'De-Risky' Business

By Kerry Pechter *Thu, Oct 15, 2015*

Prudential has dominated the burgeoning market in jumbo pension buyouts. In the week following Prudential deals with JC Penney and Philips Electronics, RIJ spoke with Peggy McDonald (above), an actuary and a leader in the insurer's pension risk transfer team.

Over the past few years, the sponsors of underfunded jumbo pensions have come to realize that interest rates won't be rising very soon (or by very much). And any hope they may have had that rising rates would lift the funded ratios of their plans (now only about 80%) has pretty much vanished.

"A few years ago they were sure that rates were about to go up," said Robert Pozen, the former Fidelity Investments president, during a retirement-focused conference sponsored by the *Journal of Investment Management* at MIT recently. "Now it's a bit like Waiting for Godot."

Many of those Fortune 500 sponsors have already closed their defined benefit plans to new hires, offered individual lump-sum buyouts, or increased their allocations to bonds. Now they're taking the next step and doing deals that transfer at least part of their remaining DB obligations to life insurance companies through "pension buyouts."

This fairly recent development has created opportunity for the handful of life insurers that are big enough to sell a multi-billion-dollar group annuity and that have the requisite amount of in-house actuarial and portfolio analysis expertise to price such a product. No life insurer has seized this opportunity as aggressively as Prudential, the second biggest life insurer in the U.S., after MetLife.

"We saw this wave coming," said Peggy McDonald, a senior vice president at Prudential and member of its pension risk transfer team, who participated in the same panel discussion at the JOIM conference as Pozen. "The focus of thinking about defined benefit plans has shifted from the HR departments to the finance departments at large sponsors, and now it's a legacy liability for them," she added. "So they're asking, 'How can I move this off my balance sheet in a way that keeps the promises we made to the people who worked for us?'"

Prudential has been involved in about $40 billion worth of large deals—a majority of the total volume of mega-deals in recent years—with General Motors, Verizon, Motorola, Bristol-Myers Squibb and others. On October 9, only days before the JOIM meeting, Prudential had announced two separate multi-billion group annuity deals. JC Penney, the long-time clothier of middle-class American women, bought a group annuity that will move an estimated 25% to 35% of its $5 billion in pension assets and liabilities, covering some 43,000 workers, to Prudential.

In the second deal, Prudential, in combination with Banner Life (a unit of Legal & General America) and American United Life (a unit of OneAmerica) relieved the North American subsidiary of Philips Electronics of about €1 billion in pension assets and liabilities affecting about 17,000 workers—reducing Philips U.S. pension liabilities to about €2.7 billion and global pension liabilities to about €8.5 billion. The deals are expected to close in December.

In this new jumbo pension buyout market, Prudential is the clear leader. "Prudential has been the winner of most if not all of the [jumbo pension risk transfer] business," said Ari Jacobs, senior partner and Global Retirement Solutions leader for AonHewitt, which advises plan sponsors. "MassMutual and Voya are also in the business. Hundreds of pension buyout deals of less than $1 billion are closed each year, but only a handful of companies can work in the mega-market. Prudential has won most of the largest bids in that market."

How Prudential does it

Watching the number of Prudential's deals in this space, some observers have wondered how one company could safely take on so much apparent longevity risk and investment risk. To be sure, these deals are vetted by consultants to make sure the plan sponsors fulfill their ERISA fiduciary responsibilities and choose the "safest" available insurance partner. Still, a lot of risk seems to be accumulating in one place.

At the JOIM conference, and in a subsequent phone interview with *RIJ*, McDonald explained that Prudential and its plan sponsor clients bring these deals to fruition by taking great care in their selection of retirees to include in the group annuity, by closely analyzing the risks of those pools, and by carefully selecting the assets that will accompany those liabilities over to the insurer.

In many cases, that means focusing on the oldest plan members, whose benefits are the least risky to transfer. "We addressed the cost issue by focusing on the retiree populations," McDonald said at the conference. "About 50% of the pension obligation is obligations to retirees, those are the most efficient to transfer. Their average ages will be 70 or 72. It can be too expensive to do the buyout for non-retirees. There's behavioral risk, interest rate risk, and longevity risk. With retirees, the duration of liabilities is relatively short. So there's not as much longevity risk or investment risk as we would see with younger participants."

It also involves a close analysis of the longevity risks of that group, and the variables that affect the longevity of sub-groups within it. "We have a longevity team that does a really deep dive and finely tunes our assumptions, based on certain variables. Geography, gender, current age and benefit size are the big ones," McDonald told *RIJ*. "We know from Society of Actuaries tables, for instance, that people with bigger benefits have better longevity. As a company, we have mortality history in our very large block of annuity business going back to 1928. We rely on what we've learned from that book of business and tweak it for what we know about each specific group."

In addition to identifying the liabilities carefully, Prudential and the jumbo plan sponsors had to identify the assets backing the liabilities with great care. Jumbo plan buy-outs require in-kind transfers of assets. In the run-up to the deal, the sponsor may have to change the plan's asset mix to fit the insurer's requirements. Those assets also need to remain equal to the liabilities during the period between the announcement of the transfer and the closing of the deal.

Cash not accepted

One big difference between the jumbo pension buyouts and those of under a billion dollars is that plan sponsors can't pay for big group annuities with cash. It has to be done with assets, and those assets have to be tailored to the liabilities. Certain assets may even have to be purchased to fit the pricing of the deal.

"In a small plan buy-out, the insurer hands over the group annuity contract and the plan sponsor hands over cash," McDonald said. "That wouldn't have worked for the General Motors deal. If they gave us $25 billion in cash it would have taken us a long time to invest that.So we generally take high quality corporate bonds. It's an in-kind exchange. We take some private equity. We give excruciating instructions on duration, sector, and quality of the bond. We say, here's the perfect portfolio you can give us and here's the price we can give."

While the mega-buyouts create new business for Prudential, they are watched with some anxiety (and much chagrin) by advocates for DB participants. "We're concerned about insurers taking on so many obligations," said Nancy Hwa, a spokesperson for the Pension Rights Center. "It's unlikely that a company like Prudential would go under, but we want to make sure they don't mess up. These transfers are another opportunity for people to fall through the cracks. We're also concerned about transfers of [personal] information. Generally, we don't dislike these transfers as much as we disliked the [now restricted] lump-sum offers to retirees."

If anything, the number of large pension buy-outs appears destined to grow. "When rates go up you'll see tons more of these transactions," McDonald said. "Plan sponsors won't miss the boat a second time. The last time they were overfunded, they were too slow to act. There were plan sponsors looking to exit, but they weren't ready. Now they're better educated and they have a stronger desire to get the liabilities off their balance sheets. It's not a matter of if, but when. Plan sponsors are coming to us. Their boards are asking them, 'Why aren't *we* doing this?'"