MassMutual

Institutional Solutions –
Updated September 2021
White paper

Key Decisions for De-Risking Your Pension Plan

Why choosing a life insurer to settle your pension risk is good for both you and your employees.

Massachusetts Mutual Life Insurance Co. (MassMutual®)

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FOR INSTITUTIONAL INVESTORS.

Plan sponsors are transferring pension costs and risks to insurers at a rising rate

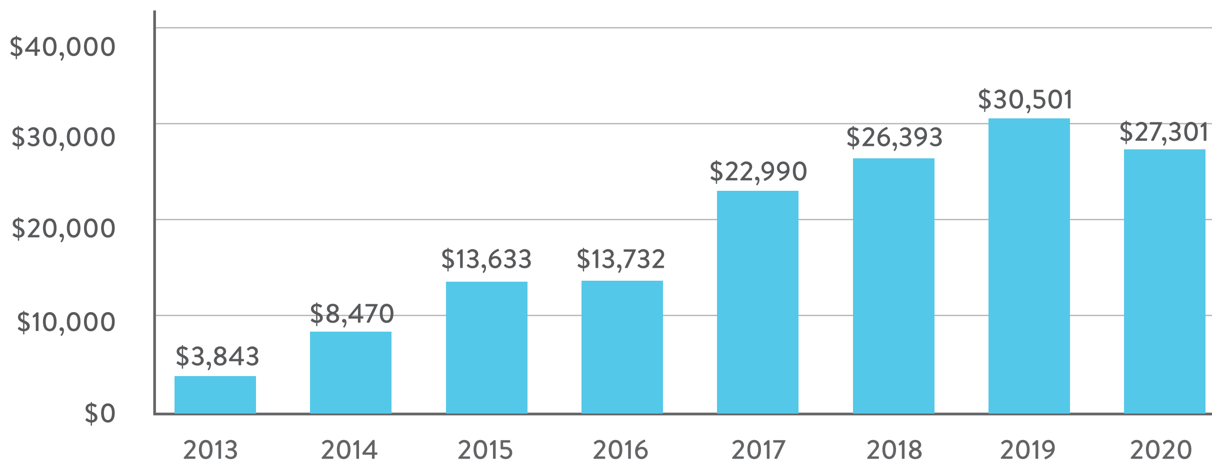
As evidenced by industry sales reports, plan sponsors are choosing to transfer pension costs and risks to insurers at a rising rate despite a brief slowdown in the first two quarters at the onset of the pandemic in 2020. LIMRA reported that sales of group annuities offered through insurance companies reached $30.5 billion in 2019 compared to $13.7 billion in 2016. While the pandemic did hamper sales activity in the first half of 2020, sales volume for the year was twofold that of 2016 figures at a healthy $27.3 billion.[1,2]

It's important to note that in 2012, two jumbo pension risk transfer transactions — Verizon, a $7.5B transaction, and General Motors, a $25.1B transaction, spawned interest in the PRT market and resulted in an all-time high record sales total of $36B.[3]

Even so, some defined benefit (DB) plan sponsors remain unfamiliar with group annuity solutions, their availability as a means to transfer plan liabilities, or the expertise, financial strength and capabilities of the providers of annuities: America's life insurance companies.

In this paper, we'll discuss ways in which plan sponsors, together with their pension risk transfer consultant, can strategically manage and potentially eliminate the costs and risks associated with their defined benefit plan including by satisfying the pension obligation through annuity solutions.

Pension Buy-out Industry Sales (billions)



Reporting through 2018 is based on 16 companies that provided single premium buy-out sales. 2019 and later is based on 17 companies due to a new entrant to market.

Sources: LIMRA Secure Retirement Institute, *Group Annuity Risk Transfer Survey* (2018, 4th Quarter and 2020 4th Quarter Reports)

Cost and risk considerations during times of uncertainty

As a highly regulated benefit, the administration costs and the costs of funding a defined benefit plan are significant. What's more, the plan's funding is subject to a variety of risks such as interest rate risk, market risk, and longevity risk, which create uncertainty and can increase the costs of funding the benefit. While the industry has discussed the concepts of managing costs and risks for decades, volatile markets have caused plan sponsors to take action in recent years.

In this dynamic environment, interest rates have been volatile hitting historical lows while equity markets are hitting historical highs in recent years — each of which impacts pension plan differently. Many U.S. pension plan portfolios with material equity exposure experienced significant asset gains as the equity markets soared.

However, a decrease in discount rates for pension plan purposes, which are determined based on yields of investment grade corporate bonds, generally increased pension liabilities. Despite liabilities increasing in recent years, the funded status of many pension plans generally improved largely due to the favorable asset performance.

Meanwhile, mandated insurance continues to increase costs. The Pension Benefit Guarantee Corporation. (PBGC), the federal agency backstopping the pensions of most American private sector workers, has significantly increased the mandatory premiums it charges in the past decade, more than doubling them since 2013[4].

Today, plan sponsors must continue to pay what has been, and is anticipated to continue to be, the escalating PBGC premiums.

The PBGC per-participant flat premium rate for plan years beginning in 2021 is $86 for single-employer plans — up from $42 in 2013, and $31 for multiemployer plans — up from $12 in 2014).[4] And, the variable-rate premium (VRP) for single-employer plans is $46 per $1,000 of unfunded vested benefits (UVBs) for plan years beginning in 2021, nearly double the 2015 rate of $24.

PBGC PREMIUMS INCREASE

Plan Years Beginning In	Single-Employer Plans	Multi-Employer Plans
2021	$86	$31
2020	$83	$30
2019	$80	$29
2018	$74	$28
2017	$69	$28
2016	$64	$27
2015	$57	$26
2014	$49	$12
2013	$42	$12
2012	$35	$9
2011	$35	$9
2010	$35	$9
2009	$34	$9
2008	$33	$9
2007	$31	$8

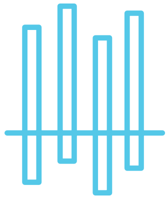
Source: Pension Benefit Guarantee Corp. (PBGC), Premium Rates[4]

While a blessing for many people, improved longevity puts more stress on pension funding as pensioners are predicted to live longer, necessitating payments for additional years and greater funding of defined benefit plans. Americans who are currently age 65 are expected on average to live another 19.5 years, according to the National Center for Health Statistics[5].

This is significantly longer than a century ago.

In 2018, life expectancy at age 65 reported for women is 20.6 years of age, and 18.1 years for men according to the National Center for Health Statistics.[5] While the pandemic has shown us how difficult it is to predict longevity and certainly life expectancy rates have been impacted during this time, generally, we have seen longevity improve and we expect continued improvement.

With consideration to these costs and risks paired with volatile markets and speculation of inflation looming, defined benefit plan sponsors are increasingly recognizing the value of insurance companies' group annuity solutions. As they look to shift risk off their balance sheets, reduce their long-term financial liabilities and costs, and ensure their pension plan commitments are satisfied, more plan sponsors are electing to transfer pension risk to insurers.



Strategies for Managing Pension Risk

Why plan sponsors choose insurers when managing their pension costs and risks

Not only are the rising cost of employee benefits straining many employers' finances and capabilities, and making the longer-term obligations of pension plans more challenging to meet, many senior leaders conclude that managing the risks, liabilities, and obligations of defined benefit pension plans are a distraction and outside their core expertise. Businesses involved in manufacturing, retail, food services or others not in the financial services arena, typically lack the expertise and experience to manage the large, long-term financial risks associated with a pension plan. It's simply not what they do.

As the management of pensions becomes more complex, many employers are concluding that they and their employees would be better served by shifting defined benefit obligations, liabilities and risks to life insurers, which focus on risk management as their primary purpose. What's more, a pension risk transfer (PRT) offers the only way to eliminate those obligations under current law.

Because life insurers, the largest of which have experience managing risks for a century or more, are professional long-term risk managers and annuity service providers, they are well equipped to handle equity market, interest rate, longevity, and the other risks associated with managing pension liabilities and they are well equipped to serve annuitants.

Simply put, the capabilities and expertise that insurers possess allows them to guarantee payment of the plan liabilities at a fixed price, which the plan can then assess in the context of the plan's overall risk profile. In addition, they are set up to administer the payments and serve the annuitants until the pension obligations are completely satisfied.

"Hibernating" Risks

A common approach to "de-risking" a defined benefit plan is to close the plan to any new entrants. To further reduce costs, further accruals for existing participants can be stopped. While freezing the plan in this manner protects against the additional costs and risks associated with new entrants and additional accruals, plan sponsors are still exposed to the other risks of maintaining the plan, including market risk, interest-rate risk, and expense risk.

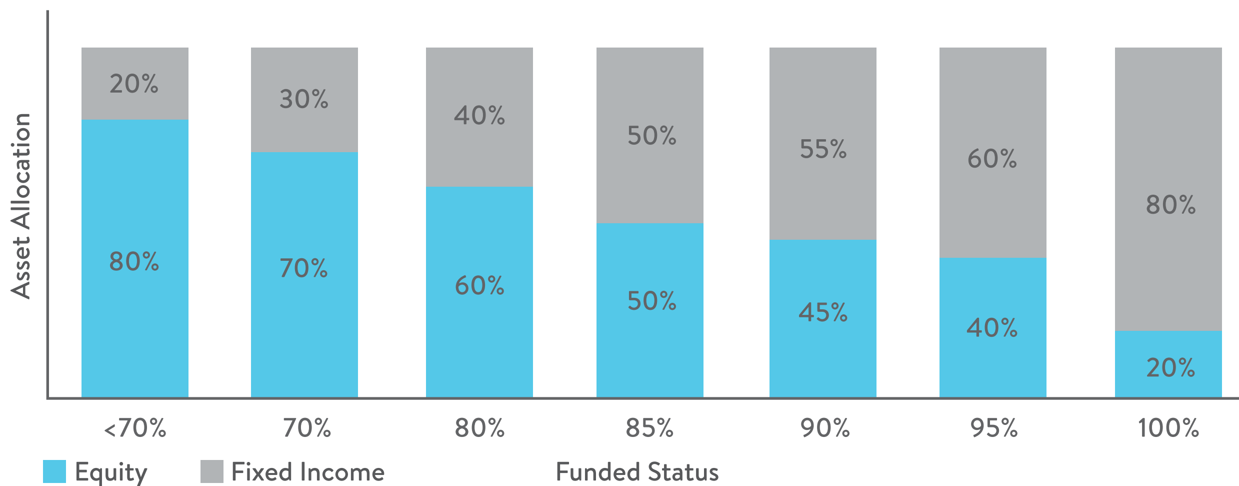
Plan sponsors looking to de-risk their pension plan without a full plan termination can elect to pursue a hibernation strategy. The goal of a hibernation strategy is to limit the financial risks of the plan while the sponsor continues to manage the plan.

A plan targeting a hibernation strategy will typically establish a "glide path" in which investments are increasingly allocated toward fixed income as the plan's funded status improves. This is done for two reasons:

1) Excess plan assets can't readily revert to the plan sponsor, so as a plan approaches 100% funded, the risk/reward trade-off associated with equities starts to diminish.
2) Fixed income assets (bonds) offer a hedging affect on pension liabilities; because interest rates effect fixed income assets and pension liabilities in a similar manner.

The chart below illustrates what a sample glide path might look like. In this example, the plan would be targeting a fixed income allocation of 40% when the plan is 80% funded. Once the plan becomes 85% funded, 10% of the total assets would be reallocated from equities to fixed income to bring the fixed income allocation up to 50%.

Glide Path Strategy



For illustrative purposes only.

Advocates of hibernation promote the tactic as a way to save money and reduce risks over a period of time before eventually executing a pension buyout. However, hibernation may not be a panacea for every pension plan or pension risk management objective.

Once in hibernation, the pension must continue to be managed and therefore continues to incur costs, including investment management expenses. Other costs continue such as actuarial consulting, recordkeeping, payment services, and reporting.

HIBERNATION CONSIDERATIONS

Pros	Cons
Reduces some of the plan's risks	Plan still exposed to many risks
Lower initial cost (relative to annuities)	Maintains ongoing cost (expenses, PBGC premiums, etc.)
Allows plan sponsor to maintain administrative relationship with retirees	Requires ongoing support (administration, actuarial, investment, etc.)
Retains existing employees by providing a meaningful retirement benefit	Bars new employees from participating Existing participants no longer accrue benefits

Hedging Risks

The fixed income assets that a plan invests in can be selected in a way to match the liability's sensitivity to interest rate movements (called "duration") to offset changes in the plan's liabilities. When interest rates decrease, the asset portfolio will increase in value in an amount close to the increase in liabilities.

This hedging strategy that is typically pursued in a plan that has progressed along its glide path can work well in reducing the investment risks associated with pension plans but does not eliminate the risk. It's impossible to eliminate every risk and therefore some market risk remains, albeit lower and less volatile than an investment strategy with no hedging. Even interest rate risk isn't fully hedged in a fixed income investment strategy that matches the plan's asset and liability durations.

Interest rates on assets (referred to as yields) aren't all created equal. The yield on assets can vary significantly due to two main components: The term of the asset (1-30 years) and the market's view of the creditworthiness of the bond issuer (more risky bond issuers have higher yields than less risky bond issuers, all else being equal).

The duration of a plan's liability indicates its relative sensitivity to interest rate risk assuming all interest rates move by the same amount. In reality, that rarely happens; rates at different terms and credit ratings tend to move differently. This means that even a "fully hedged" (assuming 100% fixed income with an asset duration matching that of the plan's liabilities) plan is still exposed to interest rate risk. This can be managed through more sophisticated hedging strategies but those become much more difficult (and possibly more expensive in terms of investment fees) to execute as a plan sponsor.

Meanwhile, the assets and liabilities of the DB plan remain on the sponsor's balance sheet. Therefore, given the goal of extinguishing the long-term financial obligations and potential impact from a company's profit-and-loss statement, a pension risk transfer transaction is the only viable solution permitted under current law.

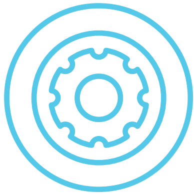
The management of interest rate risk (and other risks), administration of pension-like liabilities, and development and execution of investment strategies that appropriately back those liabilities are all strengths of insurance companies. Those aspects are part of their core business as they have not only executed them through pension annuities, but through other products such as life insurance and individual annuities as well.

Annuitize the Plan

As part of a PRT transaction, pension plan sponsors typically purchase group annuities through which they transfer the costs and risks associated with the plan to an insurer. Group annuities are designed to replicate the benefits available through the pension plan, transferring a plan sponsor's duty to satisfy the plan's pension obligations.

Annuitizing the plan can settle the plan sponsor's pension obligations. Through a group annuity solution, the insurer can offer all of the types of benefit payment options such as:

- **Income for Life** — Annuities issued by life insurers are the only product available that can guarantee an income for life. Like pension payments, income from an annuity lasts as long as the annuitant lives, ensuring a predicable source of income.
- **Fixed benefit** — Income from an annuity issued as part of a PRT is both fixed and guaranteed, meaning it will not vary due to fluctuations in the stock or bond markets. The life insurer guarantees the payments, which underscores the advantage of working with an insurer that has secured among the highest ratings from independent rating agencies for financial strength and stability.
- **Deferred Distributions** — The annuitant can decide when to begin taking payments depending upon his or her plans for retirement. In some instances, the payments from an annuity will increase if the annuitant chooses to defer taking income past his or her full retirement age. Early retirement will typically reduce payments from an annuity.
- **Joint and Survivor Annuity (J&S)** — When retiring, annuitants typically have the option to select from several available benefits that can provide income for a single life or for the joint life of the annuitant and their spouse. Typical survivor benefits pay 50 percent of the initial annuity payment and other percentages are available. The higher the survivor benefit percentage, the lower the initial income payment to the annuitant. The survivor benefit percentage available can vary from plan to plan.
- **Pre-Retirement Death Retirement Annuity (QPSA)** — When the annuitant passes before commencing retirement payments, the surviving spouse is eligible to receive a monthly annuity payment.



Kicking the Tires

Because the selection of an insurer for a pension transfer is a fiduciary act and with it comes specific responsibilities, the plan sponsor needs to perform due diligence on the insurers as part of the annuity selection process.

Department of Labor Interpretive Bulletin 95-1 (IB 95-1) requires plan sponsors "to obtain the safest annuity available" unless under the circumstances it would be in the interest of participants and beneficiaries to do otherwise.[6]

A fiduciary must evaluate a number of factors relating to a potential annuity provider's claims-paying ability and creditworthiness. Reliance solely on ratings provided by insurance rating agencies would not be sufficient to meet this requirement. The bulletin also outlines the following aspects that should be considered when selecting an annuity provider:

1) The quality and diversification of the insurer's investment portfolio
2) The size of the insurer relative to the annuity purchase
3) The level of capital and surplus held by the insurer
4) The insurers other lines of business and liabilities that they are exposed to
5) The structure and terms of the annuity contract

In addition, it's important to note that IB 95-1 also states, "it may also be in the interest of the participants and beneficiaries to choose a competing annuity [if] the annuity provider offering the safest available annuity is unable to demonstrate the ability to administer the payment of benefits to the participants and beneficiaries."[6]

It can be challenging for a plan sponsor to differentiate between insurers based on these criteria. Also, the process for soliciting quotes for annuity purchases can be complicated. For these reasons, it is usually best to seek the help of an expert intermediary that will help facilitate engagement with prospective insurance companies as well as aid in determining a safest available annuity provider.

About MassMutual

At MassMutual, we offer plan sponsors and intermediaries confidence by helping ensure their fiduciary duties and pension obligations are satisfied. As a mutual company run for the benefit of its participating policyholders, we offer confidence through our enduring financial strength, our annuity solutions expertise, and our passion for helping people secure their future and protect the ones they love.

As a mutual company, MassMutual operates for the benefit of its members and participating policy owners. MassMutual is managed with a focus on policy owners' long-term interests and are not subject to the expectations of Wall Street analysts or stockholders. Throughout its history, this focus on the long-term has helped MassMutual provide financial and retirement security to millions of people.

MassMutual earns among the highest financial ratings in the industry and has followed a prudent investment strategy for more than 170 years. This approach has given our policy owners confidence that we'll deliver on our long-term commitments to them. Our strength and stability are recognized by the following ratings:

- **A.M. Best Company: A++**
  (Superior; top category of 15)
- **Fitch Ratings: AA+**
  (Very Strong; second category of 21)
- **Moody's Investors Service: Aa3**
  (High Quality; fourth category of 21)
- **Standard & Poor's: AA+**
  (Very Strong, second category of 21)

Ratings apply to Massachusetts Mutual Life Insurance Company and its subsidiaries, C.M. Life Insurance Company and MML Bay State Life Insurance Company. Ratings are as of 10/01/2021 and are subject to change.

We would appreciate the opportunity to discuss your needs together with you and your pension risk transfer consultant.

To learn more about how MassMutual can assist with your pension risk transfer needs, visit us at **www.institutional.MassMutual.com/institutional-longevity** or contact us at **TFSales@MassMutual.com.**

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[1] LIMRA Secure Retirement Institute: **LIMRA Secure Retirement Institute, *Group Annuity Risk Transfer Survey* (2018, 4th Quarter and 2020 4th Quarter Reports)**

[2] LIMRA Secure Retirement Institute Reports, *U.S. Single Premium Pension Buy-out Sales Top $13.7 Billion in 2016* (March 1, 2017) https://**www.limra.com/en/newsroom/news-releases/2017/u.s.-single-premium-pension-buy-out-sales-top-$13.7-billion-in-2016-limra-secure-retirement-institute-reports/**

[3] **Chief Investments Officer, Special Report: Will Pension Risk Transfers Someday Control All DB Plans? (May 25, 2021)** https://**www.ai-cio.com/news/special-report-will-pension-risk-transfers-someday-control-all-db-plans/**

[4] Pension Benefit Guarantee Corp., 2019 Premium Rates, Pension Benefit Guarantee Corp. (PBGC), *Premium Rates* (Last updated October 15, 2020) https://**www.pbgc.gov**/prac/prem/premium-rates

[5] Centers for Disease Control and Prevention, National Center for Health Statistics, *Mortality in the United States*, 2018 (NCHS Data Brief No. 355, January 2020) https://**www.cdc.gov/nchs/products/databriefs/db355.htm**

[6] 29 CFR § 2509.95-1 - Interpretive bulletin relating to the fiduciary standards under ERISA when selecting an annuity provider for a defined benefit pension plan (July 1, 2016) https://**www.govinfo.gov/content/pkg/CFR-2016-title29-vol9/pdf/CFR-2016-title29-vol9-sec2509-95-1.pdf**

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