Managing group annuity buyout costs and risks with Assets-In-Kind

A mutually beneficial solution for sponsors and insurers

Leveraging 'Asset-In-Kind' process to cover the costs of a pension risk transfer annuity premium

The decision to de-risk a pension plan has far-reaching implications that no plan sponsor takes lightly. Moreover, it takes years of careful planning to unwind the plan, often using a variety of strategies and cost savings techniques.

As part of this thoughtful process, sponsors may choose to transfer all or a portion of the obligations to an insurer through a group annuity solution. After years of taking deliberate steps to mitigate the costs and risks associated with the pension plan and preparing for a successful transfer, there are yet additional costs and risks associated with the transfer to consider and strategies available to help.

In this white paper, we'll share key considerations when exploring a group annuity purchase, the risks and financial impacts such as the effects of continued interest rate volatility, and strategies available to manage them. In short, we'll discuss asset management considerations for pension risk transfers and the advantages of utilizing assets-in-kind (AIK) to cover the costs of the premium.

The growing popularity of transferring pension risk to an insurer

Currently, the only means available under the law to fully unwind a pension plan is via the purchase of a group annuity contract. Through this exit strategy, the employer purchases a group annuity contract and transfers the remaining benefit payment obligations, along with the administration and associated mortality and asset risks, to an insurance company. From that point forward the insurer takes over the responsibility of managing the obligations and making all subsequent annuity payments to retirees — delivering on the promise the employer made to its employees.

As evidenced by 250% sales growth since 2016, the popularity of group annuity contracts as a means of pension risk transfer continues to grow sharply (fig. 1). While the effects of the global pandemic hampered sales briefly with less than $7 billion in sales reported in the first half of 2020, pension buy-out sales rebounded through the end of 2020 with sales reaching $25 billion for the year and in 2021 were at an all-time high of just over $34 billion, according to the Secure Retirement Institute® (SRI™)'s Group Annuity Risk Transfer (GART) survey.

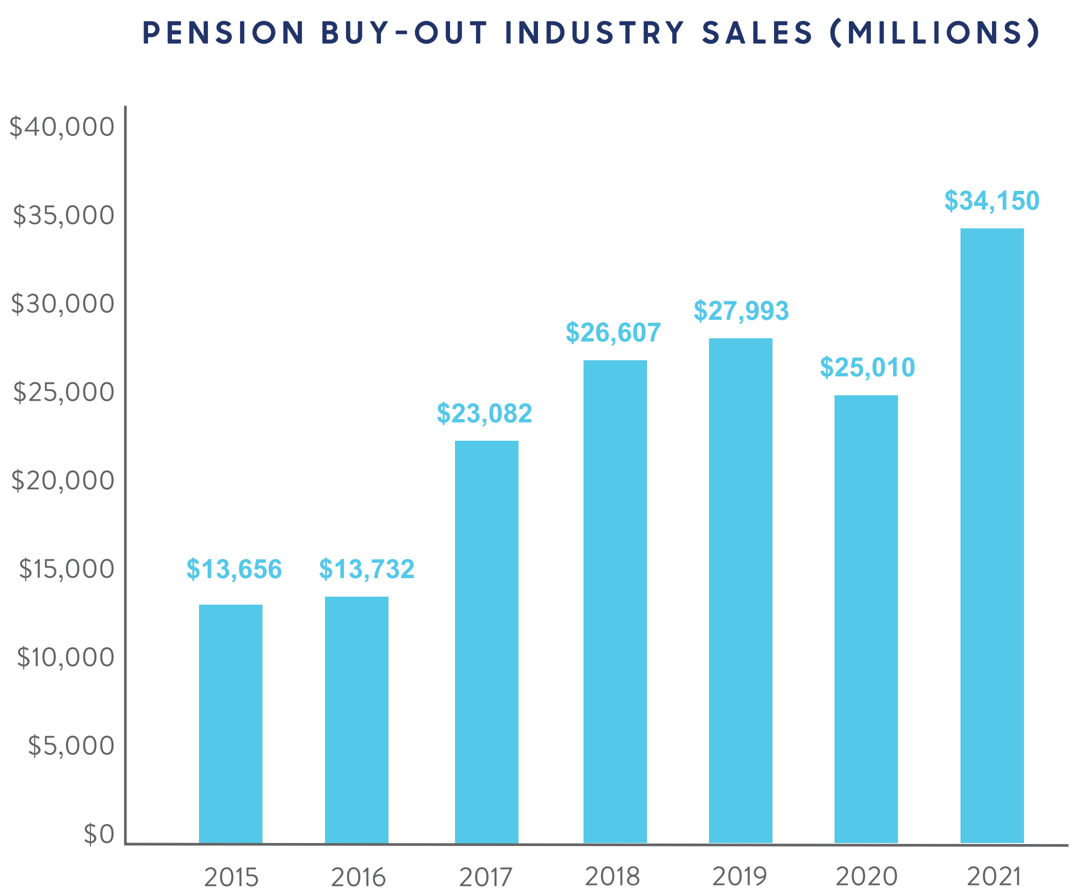


Figure 1: Pension Buy-out Industry Sales (millions)

Source: LIMRA Secure Retirement Institute. Secure Retirement Institute® (SRI™)'s Group Annuity Risk Transfer (GART) survey Second Quarter 2022; based on 18 companies that provided single premium buy- out sales.

As a leader in pension risk transfer solutions, we are noticing that plan sponsors, together with their advisors and actuaries, are making strides in strategically managing pension plan costs and risks over time — including through group annuity solutions. However, there is another risk for the plan sponsor to consider before moving the pension obligations to an insurance provider: asset transfer risk.

Typically, assets are liquidated to cash to cover the costs of the annuity's premium during the pension risk transfer transaction. Not only does this process expose both the employer and the insurer to risk, it can frequently result in significant additional costs to both. The good news is these costs and risks are manageable, and, in some cases, avoidable.

What is asset transfer risk?

Asset transfer risk is the exposure to traditional market risks — mainly market volatility and interest rate risks — during the asset transfer period.

For the plan sponsor's interests in a pension risk transfer transaction, the asset transfer period generally spans from the weeks leading up to the annuity provider selection date through the annuity premium payment date. In some cases, plan assets are liquidated following the selection of an annuity provider to amass cash needed to pay the premium due. In other cases, the transfer period can begin earlier as the plan sponsor might elect to liquidate assets in advance of the annuity purchase. In either case, the plan assets are subject to the asset transfer risks.

Moreover, the insurer is exposed to asset risks from the time the insurer is selected and commits to the transaction through the time the premium received is invested according to the insurer's strategy for backing the liability it is accepting.

In addition to the risks associated with the asset transfer period, there are transaction costs associated with liquidating the investments and with purchasing longer-term assets to back the transferred liabilities.

Let's take a closer look at the dynamics associated with asset transfer risk.

If a sponsor liquidates fixed income assets before accepting an annuity provider's quote, the asset transfer risk is the potential change in annuity cost due to market interest rate decreases between the asset liquidation date and the insurer selection date. A decline in interest rates during this time would cause annuity prices to increase, while the value of the assets liquidated to cash would remain flat.

When the plan liquidates fixed income assets after accepting an annuity provider's quote, the potential variance between the value of the fixed income assets at the time the insurer's proposal is accepted and the cash proceeds received when liquidating the assets (if interest rates have increased) is the intrinsic asset transfer risk as it relates to the plan's interests in the transaction.

This is of note for plans that employ a liability driven investing (LDI) method, a hedging strategy designed to align a plan's investments to its liabilities, because, typically, LDI strategies heavily invest in fixed income positions.

It’s important to note the impact of declining rates can result in a significant shortfall relative to the size of a transaction even if the exposure only spans a few days. Market events in 2020 illustrated this point quite well. A review of the treasury rates available on the U.S. Treasury site shows that daily interest rates fluctuated by at least ten basis points ten times during the month of March in 2020. While the market in 2022 has not been as volatile (with rates moving at least ten basis points 18 times through the first half of 2022), it’s impossible to predict what the economic climate will be around the insurer selection and premium payment date.

To better understand how fluctuating interest rates can impact the transaction, let’s review The Asset Transfer Timeline and Related Risk Exposure illustration (figure 2) below:

ASSET TRANSFER TIMELINE AND RELATED RISK EXPOSURE ILLUSTRATION

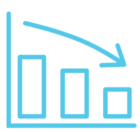
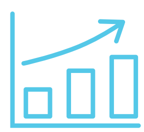
Pre-selection Days 0 ≥	Annuity Provider Selected Day 1	Transition Period Days 1 - 4	Payment Date Day 5
Declining interest rates considerations  If the sponsor liquidates fixed income assets in advance of selecting the annuity provider, there is exposure to the risk of decreasing market interest rates. Should interest rates decline during this time, annuity purchase prices will likely increase, respectively, while the cash value of the assets will remain flat.	Annuity price set	Increasing interest rates considerations  If the sponsor liquidates fixed income assets after selecting the annuity provider, there is exposure to increasing market interest rates. While the annuity price has been locked-in, the value of the fixed income assets that must be sold would decrease.	The group annuity premium is paid.

Figure 2: Asset Transfer Timeline and Related Risk Exposure Illustration

Of course, the reciprocal of the above is true if rates move in the opposite direction. However, when striving to mitigate risks, it’s prudent to manage the downside potential.

Understanding insurer considerations when negotiating the terms of an annuity buy-out

As noted earlier, the insurer invests the premium paid for the group annuity according to the insurance company's investment strategy. Insurers generally consider the predictable and long-term nature of the contractual liability when investing, and predominantly seek high quality fixed income investments.

When the insurance contract premium is paid in cash, the insurer is exposed to investment risks associated with the transition. The main risks for insurers are interest rate risk, spread risk, and delay cost. Keep in mind, the larger the transaction amount, the greater the magnitude of the risk.

In this case, interest rate risk specifically refers to the possibility that lowering interest rates during the transition period will have an adverse impact on the insurer's return on the transaction. While insurers have means to effectively hedge the effects of interest rate changes, hedging credit spreads can be more challenging.

Credit spreads are the incremental yields reflected in a bond's market value attributable to investors' assessment of the credit risk associated with the bond. As the risk associated with a given bond is viewed as increasing, the credit spread also increases to provide more potential return commensurate with that risk. A decrease in spreads between the time the cash premium is collected and the time the premium is invested will negatively impact the insurer's return.

What's more, the prudent investment of the millions, and even billions, of dollars involved with these transactions takes time. Investment managers generally require lead time to plan for large inflows to ensure there is efficient execution of the investment strategy with no adverse impact on the overall performance of the investment portfolio.

Insurers can choose to accept this timing risk, or they can leverage a two-pronged investment approach to manage spread risks and asset investment. With this approach, the insurer implements a short-term investment strategy to support the execution of the transaction, and then slowly reallocates investments over time to align with the insurer's target long-term strategy.

This two-pronged investment process elongates the transition period on the back end for the insurer and subjects them to additional and undesirable costs and risks. The cost associated with the delay in placement of the assets is referred to as delay cost, which is accounted for in the premium. Thus, reducing delay costs can reduce overall premium prices.

Simply put, time is money.

AIK: A mutually beneficial solution

As previously mentioned, many plan sponsors, particularly those who employ LDI strategies, likely have a significant portion of the pension plan's assets invested in fixed income positions at the time they are ready to execute a pension risk transfer transaction. Likewise, most insurers will invest a significant portion of the annuity assets in similar investment grade fixed income vehicles. This creates the opportunity for a solution that is mutually beneficial to sponsors and insurers: assets-in-kind, or 'AIK' payment.

Leveraging AIK, the plan sponsor selects investments it would otherwise liquidate for transfer to the insurer as a portion of the premium for an annuity purchase. As a result, the plan does not have to liquidate these investments and the insurer does not have to invest the cash in similar investments. Thus, the AIK process eliminates the asset transfer risk and related costs associated with executing cash transactions for both parties.

Because AIK can mitigate or eliminate the transaction costs and market risks associated with the transfer for all interested parties, we recommend sponsors explore the possibility of AIK and any potential cost savings with the insurer when negotiating the terms of an annuity purchase transaction.

An experienced firm you can trust

The AIK transfer experience is no longer in its infancy. MassMutual has facilitated over 25 transfers and the process is smooth and seamless, effectively eliminating the market risks generally associated with cash-based transactions with little execution risk.

We encourage you to explore whether AIK is right for you when executing a pension risk transfer transaction. There are ample benefits to all interested parties. Here are a few things to remember:

- Whether in whole or in part, AIK transfers manage asset transfer risk, can save transaction costs, reduce the total premium required to purchase the annuity contract, and mitigate market and interest rate risks for the plan and, indirectly, its sponsor.
- Accepting AIK transfers can mitigate market risks and delay cost, in addition to transaction costs, for the insurer.

With pension plans seeing improved funded status, volatile markets, record inflation, and continued uncertainty, it may be an optimal time to take risk off the table. A pension buyout solution from MassMutual can help you reduce or even eliminate the risks associated with your pension plan and help you get back to focusing on your core business, with the confidence that your participants will be taken care of in retirement.

We are happy to explore your options with you and your retirement plan consultant. Please contact us to learn more about how MassMutual can help de-risk your pension plan.

For more information, please visit our website at
https://institutional.MassMutual.com/solutions/pension-risk-transfer
or contact us at **TFSales@MassMutual.com**

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