Pension De-Risking

ULA ADVANCED ERISA SEMINAR

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Agenda

- WHAT IS A PENSION RISK TRANSFER?
- DOL INTERPRETIVE BULLETIN 95-1
- CASE STUDY ON PENSION RISK TRANSFER

De-Risking a Pension Plan

- Restrict plan participation
- Restrict benefit accruals
- De-risk plan investments
  - Asset allocation changes to reduce exposure to volatility (ex., reduce equity)
  - Cash-match portfolio (bond portfolio designed to cover benefit payments for a set period (ex., 3-7 years)
- Lump sum payouts to participants
- Pension Risk Transfer

What is a pension risk transfer?

- Buy-Out
  - Insurer makes guaranteed payments directly to participants
  - Irrevocable
  - Participants are no longer participants of the plan following PRT
- Buy-In
  - Insurer makes guaranteed payments to plan; plan continues to make payments directly to participants
  - Revocable and convertible to a buy-out at any time
  - Plan retains participants
- Under both a buy-out or a buy-in the insurer will cover the investment and longevity risk. Today we are focusing on **<u>buy-out</u>** pension risk transfers.

Why engage in a pension risk transfer?

- Under a buy-out PRT, de-risking occurs because:
  - Overall plan size is reduced – reduction in PBGC premiums and administrative expenses
  - Benefit liability is removed
  - Plan may be able to reduce risk due to reduced overall benefit obligation for remaining participants
  - Plan may be able to change asset allocation strategy based on change in liabilities

Pension Risk Transfer: Before and After

- After a PRT, there are key changes relevant to plan participants:

	Before PRT	**After PRT**
Regulatory Oversight	DOL/PBGC	State insurance regulators
Fiduciary	Board of Trustees	Not applicable
Benefit Guarantee	PBGC	State Guaranty Associations
Benefit Structure	Described in Plan Document	Described in GAC (intended to mirror benefits under Plan Document)
Funding Level	Plan can be less than 100% funded	Required to be overfunded; assets must be greater than reserves at all times

Selecting an Insurer

- Once a decision has been made to engage in a PRT, a plan must solicit quotes from an insurer and then make a selection.
- Selection of an insurer is a fiduciary decision governed by the DOL's guidance in Interpretive Bulletin 95-1.
  - Issued in 1995 amid concerns about the ability of insurers to pay claims after high-profile failure of Executive Life Insurance impacted 44,000 retirees.
- IB 95-1 provides that plan fiduciaries must select the "safest annuity available unless, under the circumstances, it would be in the interest of the participants and beneficiaries to do otherwise."

IB 95-1

- IB 95-1 specifies 6 factors that fiduciaries must consider in evaluating the insurer's claims-paying ability and creditworthiness.
- In IB 95-1, DOL states that in completing this evaluation a fiduciary must consider:
  1. The quality and diversification of the annuity provider's investment portfolio;
  2. The size of the insurer relative to the proposed contract;
  3. The level of the insurer's capital and surplus;
  4. The lines of business of the annuity provider and other indications of an insurer's exposure to liability;
  5. The structure of the annuity contract and guarantees supporting the annuities such as the use of separate accounts;
  6. The availability of additional protections through state guaranty associations and the extent of their guarantees.

IB 95-1

- IB 95-1 provides that fiduciaries should obtain the advice of a qualified independent expert unless the fiduciaries themselves possess the necessary expertise to evaluate such factors.
- IB 95-1 provides that fiduciaries may conclude that more than one insurer is able to provide the safest annuity available.

IB 95-1

- Rising influence of private equity firms
  - Private equity firms have become increasingly involved in the life insurance industry. According to the National Association of Insurance Commissioners, private-equity owned insurance companies held $534 billion in cash and invested assets in 2022.
  - In March 2022, Sen. Sherrod Brown wrote to both the NAIC and the Dept. of Treasury to evaluate concerns regarding the roe of private equity firms in the insurance industry.
- Legal challenges to PRTs
  - In 2024 alone, there have been several class action lawsuits brought against plan sponsors involving PRTs where Athene was the insurer.

IB 95-1

- Sec. 321 of SECURE 2.0 directs DOL to "review [IB 95-1] and consult with the Advisory Council on Employee Welfare and Pension Benefit Plans…to determine whether amendments to [it] are warranted" and "report to Congress on the findings of such review and consultation, including an assessment of any risk to participants" not later than Dec. 29, 2023.
- DOL consulted with stakeholders and the ERISA Advisory Council, which also heard testimony from stakeholders, in 2023. A report to Congress was issued in June 2024 which recommended no changes to IB 95-1 at present but noted that further study was needed.

IB 95-1

- PRTs have been common for single-employer defined benefit pension plans. In 2022, PRTs reached an all-time high with transactions totaling $52 billion in premiums. Buy-outs constituted 43% of PRT transactions in 2022, but represented almost 80% of the total PRT transaction value. (Source: June 2024 DOL Report to Congress on IB 95-1).
- In the multiemployer defined benefit pension world, PRTs have not occurred in decades.
  - Underfunding of multiemployer defined benefit pension plans (see restrictions under IRC)
  - Unfavorable interest rate environment (lower interest rates increases the present value of liabilities, making a PRT more expensive)

Restrictions on Pension Risk Transfers

- 26 USC Section 432(f)(2)(A)(ii) provides that a plan certified to be in critical status shall not pay "any payment for the purchase of an irrevocable commitment from an insurer to pay benefits."
- For plans certified to be in endangered, but not critical status, there is no explicit prohibition against purchasing annuities. However, Section 432(d)(1)(A) provides that a plan may not be amended after the date of adoption of a Funding Improvement Plan (FIP) to be inconsistent with a FIP. Assuming that a plan needs to be amended to reflect the PRT and the PRT results in a decrease in funding (even if temporary) due to the asset transfer, this could be viewed as inconsistent with a FIP.

Case Study: Pension Risk Transfer

- Prudential Insurance Company of America selected as insurer for a partial buy-out pension risk transfer
- Selected a tranche of liabilities with smaller annual benefits
- Detailed analysis of impact on funded percentage of plan and interest rate environment.
- Transaction will remove approximately $221 million in liabilities for 8,700 retirees and beneficiaries

Case Study: Pension Risk Transfer

- Pension risk transfer process
  - Discussions about whether to engage in a PRT started approximately 1.5 years before actual transfer
  - Consultant engaged as an expert third-party consultant, consistent with IB 95-1
  - Required coordination between all Plan professionals to identify group of participants subject to PRT, assets required, identify legal issues, etc.

Case Study: Pension Risk Transfer

- Timeline
  - 20 insurers notified of potential annuity purchase approximately 2 months before selection date
  - Preliminary quotes were due 6 weeks after notification
  - Best and final quotes due 2 weeks after preliminary quotes (due on selection date)
  - Sales agreement for finalist candidates provided a week prior to selection date; terms negotiated with each insurer prior to selection date
  - Best and final quotes issued on selection date; insurer must be selected that day (quotes expire less than 12 hours after issued)
  - Sales agreement locking in price must be signed on selection date
  - Premium paid within 1 week after selection date

Case Study: Pension Risk Transfer

- Ongoing transition process with selected insurer
  - Communication to participants – welcome package
  - Data clean up
  - Review of group annuity contract terms
  - True-up of liabilities to be transferred

Questions?