

# Risk Transfer – A Potential Alternative to Plan Termination?

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**Actuaries' Club of Boston**

**Annual Meeting**

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# Welcome

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- Disclaimer
- EA credits
- Introduction
- Questions

# Agenda

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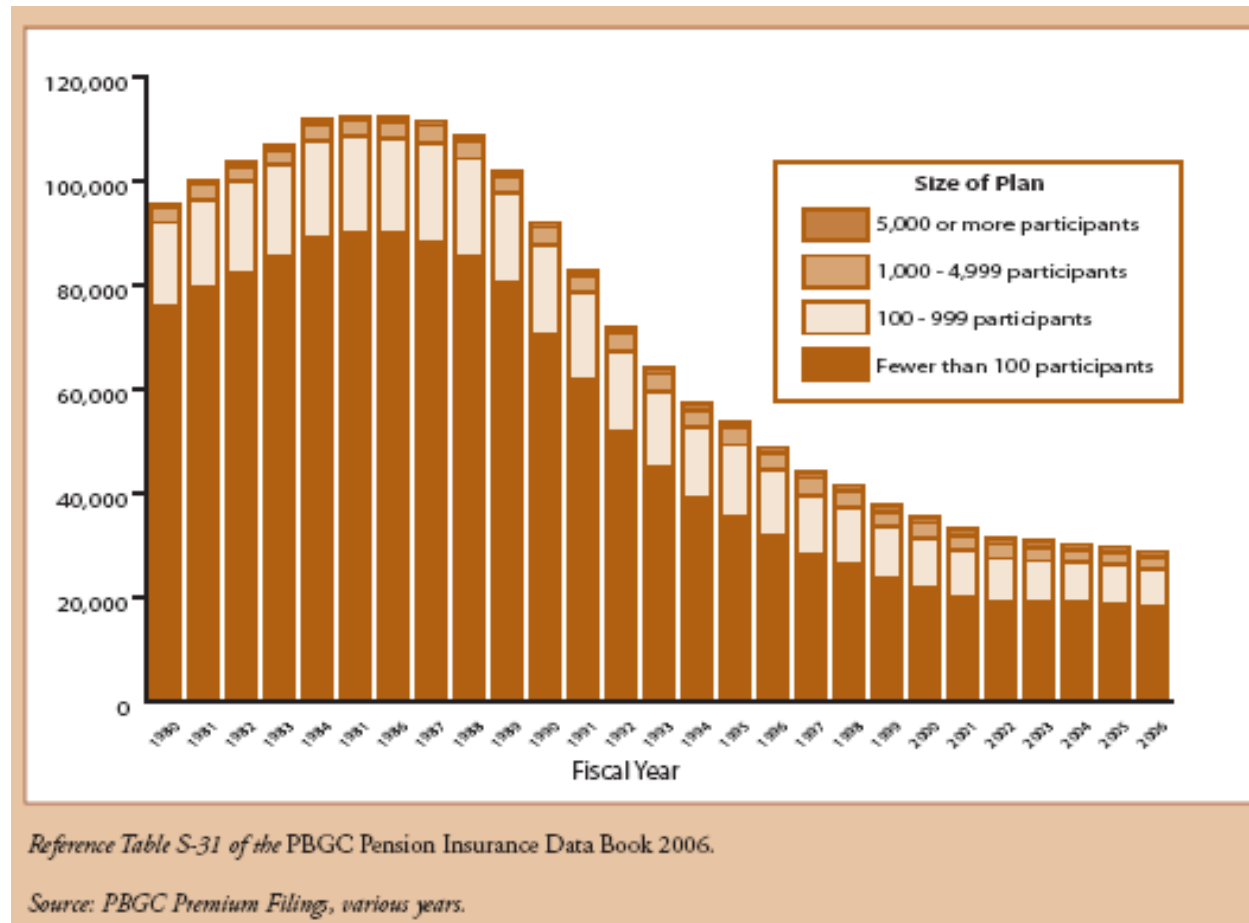
- Background
- The spectrum of pension risk management
- Pension risk transfers (aka, “pension buyouts”)
- Considerations
- Revenue Ruling 2008-45
- Outlook

# State of the DB World

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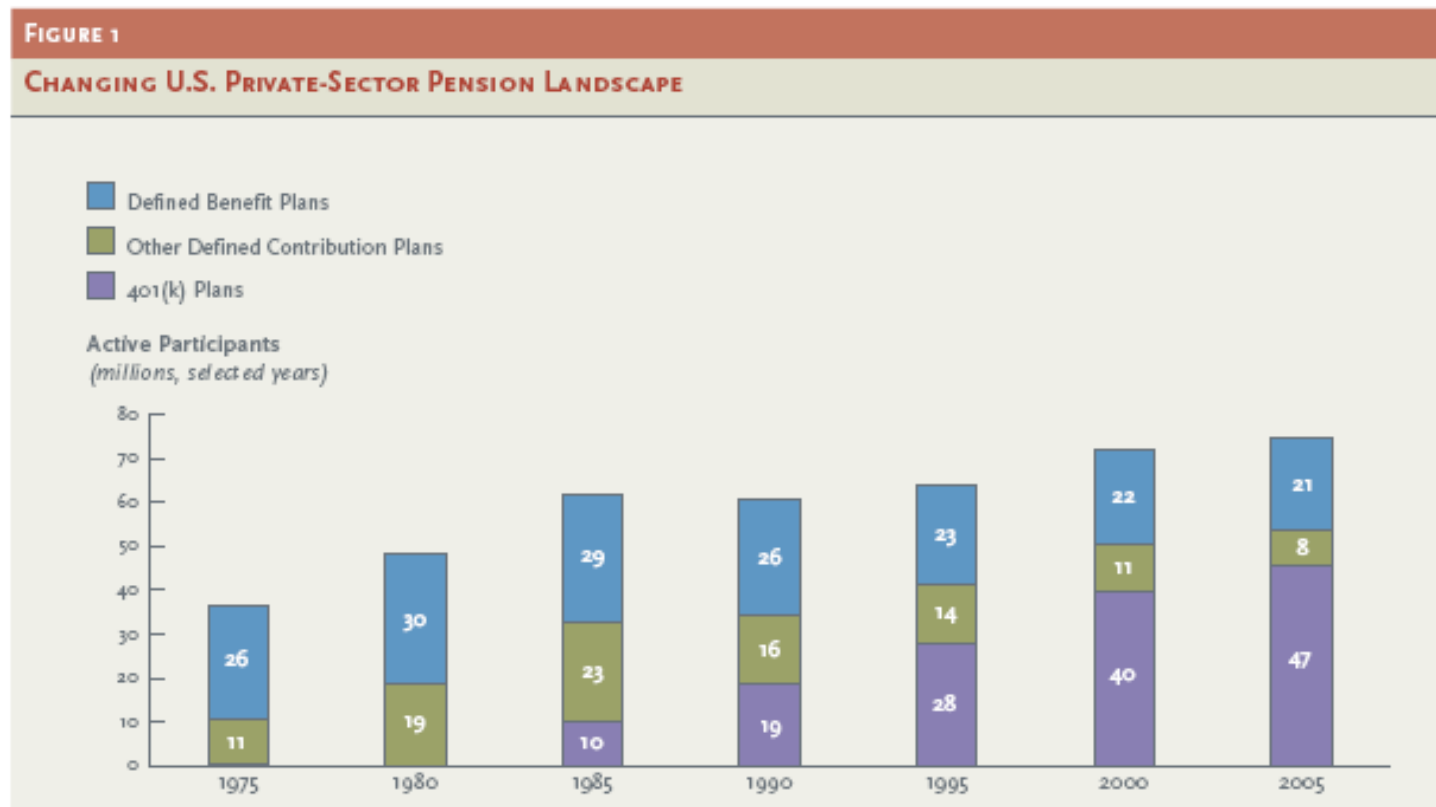
- ❑ The Pension Protection Act has set new funding targets for DB plans
- ❑ Pension accounting: FASB Phase I has moved pension liabilities onto the balance sheet; FASB Phase II and/or international convergence is forthcoming
- ❑ Many DB plans are just recovering from the 2001-2002 bear market
- ❑ Recent market conditions have stung many DB plans
- ❑ Sponsors are freezing their DB plans with greater frequency
- ❑ The PBGC is running a shortfall measured in billions of dollars; rumors are circulating about a potential taxpayer bailout

# State of the DB World (continued)



Source: PBGC

# State of the DB World (continued)



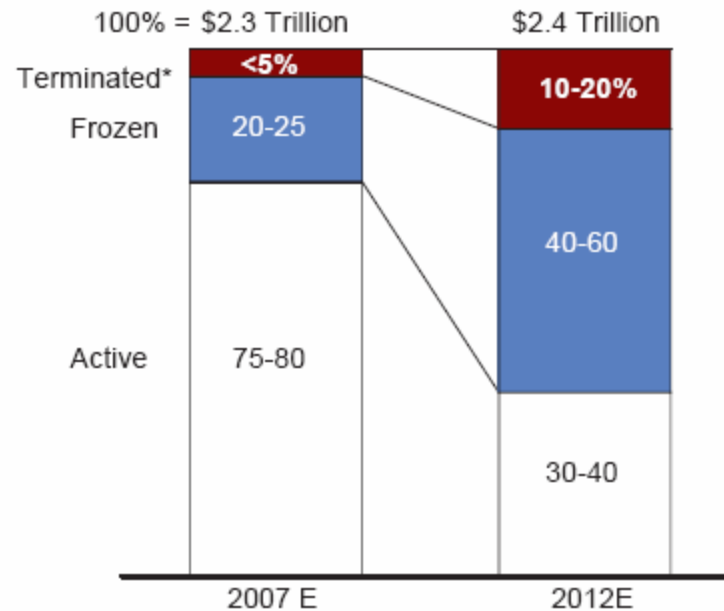
Source: Investment Company Institute

# State of the DB World (continued)

EXHIBIT 1

**Freezings and terminations are set to increase dramatically over the next 3 to 5 years**

**Total private-sector DB assets by plan status**  
Percent of assets, \$Trillions



\* Plan sponsor transfers DB pension obligations to a third party  
Source: McKinsey estimates

Source: McKinsey & Company

# Spectrum of Pension Risk Management

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- Status quo (take the “long view”)

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- Asset allocation
- Liability-driven investing
- Soft freeze
- Hard freeze
- Purchase annuities (for a subset of participants)

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- Terminate plan
- Transfer (frozen) plan to a third party

# Background – UK

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Source: Pensions & Investments

Date: October 1, 2007

## **Pension buyout firm acquires U.K. plan ...**

COVENTRY, England — Pension Corp., a U.K. pension buyout company, announced an agreement to purchase the £3.1 billion (\$6.2 billion) pension fund of telent PLC, Coventry, formerly Marconi Corp. PLC, according to Pension Corp. spokeswoman Charlotte Crosswell. Pension Corp. subsidiary Co-Investment No. 5 will acquire telent's entire business in a cash offer totaling £398 million. The subsidiary already holds 3% of telent stock and has agreed to acquire a 26.4% holding from an unnamed institutional investor, pending regulatory approval.

"If it goes ahead, the telent deal would amount to the biggest transfer of pension liabilities in the U.K. to the secondary pensions buyout market and give Pension Corp. management of pension assets in total in excess of £5 billion," Andrew Reid, head of corporate consulting at Watson Wyatt, said in a statement about the deal.

## **First pension longevity insurance policy on sale**

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Thu May 22, 2008 12:06pm BST

By Simon Challis

LONDON (Reuters) - Occupational pension funds can now insure themselves against the risk of scheme members living longer than expected through the first longevity policy on the market, said Pension Corporation, which is offering the cover.

Available from its insurance firm -- regulated by the Financial Services Authority -- the policy reimburses pension plans for retirement payments made to members who defy longevity expectations, Pension Corporation said on Thursday.

Pension funds that buy the insurance policy -- which will expire when the last member of the scheme or their dependent has died -- will pay a premium that is fixed at the outset.

Rival policies are based on a longevity index of the general population and only give cover for a defined period.

## **UK pension buyouts could hit 10 bln stg in 08-LCP**

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Wed May 7, 2008 7:01pm EDT

LONDON, May 8 (Reuters) - The value of pension buyout deals in the UK could hit 10 billion pounds (\$20 billion) in 2008, a three-fold increase on last year, a report by pensions advisory firm Lane Clarke & Peacock (LCP) said on Thursday.

The first billion-pound pension deal is also just around the corner, LCP said.

"We see the first major FTSE 100 pension scheme buyout as inevitable and likely to be imminent," the report said.

At least seven 1 billion-pound-plus schemes and 10 FTSE 100 schemes are currently considering bids from insurance companies to buy out some or all of their pension liabilities, LCP said.

Increasing numbers of firms are looking to offload their defined-benefit pension schemes, which guarantee employees an income in retirement linked to their final salary.

Tougher regulation and proposed accounting changes, which could force firms to pump billions of pounds extra into their schemes, have made these pension arrangements an increasing financial headache for many companies.

# Pension Risk Transfers – Value Proposition

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- Suppose you could structure a financial transaction, such that after the transaction takes place:
  - Participants are better off
  - Plan sponsor is better off
  - PBGC is better off
- That is, suppose a “Win-Win-Win” could be created

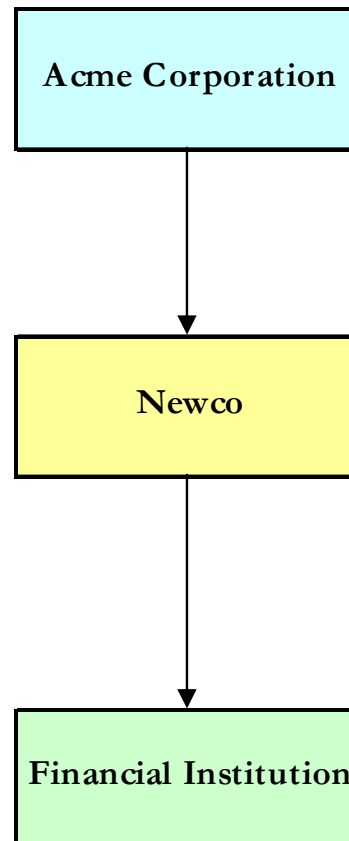
# Pension Risk Transfers – The Model

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1. Acme transfers frozen pension plan (assets and liabilities) and cash to a newly formed subsidiary, Newco

2. Acme sells Newco to Financial Institution for a nominal amount

3. Financial Institution takes over full responsibility of the plan acquired in the purchase of Newco



The amount of cash is negotiated and depends largely upon the funded status of the plan at closing

Other components of the negotiation:

- Data
- Asset values
- Actuarial assumptions
- Market conditions

Plan is covered by PBGC insurance and Financial Institution covers future administration, compliance, and minimum funding requirements

# Pension Risk Transfers – Key Points

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- Works for any kind of frozen plan
- But not necessarily for all plan sponsors
- Plan sponsor sells frozen plan (and risk) to financial institution for a negotiated fee
  - Cash payment is less than the termination cost
- Potential market: \$100 billion of plan assets in play in the next 5 years
- Similar to transfers of plan assets and liabilities that routinely occur in M&A situations

# Win for Plan Participants

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- ❑ Sponsorship transfers from a company with a lower credit rating to a financial institution with a higher credit rating (and more capital)
- ❑ Management of the pension assets improves
  - LDI will minimize losses in the pension trust
- ❑ Administration of the pension plan improves
- ❑ Under the insurance annuity option
  - No PBGC insurance
  - No participant notice and disclosure requirements
  - Potentially limited distribution options

# Win for Plan Sponsors

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- ❑ Lower cost solution than plan termination and purchase of close-out annuities
- ❑ Eliminates:
  - Balance sheet risk
  - Cash flow / contribution volatility
  - Longevity risk
  - Administrative costs and burdens
  - Legislative / regulatory risks
  - Legal / fiduciary risks
- ❑ Allows plan sponsor to focus on core business

# Win for the PBGC

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- ❑ Lower risk of distress terminations (aka “pension dumping”)
- ❑ According to the model, the pension plan is Newco’s only creditor
  - PBGC would not be one of numerous creditors
- ❑ PBGC premium revenue
  - Transferred plans continue to pay premiums
  - Terminated plans do not
- ❑ PBGC can potentially become more proactive in designing these arrangements over time

# Pension Risk Transfers – Key Players

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- Citigroup
- Prudential
- JPMorgan Chase
- Palisades Capital Advisors
- Aon
- Morgan Stanley
- Others

# Considerations - General

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- Funded status
  - Slightly underfunded (i.e., about 90%) is optimal
- Pricing
  - Data and economic/demographic assumptions are key
- Fiduciary duty
  - Exists on both sides of the transaction
- Transaction – structure
  - Newco will likely become a part of a larger controlled group
- Other
  - Current asset allocation matters
  - Deal takes far less time than a plan termination

# Regulatory Considerations - PBGC

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- ERISA §4042 (involuntary terminations)
  - Provides PBGC with limited protection
- ERISA §4069 (5-year look-back)
  - Gives PBGC authority to hold parties accountable for corporate transactions structured for the purpose of evading liability

# Regulatory Considerations – DOL/EBSA

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## □ Fiduciary obligations

- Trustee duties: loyalty, care, diversification, impartiality, etc.
- The selection of the buyout firm is likely a fiduciary decision
- The buyout firm then assumes fiduciary responsibilities

## □ ERISA §406 (prohibited transactions)

- Prohibits the transfer of plan assets to (or use by) a “party in interest” (another fiduciary, service provider, employer, etc.)
- However, sponsorship of plans is routinely transferred in M&A transactions

# Regulatory Considerations - IRS

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- Plan qualification
  - Qualification rules must be satisfied before and after the transaction
- Tax deductions for contributions
  - Should the buyout firm be allowed to deduct post-transaction contributions?
- IRC §401(a)(2) – exclusive benefit rule
  - Plan assets must be used for the exclusive benefit of employees or their beneficiaries

# Market Penetration

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- How many deals have been completed so far in the U.S.?
  - Zero

# Regulatory News

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## □ IRS Revenue Ruling 2008-45

- Released August 6<sup>th</sup>
- “The exclusive benefit rule of IRC §401(a) is violated if the sponsorship of a qualified retirement plan is transferred from an employer to an unrelated taxpayer and the transfer of the sponsorship is not in connection with a transfer of business, assets, operations, or employees from the employer to the unrelated taxpayer.”
- “This conclusion would be the same even if the new controlled group has some employees covered by the plan after the transaction, or some business assets or operations are transferred, where substantially all the business risks and opportunities under the transaction are those associated with the transfer of sponsorship of the plan”

## □ But...

# Regulatory News (continued)

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- Press release from the IRS/Treasury
  - Issued simultaneously with Revenue Ruling 2008-45
  - The Bush Administration – in conjunction with the IRS/Treasury, the DOL, the Commerce Department, and the PBGC – outlined a framework of principles that should guide legislation permitting pension buyouts in the future
    - Advance notice to participants and ERISA regulators
    - Limited to financially strong entities in well-regulated sectors
    - Must be a win/win for participants and the PBGC
    - Transactions subject to disapproval if undue concentration of risk
    - Entities acquiring plans would be subject to all fiduciary and reporting requirements

# Reaction

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- While the Revenue Ruling was not shocking, the accompanying press release was unusual
- Business Insurance: “Employers ... already outsource certain functions and sell various units to concentrate on their core business – why should frozen pension plans ... be treated differently?”
- Brad Belt: “While there are legitimate regulatory and policy considerations, much of the criticism is misplaced. [Pension buyouts are] really in the public interest if ... done correctly.”

# Reaction (continued)

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- ❑ Pension Rights Center: “We applaud the Treasury Department for ensuring that the retirement security of workers isn’t endangered by financial institutions that care only about making profits, and not about the retirement security of workers.”
- ❑ BusinessWeek: “The folks who brought you the mortgage mess and the ensuing hedge fund blowups, busted buyouts, and credit market gridlock have another bold idea: buying up and running troubled corporate pension plans.”

# Reaction (continued)

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- ❑ AARP: “Employers are in a good position to be the providers of [pension] plans because they use them to recruit and retain talent. This kind of gets lost when it’s being managed by a financial institution.”
- ❑ MetLife: “We believe that [the revenue ruling] goes a long way in protecting current and future retirees. Insurance products and the individual guarantees that come with them are paramount in protecting plan participants’ interests, should their employers choose or need to transfer the liabilities of their plan.”

# Outlook

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- ❑ The proposed framework in the press release signals the Administration's blessing
- ❑ Next steps will likely depend on the outcome on Election Day
- ❑ Rep. Earl Pomeroy (D), member of the House Ways and Means Committee: "Democratic majorities are highly skeptical of pension buyouts. I do not anticipate legislation authorizing them – period."

# Questions / Discussion

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- Predictions?
- Do you see a pension buyout as a win/win/win?
- What issues do you have with the model?
  - Should firms be able to derive a profit from frozen plans?
- Is Wall Street gambling with grandpa's retirement?

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