# What’s Good for General Motors…

By Kerry Pechter *Wed, Jun 6, 2012*

*A month after Ford’s pension buyout offer, GM is offering some salaried retirees a choice of a lump sum buyout or lifetime income from Prudential. Both automakers took advantage of a change in discount rates to reduce obligations.*

Joe Bellersen got a morale boost last week when General Motors announced plans to end its pension obligations to retired salaried workers by offering them either a lump-sum buyout or a lifetime income from a GM-funded group annuity from Prudential.

Bellersen, the founder of Cincinnati-based Qualified Annuity Services, Inc., has for years urged defined benefit plan sponsors to convert their pensions to group annuities, but with only scattered success. GM’s decision, he thinks, could be a game changer.

“This may be a watershed event,” said Bellersen, who has arranged similar pension/annuity swaps for smaller companies. “This is the first large deal of its type with any significance. There’s likely to be a lot of follow-on activity.”

Fitch Ratings seems to agree. Commenting on the GM-Prudential deal, Fitch analysts wrote, “This is the first time a pension plan of this size has been defeased in this way, and today’s transaction could spark other companies to consider similar transactions in the future to reduce exposure to plan volatility.”

“Looking ahead,” the statement added, “Fitch expects other companies with significant pension obligations to consider similar transactions, although the significant cash costs required to effect plan transfers will likely limit the number of companies that are able to do it.”

The GM decision follows by about a month a decision by Ford Motors to offer 90,000 retired and former salaried workers a lump-sum payment to settle their pension obligations. Towers Watson, the actuarial and consulting firm, called the Ford deal the “first such program to target retirees without being part of a broader plan termination.”

The Ford and GM offers “symbolize a major shift in corporate pension perspective,” said Carl Hess, global head of Towers Watson Investment Services, in a release. “Improved pricing, coupled with continued market uncertainty and increased desire to focus on core operations, may result in additional companies exploring these types of actions.”

The GM offer differs from the Ford offer in that GM is terminating an existing DB plan, putting active and recently separated salaried employees in a new DB plan, and offering a Prudential life annuity to certain salaried retirees who don’t take the lump-sum offer. GM’s retired hourly workers are not affected by the deal.

**Deal details**

Prior to the announcement, GM's combined salaried and hourly pension plans were about 13.1% underfunded, with assets of $94.3 billion and obligations of $108.6 billion. On completion of the plan, GM's pension obligations will decline about $26 billion and its pension assets will decline about $25 billion, to obligations of $82.6 billion and assets of $69.3 billion. Overall, the underfunded status of all GM pensions will decline by about 7%.

About 42,000 of GM's 118,000 salaried retirees who retired between October 1, 1997 and December 1, 2011 will be offered a choice of the lump-sum payout, a continuation of their current pension payment (as a life annuity from Prudential), or a life annuity with slightly different payout terms (single, or joint with 50% or 75% to the survivor) from Prudential.

"GM's getting quite a good deal," Bellersen told RIJ. "Retirees will get a Prudential check instead of a GM trust check. All the risks and costs of the pension will be transferred, and GM won't have to pay investment management fees, or PBGC [Pension Benefit Guaranty Corporation) premiums, or the administrative costs for writing pension checks every month, and it won't be on the hook for adjustments in longevity. It's been my premise, the premise of my business, that corporations are better off shifting these risks."

GM, though it required government support to survive the financial crisis, has enough excess cash to pay for the pension buyout without having to borrow for it, according to Fitch. "As of March 31, 2012, GM's automotive cash, cash equivalents and marketable securities totaled $31.5 billion, well above the $20 billion level that Fitch views as the target amount that the company needs to operate its business through the cycle," a Fitch release said.

Prudential, in return for assuming GM's obligations, will receive the $25 billion in assets that are currently backing up those obligations, plus an additional $1 billion so that the assets equal the present value of the liabilities, plus a negotiated premium of $2.5 billion to $3.5 billion that may depend on how many GM retirees take the lump sum and the life expectancy profile of the retirees who either stay in the plan or take the annuity.

In this context, the word "premium" doesn't mean what it does in the retail annuity market. It is the amount above the plan sponsor's accounting liability that the insurer requires to assume the risk. "The accounting liability is comparable to a real estate appraisal, and the premium is the amount needed to bring that up to the market price," said Matt Hermann, leader of Towers Watson's retirement risk management group.

**Favorable timing**

GM and Ford have apparently pursued these deals this year because of certain regulatory developments. In the past, according to Stephen Brown, a fixed income analyst at Fitch Ratings in Chicago, companies had to use 30-year Treasury rates as the discount rate in calculating lump-sum payouts.

But under provisions of the Pension Protection Act of 2006 that came into full force this year, plan sponsors can discount their pension obligations at a blend of short, intermediate and long-term high quality corporate bond rates, which are higher than the corresponding Treasury rates. The lump sums are now smaller and cost the company less.

"That is absolutely why they did it," said Leon Labrecque, an attorney-accountant-financial planner in Troy, Mich., some of whose clients are GM salaried retirees. "The lump sum would have been prohibitively expensive a year ago."

"Neither company said so publicly, but I would not be surprised if the change in calculation affected their decision," Brown agreed. "The companies also get a payout that's closer to the way they value the obligations on their balance sheets," Brown said. "They don't want a pension obligation valued at, say, $500,000 on their balance sheet when it would cost them $600,000" to pay off in reality.

GM and Prudential also appear to have structured the buyout offer to minimize adverse selection, Brown said. Only salaried workers who retired after October 1, 1997 are eligible for the lump sum. Had older retirees been eligible, they might have disproportionately opted for the lump sums, leaving Prudential with the higher longevity risks associated with a younger (on average) annuitant population.

"Assuming that the projected number of people opt for the lump sum, Prudential will take on more of a mix of older and younger retirees," he said. "If GM hadn't placed the restrictions [that keep older retirees in the plan], Prudential would take on an annuitant population more skewed to younger people with longer time horizons."

On the other hand, Brown added, relatively fewer GM people might take the lump sum than in the Ford deal, where retirees of any age could take it.

**Participant behavior**

It remains to be seen how many GM retirees take up the lump-sum offer. Labrecque has published a 30-page document for his clients and prospects that outlines the factors that they should consider before deciding.

One of his GM retiree clients is a man born in 1945 with a spouse born in 1943. Under the GM pension, they've been receiving $5,700 a month, and the spouse will receive $3,800 a month if the participant dies.

The couple can now choose to maintain the status quo, take a one-time lump sum of $850,000, or take either of two annuity payout options: $5,700 a month with $2,800 a month to the survivor or $5,500 a month with $4,100 a month to the survivor.

"You can also hybrid this, and split it between a lump sum and an annuity," Labrecque said, but to do that participants would have to take the full lump sum and buy an annuity at less favorable rates in the retail annuity market.

The retirees' decisions, Labrecque's paper shows, will also depend on their age, state of health, current expenses, savings outside the plan, tax situation, etc. In fact, Labrecque's analysis of the annuity vs. lump-sum choice would be useful to anybody (or their advisor) who is faced with the choice between buying an annuity or holding onto their assets throughout retirement.

Bellersen, whose business could conceivably boom if more companies converted their pensions to annuities without offering lump-sum buyouts, worries that too many retirees will opt for the lump sum. That might be good for GM, because a lump sum is the cheapest way for it to discharge its pension obligation, but it might not be good for a risk-averse participant, who would lose not only an under-priced annuity but also a chance for long-term peace of mind.

“There are plenty of people who will do the money grab,” Bellersen said somewhat ruefully. “A lot of people will want to pay off the boat, the house, or their medical expenses. And Wall Street [encourages that with its] mantra that in the long-run you always do better in the market.”

Though he wasn’t familiar with the exact terms of the deal, Sandy Mackenzie, a former International Monetary Fund staffer and Washington, D.C.-based author of two scholarly books on annuities, was concerned when he heard about the GM buyout offer that the size of the lump-sum might blind people to the amount of longevity risk and investment risks that they were shouldering.

“My first thoughts were, would the discount rate be appropriate or would retirees be ripped off,” he told . “There’s an analogy between what’s been going on in the country in the last 30 years in terms of the transition from defined benefit to 401(k) plans and this development.

“Companies are reducing their uncertainty, and people who opt for a buyout [instead of maintaining their pensions] are increasing theirs,” Mackenzie added. “They give up security for insecurity. It concerns me that people see the allure of what looks like a large sum of money, and then discover that they’ve been creating problems for themselves.”