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Risk Transfers: the Other Side of De-risking

By Ken Hohman

The buzzword in pension management has become "de-risking". The implication of this term is that we completely eliminate some, if not all, risk. I'm no physicist but I liken risk to energy—it never really disappears, it just changes form, and I contend that the proper term is "risk transfer". Unless you have assumed an unnecessary risk that can be removed without repercussion, eliminating a risk from your side of the ledger will generally cause another risk to appear, perhaps in someone else's risk portfolio.

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Over the last 15+ years, actuaries and retirement plan sponsors have become much more attuned to the risks inherent in retirement systems. But risk depends greatly on your perspective—one man's risk is another's opportunity. Many times in these pages we have discussed that the primary difference between defined benefit pension plans and defined contribution plans is who assumes the predominant risks—in the traditional defined benefit plan, it is the employer, while the participant takes on most of the risk in a defined contribution plan (this is particularly true of 401(k) plans). Even within the corporate structure of the plan sponsor, the perspective is different; the CFO is going to view retirement plan risks differently than the VP of Human Resources—the CFO is concerned with the financial risk the plan poses to the company, while the HR person worries about the risk of being unable to hire and retain desired employees.

In 2012 Verizon, GM, and Ford moved to "de-risk" their traditional defined benefit plans by offering lump sum benefits and/or purchasing annuities for many of their retired or terminated vested participants. And we have seen many other employers—large, small, and in between—adopt this de-risking tactic. These actions appeared to be financially motivated, implying that the de-risking was from the CFO's perspective, although, it can certainly be argued that offering additional choices to these former employees is not considered a negative from an HR standpoint.

There are many excellent articles that explain various de-risking options for defined benefit plan sponsors, and there is no need to repeat those options here other than to say there are some very good reasons from the employer's perspective to consider these moves in today's environment. What has been lost in the de-risking discussion, however, is the transfer properties of risk.

What does the new risk look like and where does it ultimately reside?

Some de-risking operations simply allow a company to exchange a highly undesirable risk for a less undesirable risk—the "lesser of two evils" risk transfer. An example of this could be liability driven investing (LDI). Many employers see volatility in contributions and financial statement liability as the worst possible risk for a pension plan sponsor. LDI allows the employer to greatly mitigate this risk by investing plan assets in bonds that mirror the securities underlying the discount rate used to value plan liabilities. This allows assets and liabilities to move in tandem, which reduces the volatility in required minimum contributions and the balance sheet liability. In many situations, however, LDI may increase the risk that required contributions will be greater over time along with the risk of a growing pension liability on the financial statement. But CFOs are making the well-reasoned determination that trading volatility risk for a higher contribution/liability is a sound strategic move for some companies. In this example, we have transferred the risk, but responsibility for the risk is retained by the company and, in particular, the financial side of the corporate structure. The fact that LDI exchanges one risk for another solely within the CFO's domain makes this a relatively non-controversial risk transfer.

Other types of de-risking strategies involve transferring risk to a second party in exchange for a specific dollar cost. The debate over these transactions centers on the financial sophistication of the second party. Typically, the plan sponsor is attempting to reduce the size of the plan because plan assets and liabilities are extraordinarily large compared to the size of the company (it has been suggested in financial circles that "GM is a pension plan masquerading as a car company"). Increases in PBGC premiums have also made reducing the number of plan participants a focus for defined benefit plan sponsors in order to reduce these premiums. There is speculation that many companies have deferred these de-risking tactics due to high costs attributable to low interest rates, but with record-setting financial markets and interest rates on the rise, the floodgates may burst with the pent-up demand.

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One such de-risking maneuver is the purchase by the plan of annuities from an insurance company. This can be either a direct purchase that removes the liability for the purchased benefit from the plan's books, or a "buy-in" purchase where the liability is retained by the plan. Under either approach, risks are being transferred from the plan to the insurance company, and it is just a question of the scope of the risks being transferred.

Regardless of what you think of insurance companies, I suspect we can all agree that they represent a financially sophisticated party in this transaction. The insurance company will thoroughly analyze the investment risk (i.e., how they will invest the premium dollars to assure that money will be available to pay the promised benefit), longevity risk (i.e., how long will the beneficiaries live and benefits be paid), and retirement timing risk (i.e., will additional benefits be due as a result of when the annuity beneficiary elects to commence the benefit), in order to assess a charge for accepting the transfer of risk that assures the insurance company's profitability. (It is no coincidence that the insurance company charges a "premium".)

The purchase of annuities by pension plans has been around for decades; it was very common prior to ERISA (adopted in 1974) for pension plans to be funded exclusively with varied annuity products. In the last 30 years, however, annuity purchases have not been as common because they were perceived as expensive, particularly in today's low interest rate environment. Of course, that expense is directly related to the insurance company's detailed analysis of the risks it will be assuming. Ford and GM, along with some other companies with large pension plans, have reached the decision that this risk transfer is worth the price.

The other common de-risking strategy for pension plans is the payment of a lump sum to participants in lieu of providing the plan's monthly lifetime retirement benefit. In a lump sum transaction, the employer is transferring the same risks it wishes to eliminate through an annuity purchase, but typically at a lower cost. By accepting a lump sum, the participant is taking on all the risks that the insurance company is assuming in an annuity purchase but without the insurance company's ability to pool the risk over a large number of lives. In addition, the lump sum may not include potential early retirement subsidies available to the participant under the lifetime income options available under the plan. The value of the lump sum relative to the early retirement benefit must be prominently displayed in the election form the participant (and spouse) must sign, but it is generally not understood by the individuals involved.

Concern has been raised by participant rights groups (e.g., the Pension Rights Center and AARP) over the lump sum de-risking approach, primarily on the basis that most plan participants do not possess sufficient financial sophistication to understand the risks they are assuming. It is important to recognize that a lump sum greater than $5,000 cannot be paid to a participant without the participant's (and spouse's) consent, so no one is forcing individuals to take lump sum payments, but the allure of taking full ownership of a large amount of money (perhaps more than the individual has ever had at one time) may outweigh rational financial planning. Furthermore, the lump sum offer is frequently a "window" benefit—available on a one-time basis; this applies even greater pressure on the participant to elect the lump sum for fear they will lose the option forever.

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There are certainly situations where electing a lump sum payment in lieu of a lifetime benefit makes sense. For example, you have other lifetime benefits that will satisfy your longevity risk, you have a rational reason to expect your life expectancy to be much shorter than the general population, or you believe you can take the lump sum and purchase an even larger annuity benefit from a sound insurance company. Unfortunately, examples of bad decisions abound, and even financially savvy individuals do not always comprehend the intricacies of longevity risk. It will not be surprising to see the Department of Labor require greater disclosure for lump sum payments, but in typical DOL fashion (well-meaning as it may be), the disclosures will likely by incomprehensible to those most in need of protection against their own actions. Greater financial education is always desirable—the conundrum is whether the necessary education can be provided at a level understood by the financially challenged participant.

If anecdotal information of bad decisions persist, and with the prodding of participant advocacy groups, it is likely that the DOL or Congress could intervene to restrict the payment of lump sums. Such a move may be good for the masses but would be at the expense of greater choice for the knowledgeable.

In perspective

As interest rates rise and legislated PBGC premium increases take effect, de-risking strategies for defined benefit pension plans will continue to be a hot topic. De-risking of defined contribution plans is also being considered through automatic enrollments, automatic contribution increases, and lifetime income options. But remember, the next time someone talks to you about de-risking, substitute the concept of risk transfer and follow the risk trail to determine who will become responsible for the "de-risked" risk.