Unique Challenges Facing Mid-Market Plans

Two Paths, One Destination

By: Michael Augustine & Louis Bélanger

Reprinted with permission from:

Benefits and Pensions
MONITOR

February 2018 Issue

Two Paths, One Destination

Michael Augustine
FCIA, FSA, CFA
Managing Director,
TD Asset Management

Louis Bélanger
CFA, FRM
Vice President & Director,
TD Asset Management

Helping to decide whether to de-risk internally or fully transfer pension risk

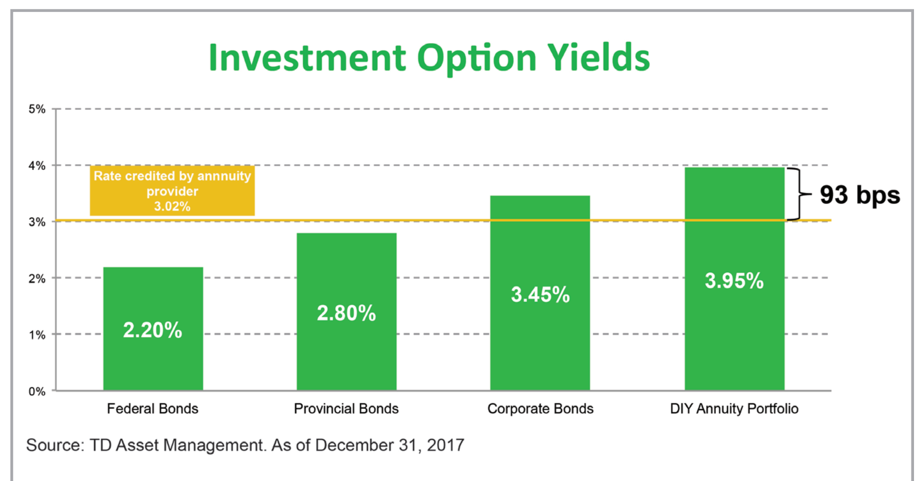
In the pension world, the recent increase in yields coupled with the tailwind of last year's favourable equity performance, have helped plans achieve a more favourable funded status. However, despite improved funding positions, pension plans may still face significant headwinds as market volatility remains a real threat. Against this backdrop, many plan sponsors are looking at ways to address pension risk. Plans have a few options when it comes to pension risk management, including plan design changes, a partial risk transfer through an annuity buy in, a full pension buyout through annuitization or de-risking internally. The main consideration is whether to fully transfer the risk or not. In this article we explore the merits and costs of transferring risk versus retaining and managing it.

De-risking through annuitization

For many plan sponsors, the costs associated with a full pension buyout have been an obstacle to transacting. Evaluating the cost of annuitization is relative. For some, "cost" is relative to the plan's funded status. If a plan is fully funded (or slightly overfunded) on a solvency valuation basis, then annuities are viewed as fair value and plan sponsors are more willing to annuitize. This is generally easy to evaluate. For others, "cost" is relative to the risk adjusted return proposition.

Plan sponsors with that view think about the economic or opportunity cost of purchasing annuities versus how they could otherwise invest their plan assets while minimizing the risk retained. This is a little more difficult to evaluate.

The general lack of transparency on annuity pricing requires plan sponsors or their consultants to perform periodic price discovery directly with providers. They can also use the data collected and published quarterly by the Canadian Institute of Actuaries ("CIA"). This data includes actual annuity purchases that have taken place and bona fide annuity quotations where the purchase does not take place, both of which inform the guidance the CIA provides around proxy annuity rates. For example, at December 31, 2017, the preliminary guidance based on the three most competitive annuity provider quotes for an illustrative medium duration (duration 11.1), non-indexed group of annuitants was an average credited rate of 3.02%. This data allows for a comparison to other investment instruments/options as shown in the chart below. For a plan sponsor considering purchasing an annuity for a similar duration profile group



Source: TD Asset Management. As of December 31, 2017

of plan members, the 3.02% rate would be equivalent to the yield they could expect to earn by investing in a fairly conservative liability matching portfolio of 65% provincial bonds and 35% corporate bonds.

Rationalizing the rate

Since insurance companies operate within smaller risk budgets, portfolios are constructed with prudence and conservatism. As a result, this low tolerance for volatility may be passed along in their product pricing. Consider again the plan sponsor seeking to purchase the medium

duration group annuity. As shown in the chart below, if the annuity provider were to invest in a combination of public bonds and private debt, they may be able to earn a yield of approximately 3.95%[1].

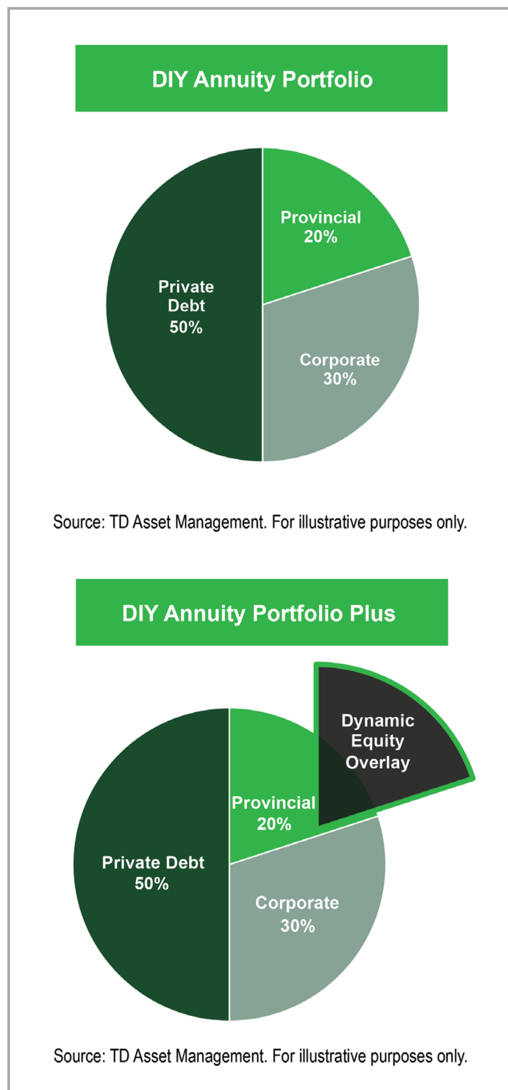
From the insurer's perspective, the approximately 90 bps difference between what they earn and what they credited to the plan sponsor is required to cover expenses, asset defaults, profit margins and capital charges. From the perspective of a plan sponsor who is comfortable with risk, but would also consider the purchase or exchange $100mm worth of plan assets for these annuities, this represents an opportunity cost of approximately $10mm[2]. Moreover, on January 1, 2018 a new regulatory capital regime (LICAT) came into effect for insurance companies that amongst other things significantly increases the capital insurers are required to hold when investing in long term assets[3].

A Do-it-yourself annuity portfolio

While plan sponsors have long had access to assets such as commercial mortgages, real estate and equities, the high-barrier-to-entry primary ingredient in an insurer's annuity portfolio is private debt. Fortunately, improved access to private debt, through vehicles like pool fund trusts, means that plan sponsors can build their own annuity portfolio—a do-it-yourself (DIY) annuity portfolio, sometimes referred to as a "hibernation" portfolio[4].

Since the group payout annuity has no surrender, withdrawal or portability features, annuity providers typically match these illiquid liabilities with a high allocation to illiquid credit. If a plan sponsor were to structure their plan's assets similarly, it might look something like the chart below:

- 50% private debt to harvest long-term illiquidity premiums
- 30% public corporate debt
- 20% provincial bonds & strips for rebalancing liquidity and long tail protection



The obvious benefit to creating a DIY annuity portfolio is that a plan sponsor can save the $10mm opportunity cost. The other benefit is that the savings can be used to help manage the harder to hedge, longer duration actives and/or deferred vested liabilities that often remain after annuitization.

A tailored strategy

The other benefit of the DIY annuity portfolio is that there is flexibility to "right risk" the portfolio as part of a more tailored strategy. This allows the plan sponsor to change the investment strategy or amount of risk in the future. For example, if a plan is looking for additional growth to, say, close a funding deficit or perhaps pre-fund future longevity costs, there may be some appetite for a limited amount of risk taken in a disciplined fashion.

To this end, an interesting way to tailor the strategy is to create a DIY annuity portfolio with a dynamic equity overlay ("DIY annuity portfolio Plus"). By implementing an equity overlay where gains are periodically/tactically harvested and redeployed to the DIY annuity portfolio, a plan could continue to seek the benefits of an appreciating equity market while the plan's underlying liabilities enjoy a high degree of protection.

While a buy-in annuity may be viewed as part of the asset portfolio, it unfortunately cannot be used as collateral for any sort of overlay. However, when the plan continues to own the assets of the DIY annuity portfolio, overlays remain possible. The DIY annuity portfolio Plus strategy can easily be integrated into a broader de-risking glide path strategy allowing the plan sponsors the ability to adjust the size of the equity exposure over time.

The benefit of choice

Whether plan sponsors choose to de-risk internally and effectively manage the risk in a DIY annuity portfolio, or fully transfer pension risk, significant thought and preparation is vital to properly prepare and take advantage of market opportunities as they arise. Through effective collaboration with their consultants and asset managers, plan sponsors will have the opportunity to maximize the benefits from the path they have chosen. ❖

1. Based on indicative data using TD Emerald Private Debt PFT and TD Emerald Long Private Debt PFT
2. Approximated as $100mm x 93bps x 11.1 years duration.
3. Effective January 1, 2018, the OSFI Life Insurance Capital Adequacy Test (LICAT) guideline replaced the Minimum Continuing Capital and Surplus Requirements (MCCSR) Guideline, in place since 1992. For example, under MCCSR where a rating is not available for a long-term bond or private placement, from a specified rating agency, the factor used should be based on the insurer's internal rating. The minimum factor that may be used is generally 2%. For example, under LICAT if it is not possible to infer a rating for a bond or loan the risk factor to be used is 6%.
4. A do -it-yourself annuity portfolio can be augmented with longevity risk protection for an even more comprehensive solution.