UNLOCKING VALUE IN PENSION PLAN TERMINATIONS

Plan sponsors need a new blueprint for risk reduction
PLAN TERMINATION: THE NEXT STEP FOR MANY CORPORATE PLAN SPONSORS

Once the shining centerpiece of a company’s benefit offerings, the defined benefit (DB) pension plan is now viewed by many corporations as a burden on the balance sheet. Volatile markets and improving longevity over the past several decades have served as a painful reminder of the risks associated with managing a pension plan. These factors have contributed to the termination of 34% of corporate pension plans since 2000 and a freeze in benefit accruals for 66% of the plans that remain.

Decline in Corporate DB Plan Sponsorship (2000-2018)

Source: PBGC 2018 Pension Data Tables

Reduction in the number of plans (%)
To dampen funded status volatility, plan sponsors have implemented liability-driven investment (LDI) techniques and other asset allocation strategies. However, most sponsors still face challenges managing pension risk through market cycles, longevity improvements, and regulatory changes. At the same time, these plans have evolved from valuable benefits used to attract and retain employees to an unwanted and costly distraction from running the core business.

Plan termination is a logical next step for sponsors. Improved funded status, increases in Pension Benefit Guaranty Corporation (PBGC) premiums, and greatly improved insurer capacity have helped to fuel an increase in settlement activity over the past decade. The pension risk transfer market has awoken from a steady $1–$2 billion market prior to 2012 into a steadily growing market of $30 billion in 2019.¹ The market is experiencing an increase in settlements related to full plan terminations and an increase in the size of the plans that are terminating, a trend expected to continue. As a result, even large pension plan sponsors who previously would not have imagined that an insurer would be interested in taking on their hefty liability, now view plan termination as a viable value-added option and a solution to burdensome pension exposure.

THREE KEY RISKS IN PLAN TERMINATION

Every sponsor will encounter unique challenges on the journey to plan termination. Some of these challenges are financial and others are related to successful execution, with most connected to the considerable length of time between the decision to terminate and the ultimate settlement of plan liabilities, which is generally 12–24 months. The length of this timeline is impacted by several factors, most notably how well prepared the sponsor is to file the required paperwork for approval and to send the required Notice of Plan Benefits information to participants. The sponsor’s decision about whether to file with the IRS also informs the length and predictability of the timeline because the IRS has a longer and more variable approval process than the PBGC, which generally has a 60-day review period. Other factors, such as the volume of terminations making their way through the government agencies, advisors, and insurers can also come into play.

1. BASIS RISK

During plan terminations, financial uncertainties are everywhere. The most glaring is that, because months will pass before liabilities are settled, the ultimate cost of the termination is generally not known until the very end of the process. During that period, changes in financial markets will impact the insurer premium amount. The value of assets in the pension portfolio that will be used to purchase annuities will also change, but in a way that is likely not consistent with the change in premium given the disparity in factors impacting a plan’s funding ratio and those impacting insurer pricing. This risk, referred to as “basis risk,” is often under-valued but failure to mitigate it can lead to an unexpected increase in the cost to complete the termination. This basis risk can exceed and sometimes dwarf the value of the insurer selection “auction” at the end of the current blueprint process.

Consider a pension plan heading toward termination with $1 billion in assets and liabilities. If the plan purchased a buy-out today, for which an insurer would charge $1 billion, the sponsor would not have to contribute anything to the plan to pay for it, as enough assets are already available to fund the premium.

Now consider a market environment where equities and interest rates both drop while the plan sponsor goes through the plan termination process. Using the first quarter of 2020 as an example, we can evaluate what would happen to the plan sponsor when interest rates drop by 100 basis points and equities decline by 25%. 
The insurer’s premium will change based on the assets used to back the liability, which are largely long-duration corporate bonds with high credit quality. If we assume that all other relevant conditions remain unchanged and a duration of nine for the liabilities, the insurer’s premium will increase by $90 million. The market value of the plan’s assets will change based on the asset mix. If the plan has a typical 60% equity allocation and a 40% allocation to fixed income with an average duration of 15, the plan’s assets will decrease by $90 million.

The basis risk in this example caused a $180 million contribution (18% of the plan’s total liabilities) the plan sponsor was not prepared for. Investing in return-seeking assets and not managing interest rate risk introduced downside risk at a time when higher returns weren’t even needed for the plan to be able to afford the transaction. The result is that the plan sponsor must either make a large payment or abandon the plan termination.

![Impact on Contribution Needed](chart.png)

### 2. INSURER CAPACITY RISK

Insurers are typically engaged around the time termination approvals are received, and the final bid for the annuity purchase happens after completion of the lump sum window, when the population to be annuitized can be finalized. Under the current blueprint, a sponsor is already quite far along the termination path before there is certainty that there will be an insurer, or better yet, a competitive group of insurers, interested in bidding on the transaction.

In an active market, insurers often decline to bid on transactions because of the time and resources needed to complete the bidding process. This is particularly true if the transaction includes deferred participants (the active and vested terminated population not yet in pay status), which is the case in virtually all plan terminations. Deferred participants are much more complicated to price, and some insurers shy away from transactions with large groups of deferred participants because of additional longevity and behavioral risks. Insurer capacity is also a concern for very large transactions where insurers may reach internal capacity limits during the time the plan proceeds through the termination pathway.
Depending on the size, the relative percentage of deferred participants, and market activity, a sponsor may have some anxiety about securing a competitive bid environment at the end of the process, because failure to do so may result in either paying a higher price or having to delay or cancel the plan termination.

3. LUMP SUM RISK

Another financial risk relates to the offer of a lump sum to participants as an alternative form of distribution. Because lump sums are often less expensive than annuities for young plan participants, most sponsors offer lump sums to the deferred population. The option to elect a lump sum is made after government approvals are received and generally give the participant 45–60 days to decide whether to accept a lump sum or instead have an annuity purchased for them.

The percentage of participants that accept a lump sum varies widely across plans, which makes it difficult for a sponsor to estimate the cost of potential savings until the end of the lump sum offer, which is typically only weeks before the termination is completed. Also, because of the long termination time period, the minimum required lump sum interest rate assumptions may also change during the process, which would impact the amount paid to any participant who elects the lump sum. Although generally favorable to the overall cost of a termination, the lump sum offer does introduce more uncertainty for sponsors seeking to nail down the economics at the beginning of the process.
SOONER IS BETTER FOR RISK REDUCTION AND VALUE CREATION

Traditionally, insurers are brought in at the end of a plan termination in an auction-style process that focuses on price and administrative timelines. While this approach works from a technical perspective, it does not necessarily provide the best economic outcomes for the plan sponsor. This process is missing the key value an insurer can bring to reducing cost and risk by participating earlier in the termination journey.

Selecting an insurer early in the plan termination process helps address the risks described previously in three ways:

1. It provides valuable risk protection with no reduction in competitiveness. Some sponsors may wish to de-risk their transaction early in the process, perhaps as soon as the decision is made to terminate the plan. Others may prefer to wait until they are ready to file the relevant paperwork. What is important is understanding that plan sponsors continue to be on-risk until the liabilities are transferred to an insurer.

2. It provides the plan sponsor with an additional partner, an insurer, to strategically provide insight and customize a transaction to meet the level of risk reduction an employer seeks.

3. It guarantees insurer capacity.

There are solutions that would eliminate risk from financial markets and lump sum election rates. All these options start with the use of a buy-in.
THE BASICS OF A BUY-IN

Much like a buy-out, a buy-in guarantees future benefit payments to a select group of participants, thereby covering all market and longevity risk at a price consistent with buy-out pricing.

A buy-in does not settle plan liabilities. Instead, it is held as a plan asset and the sponsor continues to make benefit payments to participants with funds provided by the insurer. Since liabilities are not settled, the sponsor will continue to pay premium payments to the PBGC. The buy-in can be converted to a buy-out at no additional cost when the sponsor chooses to do so, at which time the insurer begins making payments directly to participants and PBGC premium obligations end.

Buy-ins are revocable, within specified parameters. Practically speaking, all buy-ins must allow for surrender in the unlikely event that the insurer no longer meets the “Safest Available Annuity” standards of ERISA at the time the sponsor is ready to convert the contract. When used in the context of a plan termination, a second surrender option is desirable to allow for an unwind of the group annuity contract in the event the plan termination is not approved by the appropriate government agencies. While each insurer may have a different approach to surrender terms and the value of any surrender payment, the important point here is that the contract can be surrendered in the event the termination cannot be successfully completed.

HOW DOES A BUY-IN WORK FOR A PLAN TERMINATION?

For a sponsor looking to eliminate as much market risk as possible, a buy-in offers an effective solution when executed at the beginning of the termination process. This allows a sponsor to lock in both price and insurer capacity, both of which can greatly reduce risk, before the termination process is complete. The basis risk, or risk of plan assets and premium moving during the termination process, is eliminated for the group covered by the buy-in.

A buy-in would be structured to cover some or all of the participant population. Because most plans are not fully funded when the termination process begins, and because plan sponsors would need to hold back some assets for payment of PBGC premiums and other expenses, the buy-in would typically be executed for a portion of the plan population. In order to reduce risk to the greatest possible extent, the sponsor would want to execute the largest buy-in the plan assets can support.

Once the sponsor receives the required approvals for the plan termination, and assuming the sponsor wishes to offer a lump sum option to non-retired participants, option election forms would be distributed to participants offering them the choice of a lump sum or annuity form of payment. After all election forms are received by the sponsor, the distribution of assets can begin.

At the time of distribution, the group to be annuitized has been identified, and the insurer would “true up” the premium amount paid for the buy-in. This true-up would be the net of a refund for participants who elected a lump sum and the additional premium required to annuitize participants who were not covered by the initial buy-in amount. Once the true-up is complete and appropriate payment is made, the buy-in would be converted to a buy-out, and the sponsor would make lump sum distributions to electing participants. At this point, the sponsor will have settled all plan obligations and the termination process is complete.
THREE POTENTIAL BLUEPRINTS FOR PLAN TERMINATION, IN ORDER OF RISK REDUCTION

1. MODEST APPROACH—BUY-IN FOR RETIREES

The simplest option for a plan sponsor would be to execute a buy-in for retired participants at the beginning of the plan termination that would convert to buy-out at the end of the termination process. In this example, the buy-in would be for $300 million, locking in the economics for 60% of the anticipated termination cost. Shortly before distribution, the sponsor will solicit bids and select the insurer who will cover the deferred liability (which could be a different insurer from the one covering the retired lives).

The drawbacks to this approach are that the risks for the deferred population have not been locked in and there is no guarantee of a competitive bid for that population. In order to reduce the risk that no insurer will bid on the deferred population, the sponsor may be able to obtain some form of commitment from the winning buy-in insurer to at least agree to participate in the bidding process for the deferred buy-out. If the deferred population is not too significant, the insurer may be able to provide some level of price certainty through either a guarantee on the premium for deferreds or a price roll-forward formula, which would at least provide the sponsor something to hedge against.

Blueprint 1. Retirees in buy-in, deferreds in buy-out

<table>
<thead>
<tr>
<th>Decision to Terminate</th>
<th>Plan Termination Date Signing and Funding for Buy-in (Retired)</th>
<th>PBGC/IRS Approvals Received</th>
<th>Asset Distribution Date and Funding (Deferreds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preparation for termination</td>
<td>Filings, participant notices, and IRS/PBGC review</td>
<td>Payment option election period</td>
<td>Lump sums paid</td>
</tr>
<tr>
<td>Insurer engagement and selection for RETIRED LIVES</td>
<td>Execute buy-in to eliminate risk for RETIRED LIVES</td>
<td>Convert to buy-out</td>
<td>Execute buy-out for DEFERRED LIVES</td>
</tr>
<tr>
<td>Insurer engagement and selection for DEFERRED LIVES</td>
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</tr>
</tbody>
</table>
But plan sponsors should recognize that insurers may not be able to provide that level of upfront commitment, particularly if the insurer cannot predict what the final population after the lump sum program will look like in terms of liability and duration. In addition, in the event the buy-in insurer and buy-out insurer are different carriers, then the sponsor will likely need to devote additional time and resources to negotiating separate documentation with the second insurer and addressing any distinctions between each insurer’s onboarding processes.

2. ENHANCED APPROACH—INCLUDE SOME DEFERRED PARTICIPANTS IN THE BUY-IN TO REDUCE RISK FURTHER AND GUARANTEE INSURER CAPACITY

For a sponsor interested in further risk reduction, a preferred approach would be to complete a buy-in for $400M, or 80%, of plan liability. This would require adding some deferred lives (the active and vested terminated population not yet in pay status) to the buy-in.

In the figure “Blueprint 2,” we refer to the retired and deferred lives that will be included in the buy-in as GROUP I, and the deferred lives that will not be covered in the buy-in as GROUP II. This structure would work similarly to the simpler construct discussed under Blueprint 1, where the buy-in would convert to a buy-out at the time of distribution, and lives to be annuitized who were not included in the buy-in would be added to the buy-out at that time. The main difference is that there would need to be a true-up mechanism to reflect the lump sum payments made to the deferred participants in GROUP I who elect a lump sum at the same time the buy-out premium is paid for the deferred participants in GROUP II who decline the lump-sum offer.

There are significant advantages to this approach. The first is the additional basis risk protection provided by increasing the liability included in the buy-in to include a portion of the deferred population. The second benefit is simplicity, as the nature of this transaction makes it more suitable for a single transaction with one insurer. Because the amount of GROUP II liability will be relatively small, there’s a better chance the insurer will be willing to provide capacity along with some degree of price certainty for the remaining population, either via a premium guarantee or a roll-forward formula.

The enhanced approach provides various solutions regarding exactly what population is included in the initial buy-in, how the true-up is executed, and the degree of premium guarantee for GROUP II. These details are worked out in consultation with the insurer. This alternative blueprint offers significant advantages, including customization to meet sponsor needs.

Blueprint 2. Retirees/deferreds (Group I) in buy-in, additional deferred lives (Group II) in buy-out
3. THE ULTIMATE IN CERTAINTY—TRANSFER THE LUMP SUM RISK

For the most risk-averse sponsors, a buy-in that includes all lives and transfers all risk to the insurer early in the termination timeline may be of interest. In this case, the sponsor would pay a single premium upfront, which would reflect the insurer’s expectation of economic gains from the lump sum program. The sponsor would run the lump sum program as planned, and at the time of distribution the insurer would make a payment to the plan for the bulk amount necessary to pay the lump sums elected and the plan would pay out electing participants. The advantage of this approach is that the sponsor can lock in the cost of the termination upfront, providing the ultimate in risk reduction for a plan termination.

There are a few aspects of this approach that a sponsor would want to consider. First, the sponsor would have to fund the plan early in the process in order to pay a buy-in premium that covers 100% of plan termination liability. Second, to the extent the insurer’s estimate of the lump sum election rate is lower than the sponsor’s, the premium may exceed anticipated costs. Any interested sponsor will need to weigh the pros and cons of this transaction based on the particulars of their own situation. Although not well suited for all sponsors, for the most risk-averse plan sponsors it is an important option to consider.

EXPLORE FURTHER BEFORE DECIDING TO TERMINATE

For plan sponsors looking to terminate a pension plan, insurers offer solutions to the most pressing risks involved. The buy-in, premium lock-in/roll-forward, and insurer assumption of lump sum election risk are all effective solutions that can be combined in various ways to meet a sponsor’s needs, including minimizing risks and controlling costs. The key, of course, is to consult with and select an insurer early. This approach has been effective in many pension risk transfer deals and is even more important in the case of a plan termination, which extends over a long period of time and represents a significant transaction for any sponsor.
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