Viewpoints

3Q 2021

Welcome to our latest Viewpoints, a quarterly publication presenting candid discussions with industry experts on vital topics. Should you seek additional information on this issue's subject, feel free to contact us. We welcome feedback as we shape content for future issues.

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A Discussion on Paths to De-risking

We continue to see plan sponsors implement de-risking programs as a journey. Also, we see more and more plan sponsors nearing the end of that journey and thinking about their exit or end-game strategy. To LGIM America, self-sufficiency (hibernation) or a transfer to an annuity provider is a choice and deserves careful consideration for all plan sponsors. There is no one size fits all solution. In this quarter's Viewpoints, we discuss some of the hottest topics, such as preparing for a plan termination by constructing a PRT-ready portfolio, the role of less liquid hedging assets such as private credit and deciding between a full plan termination and maintaining a self-sufficient fully hedged portfolio. Additionally, we provide various perspectives from throughout the industry on one of the most popular subjects in the pension asset management business – the paths to de-risking.

Before we get started, I want to express my gratitude to David, Keith, and Dhrubo for volunteering their time and willingness to contribute to our quarterly Viewpoints publication. Each has considerable experience in the asset management sector and brings a distinct viewpoint to the table when it comes to pension risk transfer and de-risking strategies. I am looking forward to a thought-provoking conversation.

David Cantor is a Senior Principal at Mercer. In his role, he advises corporate defined benefit plan sponsors on risk management through investment strategy and liability management. He has been working in the industry for roughly 20 years.

Keith Payne is the the Managing Director of Treasury at Rollins. In his role, he manages administrative responsibilities for the defined benefit and defined contribution plans. One of his first priorities when starting at Rollins in 2015 was exploring various de-risking paths for one of the firm's pension plans.

Dhrubo Krishnaiyer is the Head of Insurance Strategy at LGIM America. In his role, he is responsible for the firm's insurance strategy as well as the development, structuring and management of the firm's investment strategies and solutions for our affiliate insurance clients. Dhrubo joined LGIM America in 2019 and has more than 17 years of industry experience.

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Dhrubo, you've participated in a number of discussions with a variety of players in the pension risk transfer (PRT) market. What is a current market trend that you are observing, and what are your predictions for the future evolution of risk management methods and the pension risk transfer industry?

Dhrubo: As we've all seen, the US PRT market has experienced substantial growth over the past eight years. The growth in PRT volumes has been distributed across transactions of various sizes. Further, not only have those insurers who've been active in the PRT market expanded their capabilities, but the number of insurers actively competing in the market has also grown significantly. We expect an increasing number of insurers and more gradually, reinsurers, to enter and support the US DB de-risking marketplace.

From a plan sponsor perspective, we've seen improved visibility around the path to PRT (whether via a partial PRT or a plan termination), competitive pricing from insurer market participants and reduced execution risk. We've also seen a growing number of plan sponsors use their own asset portfolios to fund their PRT transactions via an asset-in-kind (AIK) transfer, capturing costs savings across a few different fronts.

Additionally, we've observed that certain industry sectors are more active adopters of liability-driven investment (LDI) techniques and PRT transactions than others.

I recognize that pension plan sponsors each have their own unique circumstances, and some may be on the path to risk reduction, while others may have different objectives. Rollins recently completed a de-risking journey for one of their plans. Keith, what, in your opinion, is one of the most significant obstacles plan sponsors confront as they prepare for this journey?

Keith: The most difficult obstacle for us was collecting data about our participants. Rollins has been in business for over 50 years and has had to shift from paper records to electronic records throughout that time. Navigating this change and re-discovering some of the original material was undoubtedly one of the most difficult obstacles we encountered on our path.

From the investment consultant perspective, can you describe the journey of the plan sponsor in coming to the decision to pursue a plan termination? What are the key motivating factors? Is this often driven from the sponsor side or does it take education from other stakeholders, like investment consultants?

David: Typically, the journey starts with the closing of the pension plan to new entrants and the freezing of benefit accruals. The focus then shifts to ensuring the plan has enough assets to settle the plan's liabilities through a plan termination.

Key motivating factors influencing the decision to terminate include the level of plan funding (higher is better), overall corporate philosophy regarding debt management and reduction (attitude to debt reduction more likely to drive favorable termination decision), financial reporting implications (large settlement accounting costs may be a headwind to termination) and the ability of the company to focus time and resources to the plan termination effort (more resources available the more a company may be apt to terminate).

The plan termination decision is a company choice and usually comes after education by the actuary, acting in their role as pension plan advisor. Sometimes, investment consultants or others can help shape the discussion but often these advisors are acting in their role as a fiduciary and are not directly responsible for the plan termination decision.

Keith, given your experience at Rollins overseeing a plan termination, would you mind sharing how that journey went and highlighting the main reasons for terminating?

Keith: In order to de-risk the pension plan, we looked at three different options. First, we considered allowing an LDI manager to create a self-sufficiency portfolio that would effectively manage the assets throughout the plan's duration. After that, we considered only annuitizing the retiree population, and finally, we considered terminating the entire plan. This phase lasted roughly from 2016 to mid-2018, when we decided that terminating the plan was the best option for us. Cost was the most important factor in this decision. As part of the termination decision, we recognized the importance of implementing a de-risking strategy that eliminated any funded status volatility prior to soliciting insurer bids. The fact that our pension plan held Rollins stock was an additional factor for us. During this time, the stock price performed well which helped propel the plan to an over-funded position. So, in the third quarter of 2018, we made the decision to pursue a full plan termination, which was completed in August of 2019.

From the insurer perspective, what are some of the key sensitivities or inputs that insurers consider when pricing a pension risk transfer?

Dhrubo: There are several variables involved in determining an insurer's PRT quote and relative competitiveness. A plan's data quality/integrity can be a significant factor in an insurer's ability to quote competitively. As Keith noted, from a plan sponsor's perspective, compiling, in some cases, digitizing and validating plan participant data can be a significant undertaking.

Consistent with our observations on the growing depth of the PRT marketplace, broadly, there are a growing number of insurers who are comfortable with quoting on cases with deferred participants. This degree of comfort can of course vary by factors including the proportion of deferred participants in the PRT case, benefit and/or case size and benefit complexity in the plan. Generally, plan sponsors are benefiting from greater execution certainty and price

competitiveness as the PRT market has deepened.

It's worth noting that insurers may be more sensitive than previously thought to the timing of a plan sponsor's entry into the market. Allowing for certain simplifying assumptions, a PRT transaction entering the market earlier in the year, when PRT activity is lighter, may receive a more competitive response and better pricing from insurers than later in the year. The PRT market calendar has still tended to be back-loaded towards the fourth quarter.

De-risking can take shape as several different activities. Offering lump sum payments to participants is a common de-risking strategy used by many plans. What effect does it have on annuity pricing if a portion of the liabilities is settled in lump sums? Are lump-sum payments offered to retirees by plan sponsors? Could you elaborate on some of the advantages and disadvantages?

David: The most common liabilities to settle via lump sum are for deferred participants. There is relatively little implication on annuity pricing from this type of transaction. The key take-away is that lump sums will cost the sponsor less to defease the obligation than purchasing annuities. This is due to the discount rate and mortality assumptions that must be used to calculate lump sum amounts under US law. It also has to do with insurance company profit and expense loads, as well as carrier capital and reserve requirements.

Plan sponsors rarely offer lump sum payments to retirees. The cost of settling these obligations may be less expensive than purchasing an annuity. The reasons are similar to those stated above, though the pricing differences are not as significant due to the relative certainty of retiree benefit payments versus deferred participant benefit payments. The main disadvantage is adverse selection, as retirees who choose the lump sum are likely to be in poor health. The remaining retirees, those who did not opt for a lump sum payment, will be the healthiest. This phenomenon should be reflected in any subsequent annuity purchase, or even just ongoing actuarial valuations. If the effect is recognized, the remaining retirees' increased longevity may outweigh any benefit from cashing out those who chose the lump sum. In very limited cases, retirees are offered a lump sum, usually in the context of a plan termination. In these situations, the retiree pool is usually limited to those recently retired. This may help mitigate the anti-selection risk.

Keith, was a lump sum exercise included in your de-risking journey? How was that decision made and how did it affect the end result?

Keith: Yes, we had done a series of lump sums over the years, beginning in 2015. We subsequently did another in 2016, 2018 and then the final one was right before our termination. The first one covered participants with a total benefit of $5,000 or less, and each time we increased the lump sum payout number. The take rate for eligible participants ended up being about 50%. The lump sum window prior to termination did not have a dollar amount threshold. We opened it up to any active, terminated vested or retiree participant who had retired in the last 4 years. The sole reason was to reduce the annuity premium we ultimately had to pay, so the cost of the termination is positively impacted by the strong take rate on the lump sums.

How should a plan sponsor think about building a portfolio in preparation for an asset in-kind transfer to an insurer?

Dhrubo: A key objective guiding the approach to building a custom pre-PRT portfolio, would include protecting against the downside by avoiding downgrades and defaults. Pre-PRT portfolios are built around curve targets, to which a manager would match exposures and cashflows, which, in conjunction with custom Treasury portfolio allocations, would help ensure plan funding ratio stability and minimize portfolio transition costs.

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Important considerations include building the portfolio to be well-hedged to established targets, eliminating funded status volatility and assisting in mitigating the impact of market conditions and movements that would impact an insurer's quote at PRT.

Consistent with the PRT end-game objective, portfolio construction criteria for a pre-PRT portfolio would also include certain credit-rating tilts, sector limits/exclusions and other granular screens that would be designed to help achieve a high or full in-kind acceptance by an insurer, resulting in potential savings to the plan in the final premium price. It's critical for a manager to work to ensure that the client's de-risking objectives are met throughout the pre-PRT journey even as plan liabilities change.

David: A plan sponsor should consider asset in-kind portfolio construction in the context of portfolio size, asset vehicle and security selection. While asset in-kind has come down market and resulted in savings on portfolios as small as $100 million, many insurers place a higher value on larger transactions due to increased capital deployment efficiency. Regarding the asset vehicle, the plan sponsor must

own individual securities, so a separate account is the best structure; some funds allow for in-kind redemption, but most are designed for cash redemption only. There is no consistent set of security preference guidelines that apply to all insurers, but most insurers provide consistent cost savings for long duration US investment grade corporate bonds.

Keith: Prior to our de-risking activity, the majority of our portfolio was invested in return seeking assets and core fixed income. Once we decided to pursue a full plan termination, reducing funded status volatility became our number one priority. We transitioned to a custom LDI strategy that was built in a similar fashion to how an insurer would build their portfolio. As David and Dhrubo highlighted, this mainly consisted of high quality corporate bonds. We also included a custom Treasury component to fine tune the interest rate hedge. The goal here was to minimize the annuity premium by being able to transfer our portfolio in-kind. We solicited three insurer bids, and each one indicated they would accept close to 90% of the portfolio. Our ultimate savings by transferring the portfolio in-kind vs. cash amounted to approximately 1%.

I understand insurers will often include private credit allocations within their own portfolios to take advantage of the potential yield pick-up. Do you think the asset class will start to appear in pre-PRT portfolios?

David: Yes, we believe the allocation will begin to appear in pre-PRT portfolios. Some plan sponsors are already incorporating private credit into their portfolios. There are a variety of reasons for the increase, including, but not limited to, potential yield increases, diversification to other fixed income securities and the broader portfolio as a whole, and increased education of plan sponsors on the features and attributes (both pros and cons) of these securities.

Dhrubo: I agree with David's comments. US life insurers are significant participants in the US private placement credit market. There are several insurers with established in-house capabilities to underwrite private credit; others have opted to access the asset class via third party managers.

Life insurers optimize for the profile of their liabilities and capture compelling investment opportunities in the investment grade private credit market on a credit risk, liquidity and insurance regulatory capital-adjusted basis. These investments also offer benefits around diversification and certain structural credit protections.

These are also compelling reasons for allocations to be made to investment grade private credit in pre-PRT portfolios, and over time, we expect to see this happen. To the extent that allocations to private credit in pre-PRT portfolios are already being made, they may be occurring on a limited basis and without a requirement for such investments to be compatible with an asset-in-kind transfer at PRT. For such allocations to happen at scale, there are certain challenges to overcome in order to minimize execution risks and transaction costs for the plan sponsor when the portfolio ultimately moves to PRT. ■

About LGIM America

LGIM America (LGIMA) was founded in 2006 with the purpose of helping people achieve their long-term financial goals. We offer a range of strategies to help our institutional clients (corporations, healthcare agencies, non-profit, education, public plans and Taft-Hartley) manage their investment objectives, which can range from market-based alpha-oriented strategies to those that are designed to be more liability-centric, derivative overlays, or indexed solutions. Encouraging a diverse and inclusive environment coupled with a solutions-focused culture allows us to increase our breadth of knowledge and the likelihood of improved client outcomes and stronger financial performance. We have teams of experienced, innovative professionals committed to helping plan sponsors meet their pension promises, managing investment exposures efficiently to seek enhanced returns while mitigating risks, and working to generate returns while making a positive societal difference. As of June 30, 2021, LGIM America had $257 billion in assets under management.

For further information about LGIM America, find us at www.lgima.com

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