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White paper

Pension risk transfer: What you need to know

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Over the past decade or so, the number of PRTs undertaken by sponsors of defined benefit (DB) pension plans has grown at a significant rate. In fact, PRTs resulted in over $13.7 billion in sales of single premium group annuity contracts in the last quarter of 2020 alone, which was 21% more than the fourth quarter of 2019.[1] And despite a tumultuous 2020, 60% of insurance carriers reported year-over-year growth in the PRT market.[2] This growth has resulted in even more interest in these transactions, both by other plan sponsors as well as players in the financial services industry. In fact, one survey of DB plan sponsors revealed that 80% of them are "very or somewhat" interested in a PRT in the future.[3] These statistics are a promising sign, both for DB plan sponsors and group annuity providers, that more of these mutually beneficial transactions will increase in the marketplace.

But what exactly are PRTs? And why do they seem to be growing in popularity? This white paper will answer these questions and also provide insights on other factors to consider when contemplating whether a PRT is right for your plan and/or your clients.

What is a PRT?

The phrase, "it is what it is" is apt here, because a PRT, which stands for pension risk transfer, describes itself. It is a process by which the plan sponsor of a DB pension plan transfers its financial liability and risks to one of two parties:

1. to the participant through the payment of a lump sum amount that is actuarially equivalent to their accrued benefit in the DB plan; or
2. to an insurance company through the purchase of a group annuity contract.

It is common for DB plans to first offer a limited time lump-sum "window" to participants, before later choosing to transfer additional risk to an insurance company, because they may not yet be fully funded or able to afford the relatively higher costs of purchasing a group annuity contract. Today, when financial professionals and/or plan sponsors are determining whether to implement a PRT strategy, they are usually considering transfers of financial liability and risks to both parties.

Some people will also use the phrase "pension de-risking" when referring to PRTs. While this term is technically correct because the DB plans themselves are "de-risking," the risks themselves are not disappearing; they are transferred from the DB plan to another party (*i.e.*, to individual participants or to an insurance company). Hence, PRT is perhaps a more holistic phrase that captures the true relationship between all involved parties.

Why choose a PRT strategy?

It should come as no surprise that the decision to implement a PRT comes down to dollars and cents. Primarily, PRTs are a strategy to get significant long-term financial liability off a plan sponsor's books. It will also save the plan sponsor a significant amount of money over time by reducing, or totally removing, the recurring costs described below. As time has passed and more and more DB plans have become "frozen" to new participants or stopped the accrual of additional benefits altogether, it becomes harder to justify paying these costs for former employees who are long gone from the workplace and no longer help a plan sponsor's bottom line.

Administrative costs

The costs of administering a DB plan are relatively higher than those of a defined contribution (DC) plan. Plan administrators must calculate each participant's benefit based on the factors specified in the plan, which sometimes can be complex. For example, some larger DB plans may have more than one benefit formula, sometimes because other DB plans previously merged into the current plan; other times, a plan sponsor may have changed a plan's benefit formula in the past. In circumstances like those, some participants may have an accrued benefit under more than one formula. Keeping track of the necessary data and calculating those benefits gets complicated and can take time, and money.

Actuarial costs

Plan administrators also must rely on actuaries to calculate a plan's funding status to ensure it meets standards established by the Internal Revenue Service (IRS) in order to avoid benefit restrictions and other penalties. (See below for more details.) Actuarial calculations are complex because they are impacted by current interest rates, mortality tables issued by the IRS that change periodically, and other assumptions. Consequently, these calculations require a level of expertise that translates to higher recurring actuarial costs year after year.

Recordkeeping costs

DB plan recordkeepers generally charge more for their services than their DC plan counterparts. This is because most benefits accrued under a DB plan are not payable until the plan's normal retirement age, which may be many years after termination of employment. What's more, unlike DC plans that usually pay out benefits in a single lump-sum payment or single rollover to an IRA, DB plans generally pay retirement benefits to retirees on a monthly basis, requiring recordkeepers to repeatedly process payments to the same individual. This means that recordkeepers must keep track of all vested participants for extended periods of time to make sure they receive their promised monthly payments as well as legally required annual notices and statements. The digitalization of communication between recordkeepers and plan participants has also required upgrades to the technology and communication platforms of recordkeepers, which has further increased recordkeeping costs that are ultimately passed on to plan sponsors.

Compliance costs

Compliance costs for DB plans have also risen over the years, due to new legislation that changes how to calculate funding levels for a plan, the content and consistency of participant communication, and other disclosure requirements. The Pension Protection Act of 2006, and most recently, the American Rescue Plan of 2021, both made changes to the factors and processes used to determine a DB plan's funded status. The IRS and the U.S. Department of Labor (DOL) also promulgate other regulatory requirements to help employers implement those legal changes. Interpreting, implementing, and keeping up to date with these changes requires significant legal expertise, which adds further compliance costs for DB plan sponsors.

Funding requirements

Some of those legal changes and regulations that add compliance costs pertain to rules on how to calculate a DB plan's funded status. When a plan is not adequately funded per IRS minimum funding requirements, a DB plan will be subject to benefit restrictions such as (1) a prohibition on amendments that increase benefits, (2) a prohibition on accelerating payments (*e.g.*, offering a lump-sum window or adding a permanent lump sum option), or (3) requiring the cessation of future benefit accruals. In order to avoid those restrictions, plan sponsors must make minimum required contributions to the plan at least annually, and if there was a funding shortfall in the preceding year, quarterly.

Actuaries use multiple factors to calculate these minimum funding contributions. Two of those factors, interest rates and life expectancy, have been causing upward pressure on DB plans' minimum required contributions for years.

This is because actuaries determine minimum funding contributions by taking the present value of a plan's promised future benefits and comparing it against the actual assets held in the plan. Actuaries calculate that present value by discounting future payments using an assumed interest rate that is often referred to as the "discount rate," and which is tied to federal interest rates. When the discount rate is higher, the present value of future liabilities is lower; when the discount rate is lower, the present value of future liabilities is higher.

Likewise, thanks to improvements in healthcare, participants' life expectancy is increasing and consequently they are receiving their promised monthly plan benefits over a longer period of time, thereby also increasing future liabilities. It follows that during this extended historical period of relatively low interest rates and increased longevity, the present value of DB plan liabilities keeps rising, resulting in ever increasing minimum required contributions to keep the plan adequately funded.

PBGC premiums

Qualified DB plans that are subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA), must also pay annual premiums to the Pension Benefit Guaranty Corporation (PBGC), which is an independent federal agency. The PBGCs purpose is to act as a backstop for private sector DB plans that terminate without adequate assets to pay off their outstanding obligations. The PBGC insures (up to a certain maximum limit set by law) the vested benefits of over 34 million DB plan participants of ERISA-governed qualified DB plans.[4]

The PBGC premiums are set by Congress. The per-participant flat rate premium in 2021 is $86.[5] In 2007 the rate was $31 per participant, close to a threefold increase in under 15 years.[6] DB plans that are underfunded must pay an additional variable rate premium as well, which is calculated based on the amount of underfunding. More specifically, the plan sponsor must pay $46 for every $1,000 of the plan's unfunded vested benefits.[7] The current variable premium rate is more than five times the rate in 2007, which was only nine dollars![8]

The plan year in which a vested benefit is transferred to an individual participant or insurer will be the last plan year for which a plan sponsor will be responsible for PBGC premiums attributable to that participant and their benefit. Thus, most plans look to complete PRTs near the end of a plan year, which usually also corresponds to the end of the calendar year.

How are PRTs implemented?

A PRT is completed through a series of transactions involving, at a minimum, the plan sponsor and an insurer (*i.e.*, group annuity provider). Some combination of other third parties, such as actuaries, attorneys, recordkeepers, consultants, *etc*., are also involved, depending on the size, type, and complexity of the plan and PRT. The process for completing a PRT is also subject to detailed rules and regulations from the DOL, IRS, and PBGC.

The specific parties, process, and rules applicable to a particular PRT depend on the type of transfer taking place. PRTs fall within one of two main categories: buyouts or buy-ins. The vast majority of PRTs in the United States are buyouts, and within this category there are a number of different sub-types. Buy-ins are much less common. The process and parties involved in each type of buyout, as well as the buy-in, are described below.

Lump-sum participant buyout

The simplest type of buyout is perhaps when a DB plan sponsor offers a short-term "window" to a select group of participants that allows them to elect to take a single lump sum amount that is actuarially equivalent to their respective single life annuity benefit under the DB plan. To complete these lump sum windows, plan sponsors need to work with their legal compliance team to amend the plan to permit these forms of payment and work with actuaries to calculate the exact amount of the lump sum for each participant that elects it. The plan sponsor will also have to work with the appropriate parties (*i.e.*, legal, HR, plan administrator, *etc*.) to draft participant communications, election forms, and any other legally required disclosures that explain the lump sum opportunity and election process to all eligible participants. Lump sum windows often precede other types of PRTs, which are discussed in more detail below.

Lift-outs

Another type of buyout is known as a "lift-out." Like lump sum payment windows offered directly to participants, this process is relatively quick to execute and can be completed in as little as three to four months. In a lift-out, plan sponsors work with pension consultants or other experts to identify a subset of their plan population, whose promised benefits (and the financial liability attributable to those benefits) are transferred to a private insurer. Usually, this subset will include retirees whose total vested benefits fall under a maximum threshold or within a specific range. The cost of this transfer will be set by the insurer after receiving appropriate demographic and benefit information from the plan sponsor about the group and the liability that it is taking on. Once a lift-out occurs, the insurer becomes responsible for the ongoing administration of those participants' promised benefits from the plan.

Both lump sum windows and lift-outs are a common approach for DB plans that are not fully funded or if a plan sponsor is not in a financial position to fund a full plan termination in the immediate future. In addition, both lump sum windows and lift-outs are beneficial because they reduce the costs and liabilities associated with the subset of participants whose benefits are transferred, such as PBGC premiums and administrative charges. Lump sum windows and lift-outs are often the early steps taken on a longer-term PRT strategy and will often take place a few years before a plan termination.

Plan terminations

The most complex type of DB plan buyout is a plan termination. Plan terminations take more time (usually 12-18 months or more) to complete, because there are so many steps involved and rules to follow. First, the plan will have to be amended to (1) establish a plan termination date, (2) update the plan for all law changes and plan qualification requirements effective on the plan's termination date, (3) cease all plan contributions, and (4) authorize the distribution of all benefits in accordance with plan terms as soon as administratively possible after the termination date.[9] In addition, the plan must also notify all participants and beneficiaries about the plan termination, pay any outstanding required contributions to the plan, and file a final Form 5500 return with the DOL.[10]

Aside from the plan document changes and participant communications that must be drafted as part of a plan termination, there will also be required filings with both the PBGC and IRS. The PBGC requires the plan sponsor to file a PBGC Form 500 as well as issue a Notice of Intent to Terminate, then a Notice of Plan Benefits, and finally a Notice of Annuity Contract to all applicable impacted parties (participants, beneficiaries, alternate payees, union leadership) at various points in the termination process.[11] The IRS also requires additional items be filed with it when a DB plan terminates, which include a Form 6088 (Distributable Benefits from Employee Pension Benefit Plans), a signed and dated actuary's certification for the last two years of the plan, and a Schedule SB to the Form 5500 for the last two years (and for any other year in which plan funding was below 80% of the AFTAP, or "adjusted funding target percentage").[12]

Finally, although not legally required to do so, some plan sponsors may also want to file a determination letter application with the IRS as part of a plan termination. Having a favorable determination letter provides plan sponsors with an assurance from the IRS that the plan is qualified under Section 401(a) of the Internal Revenue Code (IRC) and the plan's trust is exempt from taxation under IRC Section 501(a).[13] Depending on a number of factors including the age, size, and complexity of the DB plan, this may be a good idea. If the DB plan is on a pre-approved Master and Prototype or Volume Submitter plan, a determination letter may not be necessary; but if the DB plan is an individually designed plan or has other complex plan design features like multiple benefit formulas or multiple merged plans, then a determination letter may be recommended by legal counsel.

Once a termination is complete, the plan no longer exists. All plan assets and liabilities will have been transferred to an insurer, who becomes solely responsible for ongoing administration and benefits for all plan participants. With a plan termination, not only are all investment and mortality risks permanently transferred to an insurance company, but the plan sponsor is no longer responsible for PBGC premiums or any other administrative expenses for the plan.

Buy-ins

As an alternative to the various types of DB plan buyout structures described above, plan sponsors may consider a plan "buy-in." In this situation, the DB plan sponsor purchases a contract from an insurer to cover the benefits promised to a select group of participants but retains administrative responsibility for them. With a buy-in, the DB plan sponsor transfers only investment risk and mortality risk to an insurance company. In other words, the insurance company assumes responsibility for providing the funds necessary to pay all future benefits due under the plan attributable to the covered participants.

One drawback of a buy-in is that the plan sponsor is still responsible for all other functions and costs of the DB plan, such as sending the monthly annuity payments, paying PBGC premiums, and covering all other expenses. That is why buy-ins are much less common than the various forms of buyouts.

Other considerations

Based on the financial considerations described earlier, it is clear why PRTs are becoming more and more common. As plan sponsors take those next steps to plan a PRT strategy that works for them, it is also important to consider the following other factors.

Fiduciary obligations

For those plan sponsors who choose to transfer some or all of their DB plan liability and risk to an insurer through the purchase of a group annuity contract, there is specific criteria laid out by the DOL that plan fiduciaries must weigh when evaluating responses to their Request(s) for Proposal(s) (RFPs). That criteria includes:

1. the quality and diversification of the insurer's investment portfolio;
2. the size of the insurer relative to the proposed group annuity contract;
3. the level of the insurer's capital and surplus;
4. the insurer's lines of business and other indications of their exposure to liability;
5. the structure of the group annuity contract and guarantees supporting the annuities (such as the use of separate accounts); and
6. the availability of additional protection through state guaranty associations and the extent of their guarantees.[14]

In most cases, plan fiduciaries will lack the required level of expertise to evaluate these factors, and will need to seek advice from a qualified, independent expert.[15] After weighing this criteria, it is possible that a plan fiduciary may find more than one appropriate group annuity provider.[16] In this circumstance, plan fiduciaries are also permitted to consider which one may be able to best administer payments to participants; the lowest bid may not always be the best.[17]

Timing

As described earlier, different types of PRTs take different amounts of time to complete. Particularly in the case of a plan termination, timing is important, because many plan terminations are timed to coincide with the last day of a plan year, which is often December 31st. This is one reason that some insurers may have limited capacity to respond to every RFP that comes in the last quarter of a calendar year. If insurers do find themselves overwhelmed with RFPs at the end of a year, they will prioritize their responses based on which ones most closely align with their target market.

Also, in the case of a termination, all involved parties need to plan ahead to make sure the various filings with the IRS, PBGC, and DOL are completed by the appropriate due date and that impacted participants receive the required notices/disclosures to which they are entitled in a timely manner. Regardless of the type of PRT contemplated, some level of planning and preparatory work will need to be completed.

Data

The accuracy and completeness of plan data is critical when purchasing a group annuity contract as part of a PRT, because insurers who respond to an RFP will want the most accurate and robust set of data available to accurately price their bid. This data should include not only information about participants (*e.g.*, age, address, form of payment elected), but it should also include pertinent information about designated beneficiaries and any form of death benefit elected.

Also, it is important to note that this data needs to be in electronic form. Although some plan administrators may still refer to paper benefit election forms, particularly when trying to determine what type of survivor benefit is to be paid to whom, insurers no longer accept such non-electronic records. Therefore, having human resources and the plan administrator complete a data clean-up project or other similar endeavor is a good idea in the months leading up to a PRT.

Price

Be aware that insurers use factors and interest rate assumptions that are different from what the IRS requires plan sponsors to use to determine a plan's funded status and to determine lump-sum equivalents of a single life annuity. The amount of money needed to be in the plan's trust to be considered fully funded by the IRS may still be quite different from the cost to provide a group annuity contract that funds the same benefits.

The plan's census data is an important factor that impacts the price of a group annuity contract. Insurers will look at a plan's mortality experience data, as well as participants' ages and geographic location, specifically the zip codes in which they live and work, in order to project the mortality/longevity of the plans remaining participants. Because many plans offer a lump-sum window to some participants before a lift-out or plan termination, it often creates an anti-selection problem. Those participants in poorer health are more likely to elect the lump sum, leaving healthier participants who are more likely to live longer in the plan. This, and other factors reflected in the census data, can increase the cost of providing a group annuity contract.

Borrowing

It may also make sense in certain circumstances for the plan sponsor to borrow money to finance a PRT. Borrowing money when interest rates are low may benefit the plan sponsor by removing a long-term financial liability from its balance sheet while also reducing or eliminating costs and expenses that detract from a company's bottom line.

Plan provisions

Certain plan provisions may be difficult for some insurers to administer - if a plan has multiple forms of payment, for example, or regular cost of living adjustments. A plan's provisions will impact pricing as well as which insurers respond to an RFP, because some may not be capable of administering the plan's particular forms of payment.

Partners

PRTs are complex transactions with a lot of factors to consider and they require a lot of advanced planning. It is critical for a plan sponsor to work with an experienced pension consultant or other knowledgeable and competent professional to plan such a project and get it over the finish line. In most cases, a pension consultant or other similar professional firm will help guide plan sponsors through this process and identify the most appropriate insurers to approach for an RFP for a group annuity contract based on the demographic and other data of the particular plan. Nationwide is happy to work with and respond to RFPs from any such pension consultant to help plan sponsors transfer their pension liabilities as well as help plan participants continue receiving their retirement benefits as originally promised.

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[1] https://www.limra.com/en/newsroom/news-releases/2021/secure-retirement-institute-fourth-quarter-u.s.-single-premium-pension-buy-out-sales-jump-21/.
[2] *Id.*
[3] https://www.lifehealth.com/whats-next-pension-risk-transfer-market/.
[4] https://www.pbgc.gov/about/how-pbgc-operates#:~:text=The%20Pension%20Benefit%20Guaranty%20Corporation,are%20operated%20and%20financed%20separately.
[5] https://www.pbgc.gov/prac/prem/premium-rates.
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[14] DOL Interpretive Bulletin 95-1.
[15] *Id.*
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[17] *Id.*