March 25, 2020

Retiree Pension Risk Transfers in THIS Low Interest Rate Environment?

Although interest rates are volatile and at all-time historic lows, it doesn't mean that a retiree pension risk transfer is a bad idea for your defined benefit pension plan. Below is a brief discussion on the pros and cons of considering a pension risk transfer for retirees at this time.

Reasons to Complete a Pension Risk Transfer

PBGC Premium Savings: If your company's pension plan is at the PBGC variable premium cap, the PBGC savings will be in excess of $644 per retiree in 2021. In a low interest rate environment, it is likely your plan is at or close to the variable premium cap. Focusing on retirees with small benefits will help manage the cost of the pension risk transfer while maximizing savings. For more on current and historical rate information, click to see *PBGC Premium Rates*

Economic Savings: Plan sponsors tend to focus on the cost of the annuity premium versus the accounting liability. However, the accounting liability ignores on-going expenses related to running the plan. These expenses include PBGC premiums, administrative costs and investment costs. The "economic cost" of the plan's liability is the accounting liability plus these additional costs. The annuity premium when compared to the economic cost typically results in overall savings for the plan sponsor even in a low interest rate environment. This is especially true when the plan is at the PBGC premium variable cap.

Competitive Market: There are currently about 10 to 15 insurers actively buying retiree liabilities from pension plans. Based on the size of a particular annuity premium, a plan sponsor can expect to receive quotes from about half of the insurers in the market. Insurance companies can be competitive with their retiree annuity premiums because they have a lot of experience predicting mortality for retirees. In addition, retiree annuities offer a good offset to life insurance risk.

Capacity: Insurance companies currently have capacity to buy retiree annuities. If interest rates rise significantly and many more pension plans start looking to sell annuities, will the insurance companies have capacity to take on a flood of new pension risk transfers? Additionally, with the basic laws of supply and demand, if there is a large supply of plan sponsors wanting to do pension risk transfers, will the annuity premium be as attractive when compared to the economic cost of the retiree liability? We believe a spike in current low interest rates could reduce capacity and pricing competitiveness.

Could insurance company capacity be hindered by a spike in pension risk transfers if interest rates rise?

Reasons Against Pension Risk Transfer (But Consider it Anyway)

Higher Minimum Required Contributions: A retiree pension risk transfer is likely to increase the minimum required contribution of a plan due to differences in assumptions used to determine minimum required contributions. Because minimum funding requirements are allowed to use more aggressive assumptions, the difference between the insurance premium paid and the liabilities released creates a loss to the plan. This loss is amortized and paid over the next seven plan years. However, the increased contributions are typically viewed as an acceleration of future contributions. As the minimum required interest rates drop, future contributions will increase if the retirees remain in the plan.

Settlement Accounting: A full retiree pension risk transfer is likely to trigger settlement accounting for a pension plan. This settlement accounting typically results in a one-time charge to the income statement. Depending on the sensitivity of one-time charges for a particular company, this could be an obstacle. However, a settlement is a “below-the-line” cost under *ASU 2017-7*. This makes settlements less of an issue for many companies. Additionally, even if settlements are an obstacle for your company, performing multiple smaller pension risk transfers with smaller premiums over a number of fiscal years can be a way to avoid settlement costs.

Plan Not 80% Funded: Annuities cannot be purchased for a plan that is not 80% funded on a PPA interest rate relief basis unless the plan sponsor makes some immediate funding to the plan. However, the 80% funded status threshold is determined based on a smoothed interest basis. As a result, the funded status of many plans is more than 80% even in this low interest rate environment.

Interest Rates Will Rise: For years, there has been talk that interest rates must go up. However, they continue to remain low. In a low interest rate environment, it makes sense to monitor interest rates. Plan sponsors should consider being ready to buy annuities by getting their data ready and setting a targeted annuity premium. They can then monitor the impact of changing interest rates. Once the target is met, they will be ready to move quickly with the pension risk transfer.

Pension Risk Transfer Takeaways

With the current market volatility and extreme swings in interest rates, we don’t expect many plan sponsors to move forward with a pension risk transfer for retirees in the near-term. However, if markets stabilize and interest rates begin to rise consistently, insurance companies will likely be eager to close some deals. This could result in attractive pricing.

It’s never too early to start planning for a pension risk transfer. As a first step, we suggest performing a financial analysis to determine the impact of a pension risk transfer for retirees. With this financial information, most plan sponsors can be positioned to move quickly and recognize the right time to buy annuities for retirees even in a low interest rate environment.

To learn more, contact Larry Scherer at *216.875.1920* or *Larry.Scherer@findley.com*