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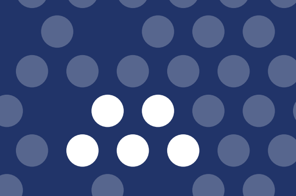
Mitigating group annuity buyout costs and risks with Assets-In-Kind Transfers

A mutually beneficial solution for sponsors and insurers



Mitigating group annuity buyout costs and risks with AIK Transfers

The decision to sunset 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 de-risking strategies and cost savings techniques.

As part of this thoughtful process, sponsors may choose to transfer all or a portion of the obligations to 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, including the risks and financial impacts, and strategies available to manage them. In short, we'll discuss asset management considerations for pension risk transfers and the advantages of transferring assets-in-kind (AIK).

The growing popularity of pension risk transfer to a group annuity solution

Currently, the only way to fully unwind a pension plan promptly as permitted by law is via a pension risk transfer to a group annuity solution. Through this exit strategy, the employer purchases a group annuity contract and transfers the remaining benefit payment obligations along with the administration and associated 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 twofold sales growth since 2016, the popularity of pension risk transfers has increased sharply in recent years (fig. 1). While the effects of the global pandemic hampered sales in the past few months with $2.2 billion in sales reported in the second quarter of 2020, pension buy-out sales in the first quarter of the year were more than double that figure at $4.5 billion, according to the Secure Retirement Institute® (SRI™)'s Group Annuity Risk Transfer (GART) survey. What's more, the survey notes that this is the second-highest first quarter group annuity sales reported on record. In addition, the sales pipeline for the second half of the year is strengthening.

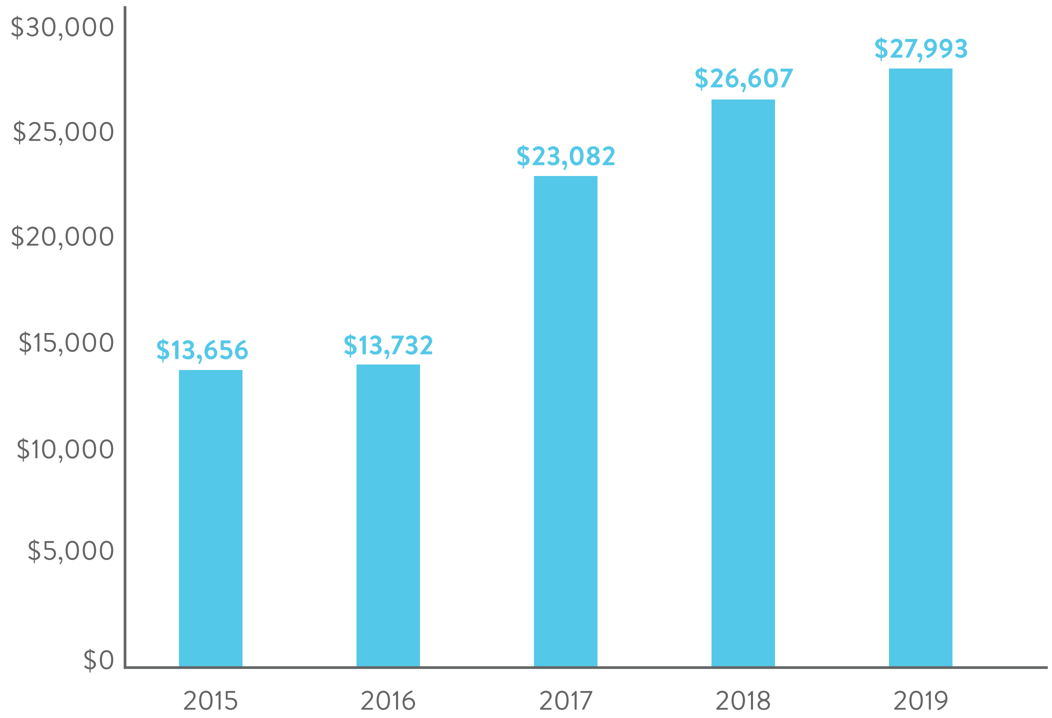


Figure 1: Pension Buy-out Industry Sales (millions)

Source: LIMRA Secure Retirement Institute. Secure Retirement Institute® (SRI™)'s Group Annuity Risk Transfer (GART) survey Second Quarter 2020; based on 16 companies that provided single premium buy-out sales.

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

Not only does the asset transfer process expose the key stakeholders to risk, it frequently can result in significant additional costs to the employer, and to the insurer. 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 usually spans the time between the annuity provider selection date and annuity premium payment date. Generally during this time, plan assets are liquidated to cash to pay the premium due. However, in some cases, the transfer period can begin earlier as the plan sponsor could liquidate assets in advance of the annuity purchase date. In either case, the plan assets are subject to the asset transfer risks, just in different ways.

Moreover, the insurer is exposed to asset risks from the time the proposal is selected through the time the premium received is in turn invested according to the insurer's strategy.

Additionally, there are transaction costs associated with liquidating the investments for all parties in any case.

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

To level set, it's important to know that generally plan assets are held in fixed income positions and are liquidated to generate the cash needed to cover the premium. 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 interest rate changes between the asset liquidation date and the premium quote date. The risk is that interest rates could decline during this time, thus annuity prices would increase, respectively, while the cash value of the assets would remain flat.

When the sponsor 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 is the intrinsic asset transfer risk as it relates to the sponsor's interests in the transaction. This is of particular note for plan sponsors 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 in either scenario can result in significant costs based on the size of these transactions even if the exposure only spans a few business days. Recent market events illustrate this 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 this year.

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, 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 costs associated with the delay in placement of the assets is referred to as delay cost, which is accounted for in the group annuity proposal. Thus, reducing delay costs can reduce overall premium prices, respectively.

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' transfers.

With an AIK transfer, the plan asset holdings that are desirable to the insurer are directly transferred to the insurer to cover part or all of the premium for an annuity purchase in lieu of cash. As a result, the plan sponsor does not have to liquidate investments to pay the annuity premium and the insurer does not have to invest the cash. Thus, the AIK process eliminates the asset transfer risk and related costs associated with cash transactions for both parties.

What's more, many insurers will offer discounted annuity purchase premium, as compared to the quote associated to a cash transaction, given the benefits of the reduced risks and costs associated with AIK transfers. Moreover, each quote is customized based on the specifics of the transaction.

Because an AIK transfer 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 transfers and any potential cost savings with the insurer when negotiating the terms of the transaction.

An experienced partner you can trust

Over the past year or so, MassMutual® has facilitated nine transfers via AIK yielding over $20 million in cost savings for our customers. Moreover, the AIK transfer experience is no longer in its infancy, and the process is smooth and seamless, effectively eliminating the market risks generally associated with cash-based transactions with little execution risk.

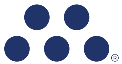
We encourage you to explore whether AIK transfer is right for you when executing a pension risk transfer transaction. There are ample benefits to all interested parties, which may translate into lower costs and reduced risks for the plan sponsor and the insurer. Here are a few things to remember:

- 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 sponsor.
- Accepting AIK transfers can mitigate market risks and delay cost, in addition to transaction costs, for the insurer.

Today, pension plan sponsors are facing funding challenges, volatile markets, and unprecedented risk. A pension buyout solution from MassMutual can 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 in partnership with 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
Institutional.MassMutual.com/Solutions/Institutional-Longevity
or contact us at **TFSales@MassMutual.com**



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