ONE LESS THING: DE-MYSTIFYING THE GM DE-RISKING TRANSACTION

"Essentially, GM has made its entire salaried pension [for retirees] go away by paying out a little more than 10 per cent of its … cash balance. As Forrest Gump said, 'That's good. One less thing'."[1]

In June, General Motors (GM) announced that it was de-risking its salaried pension plan and reducing its pension obligations[2] by US$26 billion through a combination of lump sums and annuities.

This is the largest pension de-risking transaction ever announced and it signals a shift in the way that organizations think about their pension obligations. Rather than being deferred compensation arrangements administered by human resources, pension plans are now subject to the same risk management process and cash flow evaluations that finance applies to other corporate assets.

Analysts have applauded the GM transaction and, as a result, other U.S. corporations will likely follow in GM's footsteps. Within Canada, serious interest in de-risking is growing and next year it's expected that the country will see its first $1 billion pension de-risking transaction.

The following article provides the background on the GM transaction. It also discusses the steps that Canadian Defined Benefit plan sponsors can take to evaluate whether a similar transaction is right for them.

PENSION HEADACHE

When breaking down the mechanics of the GM transaction, it is important to understand that GM is essentially a pension plan that makes cars on the side. At the end of 2011, GM's pension obligations were about US$134 billion while its stock market value was only about US$32 billion. Put another way, GM's pension investment unit manages assets that are four times larger than the value of GM's manufacturing business. This means that the value of GM's stock has largely been determined by GM's pension investment skills, as opposed to GM's manufacturing skills.

GM's pension plans have also been a huge drain on cash. Over a 15-year period ended December 2006, it put US$55 billion into its workers' pension plans, compared with US$13 billion it paid out in dividends, says the Roger Lowenstein book 'While America Aged.'

Despite these large contributions, GM's pension plans are still not well funded. At the end of March 2012, its U.S. pension plans were US$12.9 billion short of its obligations, and its non-U.S. pension plans were US$11.6 billion short of obligations.

[1] Source: Morgan Stanley, Sales and Trading. June 4, 2012
[2] Unless otherwise noted, pension obligation refers to the amount being shown in a company's financial statements. This is usually referred to as the 'accounting basis.'

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THE EXTRA STRENGTH TYLENOL

In June, GM announced that it was de-risking its U.S. salaried plan through a combination of lump sum cash settlements and an annuity buy-out.

As a part of the transaction, GM will purchase a group annuity from Prudential Financial Inc. (Prudential) for 76,000 retirees and spouses who retired before October 1, 1997. The remaining 42,000 retirees, who retired after that date and before December 1, 2011, will be able to choose between a group annuity and a lump sum cash settlement. Salaried plan members not impacted by the transaction will be moved to a new plan and the current plan will be terminated.

This de-risking will reduce GM's pension obligations in its U.S. salaried plan by about US$26 billion to US$10 billion from the US$36 billion reported at the end of 2011. It will require a cash contribution of between US$3.5 and $4.5 billion from GM. GM will pay US$29 billion to Prudential and the retirees who elect lump sums.

Prudential will hold the assets related to the GM annuity buy-out in a separate account. If this account is insufficient, Prudential will make up the difference from its general account. According to a GM filing, both it and Prudential could pull out of the deal before it is set to close at the end of the year if markets deteriorate and increase the total cash required to close the transaction.

If the deal goes through, it will eclipse anything seen previously in the group annuity market. The last such U.S. deal to involve the transfer of more than US$1 billion in obligations was in the 1980s, according to Aon Hewitt.

NEW CORPORATE FINANCE

One unique feature of the GM transaction compared to prior U.S. pension risk transfer transactions was the evaluation of the transaction from a corporate finance perspective. GM approached the transaction strategically by investigating the relative merits of the transaction versus other potential uses of cash (share repurchases, dividends, acquisitions, capital improvements, etc.).

The US$3.5 to $4.5 billion of cash that GM contributes is the difference between the cost of the annuity/lump sums and the pension obligations that GM holds on its books, and represents a 10 per cent premium. GM's actual cost is lower than the 10 per cent premium as it no longer has to pay administration expenses and Pension Benefit Guarantee Corporation assessments for 118,000 retirees. From a risk management perspective, this premium provides future certainty by reducing cash and accounting volatility. As GM CFO Dan Ammann said, after offloading the US$26 billion obligation, "we'll never have to address it again."

GM's CEO, Dan Akerson, has said that the company would consider offering a similar choice for its 400,000 union plan retirees and spouses, so this transaction could just be the first step. Transferring the union plan obligations would further transform GM's business footprint from pension investment manager to manufacturer, allowing it to get back to focusing on its core business.

CAN IT HAPPEN HERE?

Since the GM deal was announced, Sun Life has been receiving regular inquiries about whether a similar transaction can happen in Canada. We believe that many boards and management teams are asking the question, 'If pension de-risking makes sense for GM then is this something our company should do?'

Capacity in the Canadian market is large enough that pension risk transfer transactions in excess of $1 billion are possible now. It may take time for the market to digest large transactions, so there may be a first mover advantage for plan sponsors who are considering risk transfer transactions.

Though much of the discussion around the GM transaction has focused on jumbo deals, it's important to remember that pension plans of all sizes are causing considerable headaches for their employers.

We expect that the overall number of pension risk transfer transactions will increase as employers of all sizes begin de-risking their plans.

Each plan sponsor should evaluate their de-risking options based on their own situation and priorities. It's not a one-size-fits-all solution. Here are some steps that plan sponsors should be considering in light of the GM transaction:

STEPS TO CONSIDER

- **Contact your pension consultant** – De-risking best practices are evolving quickly and a consultant can assist in evaluating the wide range of solutions available.
- **Contact your investment banker** – One of the insights from the GM transactions is that pension plans should be evaluated within the broader corporate finance framework.
- **Understand the longevity particulars of your plan** – Each pension plan has its own characteristics that will impact the life expectancy of its members. Understanding these characteristics will help the plan sponsor better evaluate the costs and benefits of pension risk transfer solutions.
- **Get an illustrative quote** – Illustrative annuity and longevity insurance quotes from insurers are free and provide great information on the relative cost of pension risk transfer. They can also serve as an important benchmark when evaluating the relative merits of asset-only de-risking strategies.

The GM transaction has changed the pension risk transfer playing field and is generating global discussion as plan sponsors evaluate their pension plans within a broader corporate finance framework. The bottle of extra-strength Tylenol to cure plan sponsors' pension headaches may be a short reach away.

MARKET REACTION

Analyst reaction to the GM transaction has been very positive, despite the fact that GM's annual earnings will decrease by US$200 million because of smaller pension income. In the past, analysts routinely mentioned GM's pension challenges as being one of several factors restraining its stock price.

Investors also had a positive view, seeing the longer term benefits. GM shares rose six cents, or 0.3 per cent, to $22.26 on a day when the rest of the stock market was down more than two per cent.

The media are commenting that the GM deal could be the tip of the iceberg in the U.S. With S&P 500 companies facing combined pension obligations of US$1.7 trillion, according to Credit Suisse, and U.S. states and municipal governments also exposed to Defined Benefit schemes, some say that a tipping point may have been reached.

"As GM continues to fund and de-risk its pension, investors should develop increased confidence that incremental cash flows will accrue to them, and not the pension. As this happens, GM's multiple should expand."[3]

"Although there could be some negative perception in the market associated with the premium paid, as well as the one time EPS charge from settling the liability, investors, and rating agencies recognize the reduction in volatility achieved. Longer term, settling a material portion of the liability could lead to improved valuation and enhance the firm's flexibility for additional capital allocation investments outside the pension plan."[4]

[3] Source: Credit Suisse, Equity Research. June 4, 2012
[4] Source: 'Time for a Pension Paradigm Shift?' J.P. Morgan. September 2012

ABOUT THE AUTHOR

Brent Simmons leads Sun Life Financial's Defined Benefit Solutions business, providing a wide array of customized de-risking solutions for defined benefit pension plan sponsors.

Brent has been in the pension and insurance industry for 17 years, as a consultant, strategist and executive. His experience includes the design, pricing and governance of insurance and pension products, including buy-in and buy-out annuities, GMxB products, registered pension plans, executive pension plans and group RRSPs.

For more information about how annuities might help your pension plan, contact your pension or investment consultant. For more information about Sun Life Financial's de-risking solutions for defined benefit pension plans, please contact:

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