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What do historically low interest rates mean for DB pension de-risking?

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When the coronavirus pandemic hit, many organizations were focused on getting through the short term. But defined benefit plan sponsors are starting to take another look at de-risking.

As of the second quarter of 2020, the total market volume of group annuity purchases year-to-date was $0.5 billion, compared to $1.5 billion in the first two quarters of 2019, according to the Willis Towers Watson annuity purchase index.

The $1 billion drop in annuity purchases can be tied to the fact that plan sponsors were focused on their core business when the pandemic arrived and pension funding levels were on a roller-coaster ride, says Brent Simmons, senior managing director and head of DB solutions at Sun Life Financial. "I think those two factors contributed to a pretty slow start to the first half of the year."

Yet, by the end of the third quarter, the market caught up to the same spot in terms of annuity sales from the previous year, he notes. "[As] at Sept. 30, 2019, the sales for the first nine months of the year were about $2.6 billion and we're not that far off of that in 2020. So Q3 has actually been a very busy [quarter], with a couple [of] large transactions closing, to the point that we caught up for that billion dollars that we were behind, and then matched Q3 from last year as well."

In the environment of low interest rates, the price of annuities is higher because insurance companies back annuities with high-quality fixed income assets. When interest rates are low, the price to buy those assets rises.

Simmons acknowledges that, on an absolute basis, annuity pricing has increased, but on the other hand, when interest rates come down, bond prices increase as well. "To the extent that pension plans have bonds in their asset mix, there's actually a really neat opportunity to trade in their bonds for an annuity. So annuities might cost more, but their bonds are worth more. And we've done some work to say, a passive bond portfolio, which a lot of pension plans are invested in, just matching the bond index that's out there, annuity pricing right now is actually 50 basis points better than the return that a company can get on their passive bond portfolio."

Marco Dickner, retirement risk management leader at Willis Towers Watson, says in most transactions, plan sponsors will sell bonds for annuities. "If you sell bonds for annuities, the level of interest rates . . . does not really matter."

Using the analogy of owning a house, he notes that, if the housing market skyrockets, a person may need to pay much more to buy a new house, but they can also sell their house for a much higher amount. "Annuities are fixed income. Yes, they're very expensive, but plan sponsors, they're sitting on lots of long bonds. Therefore, the beauty of hedging is basically those sponsors are not that affected by the increased costs because they have the corresponding bonds to match. They would have similar gains on their bonds to offset the increase in price on the annuity."

Despite higher annuity prices, Dean Newell, vice-president at Actuarial Solutions Inc., thinks pension plan sponsors that had already done the work to de-risk their plans may not view the lower interest rates as a show stopper because they're already largely invested in fixed income.

"If their pension plan is in a decent financial shape, they still might want to move forward to purchase annuities to alleviate themselves from the mortality risk. And . . . that's a lot easier to do if you've done the work over the last number of years to de-risk your pension fund and adopt an asset-to-liability investment strategy. . . . Even as interest rates have declined over the last number of years and are at . . . historic lows now, your funded status of the plan might still be OK. Or the amount of additional top-up contribution you need to make might be not that material. And the organizational goals of potentially exiting from your defined benefit plan might still be achieved by purchasing an annuity."

That said, annuities that are indexed to inflation are even more costly. To deal with the additional risk that inflation imposes on indexed annuities, insurance companies will hedge this risk by driving the yield even lower, which can produce a negative interest rate for the price of the annuity, Newell says. "It's not that the assets that they're investing in are yielding negative results, it's just that the price that they charge is so high that the portfolio as a whole would implicitly yield a negative return."

Some plan sponsors might be willing to maintain their plan for a longer period to wait for better pricing if they're looking for indexed annuities, he adds. "I think it, again, comes down to, what is the plan sponsor's ultimate strategy and exit strategy with the DB plan? . . . If they've taken a de-risked approach, they might sit and say, 'We can afford this now, we can exit and, sure, it's awfully expensive, but we'll pull the trigger and do it.' But some of them might say, 'You know what? It's awfully expensive right now. We don't mind taking on the inflation risk for the next [few] years. So we'll definitely not do it now, but maybe we'll re-investigate this in a number of years' time.'"

While real-return bonds have very low yields, they're worth a tremendous amount of money, Simmons notes. Therefore, while these annuities are expensive, plan sponsors could sell existing real-return bonds to buy consumer price index-linked annuities or transfer those bonds in kind. "So [there's] always two ways to look at the pricing of everything. What's that absolute price? But maybe more importantly, what's the price relative of the assets that you already are holding?"

When looking at annuity pricing, another factor to consider is the competitiveness of the market, says Newell. And Dickner highlights that it's a buyers' market due to the slow start to the year.

Simons notes that many pension plans are now fully funded again and smart companies realized insurance companies were hungry for business in the third quarter. Plus, the market still has a lot of capacity remaining for the fourth quarter. "We're thinking that Q4 could also be very busy given [the] great competitive landscape and pricing put forth by the different insurers."
