HEALTH WEALTH CAREER

RETIREE LUMP SUMS: HOW DO THEY CHANGE THE JOURNEY?

CLIENT WEBCAST

APRIL 9, 2019

TODAY'S SPEAKERS

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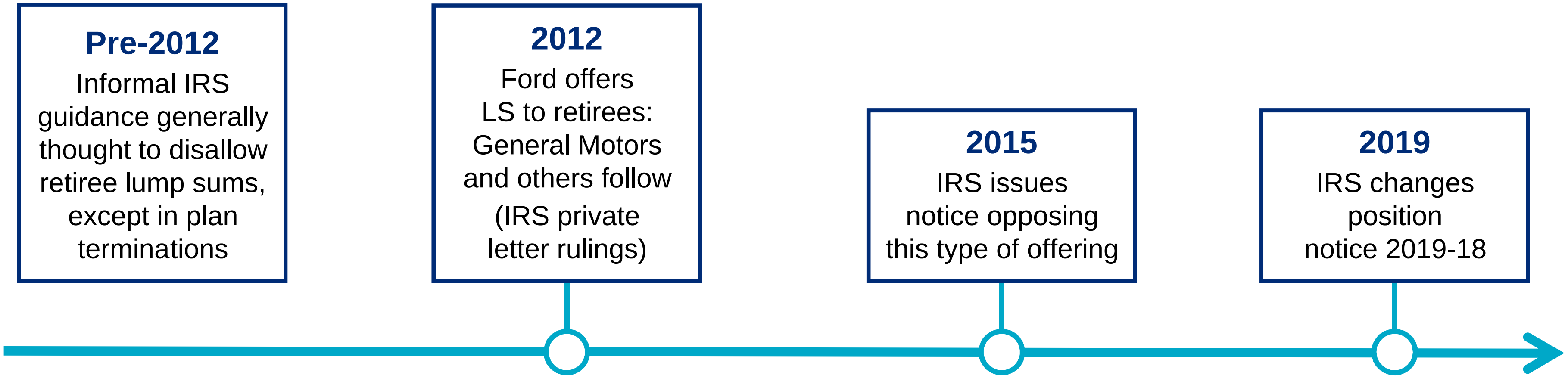
EXECUTIVE SUMMARY

- Plan sponsors continue to look for ways to reduce the risk of their pension plans
- Recent IRS guidance creates new de-risking opportunities using retiree lump sum windows
- Offering lump sum cash outs to retirees achieves many of the same objectives as annuity purchases for retirees and lump sum cash outs for terminated vested participants
  - Interest rate, investment, and longevity risks are reduced and future liability carrying costs are also reduced
- To evaluate a retiree lump sum, plan sponsors should examine the financial implications of the transaction and compare outcomes to similar alternatives
- There are issues plan sponsors should consider before determining if a retiree lump sum transaction is suitable for them, including participant benefit security and the potential for negative press

BACKGROUND

RETIREE DE-RISKING ALTERNATIVES
RECENT IRS UPDATE REVIVES LUMP SUM OPTION



Since 2015, the IRS lump sum mortality basis has been updated (increasing lump sums) and annuity pricing has become more attractive, limiting the relative economic advantage of lump sum windows.

RETIREE LUMP SUMS
TRANSACTION CONSIDERATIONS

- Offers are optional, not mandatory
- Cash outs are offered on a one-time basis, not as a permanent plan feature
  - Window periods normally are open for 30 to 90 days
- A retiree's cash out election will trigger a new annuity starting date, and qualified Joint & Survivor optional forms need to be offered at the same time of the lump sum offer
  - QJSA and QOSA for married participants; single life annuity for unmarried participants
  - Required distribution options actuarially equivalent to remaining payments
- Elections made during the window are subject to spousal consent, with complications if there have been changes in marital status since the original date of retirement
  - If remarried, consent from ex-spouse and new spouse may be required
  - Qualified Domestic Relations Orders (QDROs) create additional complexity
- Participants may roll over lump sum cash outs to an IRA or another the portion that constitutes a Required Minimum Distribution is not rollover-eligible

PENSION RISK MANAGEMENT

TODAY
PENSION ENVIRONMENT

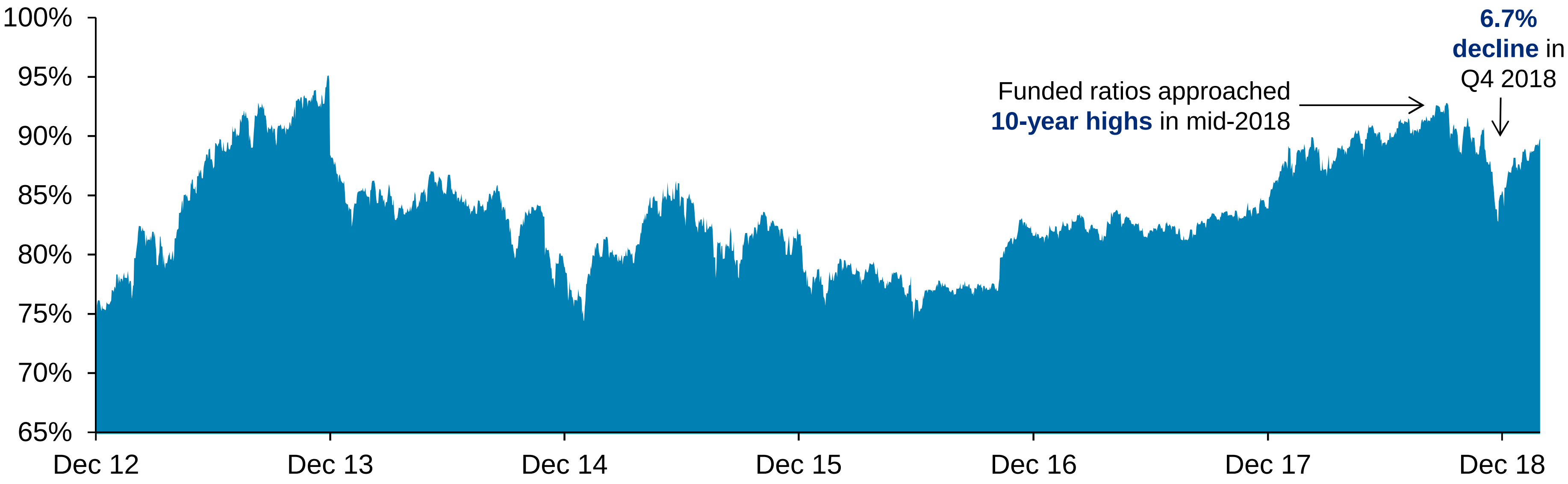
Market themes

- Recent market volatility highlighting uncertainty
- Interest rates have fallen from recent high while yield curve continues to flatten and invert at times

Liability themes

- Uptick in pension risk transfer
- Underfunding PBGC “tax” of 4.3% per year (total premiums up to $621 / person)

Funded status of pension plans in S&P 1500

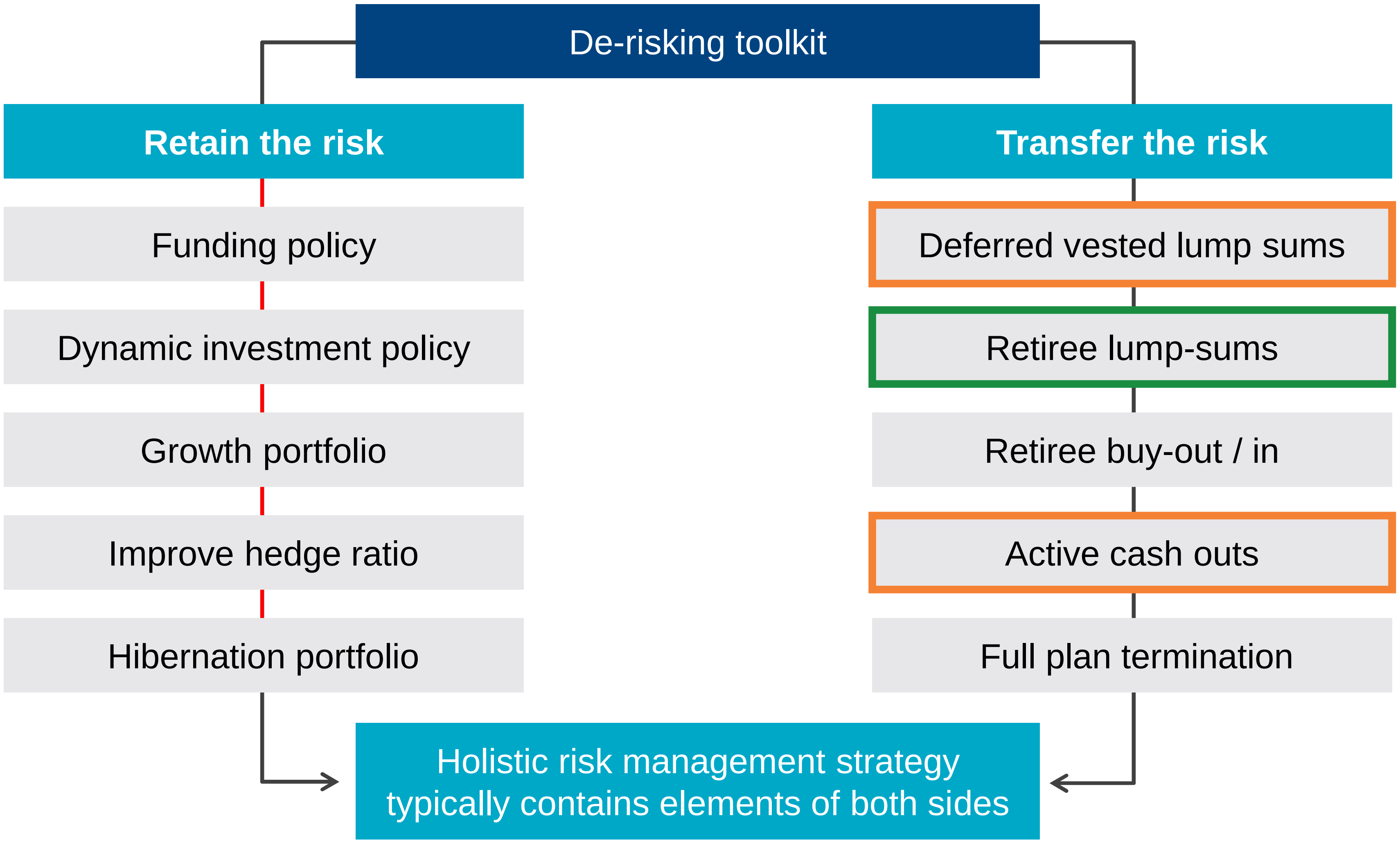


Source: Bloomberg, Mercer. S&P 1500 funded status estimates are from Mercer’s proprietary database.

RISK MANAGEMENT
PENSION TOOLKIT

Current discussion

Other lump sum opportunity



RISK MANAGEMENT

OPTIONS SHOULD BE EVALUATED THROUGH MULTIPLE LENSES

Economics	HR and participant impact	Portfolio and cash impact	Accounting implications
• Economic liability = market value of obligation plus the hard dollar costs associated with maintaining the plan • Economic savings = difference in economic cost and annuity purchase / retiree cost	• Data quality • Employee and retiree relations • Participant communications • Public and investor relations • Legal considerations	• Flexibility over discretionary contribution policy • Change in required contributions • Asset allocation (pre- and post-transaction) • Funded status volatility	• Potential settlement charge • Ongoing P&L impact • Balance sheet funded status impact

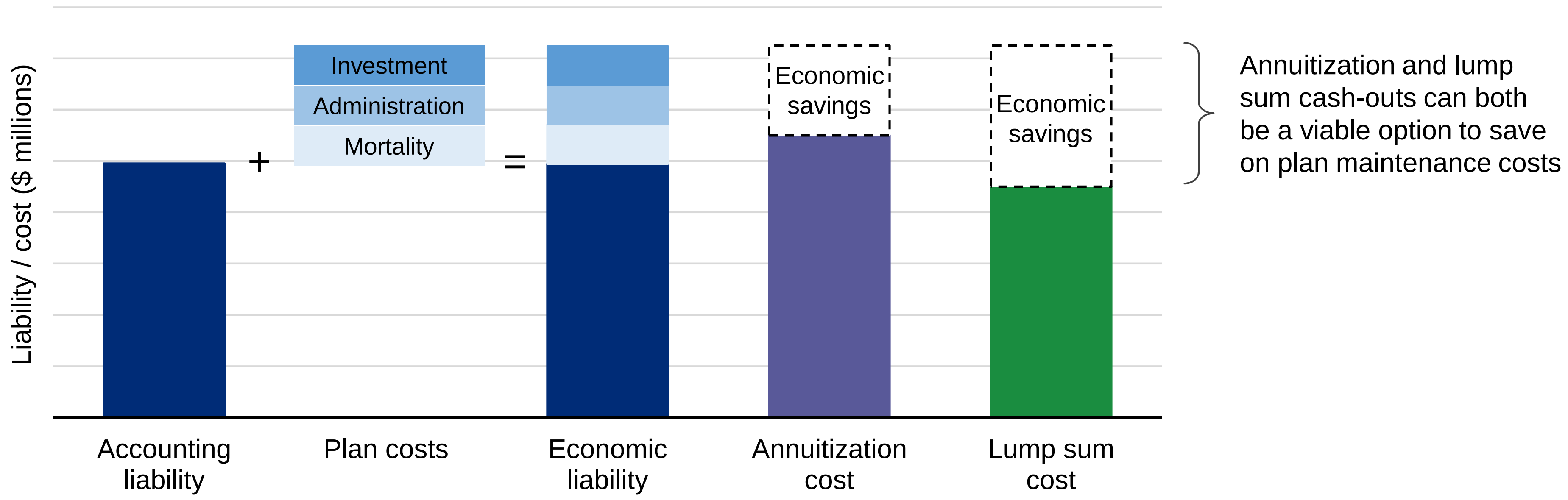
To determine if the transaction is attractive (Economics; HR and participant impact)

To determine the right time to execute (Portfolio and cash impact; Accounting implications)

EVALUATION FRAMEWORK

ILLUSTRATIVE: 100% TAKE RATE

ALL RETIREE ANNUITY VS. ALL RETIREE LUMP SUM

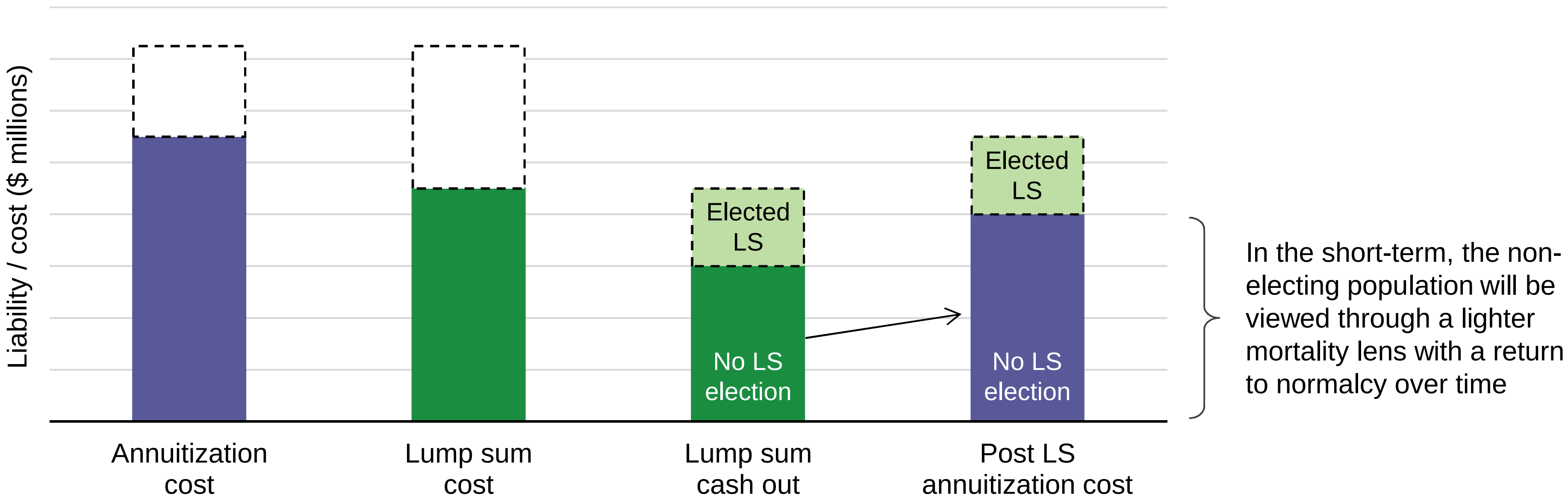


An alternative to risk transfer is to maintain the plan liabilities on the sponsor's balance sheet while minimizing risk exposure through a liability-driven investment strategy

- Therefore, it is appropriate to compare the risk transfer cost, whether through an annuity purchase or lump sum window, to the total cost of plan retention on a theoretically risk-neutral basis ("Economic Liability")
- The difference between the economic cost and the cost of alternative risk transfer activities is defined here as the net economic savings

"REAL LIFE": LESS THAN 100% TAKE RATE

FULL ANNUITIZATION VS. PARTIAL LUMP SUM TAKE UP



- Lump sums may be economically attractive due to differences in mortality assumptions and discount rates relative to market assumptions
- Total cost to pay partial lump sums and retain residual liability may be more or less than upfront annuitization cost
- This risk / reward profile will vary on a basis depending on population demographics and the divergence between regulatory and market assumptions

MULTIFACETED TRANSACTION
ECONOMIC SAVINGS DRIVERS

Driver	Description / general implications	Current market
Lump sum take rates	Lump sums are elective and as such cannot ensure a particular subset is cashed-out. A very low take rate will diminish the economic savings of a lump sum exercise	Very minimal recent market data on expected retiree lump take rates, but generally lower than actives or vested terminated participants
Interest rates	Market rates vs. IRS 417(e) rates (generally pegged with a lookback month)	Potential for economic savings for calendar year stability periods due to rate declines from late 2018
Mortality	Best estimate vs. IRS 417(e) mortality (unisex)	• Can move liability by a few percent in either direction • Highly driven by liability-weighted gender split
Population demographics	Age, gender, form of payment, benefit size, prior lump sum offers	Specific to each plan
Anti-selection	Those who reject a lump sum offer are likely to have lighter future mortality experience due to information asymmetry around longevity expectations. This cost for those not electing may be borne immediately (if annuitized) or over time (if retained by plan)	Insurer view of post-offer mortality is evolving with more experience

HR and participant impact

RETIREE LUMP SUMS
HR CONSIDERATIONS

Sponsors considering a retiree lump sum should weigh HR considerations, including:

- Desire to provide retirees with increased financial flexibility
- Views on legal risk associated with recent IRS positioning
- Attitude toward paternalism
- Public perception and headline risk
- The need for clear communication about the window
- Implementation issues

RETIREE LUMP SUMS

CASH IMPACT

- Plan's adjusted funding target attainment percentage must be 80% to pay full lump sums
- Most plan sponsors currently have reduced contribution requirements due to funding relief (HATFA / MAP-21) that allows liabilities to be valued at higher-than-market discount rates:
  - Paying lump sums at closer to market rates will tend to increase the deficit while relief is in effect
  - Depending on the plan's financial position, this could accelerate contribution requirements in the short term
  - Long-term contribution requirements are unlikely to change materially
  - Plans using a funding policy in excess of the minimum required amount are less likely to see large changes in short-term contributions
- Sponsors should also consider liquidity and pre and post investment strategy

Accounting implications

RETIREE LUMP SUMS
ACCOUNTING IMPACT

- Lump sum payments will result in a gain or loss relative to accounting PBO
  - Many calendar-year plan sponsors would see a gain based on current discount rate movements
- Under US GAAP:
  - Settlement accounting is generally required if liability settled is greater than sum of service cost plus interest cost. Settlement charges are often excluded in financial analysis of P&L. Companies may be able to avoid settlement accounting by limiting the size of the group or by offering in multiple tranches
  - Ongoing P&L may increase due to the spread between the company's EROA assumption and discount rate, but this can be mitigated with financing / investment strategy
- Under IFRS:
  - The gain or loss arising from the lump sum window is generally recognized in P&L immediately
  - Ongoing P&L impact is likely to be small
- A liability transfer transaction de-levers the company, which decreases the discount rate used to value a company's cash flows in determining its overall valuation. May also improve credit rating agency views

FURTHER CONSIDERATIONS

RETIREE LUMP SUMS
STRUCTURING THE DEAL

- Many risk factors can be mitigated by limiting the offering to:
  - Retirees with smaller benefits
  - Younger retirees
  - Certain divisions or business units
- Surveying population prior to offering can give the sponsor a clearer view into the economics of the transaction before executing
- Be sure to consider the impact of group makeup on nondiscrimination rules

RETIREE LS CASH OUT PROGRAM
ILLUSTRATIVE TIMELINE FOR A 60-DAY WINDOW

MONTHS						
Month 1	**Month 2**	**Month 3**	**Month 4**	**Month 5**	**Month 6**	**Month 7**
Implementation		Production and launch	Election period Process elections and final reminders		Payment processing and receipt	
DETAILED STEPS						
Project kickoff	Test data for statements	Mail announcement postcards	Administration center: answer questions, process elections, resolve issues			
Draft communications	Draft v2 in layout	Print packets	Resolve escalated issues		Files to Trustee	
Receive data from administrator	Test statements	Mail packets		Mail reminder postcards		Payments distributed
	Statements approved	Launch election wizard				
Benefit calculations						

All — Advisor — Company — Trustee

NEXT STEPS

ANNUITIZATION VS. LUMP SUMS
FINANCIAL VS. PARTICIPANT CONSIDERATIONS

Annuitization

+ Financial considerations –

+
- Ability to target specific liability size and groups (e.g. small benefits)
- No obligation to transact if pricing is unfavorable
- No anti-selection risk (no optionality)

–
- Small premium relative to accounting liability

+ HR considerations –

+
- Retiree benefit unchanged and secure
- Minimal sponsor implementation effort
- Participant annuities protected by rigorous insurance industry regulations and State Guarantee Association

–
- Required retiree communication regarding change of payment source, etc.

Lump sums

+ Financial considerations –

+
- All else equal, lump sum costs generally below annuitization costs
- Economics may be favorable in certain circumstances (e.g., based on demographics and accounting basis)

–
- Outcomes depend on many factors / difficult to predict
- Difficult to control transaction size to meet objectives
- Subject to anti-selection risk

+ HR considerations –

+
- Some retirees will appreciate lump sum option
- Legal risk mitigated by recent IRS guidance

–
- Participant must manage payment / absorb longevity risk
- Paternalism and public perception risk
- Communication and implementation challenges

NEXT STEPS

REVIEW overall pension risk management strategy

EXAMINE efficacy of retiree lump sum transaction

EXECUTE transaction if favorable

CONTINUE to monitor and look for additional de-risking opportunities

QUESTIONS AND FEEDBACK

WE'D LOVE TO HEAR FROM YOU

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APPENDIX

ECONOMIC FRAMEWORK

- An alternative to risk transfer is to maintain the plan liabilities on the sponsor's balance sheet while minimizing risk exposure through a liability-driven investment strategy
  - Therefore, it is appropriate to compare the risk transfer cost to the total cost of plan retention on a theoretically risk-neutral basis ("Economic Liability")
  - The difference between the economic liability and the cost of plan termination is the net economic benefit
- We define economic liability as the balance sheet liability (PBO) adjusted for market mortality and interest rates plus the present value of plan retention costs:
  - **Discount Rate:** The discount rate should reflect an investable portfolio, which does not take market risk to meet future obligations
  - **Mortality:** The longevity assumptions should attempt to accurately measure the long-term expectation of the underlying population as well as the risk that actual experience does not align with expected due to cohort size
  - **Plan Retention Costs**
    - Annual maintenance fees (including PBGC premiums)
    - Investment costs, which include manager fees and funded status deterioration due to downgrades, defaults, or fixed income asset underperformance relative to the liability benchmark

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