Topics in Pension Risk Management

MetLife

PREPARING TO IMPLEMENT AN ANNUITIZATION APPROACH

Poor asset returns coupled with high volatility in fixed income and equity markets have left many pension plan sponsors longing for a return to adequate funding levels and the refuge of a "safe" investment policy. In the current FAS 158, PPA, and economic environment, today's safe strategy is one that enhances or stabilizes the plan's funded status at an acceptable cost, rather than having a portfolio with a standard investment allocation that beats its market benchmark. Many companies that were considering risk reduction strategies last year are no longer in a position to execute them. To avoid missing the opportunity a second time, plan sponsors should be prepared to execute risk reduction strategies when market conditions permit.

Risk reduction strategies range widely, from immunization, partial risk transfers (annuitization of a portion of the plan's benefits) all the way to a plan termination, which entails distributing all benefits in the form of an annuity or a lump sum. This paper focuses on annuitization, but many of the steps would apply to other strategies as well.

Given the weakened funded status of many plans, there are various "costs" to consider before implementing a strategy. These costs may include the total amount needed to adequately fund the plan, the foregone earnings resulting from reduced investment risk, the financial impact of a change in the expected return on assets and the accelerated recognition of accrued gains/losses. Many sponsors have decided that the benefits of reduced risk more than offset such costs — or will when costs reach a level that the plan sponsor deems reasonable. Since each company's financial drivers and accounting history varies, there is no one "crossover" point that applies generally.

That said, as economic developments of 2008 and 2009 have clearly indicated, the opportunity to implement any type of risk reduction strategy can be unexpectedly transitory, and very sensitive to fluctuations in equity markets and interest rates. A 0.5% to 1.5% spike in interest rates, for example, could translate into a reduction in the present value of an average plan's liability—and a 5% to 20% reduction in the assets required to implement a risk reduction strategy, depending on the liability's duration.

[AUGUST 2011]

We recommend that plan sponsors prepare to react promptly so that they are able to execute, if it makes sense for them to do so, when an opportunity arises. This preparation includes:

1. Quantifying costs and financial impact;
2. Identifying an acceptable level of costs and financial impact;
3. Obtaining the necessary approvals for action;
4. Monitoring the environment so that opportunities are not missed; and
5. Implementing a strategy when appropriate.

These steps should be taken regardless of the risk reduction approach contemplated and can be taken while the sponsor's alternatives are under consideration.

QUANTIFY COST / BENEFIT ISSUES

The quantification of a cost level at which implementing a risk reduction approach makes sense is vital. There are a number of explicit and implicit costs—and benefits—to be weighed. Depending on the approach used, these costs and benefits may vary. For annuitization they may entail:

- The differences among the Plan's current funded status, existing assets and the amount required to settle all or a portion of the liability. For sponsors used to viewing the accounting liabilities as the "true" measure of the liability, rather than as a current "snapshot," an insurer's estimate of the actual cost to transfer the liability permanently may come as a surprise. Generally, when a liability is measured for accounting purposes, it represents a point-in-time estimate based on a number of current assumptions, with the expectation that it will be adjusted prospectively each measurement period as another year of actual experience replaces a year of assumptions.
- The impact on accounting pension expense if a change in Expected Return on Assets is required as a result of a change in the ongoing asset allocation
- A reduction in the future volatility in pension expense, contributions and funded status
- The impact of the accelerated recognition of a portion of the plan's accumulated actuarial gains or losses
- An effect on funded status of the "remaining" plan resulting from the settlement of a portion of the liability at a premium or discount to its actuarial value
- A reduction in ongoing expenses associated with the plan. Calculating the present value of 10 years of such expenses (including investment-related expenses) is one reasonable method. This can approach 10% of the liability.

An initial step that may be helpful in quantifying the magnitude and direction of costs is to secure an illustrative bid from an insurer. The bidder should also provide commentary on the durations (interest rate sensitivities) of the liabilities. The plan's advisors can then quantify the resulting cost impacts discussed above, and how they would change if rates or markets rise or fall significantly.

> **PLEASE CONTACT YOUR METLIFE CORPORATE BENEFIT FUNDING REPRESENTATIVE OR CALL 1-888-217-1858 IF YOU WOULD LIKE TO DISCUSS THESE IDEAS IN GREATER DEPTH.**

DETERMINE ACCEPTABLE COSTS FOR MITIGATING RISKS

As a simple example, assume the sponsor is investigating the settlement of retirees, and is concerned only with the difference between the accounting and economic liabilities. If the accounting liability for retirees is $500 million and a competitive annuity bid is $600 million, the "price difference" might be viewed as $100 million, before factoring in a discount for the factors (like expenses) mentioned above. If that price is too high, the next logical question is—what price is not too high? The acceptable cost will vary by firm; a cash-rich firm with a plan that's large relative to the firm may be more willing to absorb costs than a firm with liquidity issues and a small legacy plan. Answering this question is often difficult, and real-life situations are more complex, however, it is a necessary part of the process of understanding, assessing and ultimately addressing pension risk.

Once current costs, the sensitivity of those costs to changes in the investment environment and acceptable costs in return for a risk reduction have been determined, it is relatively easy to monitor asset and liability levels regularly to assure that the sponsor can react when costs have reached an appropriate level.

OBTAIN NECESSARY APPROVALS

While this discussion focuses on annuity approaches, similar steps would be required for an immunization strategy as well. The three major steps for an annuity-based strategy are:

- Get agreement among all decision makers on the acceptable level of additional "costs" in order to implement an annuitization strategy.
- Decide on insurers who may be considered for annuity quotes.
- Design an implementation strategy and a protocol for authorization to execute the strategy when acceptable conditions are met.

The entities that might be involved, and their roles, are as follows:

Investment Committee	An existing Investment Policy Statement may be required to be modified to reflect changes to the overall investment strategy and (or) use of annuities. Additionally, the liquidity of plan assets needs to be assessed. An annuitization strategy should involve a review of the annuity provider's financial quality.
Counsel	Counsel should review fiduciary and regulatory aspects of the desired strategy.
Accountants	These strategies may impact cash flow and accounting expense. Impacts should be estimated and understood well before a change is implemented.
Plan actuary	A change in investment strategy or partial settlement may impact the funded status and the expected return on assets. The implications of these impacts should be quantified.
CFO	The CFO needs to deem the financial impacts of implementation beneficial, or at least acceptable to the company. A detailed analysis of the estimated costs and benefits of the contemplated approaches may be useful.
Board of Directors	The Board may wish to agree on acceptable funding level at which to implement to an annuitization strategy, and approve the transaction in advance subject to achievement of that funding level and a proper due diligence review.

MONITORING THE ENVIRONMENT: TRACKING FUNDED STATUS

The main factors that improve the funded status of a DB plan and thus reduce the costs of implementing a risk-reducing investment strategy are an improving stock market and increasing interest rates. Most plans should have access to aggregate asset values on a monthly basis; the plan's actuary can do a rough update of the plan's liabilities based on illustrative rates and interest rate sensitivities—or alternatively, bid updates can be provided by insurers.

As the costs of implementing a risk reduction strategy proxied by the funded status of the plan near a trigger point where implementation seems in range, more frequent monitoring of assets and liabilities may be required; this may also require a change in the plan's investment strategy to assets that offer daily valuation and liquidity.

BEING PREPARED TO IMPLEMENT

Once the above steps have been accomplished a plan sponsor should monitor market returns, interest rates and other variables to implement an annuitization strategy when appropriate. It may also proceed with a provisional selection of an annuity provider. In this case, when a decision is reached to proceed with implementation, the provisional selection should be reviewed to ensure that none of the key factors supporting the selection have changed.

Upon final selection of an annuity provider, implementation of the group annuity contract will involve close interaction among the plan sponsor, its advisors and the annuity provider. Some of the steps involved are data cleanup, participant communication to ensure a smooth transition for those affected, final contract execution and release of participant certificates.

The key, however, is to be prepared. Evaluating costs and benefits, identifying an acceptable cost level, securing the necessary agreements and monitoring the environment and funded status will put the plan sponsor in a position to act when market conditions permit.

MetLife

Metropolitan Life Insurance Company
200 Park Avenue, New York, NY 10166
www.metlife.com

1108-2768
L0811199391(exp1012)(All States)(DC)