SEISMIC SHIFTS IN PENSION INVESTMENTS SPELL OPPORTUNITIES FOR U.S. LIFE INSURERS

By Victor Modugno

The Pension Protection Act of 2006 (PPA)—which will be phased into effect between 2008 and 2011—will result in higher and more volatile required cash contributions for most U.S. private sector defined benefit pension plans (DB plans}. SFAS 158 will revise U.S. GAAP accounting for these plans to place net projected pension obligations on the balance sheet starting at the end of 2006. The next phase of the Financial Accounting Standards Board (FASB)'s pension project is likely to use market value of pension assets and liabilities and result in even greater volatility in earnings.[1]

This will result in a paradigm shift in DB plan assets from equities to long-term bonds, alternative investments and insured products—very similar to what happened in the United Kingdom following similar reforms. A McKinsey study projected that frozen and terminated DB plans will increase from 25 percent up to 75 percent of total plan assets over the next five years, while terminated DB plans will increase from under 5 percent up to 20 percent.[2] Lump sums have become a common form of settlement for terminating DB plans. When offered a lump sum, 88 percent of participants take it.[3] Lump sums are also popular with employers, since they generally cost less than annuities. Since the plan's early retirement factors are fixed, lower interest rates should lessen the cost of the plan's early retirement, which is not factored into the lump sum, but must be included in the annuity. Some employers do not offer the lump sum option, perhaps because most recipients spend these funds instead of rolling them over into to retirement accounts.[4] If only 10 percent of $360 billion increase in terminating plans' assets over the next five years is used to purchase annuities, it would more than triple the current $2 billion a year in annuity buy-out premiums. This is consistent with the EBRI/Mercer survey that shows those planning to terminate in the next two years are more than triple those terminating in the last two years.[5]

The approaching tsunami in DB plans discontinuance and termination has attracted the interest of new providers such as investment banks and other funds.[6] However, distributions needed to effect a termination in the United States will be limited to lump sums or annuity purchases. The safest annuity rule will limit annuity purchases to highly rated life insurers.[7] These new providers will have to content themselves to managing assets and providing products to reduce earnings and cash flow volatility for DB plans prior to termination. In some cases, the frozen plan could be transferred to another corporation. It has been suggested by some of these new providers that the PBGC would not object to the sale of a frozen DB plan to a corporation with higher credit ratings. ERISA imposes only broad fiduciary standards—it allows A/L mismatch and high-risk investments. The prudent investor rule looks to what other pension plans are doing in determining pru-

1 Modugno, V., "The Impact of Reversion Taxes on Pension Plan Funding," pp. 9-11, includes a detailed discussion of the effects PPA and FASB on defined benefit plans http://www.soa.org/research/pension/research-the-impact-of-reversion-taxes-on-pension-plan-funding.aspx

2 McKinsey & Company, "The Coming Shakeout in the Defined Benefit Market" p.7 http://www.mckinsey.com/clientservice/financialservices/pdf/coming_shakeout_in_defined_benefit_market.pdf

3 Watson Wyatt, "Choosey Employees Choose Lump Sums!" The Insider, April 2001 http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=7249

4 Working Group On Retirement Plan Leakage, U.S. Dept of Labor, Advisory Council On Employee Welfare And Pension Benefits, "Are We Cashing Out Our Future?" http://www.dol.gov/dol/pwba/public/adcoun/leaknew1.htm

5 EBRI Issue Brief No. 307 (July, 2007) p.7 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1002643

6 Woolner, Aaron, "Playing Catch Up", Life & Pensions December, 2007 p 32 http://www.life-pensions.com/

7 U.S. Department of Labor, "Interpretive Bulletin 95-1" 29CFR2509.95-1 (1995) http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.95-1.htm

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dence. So the acquiring corporations can run these pension funds like hedge funds benchmarked to the liability index. They can quote a lower price than a lump sum/annuity buyout termination.

This approach has several problems beyond the possibility of PBGC lawsuit. All of the accounting, funding, reporting, fiduciary requirements and PBGC premiums for an ongoing plan continue to apply. If the arrangement blows up, the DOL is likely to go after the original fiduciaries that sold the plan, in addition to the new ones actually responsible for benefit losses. Moving the assets to a higher rated, better-capitalized company doesn't make economic sense. It would be more capital efficient to manage the assets at the original company. The sponsors of these new arrangements appear to be underestimating the underwriting risks in guaranteeing annuity benefits. Perhaps they believe that mortality losses from using the minimal required mortality will not appear until the distant future, and so they can under price longevity risk. Early retirement and forms of benefit losses can appear quickly, before the sponsors of these new arrangements can extract their funds.
The reasons that DB plan sponsors freeze rather than terminate their plans include:

1) They do not view annuity rates as attractive. This misconception is driven by use of assumed returns on equities and extremely aggressive demographic assumptions in the valuation of ongoing plans. New accounting and funding rules should reduce the assumed returns to corporate bonds. This still leaves the issue of default and cash flow risk in corporate bonds and the demographic assumptions. There are at least 10 large insurers competing for annuity closeouts. So the low bid from these safe annuity providers reflect the fair market value of these benefits. It is not high because of state regulatory investment, reserve and capital requirements. The capital costs and investment strategies are driven by the rating agencies' requirements for a double A rating. For example, the rating agency requirements to set up a triple A structured company to issue GICs results in capital requirements and investment restrictions that are less favorable than those for an insurer and this would be even more true with additional underwriting risks in annuities, if such a company could be set up. The capital requirements would be slightly less for an AA company.

2) The DB plan is under funded and cannot afford to terminate. PPA should eventually lead to full funding if the company does not qualify for distress termination (i.e., bankruptcy).

3) The DB plan is over funded and does not want to pay reversion tax. This is usually solved by conversion to cash balance plan, where the excess assets can fund future defined contribution benefits. Indeed, in most plan freezes, the employer funds future retirement benefits through defined contribution arrangements.[8] Once the over funding is used up, the cash balance plan can be terminated in favor of a 401k plan.

While it is theoretically possible to continue a frozen plan until the last annuitant has died, most DB plan freezes are a way station to eventual plan termination.

[8] EBRI, Op. Cit., pp. 17-19
[9] McKinsey & Company, Op. Cit., p. 19 ff.

CONTINUED ON PAGE 24

For U.S. insurers who qualify as safe providers, the annuity buyout market presents the greatest opportunity due to the limited competition. The previously cited McKinsey study discusses the coming battle between insurers, investment banks, and asset managers for DB plan assets under this shift in investment strategy.[9] While investment banks tend to be innovative and aggressive at going after profitable business, insurers have special expertise in long-term fixed income assets and liabilities and risk management of annuities that should help them compete for frozen and ongoing plans that will be more focused on accounting and funding risk than on expected equity returns.

Victor Modugno, FSA, MAAA, FCA, is a consulting actuary in California. He can be reached at vic@internetactuary.com.