CARLTON FIELDS

Sometimes, Pension De-Risking Makes Cents

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In a defined benefit plan, participants usually accrue a monthly benefit based on a formula that typically considers their last three years' salary before retirement and years of service with their employer. For example, the formula might read 2% of your average W-2 compensation for the last three years before retirement, for every year of service up to 35 years. The maximum defined benefit under this formula would be 35 years times 2%. This would yield 70% of their average final three years of compensation. For a single person retiring at the end of 2024 with a pay of $110,000 in 2024, $100,000 in 2023, and $90,000 in 2022, the final three-year average would be the sum of these three numbers, $300,000 divided by three, which equals $100,000. With 35 years of credited service, that individual would receive 70% of $100,000 as a benefit or an annual pension of $70,000 per year. When a participant reaches retirement age, the promised benefit is paid out monthly until his or her death. Importantly, this benefit is paid regardless of market conditions, placing all market risk on the employer. This differs from a 401(k) or other defined contribution plans, as those benefits depend on account balances at retirement, and the market risk therefore falls on the participant. The Employee Retirement Income Security Act (ERISA) also requires that defined benefit plans be funded at certain levels; in down market years, this can put pressure on employers to come up with funds they may not have. Because of these risks, pension risk transfer (PRT) transactions have become increasingly popular. **What Is Pension De-Risking?** Pension de-risking or PRT involves shifting an employer's ongoing pension liabilities from the company's balance sheet to a third-party insurer. Annuity contracts (or certificates if group annuities are purchased) are issued to participants (and beneficiaries), providing the same benefits as would have been available from the plan sponsor under the defined benefit plan. After the transaction, in theory, all benefits have been fully funded and paid out in the form of annuities, allowing the sponsor to terminate its plan. This process helps employers shed the liability of the costs associated with maintaining a defined benefit plan. Even frozen pension plans can incur significant costs, especially when factoring in Pension Benefit Guaranty Corp. (PBGC) insurance premiums, which can remain on balance sheets for decades while employees are in payout status after retirement. Another factor is the recent high interest rate environment. Bond investments have higher yields in a high interest rate environment. Because of the low-risk nature of bonds, many defined benefit plans have more than half their assets in bond investments. With the rise in yields, previously underfunded plans are now fully funded and ripe for

termination. This may explain the recent uptick in PRT deals. **Benefits of Pension Risk Transfer** PRT transactions often make financial sense for plan sponsors. The sponsor is able to remove from its books the obligations to pay and shift that liability to the insurer. These transactions reduce long-term financial risks for employers, as the insurance company charges a premium for the annuities and takes on the ongoing payouts. **Potential Risks to Consider** Currently, Department of Labor (DOL) Interpretive Bulletin (IB) 95-1 explains that selecting an annuity provider for the distribution of benefits is a fiduciary act and fiduciaries must act prudently, solely in the interest of participants and beneficiaries, for the exclusive benefit of providing benefits to the participants, as well as defraying reasonable expenses of administering a plan. Further, the interpretive bulletin discusses the importance of obtaining the safest available annuity unless it is in the participants' and beneficiaries' interest to do otherwise. The requirements make the process by which an annuity provider is chosen not simple; meeting the requirements of 95-1 is expensive. There is also the potential for change in these rules, as well as changes in pension and insurance laws, that can affect the cost and feasibility of PRT deals. Just this past year, the ERISA Advisory Council produced a report on PRT, and the DOL had been considering changes to IB 95-1, outlining criteria that plan sponsors should follow to meet their fiduciary duty when choosing a PRT provider. Although the DOL did not amend the interpretive bulletin at this time, as with most guidance that is not subject to notice and comment, changes are always a possibility in the future. **Key Considerations for Plan Sponsors** IB 95-1 notes that the minimum requirement for selecting a PRT provider is conducting an objective, thorough, and analytical search including the following considerations:

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 surplus.
4. The lines of business of the annuity provider and other indications of the 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 state insurance guaranty associations and the extent of guarantees.

Best Practices for Sponsors For sponsors, since there is a list of factors to consider in the interpretive bulletin, it is important to thoroughly document the decision-making process regarding de-risking your pension and the considerations you explored in making your decision. Ensuring that the pension transfer is in the best interest of plan participants can be complex and requires transparency. It's important to ensure that the insurer you are using is financially healthy and can meet ongoing payment obligations. While the PBGC will not act as a guarantor after the transfer, state insurance guaranty associations can protect annuitants and may guarantee some or all benefits. Documentation is becoming even more important due to rising litigation regarding the

definition of the “safest” available annuity. Sponsors may also face reputational risks during pension de-risking transactions. Poor communication with plan participants about the transfer, changes in benefit payment structures, or even just changes in the providers issuing payments can affect participants' perceptions of benefits, security, and reliability. With these transactions, perception is particularly important. Thus, if the transfer of pension obligations is not well executed, regardless of an insurer’s financials, it can make participants feel their benefits are less secure. This can make for sticky situations with employees, retirees, unions, and other stakeholders who can, in the end, influence the success and acceptance of the PRT deal. Clear communication and a well-executed transaction will help keep reputations intact and minimize the risk of unhappy participants and potential litigation. Insurers face financial risks as well; miscalculating longevity or relying on inaccurate data from plan sponsors can lead to underpriced premiums. Therefore, obtaining accurate data is critical in PRT transactions. Additionally, the complexity of these deals requires careful planning and execution, as missteps in the implementation process can lead to costly delays and errors. Contractual risks can be found on both sides of any transaction. Both parties must ensure that contracts have clearly defined terms and adequately address likely contingencies. Once liabilities and premiums are transferred, companies lose control over assets and investments, which can limit future flexibility. Although PRT transactions can be economically advantageous, they should be approached thoughtfully, with resources put toward disclosure, transparency, execution, and legal compliance.

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