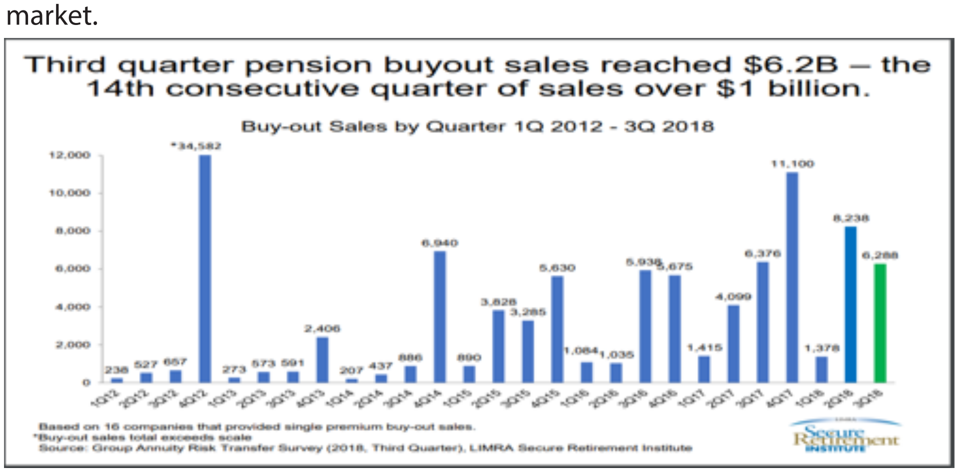
Many recent trends have contributed to, and continue to contribute to the growing PRT business. Because a higher funding ratio (the ratio of a plan's assets to liabilities) increases the ability of a U.S. corporation to purchase a group annuity contract, two of the major drivers of the growing PRT business are corporate tax reform and Pension Benefit Guaranty Corp., or PBGC premiums. Both have spurred corporations to accelerate the contributions to their plans, which in turn greatly improves their funding ratios and motivation to do a pension buyout.

The Tax Cuts and Jobs Act, signed into law by President Trump late in 2017, reduced the corporate tax rate to 21% from 35%. Tax law allows a plan sponsor to deduct a portion of its pension contributions based on its tax rate, and Corporations had until September 15, 2018, the final tax deadline, to deduct those contributions at the higher 2017 rate.

The PBGC's variable rate used to calculate premiums is based on the unfunded obligations in a defined benefit plan. The variable rate, which was as low as $9 per $1,000 of unfunded vested benefits as recently as 2013, was $34 in 2018 and rose to $42 in 2019.

There is also more competitiveness today in the pricing of premiums among insurance companies as the market has increased to over 15 participants from approximately eight insurance companies back in 2012. While the higher number of players in the market has contributed in some part to a trend of lower premiums, not only have there been an increasing number of insurers, the insurers have become more focused on particular segments of the market, whether that's the size of transactions or nature of the transactions. Not all companies are any longer bidding on everything; they are being more selective and determined on particular markets.

According to the LIMRA secure retirement institute, over $23 billion in U.S. corporate pension plan liabilities were settled in 2017 through group annuity purchases from the 15 insurance companies that serve the market, up from almost $14 billion in 2016. Through the third quarter of 2018, there was $15.9 billion, up from the $11.9 billion during the same three quarters in 2017, and it is projected that there was close to $25 billion again for the full year 2018. The total volume of group annuity purchases since 2012, when General Motors and Verizon jump-started the growth of the market by transferring almost $34 billion just between the two of them, to Prudential, is about $115 billion in settled pension liabilities. The industry strongly believes that the PRT market will continue to grow beyond 2018. The story more recently has been that we continue to see fantastic years of growth for the PRT market despite not having jumbo deals like in the past. The strong sales numbers in 2017 and 2018 proves that jumbo deals are not needed for large dollars in the overall market.



What Does This Mean for the Regulation of Insurance Companies?

The result of all of this growth in the market of course brings on not only increased risk and need for regulation just due to the new business itself, but has also led to changes within companies themselves, again increasing risk. Companies now need additional resources and have increased costs for pricing and support staff. There is increased competition in the marketplace that causes companies to lower premiums and raise minimum quote thresholds. And of course, there is the need for additional capital to support the growth.

While the areas requiring review when examining insurance companies and their PRT business might be obvious, they certainly deserve a reminder to all of us. Moreover, while DOL 95-1 does a good job of highlighting what an insurance company's overall strength and profile should look like, the list of specific impacts and risks that the PRT business will have on the company includes:

- ERM – including risk appetite, risk analysis and limit setting
- Plans for Growth / Capacity – a company cannot grow too much or too fast without understanding the risk
- Pricing and Underwriting – this becomes more important as competition increases
- Reserving – especially as the impacts of PBR become more important
- Diversification of Mortality and Longevity Risks – appropriately incorporating longevity risk into any analysis
- Mortality Assumptions – especially the inclusion of mortality improvement assumptions
- ALM Practices
- Data and Administration – under scrutiny due to recent issues with missing or lost participants

The primary risks of a PRT case are longevity risk and investment risk. An insurance company sets mortality, mortality improvement and investment return assumptions when pricing a new case. When the policyholders are on-boarded and a company takes on the ongoing obligation of ongoing annuity payments, there are no opportunities to adjust the original pricing. The risk of mispricing a case could have significant long-term financial impact on a company due to the long-term nature of the liabilities, so prudent assumption setting is necessary to mitigate the long term risks.

Determination of assumptions for deferred lives (individuals who have not yet commenced annuity payments) can produce additional uncertainty and long-term risk due to the unknown pattern of future benefit payments. To mitigate the deferred lives risk, many companies will strategically target cases where the payment patterns are known, and where minimal amounts of the current PRT inforce is made up of deferred lives.

These risks also require that a company closely monitor experience mortality versus pricing mortality, and actual investment performance against the assumptions used in the pricing process. Failure to have an understanding of evolving experience creates challenges when determining reserve adequacy and understanding how business is tracking versus expectations. The long-tail nature of the liabilities exacerbates the potential risk of under-reserving.

Conclusion

Therefore, when looking to assess, examine, monitor and opine on insurance company practices when it comes to managing their PRT business, a number of areas have emerged as best practices and high profile in terms of what the top companies do and what regulators or industry analysts should be looking for.

Firstly, the growth and size of the business has prompted companies to evaluating risk and risk exposures for the PRT business at the enterprise level; considering items such as risk appetite, risk tolerance, and the natural diversification benefits that arise between the PRT business and traditional mortality risk business such as whole life.

Of course the normal analyses of any line of business within an insurance company needs to be developed and in place for the PRT business to be able to analyze the risk profile of the PRT business, such as pricing analysis; reserving analysis on an economic, GAAP and statutory basis; mortality analysis; and experience studies.

One increasingly important area for review is the extent to which the company monitors, manages and analyzes the capacity for growth in the PRT business on a regular basis, either internally or through engaging outside experts; and how they consider and evaluate opportunities for reinsurance (including longevity swaps). As companies grow their PRT business they need to be aware of the increasing proportion it is of their overall business and how it might therefore alter their overall risk profile and risk appetite.

Finally, sometimes the need for governance and oversight and participation by all of the appropriate bodies gets lost in the growth phase of this business and it is very important to incorporating the PRT analyses into the overall firm governance process, including management and Board level participation early on.

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