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Pension risk transfer: What you need to know

George W. Schein, JD, ChFC
Technical Director, Advanced Consulting Group

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Summary

Today, very few employers continue to provide their employees defined benefit (DB) pension plans. Instead, defined contribution plans, such as 401(k)s, are their top choice. But what happens to existing DB plans previously offered by employers?

Plan sponsors can pursue a pension risk transfer (PRT). PRTs reduce, or potentially totally remove, the ongoing financial responsibility and risk DB plans expose to an employer's bottom line by the purchase of a group annuity, which transfers that financial risk to the insurance company. Learn more about PRTs, what makes them appealing, as well as PRT options and items plan sponsors need to consider.

Key highlights

The basics
Definition of pension risk transfer (PRT) and identification of participating parties.

The appeal of a PRT strategy
A PRT strategy is attractive because it removes significant long-term financial liability from plan sponsor books while reducing or eliminating recurring costs.

PRT implementation
Implementing a PRT strategy requires a number of steps from numerous parties. Preparation and teamwork is key.

Other considerations
Once the decision is made to pursue a PRT strategy, there are important factors to consider including fiduciary obligations, timing, plan provisions and partners.

Have you noticed that PRTs are on the rise?

Over the past decade or so, the number of PRTs undertaken by sponsors of DB pension plans has grown significantly.

In fact, despite a tumultuous 2020, 60% of insurance carriers reported year-over-year growth in the PRT market.[1]

This growth has resulted in even more interest in these transactions. These are promising signs that sponsors will increasingly opt for these transactions.

Join Nationwide as we explain PRTs, explore their recent growth in popularity and other factors you should consider when contemplating whether a PRT is right for your plan and/or your clients.

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/

The basics

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Simply put, PRT is a process by which the plan sponsor of a DB pension plan transfers its financial liability and risks to one of two parties:

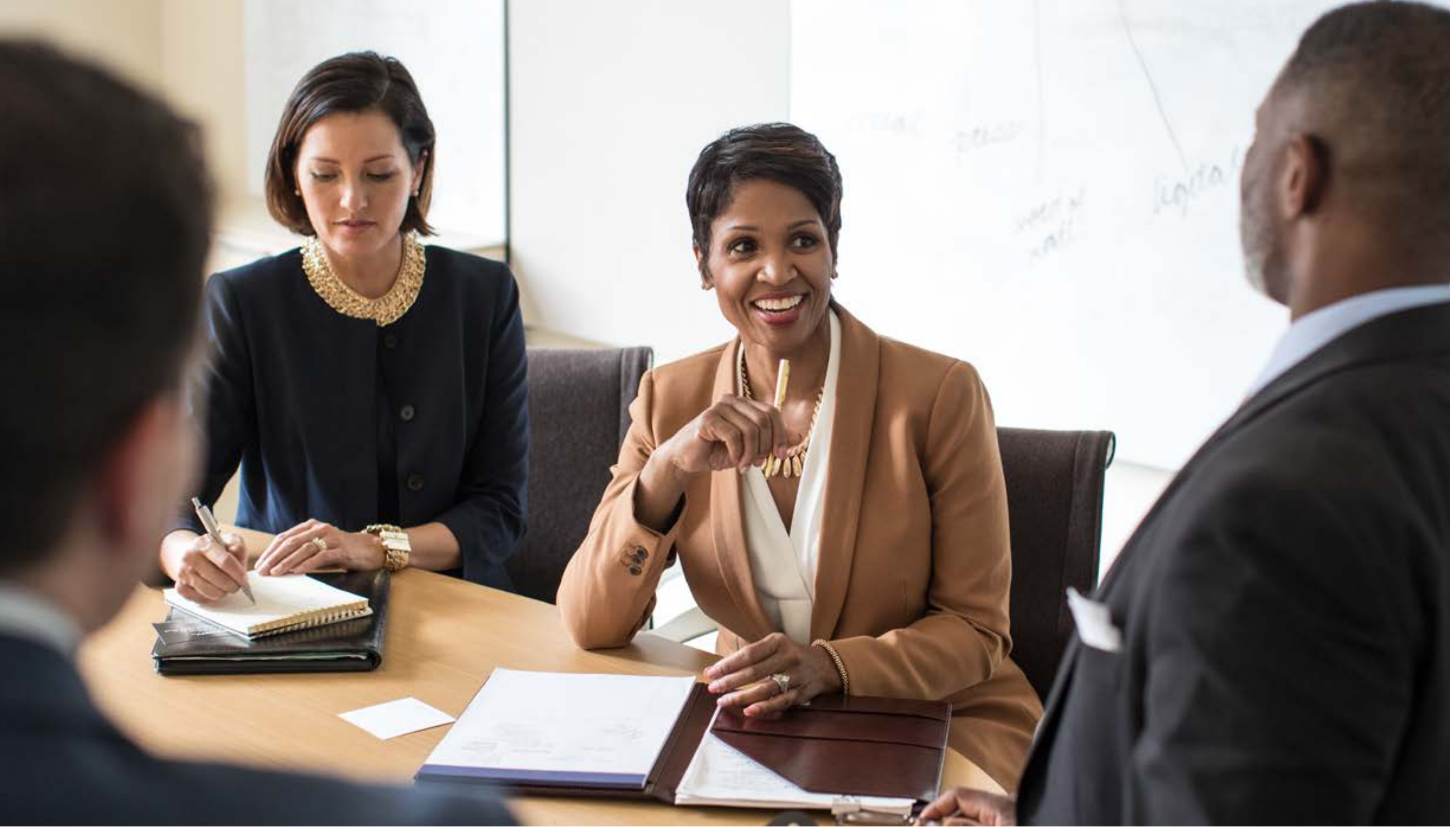
To the participant

Through the payment of a lump sum amount that is actuarially equivalent to their accrued benefit in the DB plan.

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. The current financial health of both plan sponsors and insurance providers are of critical importance when determining whether and how to implement a PRT strategy.



The appeal of a PRT strategy

Primarily, PRTs are a strategy to take 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:

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 can sometimes be complex.

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.

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.

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.

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 the average person's increased life expectancy, have been causing upward pressure on DB plans' minimum required contributions for years.

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 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.[2]

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.

2 https://www.pbgc.gov/about/how-pbgc-operates#:~:text=The%20Pension%20Benefit%20Guaranty%20Corporation,are%20operated%20and%20financed%20separately.

PRT options

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.

Buyouts:

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. 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.

Both lump sum windows and lift-outs are a common approach for DB plans that are not fully funded or plan sponsors that are 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.

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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. 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.[3] In addition, the plan sponsor 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.[4]

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. 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.

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.

3 https://www.irs.gov/retirement-plans/terminating-a-retirement-plan.
4 *Id.*

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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 factors:

Fiduciary obligations

For 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)
6. The availability of additional protection through state guaranty associations and the extent of their guarantees[5]

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.[6] After weighing this criteria, it is possible that a plan fiduciary may find more than one appropriate group annuity provider.[7] 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.[8]

5 DOL Interpretive Bulletin 95-1.
6 *Id.*
7 *Id.*
8 *Id.*

Timing
As described earlier, different types of PRTs take different amounts of time to complete. Timing is important in the case of a plan termination 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.

Also, in the case of a termination, all involved parties need 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, but it should also include pertinent information about designated beneficiaries and any form of death benefit elected. Additionally, insurers no longer accept non-electronic records, so it is critical that all data is in an electronic form.

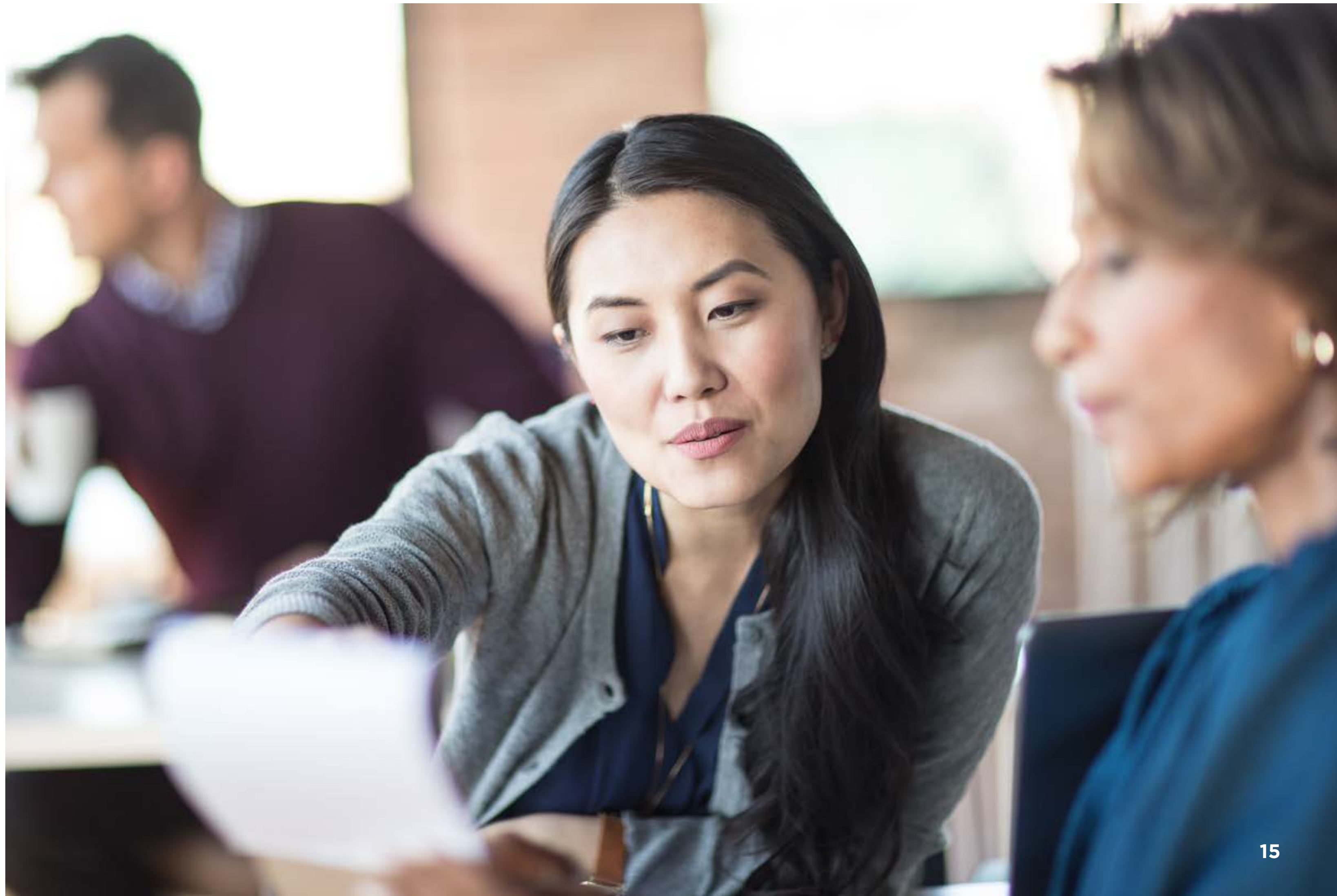
Price
Be aware that insurers use factors and interest rate assumptions that are different from what the IRS requires plan sponsors to use to determine a plan's funded status and to determine lump-sum equivalents of a single life annuity. The amount of money needed to be in the plan's trust to be considered 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. 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 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.



Conclusion

The transfer of pension liabilities ensures that plan sponsors can better manage their core business financials once the transfer is complete and risk is removed, while providing continuity to retirees receiving benefits.

After exploring what you need to know about PRTs, questions to ask yourself as you move forward with the process include:

- What partners will be a part of your process (i.e., recordkeepers, actuaries, legal counsel)?
- What strategy is right for you — a buy out or a buy-in?
- How will you gather, organize and analyze data?
- If you do not choose a lump-sum participant buyout, which annuity provider will you choose?
- How will you communicate with partners and plan participants?

To learn more about pension risk transfer and the advantages of working with a strong and stable company like Nationwide, please visit www.nationwide.com/pensiontransfer

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