Fidelity Benefits Consulting

Retiree Benefit Buyouts

The pros and cons of the current trend

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The purchase of group annuities ("buyouts") for retirees with relatively small benefits has become a popular strategy for many plan sponsors. These buyouts continue to reduce the size of the pension plan and provide some relatively short term financial benefits. But, these buyouts can also limit a plan sponsor's ability to fully terminate the plan down the road. Before committing to action, plan sponsors may want to consider balancing the short-term benefits of a buyout with the long-term goal of full plan termination.

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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 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 are the economics of these transactions?

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. For the comparison, is it the liability held for accounting purposes or funding? Or is it a different measurement selected by finance but not specifically tied to statutory interest rates? Administrative costs and PBGC premiums also come into play. While these costs are paid each year by the plan, they are not included in the statutory liability measurements. Adding these expenses in on a present value basis gives the plan sponsors a more complete picture of the potential economics of holding on to retiree liabilities.

Plan sponsors also debate the most suitable interest rate for assessing the plan liability. The right answer depends on the specifics of each situation. If the timeline to full termination 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.

Example

Let's take a look at a 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	
Average Age	72	72	
Funding Target liability	$5,950,000	$71,410,000	$77,360,000
Accounting PBO	$6,540,000	$78,500,000	$85,040,000
Annuity Purchase Price	$7,330,000	$81,440,000	$88,770,000

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

Breakdown of Annual Administrative Costs	
Recordkeeping Cost	$40
Flat PBGC Premium	$74
Variable Rate Premium	$523
Total Administration Cost	$637

Example continued on next page.

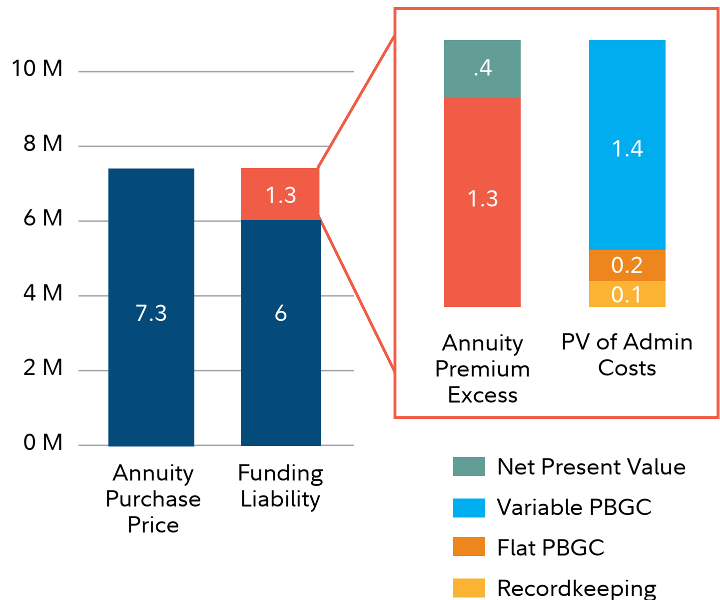
Assuming the plan sponsor uses the funding liability as the baseline, the exhibit below shows the economics of an annuity purchase for all retirees with benefits under $300 per month.

- The annuity purchase price of $7.3 million exceeds the funding liability by $1.3 million (the "annuity premium excess")

- However, the present value of administrative costs is 1.7 million, consisting mostly of a $1.4 million PV of the variable rate premium. These costs would be eliminated if a group annuity contract is purchased

- When administrative costs are considered, this transaction generates a positive **400,000 NPV** for the plan

- While this transaction has a positive NPV, the immediate cash flow impact is negative. A $7.3 million premium, or $1.3 in excess of the current plan liability, would be payable immediately to the insurance company. The administrative savings would be around $160,00 per year. It would take around 8 years for the annual administrative savings to reach the break-even point in this example.



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. Sponsors should ask themselves a couple of questions regarding their plan data:

- Have there been any issues with the retiree data, such as outstanding checks or discrepancies between the recordkeeping system and the disbursement agent?

- Is joint annuitant information for each retiree stored in the recordkeeping system or in imaged files? Typically SSN, name, date of birth, and gender are required.

Answering these questions 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. 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 advantageous factors 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. It is important to keep that long-term goal in mind, because the order in which you liquidate liabilities can be very important. As we just discussed, insurers have been eager to take on retiree liabilities. The same cannot be said for active and terminated vested liabilities. And cash balance formulas are even less popular.

In fact, many insurers have fairly specific business acceptance guidelines that limit the amount of deferred benefit and cash balance liability they will take on. A common guideline is that any annuity purchase deal must be at least 50% retiree liability. Some carriers are accepting only retiree liability right now. These guidelines 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. By adding terminated vested participants in the deal, this will complicate the purchase process a bit, but it is still worth considering. Don't miss an 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 plan termination, but not in the immediate future

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