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Pension Risk Transfer as a Team Sport: Preparing for the Game in Six Simple Steps

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Summary

How do you prepare for a pension risk transfer (PRT)?

Plan sponsors of defined benefit (DB) pension plans who look to transfer financial liability and risks to others through a PRT process often have trouble knowing where to begin.

- Who needs to be involved?
- How long does the PRT process take?
- To whom should the risks be transferred?

All of these are examples of essential questions that can overwhelm plan sponsors.

Introduction

A PRT is a complex series of transactions through which plan sponsors of DB pension plans transfer financial liability and risks to others. To help understand this financial transaction, consider a PRT as a team sport.

Like any team sport, in PRTs there are a number of players involved and strategies to consider. As any competitor can attest, in order to be successful, preparation is key. With that in mind, here is a winning playbook to help lead plan sponsors to a PRT victory.

Step One:

Assemble a Winning PRT Team

Like other team sports, in a PRT there are a number of different positions and roles to play, each of which is necessary to ensure success. The most critical role on any team is that of the coach. In this analogy, the PRT coach is the experienced retirement plan consultant who coordinates and drives the work of all other teammates on the PRT team. The PRT team is then filled by other individual players, who include:

Plan Sponsors

Members of the plan sponsor's finance and human resources departments, who work with the other teammates to communicate financial and business objectives and transfer data, as well as help with messaging to all plan participants;

Actuaries

Calculate the financial contributions required to ensure adequate funding for the future benefits promised to plan participants and keep track of the DB plan's ongoing funded status per IRS regulations;

Legal Counsel

Draft amendments to plan documents specifying the actions taken by the DB plan to transfer risk, draft legally required employee communications that explain those same actions, and complete governmental and regulatory filings pertaining to PRTs; and

Recordkeepers & Plan Administrators

Handle the day to day work involved with administering a DB plan.

Once a PRT team is in place, they all work together towards the goal of transferring risk away from the plan sponsor.

Step Two:

Choose a Game Strategy

In sports no two games are exactly the same. Similarly, PRTs are unique and require individualized plays. A number of factors will influence the game-time strategy, including the DB plan's benefit formula(s), participant demographics, number of active participants accruing benefits versus those who are deferred-vested or in-pay status, level of funding, and whether or not the plan is already frozen (i.e., closed to new participants and/or participants no longer accrue additional benefits).

Once all appropriate factors are considered, the PRT team will need to decide on the best PRT game-plan to follow:

Lump Sum Window

The PRT team may decide to initially start off with a small and simple "play" - by offering a "lump-sum window" to a subset of participants. Lump-sum windows are a short-term period of time, typically 30-90 days, where a select group of participants will be offered the chance to elect to take a single lump-sum amount that is actuarially equivalent to their respective single life annuity benefit under the DB plan. In this situation, the risk is transferred to the participants electing the lump sum.

Lift-Out

The PRT team may also decide to call for a "lift-out." Like lump-sum windows, a lift-out is a relatively quick play to execute and can be completed in as little as three to four months. In a lift-out, the PRT team will identify a subset of plan participants whose promised benefits, and the financial liability attributable to those benefits, are transferred to a private insurer via the purchase of a group annuity contract that covers the identified plan participants.

Both lump-sum windows and lift-outs are common strategies for DB plans that are not fully funded. 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 Pension Benefit Guaranty Corporation ("PBGC") premiums and administrative fees. A lift-out, or series of lift-out transactions, may be used as part of a longer-term strategy culminating in an eventual full plan termination.

Buy-In

Another possible "play" is called a "buy-in." This is an alternative to, and utilized much less often than, the lump-sum window or lift-out described above. This alternative PRT strategy calls for the DB plan sponsor to purchase a contract from an insurer to cover the benefits promised to a select group of participants. Unlike the strategies above, with a buy-in the plan sponsor retains administrative responsibility for paying plan benefits because they transfer only investment risk and mortality risk to an insurance company. This means the plan will retain the responsibility of paying PBGC premiums and monthly payments. However, it will be the insurance company that assumes responsibility for providing the funds to the DB plan that are necessary to pay the future benefits attributable to participants covered by the buy-in.

Plan Termination

The most aggressive strategy in the PRT playbook is a full DB plan termination. Plan terminations require the most resources, both in terms of time and money. The plan will have to be fully funded and the termination process will take over a year to complete. In a plan termination, a DB plan's entire liability will be transferred to another party via the purchase of a group annuity contract covering all remaining participants. At such time, the plan will cease to exist.

3 Step Three: Analyze and Adjust Plan Assets

Once the game strategy is determined, the recordkeeper, actuary, and the plan sponsor's finance department will need to analyze the current plan's assets and liabilities as well as the general finances of the company. There are a number of issues to think through during this analysis.

1. **Does the plan sponsor have adequate funds and cash flow to finance the preferred PRT strategy, or does the DB plan itself have adequate funds to support the chosen game plan?**

2. **What impact will the PRT have on the plan sponsors long-term financial liabilities and remaining DB plan's funded status?**

Once an appropriate strategy is selected, the plan sponsor may need time to make adjustments to the DB plan's investments to ensure enough liquidity of plan assets exists to transfer large sums of cash to individual participants (via lump-sum payments) and/or to transfer cash or in-kind assets to insurers (via the purchase of a group annuity). Insurers determine the price of their group annuity offerings by taking into account the type and quality of the DB plan's asset and often prefer working with liquid assets, such as Treasurys, corporate bonds, and/or cash, as opposed to other more complex financial instruments. This is another reason the plan sponsor and its finance department may want to adjust the plan's investments before issuing a Request for Proposal (a "RFP") to potential insurers. Finally, if the DB plan will continue after a PRT transaction, the plan's investments will need to be rebalanced as appropriate to fund the benefits of the plan's remaining participants.

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Step Four: Gather Data

Collecting plan and participant data for a PRT can be likened to keeping track of game-day stats to prepare for the next game. This task falls largely on the recordkeeper, plan administrator, and/or the plan sponsor's human resources department. Insurers who respond to a RFP for a group annuity need the most accurate and robust participant data available to accurately price their product, as well as to eventually administer the benefit payments accrued under the plan. This data should include not only information about participants (e.g., age, address, form of payment elected), but also pertinent information about designated beneficiaries and any form of death benefit elected. This is because insurers need to understand the life expectancy of the people whose benefits they will be covering, which is impacted by gender, the type of work they did, where they live, and so on.

Once the data is collected, it will need to be converted to an all-electronic form. Although some recordkeepers, plan administrators, and HR professionals 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, the appropriate team members may need to complete a data collection and clean-up project as part of the PRT game-time preparation.

5 Step Five:

Choose an Annuity Provider

Aside from lump-sum windows, all PRT strategies will include issuing an RFP to insurers to find the best group annuity contract to purchase with the DB plan's assets. At this point of the PRT game, think of the Department of Labor (DOL) as your referee who sets out the rules to follow. The DOL has laid out very specific criteria for the PRT team to weigh when evaluating insurer responses to their RFPs, including:

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[1]

After evaluating each potential insurer's RFP response against this criteria, it is possible that more than one competent group annuity provider may be identified.[2] In this circumstance, the team may also consider which one may be able to best administer benefits to participants; the lowest bid may not always be the best.[3]

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[1] DOL Interpretive Bulletin 95-1.
[2] Id.
[3] Id.

6 Step Six:
Communicate

A PRT team must clearly communicate with one another while simultaneously explaining necessary information to DB plan participants. This is a two-fold approach; meaning both internal and external.

Internally, all PRT team members need to communicate with each other in a timely and concise manner to ensure their responsibilities are met and to draft and distribute external communications. This is even more critical to ensure that all necessary governmental filings, as well as all legally required participant notices, contain correct and accurate information.

Externally, the plan sponsor, with help from their legal counsel, and perhaps also the plan administrator and recordkeeper, will need to draft communications meant for plan participants and other interested parties. Depending on the specific PRT game strategy, certain communications will be legally required to contain specific content and be distributed by specific deadlines. Plan participants and beneficiaries whose benefits will be impacted must be informed of their potential pay-out options, or whether their benefits will be transferred to an insurer. If their benefits will be transferred to an insurer, the communications must identify the selected insurer and establish a timeline for the transition.

Aside from specific legal requirements, it is a best practice to keep all plan participants and their designated beneficiaries, as well as all other employees, well informed during a PRT process. This will help make all impacted individuals feel more comfortable and secure with the transfer of their retirement benefit to a third party with whom they have no current or former employment relationship. Such well-crafted communications will ultimately reduce call volume and email inquiries to human resources from concerned employees and retirees, as well as potentially prevent bad publicity for the plan sponsor.

Post Game Wrap-Up

PRT transactions require a number of different individuals coming together as a “team” to achieve the common goal of offloading risk from a DB plan sponsor to another party. In order to be successful in that endeavor, just like with any other team sport, each individual player needs to understand and execute their role while simultaneously working together with others. Doing so will help achieve a “win” for the long-term financial health of the plan sponsor.

To learn more about pension risk transfer and how to build a winning PRT team, please visit www.nationwide.com/pensiontransfer.

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