Fidelity Workplace Consulting

Retiree Benefit Buyouts

The pros and cons

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The purchase of group annuities (“buyouts”) for retirees – whether it be for just those participants with relatively small benefits, or for larger groups – has become a popular strategy for many plan sponsors. These buyouts reduce the size of the pension plan and, often provide shorter-term financial benefits. But, these buyouts, if not carefully crafted, can limit a plan sponsor’s ability to fully terminate the plan down the road. Before committing to action, plan sponsors want to consider balancing the short-term benefits of a retiree buyout with the long-term goal of full plan termination.

What’s Inside

Fidelity INVESTMENTS

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What is a retiree buyout?

In a retiree buyout, an insurance carrier assumes the liabilities for a selected population of retirees in exchange for a one-time premium payment from the plan sponsor. Essentially, this transaction has the effect of moving assets and liabilities for these retirees out of the ERISA-sponsored defined benefit pension plan and onto the insurance carrier's balance sheet. After the transaction is complete, the pension plan has no ongoing financial or administrative responsibility for these participants.

What to consider in completing a retiree buyout?

Generally, plan sponsors considering a buyout will compare the price of the transaction as quoted by the insurer to the liability they are currently holding on the books for these retirees. The price from the insurer is a straightforward data point; defining the plan liability appropriately can be more complicated. Plan liability can be measured different ways for different purposes. See the article, *"How well funded is your pension plan?"* released recently that explores this in greater detail.

When determining the appropriate liability for evaluating a retiree buyout transaction, some of the key considerations include:

- **Accounting liability or funding liability?** The accounting liability, being a "mark-to-market" measure, provides a good picture of plan liability based on current market conditions. But funding liability could be important if the plan is significantly underfunded, as the difference between funding liability and the insurer price will be an additional – possibly significant – deficit to be made up over time, and may contribute to a short-term increase in cash contribution requirements. (This is potentially a bigger issue with the passage in March 2021 of funding relief as part of the American Rescue Plan Act.)
- **Including future expenses?** Neither accounting nor funding liability requires the inclusion of future administrative expenses, including PBGC premiums. Adding these expenses in on a present value basis gives a more complete picture of the potential economics of holding on to retiree liabilities.
- **Interest rates?** The right interest rate for assessing plan liability depends on the specifics of the plan sponsor's "pension situation". If the timeline for terminating the plan completely is relatively short, it could be argued that the annuity purchase price is the true liability for these participants, with the present value of administrative costs being the additional cost of maintaining these participants. For a longer-term view, the interest rate selected might be the funding, accounting, or even a long-term asset return assumption. This decision is often made by finance and the investment advisor to the plan, but the right assumptions for evaluating a buyout might differ from the current assumptions used for other measurements of liability.

- **Mandated or selected assumptions?** Liability measures are based on a variety of assumptions, for which there is often not one "right answer" but a range of acceptable answers. How are the plan's assumptions comparing to the experience over time? If there is significant deviation, then the assumptions should be adjusted – both in this analysis and more generally. And with funding liability, it's worth remembering that some assumptions – notably, mortality – are mandated by the government and do not fully reflect the specifics of your plan's situation or the population being considered for the annuity purchase. No matter what assumptions you are using, what ultimately happens to this group over time is what will drive the plan's true cost – and that's the target against which you want to compare.

Example

Let's take a look at a potential transaction for a hypothetical group of retirees:

	Benefits under $300 per month	Benefits over $300 per month	Total
Count	250	750	1,000
Average Annual Benefit	$2,500	$10,000	$8,125
Average Age	72	72	72
Funding Target Liability	$6,600,000	$79,600,000	$86,200,000
Accounting PBO	$8,200,000	$98,600,000	$106,800,000
Annuity Purchase Price	$8,500,000	$101,600,000	$110,100,000

The annual per head administrative costs for these retirees break down as follows:

Breakdown of Annual Administrative Costs	
Recordkeeping Cost	$40
Flat PBGC Premium	$86
Variable Rate Per Participant Premium	$582[1]
Total Administration Cost	**$708**

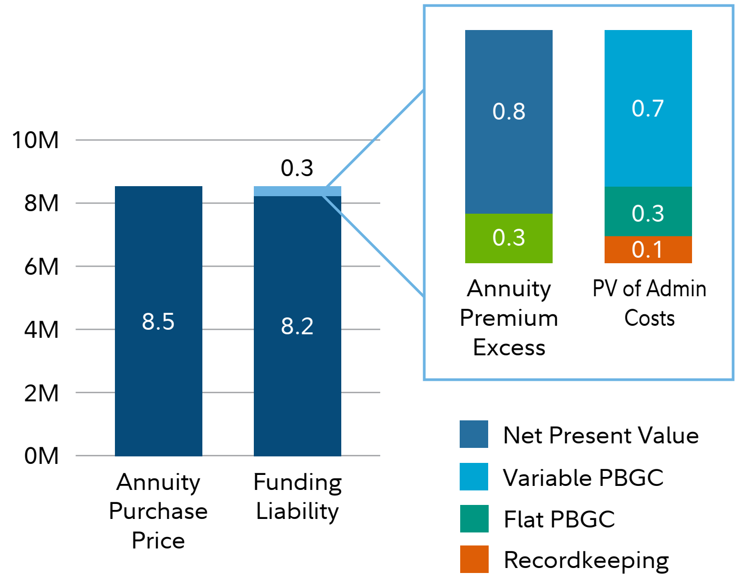
[1]This represents the PBGC per-participant cap for 2021. All PBGC premiums increase annually based on inflation. Based on projections for this hypothetical plan, we will assume that the plan will be paying the per-participant cap for the next five years.

Assuming the plan sponsor uses the accounting liability as the baseline, the exhibit below shows the economics of an annuity purchase for all retirees with benefits under $300 per month.

- The annuity purchase price of $8.5 million exceeds the accounting liability by $300,000 (the "annuity premium excess").

- However, the present value of administrative costs is $1.1 million, consisting mostly of $700,000 of variable rate premium expected to be paid over the next five years. These costs would be eliminated if a group annuity contract is purchased.

- When administrative costs are considered, this transaction generates a positive **$800,000 NPV** for the plan.



- While this transaction has a positive NPV, the immediate cash flow impact is negative. An $8.5 million premium is $1.9 million in excess of the current plan funding liability. This is immediately payable to the insurance company. In turn, this increases the plan's underfunding by $1.9 million, which would result in an increase in annual cash contributions of at least $175,000 (on top of the current required contributions to address already-existing underfunding).

- For plan sponsors that use US GAAP accounting for their financial statements, depending on the size of the annuity purchase relative to the plan, one-time settlement accounting may be triggered by the transaction. The settlement charge, which would hit non-operating expense, represents a portion of unrecognized losses that otherwise would have amortized ratably through future expense over several years.

Is your data ready?

Once sponsors decide to transfer risk out of a plan through a retiree benefit buyout, ensuring that the required data is available becomes crucial. One might think that, since these retirees are in receipt of monthly checks, that all the critical data would be known. However, there are a couple key spots where missing data can create issues or delays with insurer pricing:

- If there have been issues with the retiree data, such as outstanding checks or discrepancies between the recordkeeping system and the disbursement agent.

- If joint annuitant information for each retiree is missing. Typically, SSN, name, date of birth, and gender are required. Sometimes this information is stored in recordkeeping systems, but other times it may be in paper or imaged files.

Knowing if there are gaps in advance will give sponsors a sense of the amount of effort needed to clean up plan data prior to initiating the retiree benefit buyout, or ultimately a plan termination.

Why a longer view matters

A decision framework based on a narrow view of the economics, as described above, will often support the resolution to pursue a buyout. However, there are a few more factors worth considering.

Insurance companies have been very enthusiastic in pursuing these small retiree buyouts. In fact, in some recent transactions, the insurer premium relative to the accounting liability has been close to zero.

What do insurers know that plan sponsors don't? Retiree liability is the most predictable and easily hedged of all pension liabilities, and insurance companies are happy to take it on. When the benefits are small, the longevity risk per dollar of liability is widely spread among more retirees, providing additional risk diversification. These advantages are as true for the plan sponsor as they are for the insurer, and should be included in any analysis. Indeed, transferring a highly predictable segment of the participant population may change the overall risk profile of the post-buyout plan (and not necessarily for the better).

Many sponsors view a small retiree purchase as a step along the path to full liquidation, or termination. It is important to keep that long-term goal in mind, because the order in which you liquidate liabilities can be very important. While insurers have been eager to take on retiree liabilities, the same cannot be said for active and terminated vested liabilities. And plans that include a lump sum payment option, such as cash balance plans, are even less popular.

Some carriers are accepting only retiree liability, especially carriers who have recently entered the market and do not have a robust recordkeeping system. Other carriers prefer full plan terminations because they are not as competitive with retiree only buyouts, while still others are reluctant to bid on non-retirees unless a meaningful portion of retirees (i.e., 50% to 75% of the liability) are included as well.

These conditions might change in the future as new carriers enter the market. But in general, when it comes time to fully terminate the plan, the more retiree liability you have, the easier it may be to find willing partners and a competitive bidding situation.

At a minimum, plan sponsors should consider including some terminated vested participants in any annuity purchase deal. Adding terminated vested participants into the deal will complicate the purchase process a bit, but may still be worth considering. Don't miss the potential opportunity to leverage the desirable retiree obligations to offload some of the less desirable deferred liability prior to a full plan termination.

Going back to our example, the sponsor was able to offload 25% of the retiree population but moved only 7.7% of the liability. Many sponsors would view this transaction, in light of all considerations mentioned here, a good move that reduces short-term cost and also retains flexibility for the future. Ultimately sponsors of frozen pension plans should be looking at all derisking tactics within their broader long-term strategic framework. All frozen plans are essentially terminated plans, with only the timing of liquidation in question. Before initiating any risk transfer activity, plan sponsors should consider how the short-term advantages may affect their longer-term derisking and plan termination strategy.

Plans that may be good candidates for a retiree buyout...

Pay PBGC premiums at the Variable Rate Premium cap

Have a significant portion of the plan headcount in pay status; many with relatively small benefits

May be considering a full termination, but not in the immediate future

For more information

Fidelity Workplace Consulting includes over 70 fully credentialed actuaries, who help their clients navigate the pros and cons of potential risk transfer actions such as retiree buyouts. Our consultants have also been active in the implementation of buyouts for those where the transaction is attractive. In recent years, our team have conducted over 35 transactions, with a total premium of $2 billion. Annuity placements have ranged in size from $500,000 to $225 million.

For more information on this topic, please contact your Fidelity Relationship Manager or email Fidelity Workplace Consulting directly at FidelityWorkplaceConsulting@fmr.com, or visit https://www.fidelityworkplace.com/s/workplaceconsulting.