

The BCG Pension Insider

March 2023 – Volume 137, Edition 1

Spotlight Series – Q&A with NISA Investment Advisors

Breaking Down the Hibernation vs. Termination Decision



NISA Investment Advisors, LLC

Headquarters	St. Louis, MO
Year Founded	1994
Asset Under Management	\$439 billion*
Number of Clients	216*
Website	www.nisa.com

* As of December 31, 2022, NISA managed \$259 billion in physical assets and \$180 billion in derivative notional value in separate account portfolios. \$21.8 Billion in Repurchase Agreement notional and underlying assets are reported in both physical assets and derivatives notional value under management.

David Eichhorn, CFA



Chief Executive Officer and Head of Investment Strategies

David is the chair of NISA's Investment Committee, a member of the Management Committee and oversees the development of client portfolio strategies and growth initiatives. David has authored many papers on institutional investing and holds a BSBA from Washington University in St. Louis with majors in Finance and Mathematics.

David Eichhorn can be contacted at 314-721-1900, or david.eichhorn@nisa.com

BCG: Describe NISA's position in the asset management industry and specifically its history with pension risk management strategies?

Eichhorn: As an asset manager, NISA focuses on designing, developing and managing highly customized, risk-controlled investment strategies. Since the inception of the firm in the mid-90's, we have advocated for liability-focused strategies and were implementing liability-driven investing for clients well before the adoption of the Pension Protection Act of 2006 (PPA). We were also an early advocate of the importance of managing plan asset allocation to reduce funded status volatility.

BCG: What are the most common strategies NISA clients use to manage pension risk? Has that changed given the large increase in interest rates over the past year?

Eichhorn: Pension risk management strategies take many different forms. For plan sponsors that are newer to LDI, this may mean simply extending the duration of their fixed income allocation. Fifteen years ago, it was common to have discussions with plan sponsors on moving from a U.S. Aggregate benchmark policy allocation to longer duration U.S. Treasury or credit benchmarks. More recently, and largely due to increases in funded status, the last 5-10 years has seen an increased focus on fixed income strategies to manage funded status risk. This includes strategies which increase interest rate hedge ratios against the liability and strategies which further customize fixed income benchmark exposure. For sponsors with a high fixed income allocation, this has meant shifting a portion of their assets to more intermediate duration benchmarks as plans become more fully funded and liabilities have aged.

The material funded status increase has been driven by increases in interest rates along with the equity market rally over the last decade. With the average plan currently over 105% funded, pension de-risking strategies such as more comprehensive LDI approaches including hibernation as well as lump sum and annuity strategies are becoming more the norm.

BCG: Speaking of hibernation, how do you frame the hibernation vs. annuitization decision for clients?

Eichhorn: Generally, we frame this decision around two components: cost and risk. From a risk perspective, the question is whether or not the pension continues to introduce meaningful risk to the plan sponsor once hibernated. When sponsors had materially higher equity allocations, and therefore lower fixed income allocations and hedge ratios, pension risk was more material to the sponsor. By de-risking (reducing equity and increasing the interest rate hedge), pension plan funded status volatility can be reduced to sub-3% levels. Even for highly pension-levered firms, this level of risk has little or no impact on the enterprise. The question then becomes "what is the cost of maintaining the plan versus terminating the plan?"

To assist plan sponsor decision making, we share a framework for cost and risk with sponsors to help them make the most well-informed decision possible. The framework looks at costs that occur when sponsors choose to hibernate versus the upfront costs that sponsors will pay under a termination strategy. While more complex, it often boils down to the cost of fixed-rate PBGC premiums when maintaining the plan versus the insurer cost of capital when terminating. Plan advisors (such as BCG) can also help plan sponsors carefully consider and think through their pension de-risking options from a cost and risk perspective.

Which strategy is ultimately chosen has often differed based on the size of

[Thought Leadership](#)
[The BCG Pension Insider](#)
[Spotlight Series](#)
[Webinars](#)

the plan. For example, plan terminations have historically been more common for smaller plans, which naturally have higher fixed costs, while hibernation has been more common among larger plans. With plan funded status being near 15-year highs, sponsors are now having to examine these strategies more closely. For many sponsors that have seen a significant improvement in their plan's funded status they should now be thinking about what steps can be taken to lock in their funded status gain.

BCG: *Do you assist sponsors terminating their pension?*

Eichhorn: Yes. Many sponsors we work with pursue in-kind transfers, and so once a termination or lift-out decision is made, they often will structure the asset portfolio to match the pension liabilities. This can require coordination with plan actuaries, consultants, asset managers and ultimately the selected insurance company.

At the end of the day, we are ultimately an asset manager, so decisions relating to whether or not to terminate are ultimately left up to the plan sponsor and their advisors. If it is determined to pursue a termination, it can be useful to have a quarterback on the asset management side due to the large amount of coordination required.

BCG: *While you don't select insurance companies, you wrote a piece on a potential method for selecting an insurance company. Why?*

Eichhorn: The most important decision when conducting an annuity buyout is choosing an insurance company to provide the annuity. There are guidelines on how the DOL thinks this choice must be made. In order to make this decision, insurers are evaluated on a handful of criteria – notably, the insurers' credit worthiness. But in our experience, something that isn't often discussed is how the market itself can be helpful to understanding relative riskiness between insurance companies. In particular, most large insurers issue Funding Agreement Backed Notes (FABNs) – securities that are sold in the public fixed income markets that are pari passu with insurance policies and therefore provide a directly comparable measure of the insurers' claims-paying ability. As such, they represent a ready-made, market-based measure of relative credit risk for fiduciaries who are seeking to satisfy DOL IB 95-1 when selecting a pension risk transfer (PRT) annuity provider.

Keep in mind a PRT annuity contract cannot be sold after the fact unlike a market-based security. As such, the selection of the annuity provider is critical to ensuring participant safety. It's been our observation from market prices that the valuation of the same benefit promise from different insurance companies can differ by as much as ~14%. In our view, that is a material difference and plan sponsors need to be aware when choosing an annuity provider.

BCG: *A critique of your piece has been the reliance on FABNs as a source for the analysis. What is your response to that?*

Eichhorn: While FABNs aren't perfect, we believe they are a reasonable instrument for comparing insurance companies. One unfounded critique is the idea that these securities represent a niche portion of the fixed income market. In many cases, both the issuance and average daily volume of FABNs exceed that of index-eligible senior, unsecured insurer debt. With greater issuance and more liquidity, that's a tough argument to make.

We are certainly open to adjusting the model when a different situation arises. As an example, because FABNs are general account policies, they won't necessarily reflect the added benefit of an annuity buyout written in a separate account. As such, an estimated adjustment to market pricing could be included to reflect this credit enhancement, although this adjustment should be applied to all insurance companies being considered for the annuity buyout. We think it is reasonable to assume a similar quality ranking and distance between the quality measurement of insurance companies would be maintained after the adjustment.

Plan sponsors and their advisors also should remember that separate accounts shouldn't be viewed as a panacea – they protect against general creditor risk, but they don't provide protection from the separate account being underfunded in the future. When that occurs, participants would have equal standing with general account policy holders. Of course, that risk could be partially addressed via overfunding the separate account at inception or adding investment restrictions. Ultimately, these are all factors that we would leave to the independent fiduciary and/or the advisor chosen by the acting fiduciary to serve in the "Independent Expert" capacity as contemplated in DOL IB 95-1.

BCG: *To close out, what piece of advice would you give plan sponsors contemplating a termination over the coming year?*

Eichhorn: For sponsors considering a plan termination, they should have a

March 2023 – Volume 137, Edition 1

Spotlight Series – Q&A with NISA Investment Advisors

Breaking Down the Hibernation vs. Termination Decision



BCG: Describe NISA's position in the asset management industry and specifically its history with pension risk management strategies?

Eichhorn: As an asset manager, NISA focuses on designing, developing and managing highly customized, risk-controlled investment strategies. Since the inception of the firm in the mid-90's, we have advocated for liability-focused strategies and were implementing liability-driven investing for clients well

NISA Investment

To contact BCG, please reach out to Steve Keating at 203-955-1566 or skeating@bcgpension.com

ANNUITY PURCHASE RATES

Sample Interest Rates for a Pension Annuity Buyout
(Assumes no lump sums, disability, or unusual provisions)

- Retirees (duration of 7) – 4.80%
- Term Vesteds (duration of 10) – 4.75%
- Actives (duration of 15) – 4.69%

Annuity Purchase Rates as of March 1, 2023

The BCG Pension Insider

Spotlight Series

Webinars



BCG Pension Risk Consultants | BCG Penbridge
100 Grandview Road, Suite 303, Braintree, MA 02184

For more information, please contact **781-356-2299** or sales@bcgpension.com

Follow Us

