An introduction to pension risk transfers

By Brian Barrett, Cynthia Shoss, Allison Wielobob, and Joshua Borden

Pension plan providers are increasingly focused on de-risking, or transferring risk from, defined benefit plans. It has quickly become a topic pension plan providers are discussing nationwide.

One element that has fueled this increased focus on de-risking is the rising cost of Pension Benefit Guaranty Corporation (PBGC) premiums. These rising premiums are making it more burdensome than ever for companies to continue with the status quo of managing their pension plans. The higher the PBGC premiums rise, the greater the potential for a pension lift-out or buyout to result in cost savings for the plan sponsor. This is especially true with respect to those retirees in pay-status that are receiving smaller pension payments, because the PBGC premiums may be a large percentage of the total pension payments made to these retirees. Pursuant to the Bipartisan Budget Act of 2015, the PBGC’s flat-rate premium increases each year until 2019, when it will reach $80 per person, and thereafter will be indexed for inflation. On top of this flat-rate premium, sponsors of single-employer plans are required to pay a variable-rate premium that is based on the plan’s unfunded vested benefits – the amount of potential liability the plan creates for the PBGC. For 2018, the variable-rate premium for single-employer plans is 3.8% per $1,000 of unfunded vested benefits (and is capped at $523 per participant). This amounts to $38 per $1,000 of underfunding, subject to the cap. Depending on the number of participants in a plan and the extent of any underfunding, premium costs may be considerable.

Another element leading to the recent emphasis on de-risking is a plan sponsor’s desire to mitigate the possibility of it needing to make subsequent contributions to the plan, e.g., in the event of a decrease in the value of the plan’s assets or retirees living longer than expected. Plan sponsors are instead opting to transfer these risks to annuity providers that specialize in investment and longevity risk.
In the event a plan sponsor determines to de-risk, several options are available, including (i) paying lump sums to pension plan participants, (ii) plan termination, and/or (iii) purchasing an annuity contract. The most common option in the United States is for plan sponsors to purchase a group annuity contract as part of a lift-out, where the plan sponsor fully transfers its obligation to make pension payments to the annuity provider. This article will focus on lift-outs and the elements that any plan sponsor needs to be aware of before traveling down this potentially necessary path.

A lift-out transaction involves a subset of participants under a defined benefit plan. This subset may consist of retirees in pay status, or may also include terminated vested participants.

Selecting an annuity provider

A plan sponsor begins the lift-out process by issuing a Request for Proposal (RFP) requesting price estimates and proposed terms from potential insurers. The RFP includes the census data of the relevant plan participant group. Additionally, the RFP includes terms that the plan sponsor deems necessary to the successful completion of the transaction, whether that be specific dates (such as a mortality assumption date), specific forms of annuities to be issued to the plan participants, or specific provisions to be included in the group annuity contract.

Upon receipt of the insurance company proposals, the plan sponsor endeavors to select an annuity provider. Fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA) apply to this choice. Under ERISA, plan fiduciaries are required to act prudently and without conflicts of interest.

By this standard, plan fiduciaries selecting an annuity provider are held to a prudent expert standard and must follow a prudent selection process. If the fiduciary does not have the necessary expertise to evaluate the factors that are relevant to this process, the fiduciary will seek the advice of a qualified, independent expert. The independent fiduciary must be fully discretionary, an expert, and a co-decision maker with the plan fiduciary.

The US Department of Labor, the federal agency charged with administering ERISA, issued guidance on the annuity provider selection process in response to the well-publicized failures of major insurers such as Executive Life and Mutual Benefit in the early 1990s. In those cases, retirement plans had purchased contracts from insurance carriers whose ability to satisfy their annuity liabilities was in question. Interpretive Bulletin 95-1 (IB 95-1) provides guidelines for annuity provider selection by ERISA plan fiduciaries and sets forth multiple factors to consider in selecting the “safest available annuity.” Under this standard, ERISA plan fiduciaries are required to take steps calculated to obtain the safest annuity available unless it would be in the interests of participants to do otherwise. Fiduciaries may find, and the guidance anticipates, that more than one annuity provider is able to offer the “safest available annuity.”

Negotiating the purchase agreement and group annuity contract

In connection with the selection of the annuity provider, the commitment agreement and the group annuity contract are negotiated and finalized. These documents provide that the insurer irrevocably commits to make payments to the applicable plan participants, who are now annuitants under the group annuity contract. The forms of annuity (i.e., Life Annuity, Life and Period Certain Annuity, Joint and Survivor Life Annuity, etc.) are drafted in order to track the benefits paid to participants under the defined benefit plan. It is vital that the payments to annuitants under the group annuity contract mirror the payments they would have received under the defined benefit plan.

Often, a plan sponsor desires for the lift-out to fully relieve it of any and all obligations with respect to the plan participants included in the transaction. Accordingly, a plan sponsor may wish to have no rights or obligations under the group annuity contract following the issuance of the group annuity contract (or the date thereafter as of which the parties have agreed on the data regarding payees under the contract). This is often referred to as a data finalization date. The group annuity contract might provide that the plan sponsor will not have any enforcement rights following that date. Instead, third-party beneficiary rights are given to the payees under the group annuity contract and, after the data finalization date, these payees will be solely responsible for enforcing the terms of the group annuity contract.

Some plan sponsors, however, want to provide a mechanism for correcting data misstatements at any time. In these contracts, the premium amount would be adjusted to the amount that would have been due if the correct data had been used at the time of purchase. Following the adjustment to the premium, the annuity payments to the applicable payee are adjusted accordingly.

Administrative transition and premium adjustments

It is essential that an annuity provider plan for the administration of the group annuity contract, and there is generally an administrative transition period during which the administration will be transferred from the defined benefit plan’s administrator to the insurer’s administrator. This process must be built out in the commitment agreement.

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Additionally, the census data on which the initial premium amount is based will be included in the exhibits to the group annuity contract. This data will continue to be updated following the effective date of the group annuity contract. Accordingly, there will be subsequent adjustments to the purchase price. These contribution adjustment amounts may be either positive or negative. In the event of a positive amount, the contract-holder is required to make an additional premium payment to the insurer of such amount. In the event of a negative amount, the insurer is required to refund the contract-holder such portion of premium paid by the contract-holder.

**Annuity certificates**

The annuity provider will be required to distribute annuity certificates to the annuitants (and contingent annuitants, where applicable). Although not a contract itself, the annuity certificates summarize the applicable terms of the group annuity contract. Some, but not all, states require insurance department approval of the annuity certificate prior to issuance.

**Looking forward**

We expect plan sponsors to continue to seek out transactions by which they de-risk. As these deals occur more frequently, we also expect that plan sponsors will seek out contracts with terms specialized to address their unique issues and concerns. For example, the need for a seamless transfer of administration is likely to be a matter of increasing importance that is built into the group annuity contract and/or the purchase agreement. Annuity providers will also likely compete over issues such as data security and customer privacy. Ultimately, as the marketplace becomes more sophisticated regarding these transactions, plan sponsors may be making increasing demands on annuity providers prior to purchasing group annuity contracts.

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