Managing Pension Liabilities In A Low Interest Rate Environment

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Historically low interest rates and average 20 year returns that are significantly below expectations (we need to take the July 27th newsletter & turn into PDF & web content (I can then make a link) – I know it was going to be a blog post, but I don't see it) have led many to question whether the discount rate assumptions that have been traditionally used (around 8.25%) are realistic. Based on recent experience, many auditors, rating firms & supervisory agencies are pushing for valuations with lower interest rates (closer to 7.5%). This significantly increases disclosed liabilities and will force plan sponsors to make larger contributions to their pension plans.

1. Liability Driven Funding

Consider the goal of your investments—to meet pension obligations as they come due. The problem is that both your pension liabilities and the returns on your investments can be volatile. Consider an investment strategy that complements the needs of your pension plan by matching your assets and your liabilities. This will help to hedge your risk. As interest rates increase, the value of a bond will decrease, however this is offset by the fact that your liabilities have also decreased. Conversely as interest rates decrease liabilities decrease, but the value of your bonds increase.

2. Lump Sum

Consider offering a lump sum payment to pensioners, who have yet to begin taking benefits. While this has a significant up front cost that cost is known. It eliminates uncertainty, and the risks associated with interest rates, longevity, inflation etc.

3. Annuitization

a. Buy-in

A buy-in is an insurance contract whereby the insurer makes pension payments as they come due, thus removing longevity, investment, and inflation risk. A plan sponsor may choose to buy a contract that covers all plan participants, or a subset of plan participants. Buy-ins do not reduce a plan's liability as the plan sponsor is still required to make all payments. The buy-in is considered an asset to offset the cost of these payments. Buy-ins are easy to implement and can be converted to buy-outs at a later date. Also note that they do not negatively impact plan solvency.

b. Buy-Out

With a Buy Out, an annuity contract is purchased on behalf of each retiree. As such, liability is completely transferred from the plan sponsor to the insurer and is no longer reflected on the plan sponsor's financial statement. There are a few considerations to keep in mind. First off, federally regulated plans must ensure that a buy-out does not negatively impact the plan's solvency ratio, as it has the potential to do so. Also a buy-out may trigger a settlement under accounting rules.

c. Longevity Swap

A longevity swap is used to hedge longevity risk. In a longevity swap, a plan sponsor makes predetermined premium payments to the insurer. In return the insurer makes payments based upon actual mortality experience or based on an agreed upon index.

4. Freeze (Soft or Hard)

a. Soft Freeze

Continues service and/or pay related accruals for at least a portion of participants. No new participants are introduced into the plan.

b. Hard Freeze

Freezes all future accruals. No new participants are introduced into the plan.

5. Termination

When a pension plan is frozen, employees may stop earning benefits, but the plan remains in operation. In the case of a termination, all benefits are distributed in the form of lump sums or annuities, after which the plan ceases to exist.

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