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Settling Pension Liabilities: An Interview With Matthew Bond

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Matthew Bond, FSA, EA, MAAA, is a partner with Aon Consulting and an expert in risk management and longevity analysis. He supports plan sponsors with pension risk assessments, pension risk transfers, and a wide variety of other topics. Matthew also helps develop Aon's practice-wide tools, training, and other guidance and speaks regularly at the Enrolled Actuaries meeting.

In recent years, sponsors of defined benefit pension plans have increasingly sought to understand and mitigate their risk exposure. Risk transfers to participants (through lump sums) or to insurers (through annuity purchases) are now an important risk management tool. Consulting actuaries often advise clients on which strategies (if any) to pursue.

I am pleased to interview Matthew Bond, who will provide an overview of risk transfer strategies and considerations for United States qualified pension plans.

Patrick Ring (PR): How did you get interested in pension risk transfers?

Matthew Bond (MB): In 2012, the risk transfer market dynamic changed suddenly. Groundbreaking transactions by General Motors and Verizon signaled a shift to larger deals and broadened the range of strategies in play.

I help many clients design and implement pension risk transfers. In addition, I develop firm-wide consulting and tools, present related internal and external training, and founded an Aon team focused on longevity trends and opportunities.

PR: Why are plan sponsors interested in managing pension risk?

MB: Over the past several decades, many pension plan sponsors have reduced or eliminated benefit accruals. Therefore, pensions are increasingly viewed as a legacy issue, posing financial, administrative, and compliance distractions from core operations.

With the dotcom bubble bursting in 2000 and the Great Recession starting in 2008, plan sponsors encountered two so-called perfect storms in less than a decade. Fluctuating markets increased plan sponsors' concern about volatility of pension results and its impact on their organizations.

The trend toward holistic risk management has been reinforced by regulatory and accounting changes. Those changes generally have moved contributions and financial reporting toward a mark-to-market basis.

PR: How have plan sponsors acted to address pension risk?

MB: Plan sponsors initially focused mainly on mitigating risks within their plans. Common strategies include making discretionary cash contributions and adjusting assets to more closely track liabilities.

These actions mitigate volatility, but leave residual economic and demographic risks. Meanwhile, intensified audit and compliance requirements and sharp increases in Pension Benefit Guaranty Corporation (PBGC) premiums have driven up the cost and effort of managing pensions.

In response, pension plan sponsors are increasingly looking to transfer the risk and responsibility of managing some or all of their participants' benefits.

PR: What are the options for transferring pension risk?

MB: Risk can be transferred through offering lump sums to participants, buying annuities from an insurer, or a combination of these strategies.

PR: What are the pros and cons of lump sums in general?

MB: For deferred vesteds and actives, lump sums do not have to include the value of pre-retirement death benefits or any early retirement subsidies. Therefore, their lump sums are often paid at a discount to accounting liability.

Participants who are not living off their pension benefits tend to value liquidity. With a robust communications campaign, typical uptake of lump sums is around 60 percent for deferreds and higher for actives (in terminating plans), varying by plan demographics and other factors. Because these participants are usually many years away from death, their decision is rarely driven by health status, minimizing adverse selection.

In-service lump-sum distributions are only allowed for actives older than 62 or when the plan is terminating (possibly with a residual plan spinning off). These restrictions make in-service lump sum offers less attractive to plan sponsors and participants.

For annuitants, IRS policy regarding lump sums (absent plan termination) has changed repeatedly. These lump sums were prohibited before 2012, allowed from 2012 to mid-2015, prohibited from mid-2015 to March 2019, and then re-enabled. Retiree lump sums provide another risk transfer opportunity to plan sponsors, especially those that have exhausted other options. However, annuitant lump sums also present potential financial, administrative, and public relations drawbacks.

PR: What are the pros and cons of annuity purchases?

MB: Annuity purchases complement lump sums, resulting in at least one viable risk transfer option for almost any participant group within a plan.

For deferreds and actives, annuity purchases tend to be relatively expensive, since the form and timing of payment are not yet known and benefits are payable many years in the future.

For annuitants, the form and timing of payment are known and the time horizon is shorter, producing more competitive insurer pricing.

One advantage of annuity purchases is that the plan sponsor controls the population to buy out, without needing participant consent/elections. Therefore, there is more certainty about the outcome of the process.

PR: What risk transfer solutions are most prevalent today, and why?

MB: For deferred vesteds with lump-sum benefit values up to $5,000, it is common to mandate a lump-sum distribution. Administrative costs and per-participant PBGC premiums generally do not scale with benefit size, making small lump sums an efficient way to mitigate plan management costs.

For benefit values higher than $5,000, lump sums cannot be mandated. However, many plans historically have offered voluntary lump-sum distributions to deferred vesteds on an ongoing basis. These distributions provide participants with flexibility and produce gradual de-risking as part of regular plan operations, but they usually make a plan less attractive to insurers in a plan termination.

Voluntary lump-sum windows for deferred vesteds have been very popular in recent years. In fact, most sponsors of large plans have offered one or more deferred vested windows in the past several years. These windows can be executed without terminating the plan, often produce savings versus accounting liability, and are popular with participants.

The dollar amount of insured annuity buyouts has been growing at a cumulative annual rate of 60 percent per year since 2011, increasing from about $1 billion in 2011 to around $28 billion in 2018.

The growth in buyouts has primarily been driven by transactions for annuitants, especially those with smaller benefit amounts. In many cases, annuitant benefits can be bought out at close to or only a few percent above the accounting liability.

These transactions are often structured to maximize the reduction in participant counts (and associated administrative costs and PBGC premiums), relative to the assets deployed and dollar amount of markup over accounting liability.

PR: How does plan size impact risk transfer opportunities?

MB: For larger plans, it is common to segment the population into tranches and strategically transfer risk in phases. For example, a plan sponsor might sequentially offer a deferred vested window (or series of windows), buy out annuitants with smaller benefits, and terminate the residual plan.

For smaller plans, the incremental execution costs of a phased series of transactions may not be worthwhile. Therefore, waiting until the plan is ready for termination as a single transaction remains the most common risk transfer strategy for smaller plans.

Similarly, larger plan sponsors that have exhausted the “low-hanging fruit” opportunities may find it cost-effective to pursue more esoteric strategies. Those strategies can include in-service lump-sum offerings, repeated plan terminations with associated spinoffs, or risk transfers coupled with changes in the plan year. These strategies can produce additional risk reduction and/or PBGC premium savings.

However, for smaller plans, these strategies would typically entail prohibitive execution costs and effort.

PR: What are the implications of risk transfers for participants?

MB: For lump-sum offers, participants should think carefully about their financial situation, consult with family members who may be impacted by the decision, and strongly consider seeking professional financial advice.

A lump sum provides liquidity. This can help protect a participant against emergency expenses, allow the participant to clear high-cost debt, or enable deferral of Social Security commencement. The latter strategy can provide greater lifetime income and more protection against longevity risk, since Social Security benefits are indexed to inflation.

By taking a lump sum, a participant assumes the investment risks and costs associated with managing the assets and the longevity risk of outliving their assets. Participants generally should not take the lump sum if they are uncomfortable managing the resulting assets and/or prefer the security of guaranteed lifetime income. Participants should also be wary of the potential for tax consequences and investment fees to erode the value of their retirement savings.

In an annuity purchase, participants retain their current benefits (including future timing and payment form options for nonannuitants). Therefore, for a qualified pension plan, an annuity purchase usually has no direct financial impact on participants.

PR: How do you see the risk transfer market evolving in the next three to five years?

MB: I predict a continuation of the trends that have occurred since 2012.

Annuity purchases will continue to grow—though probably not at a 60 percent annual rate. Plan sponsors will continue to explore more exotic deal structures as the easier opportunities are exhausted.

In-service lump-sum offers have historically been quite rare. As active populations age (especially in long-frozen plans), significantly more plan sponsors may consider lump sums or other settlement options for these participants.

When market conditions are poor, plan sponsors have usually viewed termination as too expensive. When markets are good, sponsors have tended to forget the downside risk and retain their plans. I think this dynamic has changed; so many plan sponsors may terminate their plans if and when financial markets next move in their favor. ■

Patrick Ring, ASA, volunteers as a member of the SOA Retirement Section Council’s Communications Team. In addition, he is assisting SOA in fine-tuning and optimizing the Retirement Section’s web page on *SOA.org*. He can be reached at *pringactuary@gmail.com*.