

PRUDENTIAL RETIREMENT

PREPARING FOR PENSION RISK TRANSFER

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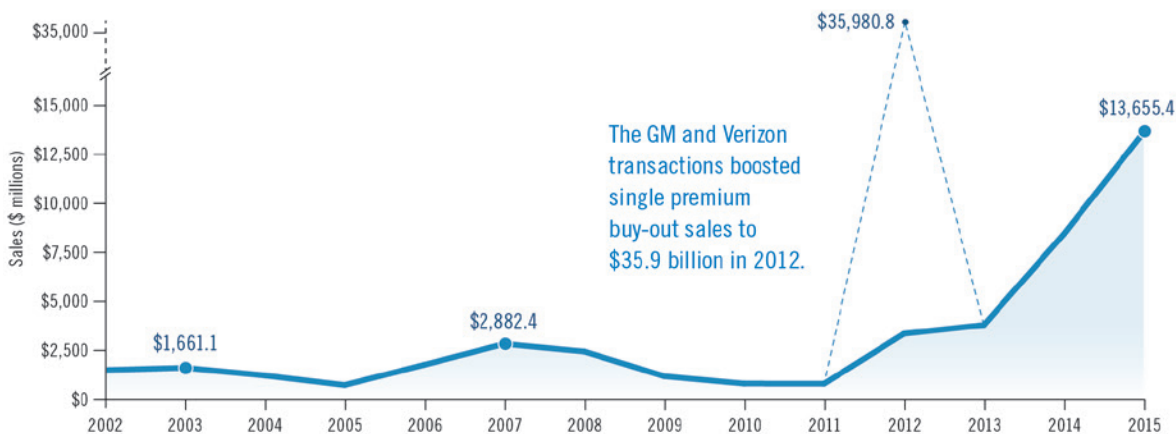
FROM WHY TO HOW

Recent papers by Prudential and others have focused on the “what” and the “why” of pension risk transfer, describing the types of solutions that are available and the trends that are driving increased interest in de-risking. This paper will focus on the “how,” outlining the steps involved in the most complete form of pension risk transfer: a buy-out transaction. Whether or not a buy-out is imminent, there are preparations a plan sponsor can undertake to make a future transaction easier and to shorten the timeline for execution.



GROWING INTEREST IN PENSION RISK TRANSFER

Interest in pension risk transfer continues to intensify among corporate sponsors of U.S. defined benefit (DB) plans, as plan sponsors are looking for ways to reduce both balance sheet liabilities and funded status volatility. Against the backdrop of significantly increasing Pension Benefit Guaranty Corporation (PBGC) premiums due to recent legislation, as well as new mortality assumptions that increase DB plan liabilities, the market for buy-out solutions is steadily developing.



Source: LIMRA. Sales results based on a non-constant group of companies and reported in millions.

Prudential has completed large buy-out transactions with General Motors, Verizon, Motorola, Bristol-Myers Squibb, Kimberly-Clark, Timken, Philips and J.C. Penney. These transactions, totaling approximately \$42 billion, firmly re-established a U.S. market for buy-out solutions that had been largely dormant since the 1990s. Although news coverage focuses on the “jumbo” transactions, the stepped-up activity in the buy-out market has not just been for large companies. Transaction volume in the small- to mid-market has also increased.¹

Many other companies that have not yet transacted are considering buy-out solutions. In a recent survey of senior financial executives, 55% indicated that they are likely to transfer DB plan risk to a third-party insurer within the next two years.²

In considering a buy-out, plan sponsors should weigh the cost of the transaction against the cost of maintaining the plan, measured not only by the cash cost associated with the plan for a given year, but the impact to the core business—in terms of cash flow, earnings

¹ LIMRA, February 2016.

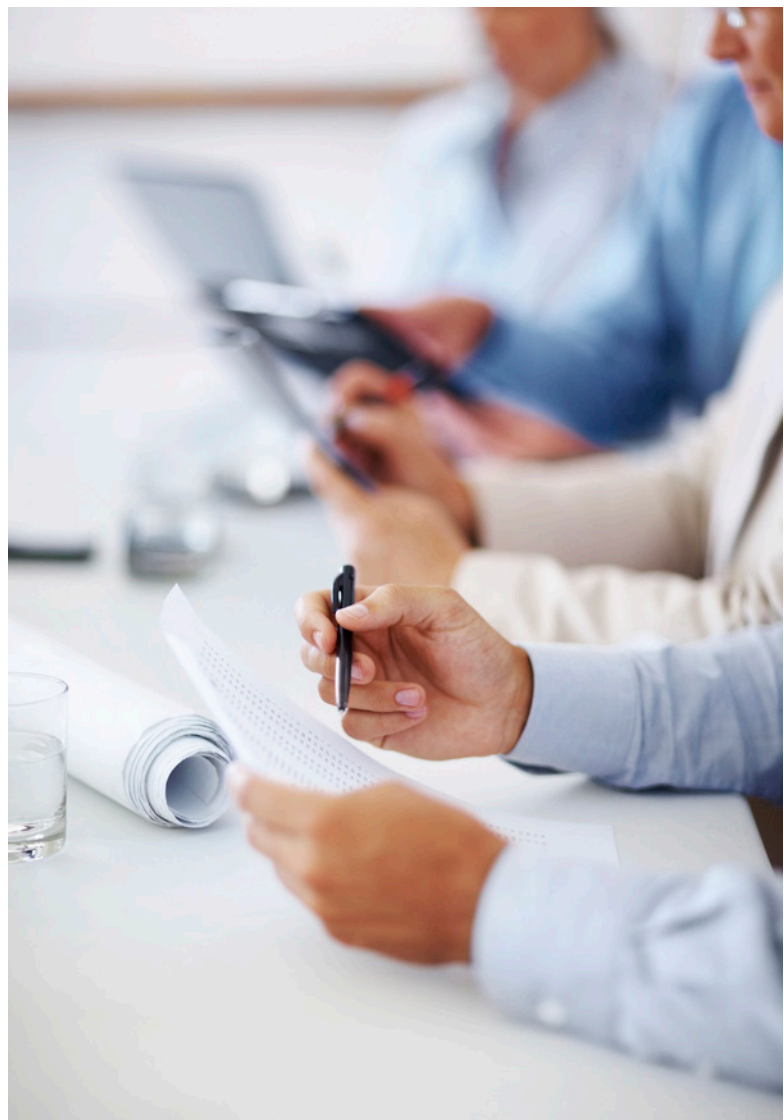
² Prudential and CFO Research Services survey of senior finance executives, August 2015.

volatility, and ultimately, the ability to grow. In the same survey, 46% of senior finance executives indicated that their DB plan placed a constraint on the company's cash flow, 47% indicated an impact on earnings due to volatility of plan funded status and 34% indicated an impact on their ability to invest in growth opportunities.³

When evaluating the cost of a transaction, it is common to compare buy-out pricing to accounting liabilities. However, the calculation of pension liabilities for accounting purposes understates the true economic value of plan liabilities that an insurer would consider in pricing a buy-out. There are two reasons for this:

- First, accounting liabilities do not include the present value of certain costs that a plan sponsor bears, such as administration costs, investment management fees and PBGC premiums.
- Second, historically, accounting liabilities had typically been based on outdated longevity assumptions which underestimated the true value of the liability by 6–7%. Now, as more corporations have adopted the new mortality assumptions, the accounting view of mortality more closely aligns with the insurer view.

The common rule of thumb had been that, for a retiree population, the cost of a buy-out would be about 110% of the accounting liability. However, with the adoption of new mortality assumptions, accounting liabilities have increased, while the cost of a buy-out from the insurers' perspective has remained about the same. As a result, the estimated cost of a buy-out as a percentage of the accounting liability has decreased from about 110% to about 104%. Of course, these cost estimates will vary for every transaction.



³ Prudential and CFO Research Services survey of senior finance executives, August 2015.

Types of Pension De-Risking

There is a range of pension de-risking options available to DB plan sponsors, from investment strategies that reduce risk to transactions that fully transfer risk from the plan sponsor to a third party.

Risk Management		Risk Transfer			
Plan Design Changes	Liability-driven Investing (LDI)	Longevity Insurance	Buy-in	Buy-out	Lump Sum
Curtail benefits	<p>LDI manages investment risks by closely matching a bond portfolio to the liability cash flow, reducing the volatility of pension funded status</p> <p>Primarily involves the use of long-duration fixed income</p> <p>Assets and liabilities remain with the pension plan</p>	<p>Transfers only longevity risk to insurer and results in a fixed and known life expectancy for plan participants</p> <p>LDI can be combined with longevity insurance to address asset and liability risks</p> <p>Longevity insurance is actively used in the U.K. but not yet in the U.S.</p> <p>The first longevity insurance transaction in North America occurred in Canada in 2015</p>	Transactions that transfer the investment and longevity risk associated with pension liabilities to insurers		<p>Employer pays benefits in a lump sum to specified participants who elect that option; plan liabilities are thereby reduced</p> <p>Can be offered as a stand-alone option or part of a broader de-risking strategy (e.g., lump-sum program for vested terminated population in conjunction with a buy-out for retirees)</p> <p>22% have already offered lump-sum programs⁴</p> <p>46% are likely to offer a lump-sum program within two years⁵</p>
Freeze benefits			The insurer pays the monthly annuity amount to the plan, which continues to make pension payments to plan participants	The insurer has a direct, irrevocable commitment to each covered participant to make the specified annuity payments	
Convert to cash balance			Assets remain in the pension plan, and associated liabilities remain obligations of the plan	Specified liabilities and associated assets transfer to insurer	
		Does not trigger settlement accounting or reduce funded status	May trigger settlement accounting and reduce funded status	Irrevocable	
		Convertible to buy-out			
			Buy-in	Buy-out	
			+ Pros and Cons –		
			<ul style="list-style-type: none"> – Does not reduce pension plan's liabilities + Can be converted to a buy-out at no additional cost + Does not create the need for a cash contribution – PBGC premiums continue for covered participants + Does not trigger settlement accounting 	<ul style="list-style-type: none"> + Reduces pension plan's liabilities – May trigger the need for an additional cash contribution + Eliminates PBGC premiums for covered participants – May trigger settlement accounting 	

⁴ Prudential and CFO Research Services survey of senior finance executives, August 2015.

⁵ Ibid.

Types of Buy-out Transactions

There are three basic types of buy-out transactions.

1. Full Buy-out

The entire plan is terminated and a group annuity is purchased covering all participants (or all participants who do not elect a lump sum, if one is offered). This requires that the plan be fully funded and the formal plan termination process be followed.



Annuity purchased for all participants

2. Partial Buy-out with Lift-out

A group annuity is purchased for a given segment of plan participants, most commonly some or all of the retired population. With a partial buy-out, the plan remains active. This is the simplest way to initiate a buy-out, since the plan does not terminate and the sponsor can decide how much of the liability to transfer to the insurer.

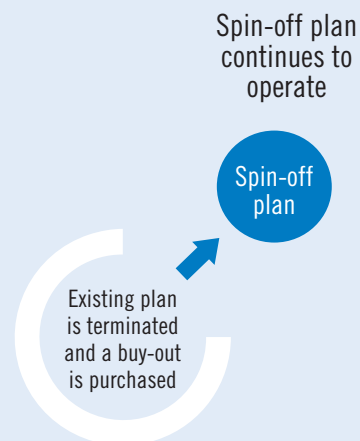
Purchase annuity for specified liabilities, usually retirees



Roughly 50% of private U.S. DB plan liabilities are associated with retirees.⁶

3. Partial Buy-out with Spin-off and Termination

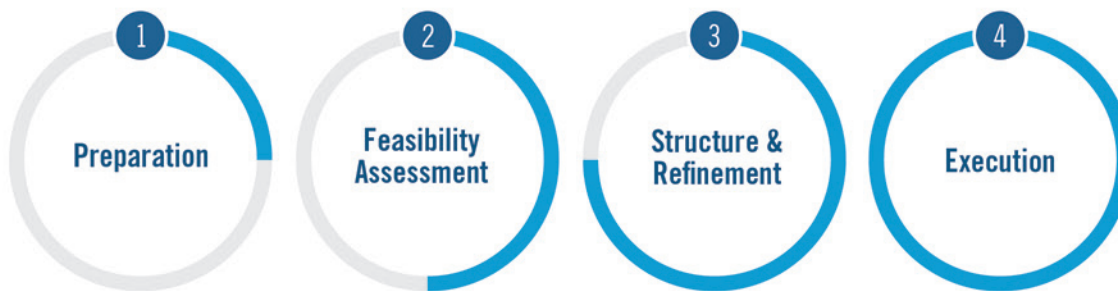
A segment of participants, those who are not part of the transaction group, is transferred to a new plan—the spin-off plan. Participants who will be part of the buy-out transaction remain in the existing plan. The existing plan is terminated, and once the termination process is complete, a buy-out is purchased for all participants (or those who do not elect a lump sum, if one is offered). The new plan will continue to operate in the future on its own. As opposed to a partial buy-out with a lift-out, the spin-off approach results in a plan termination. Since PBGC plan termination procedures must be followed, some plan sponsors may feel that this approach affords additional protection from potential employee litigation. Other sponsors may prefer to opt for the relative simplicity of the lift-out approach.



⁶ Russell Investments, "Update: Risk Transfer Options for Defined Benefit Plan Sponsors," Russell Research Practice Note, p.3, June 2013.

THE BUY-OUT PROCESS

The buy-out process can be viewed in four phases: Preparation, Feasibility Assessment, Structure and Refinement, and Execution. The amount of work in each phase will vary based on the size and complexity of the contemplated transaction.



- **Preparation**—includes identifying the internal team that will be responsible for the pension risk transfer process, selecting any outside advisors, defining transaction objectives and identifying any constraints. The transaction strategy will begin to take shape in this phase. The plan sponsor should also begin to organize plan data by determining the best source of transaction data (i.e., actuarial data versus administrative data), as well as analyze the general quality of the data relative to insurer requirements.

- **Feasibility Assessment**—entails providing the plan sponsor’s initial transaction strategy and data set to insurers through a Request for Information (RFI) process in order to:

- Gain feedback on insurers’ ability to take on the transaction as presented
- Assess the availability of insurers’ capital
- Evaluate the potential use of an in-kind asset transfer versus cash
- Receive indicative pricing

By the end of this phase, the plan sponsor will be better able to confirm the company’s commitment to pursuing a buy-out and begin any data clean-up or asset repositioning work required.

A governance process should also be established to allow the sponsor to obtain the necessary approvals in a timely fashion as the transaction progresses.

- **Structure and Refinement**—provides the plan sponsor with time to assess results from the feasibility phase, refine transaction specifics, refine the data set for submission to insurers for formal pricing and, by the end of this phase, select an insurer from which to purchase the buy-out. In this phase, the plan sponsor will also finalize details of the transaction strategy; for example, deciding whether to terminate the plan or do a partial plan transaction, using either the lift-out or spin-off and termination approach. The selection of an insurer from which to purchase the annuities is a fiduciary decision, and the plan sponsor will decide in this phase which

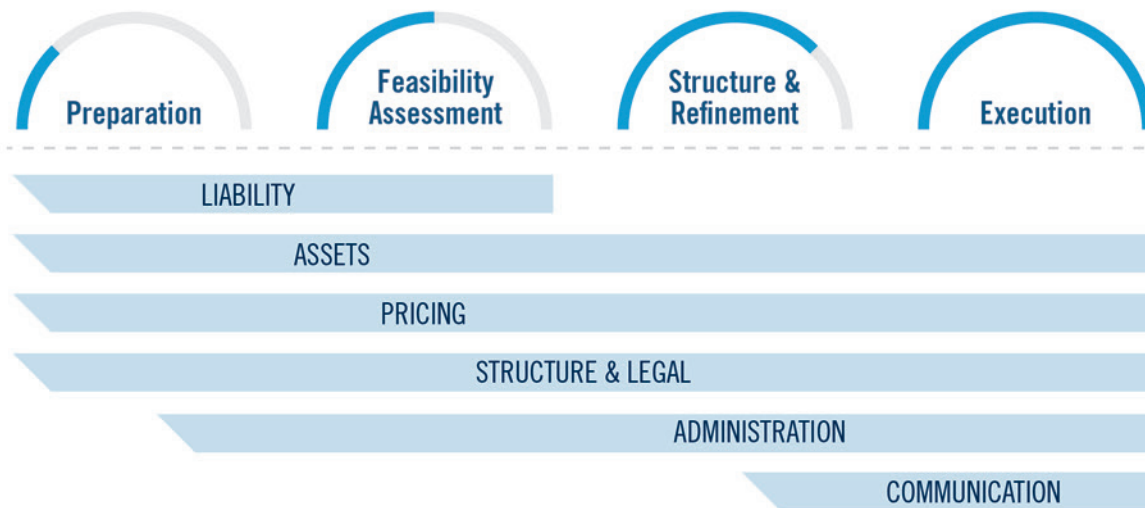
party will serve in a fiduciary capacity during the buy-out process. In addition, the path for any required regulatory approval will be defined in this phase, contracts will be finalized and the asset portfolio will be re-positioned.

- **Execution**—is the final stage of the process. The group annuity contract is executed, assets are transferred and data reconciliations occur. During this phase, there is a very high volume of communication between the plan sponsor, their administrator and the insurers.

Typical Roles in the Buy-out Process			
Many different entities are involved in a buy-out transaction.			
Plan Sponsor	Strategic Advisor	Annuity Provider	
Determines whether to transfer DB liabilities to an insurer, and, if so, which plan participants to include in the group annuity buy-out.	Provides counsel throughout the process, including the evaluation of whether to pursue a buy-out. Develops annuity bid specifications and works with insurers to secure pricing quotes.	Assumes the DB plan liabilities and provides guaranteed lifetime income payments to pensioners as part of a group annuity buy-out transaction.	
Annuity Placement Specialist	Fiduciary Oversight	Outside Legal Counsel	Transition Manager
Develops annuity bid specifications and works with insurers to secure pricing quotes.	Selects the annuity provider, carrying out the plan sponsor’s fiduciary obligations under ERISA and working for the exclusive benefit of plan participants to select the “safest available annuity.”	Draws up agreements related to a buy-out. Provides expertise in areas of asset transfer, federal tax law, securities law, ERISA and/or state insurance law.	Helps transition assets from the DB plan to the insurer. The transition manager is accountable for the investment performance of the assets being transferred, while minimizing costs and risks during the transition period.

THE SIX WORKSTREAMS OF A BUY-OUT TRANSACTION

There are six workstreams that progress through the various phases of a transaction: Liability, Assets, Pricing, Structure and Legal, Administration, and Communication.



Liability

This workstream involves the development of the transaction strategy from the liability perspective. Typically, this would begin with an analysis of various transaction alternatives—the type of buy-out, the inclusion of a lump-sum offering and the population groups for whom liabilities will be transferred. The two most common scenarios, described in more detail on page 6, are the full buy-out or partial buy-out covering some or all of the retirees of the plan.

If mortality experience data is available (it may be required for large transactions), this workstream will coordinate the collection of experience data to be presented to the insurer. Also, the plan sponsor will provide the data files to be used for indicative and final pricing as well as any data true-ups.

Assets

This workstream involves the preparation of plan assets for transfer to the insurer. For smaller plan sponsors (under \$500 million in plan assets), this is typically the development of a plan for liquidating the portfolio, since the group annuity premium will generally be paid in cash. For larger transactions, in-kind asset transfers should be investigated. That process would usually start by having conversations with insurers about what assets they would consider acceptable for in-kind transfer and how the delivery of an optimal asset portfolio to the insurer could reduce transaction cost.

A number of factors make in-kind asset transfers preferable. First, this approach assures that the funds underlying a transaction are immediately invested. Alternatively, if cash is used for a large

transaction, it can take a substantial amount of time to be fully invested. This creates a cash lag where the insurer is earning a much lower rate of return for a period of time. Second, it is more tax efficient for the DB plan to buy and sell assets, since the plan doesn't pay taxes on gains and losses resulting from transactions. Third, transaction costs can be minimized to the extent the sponsor buys the securities the insurer will ultimately want to hold. It is important to identify the most efficient way to transfer assets to the insurer to reduce possible friction costs—such as cash lag, taxes and transaction costs—as these will impact the transaction price.

Working with the plan sponsor, the insurer identifies the desired transaction portfolio and

In-kind Asset Transfer	
Cost Benefits	
1.	Transaction funds are immediately invested; avoids cash lag
2.	Tax efficient for plan sponsor
3.	Minimizes transaction costs

then determines which assets are eligible to be transferred to the insurer in-kind. The plan sponsor will determine the assets to purchase or sell to achieve the end state, and which investment managers to involve. A plan may already have investment managers who

Types of Assets Generally Acceptable for In-kind Transfer

Not all assets currently held by DB plans are of a type that insurers would ultimately want to include in the investment portfolio supporting the group annuity payments. Insurers are subject to strict capital and reserve requirements by the states that oversee them. Risk-based capital requirements dictate the minimum amount of capital to be held by an insurer to support its business.⁷ As such, assets that require the insurer to hold higher amounts of capital are generally less desirable from the insurer's perspective.

Most DB plans are underexposed to assets preferred by insurers, most notably long-duration corporate bonds. Although insurers prefer long-term corporate bonds with high credit quality, insurers may take a small amount of below investment grade bonds. Insurers prefer assets with durations that closely match the liabilities. Plans with LDI bond strategies are likely much closer to the asset-liability match that insurers are seeking than are plans without LDI in place. Having an LDI strategy in place would also help to minimize basis risk as the time approaches to transition the assets to the insurer. Basis risk occurs when the price of a group annuity increases, but assets in the plan earmarked for the annuity premium do not increase in a similar manner. If assets are closely matched to liabilities, basis risk is minimized.

Conversely, DB plans are typically overexposed to risky assets that insurers will not find attractive due to the risk-based capital regime. Some insurers may be able to take on some alternative investments as part of the transaction. However, the appetite for alternative investments will vary among insurers, can change quickly and would generally be limited to a very small portion of the portfolio (5% or less). If a plan sponsor is considering a buy-out in the next few years, the sponsor should consider how the purchase of risky assets—especially illiquid risky assets—fits into the overall pension strategy.

⁷ NAIC, <http://www.naic.org/cipr>.

can facilitate construction of a fixed-income portfolio, or it may need to hire an investment manager to accomplish this. As the plan sponsor progresses toward execution of the buy-out transaction, the investment portfolio will increasingly resemble the transaction portfolio desired by the insurer.

As the asset transfer date nears, comprehensive asset and liability monitoring should be put into place so that decisions can be made quickly should markets become volatile.

If the transaction is not a full buy-out, the plan sponsor will need to be mindful of asset allocation for the remaining plan. Ideally, the portfolio desired for the remaining plan will be constructed at the same time the transaction portfolio is being constructed for the buy-out.

Pricing

In this workstream, plan sponsors will gain an understanding of the pricing of the transaction and how alternative transaction structures and market conditions can affect price. This will include the solicitation of indicative pricing from insurers, as well as final pricing and negotiation of related documents.

The first step in this workstream is for the plan sponsor, generally assisted by an advisor such as an investment bank, consulting firm or an annuity placement specialist, to approach insurers via an RFI process. This may be done on a confidential basis, with the name of the prospective client not disclosed to the insurer. The goal of this initial round of engagement with insurers is to receive indicative pricing for the buy-out solution.

Receiving indicative pricing from an insurer is the best way to estimate the cost of a buy-out. By providing details of the transaction and the

appropriate participant data to an insurer, the plan sponsor will be able to obtain a reasonable estimate of the price for the transaction from the insurer. The insurer will also be able to advise the plan sponsor as to whether there are data elements that are missing or any other concerns about the transaction.

In order to provide indicative pricing, insurers will require participant data that reflects the age, gender, benefit amount and form of annuity (or available optional forms) for each participant. The plan sponsor should perform an initial evaluation of participant data supporting the liabilities that may be transferred. The data should be cleansed to ensure its accuracy and completeness. For example, the plan's recordkeeper may be keeping track of certain pension provisions (e.g., a Qualified Domestic Relations Order that splits benefits due to a divorce) manually, while the insurer will want such information on the electronic data file submitted for the transaction. The more complete and accurate the data, the more accurate the indicative pricing.

In addition to receiving participant data, insurers may require plan-specific mortality experience in order to provide indicative pricing. This is particularly true for large transactions, and can be a helpful step for sponsors with smaller transactions as well.

Insurers will also need to know if lump-sum payments have been or will be offered to any of the participants. If a lump-sum option will be offered to retirees, insurers may factor in an additional cost for potential anti-selection. Anti-selection occurs when less healthy retirees opt for the lump-sum option, and healthier retirees elect to receive annuity payments as part of the buy-out.

Plan sponsors may wish to receive indicative pricing for different groups of participants (e.g., various subsets of retirees, vested terminated participants). Indicative pricing is not binding to either party, but provides the plan sponsor with the approximate cost of the transaction. This is important for planning purposes, whether plan sponsors intend to transact in the near future or further down the road.

After receiving indicative pricing, sponsors with large or more complex transactions may choose to enter into exclusive negotiations with one insurer. In an exclusive negotiation, the plan sponsor agrees to focus its negotiations with one insurer in order to fully develop the arrangement in a time-efficient manner.

If the sponsor continues to work with multiple insurers, there will be a final bid process from which the sponsor will select the insurer for the transaction.

Indicative Pricing
What Insurers Require for an Accurate Pricing Estimate
1. Complete and accurate participant data for transaction group(s)
2. Plan-specific mortality experience
3. Lump-sum history or plans to offer lump sums

Structure and Legal

Once feasibility is established, legal counsel will be engaged to execute confidentiality agreements, define the fiduciary process, obtain required regulatory approvals, and decide which type of structure to use for the group annuity—either the insurer’s general account or a separate account. Under a separate account, assets supporting the liabilities are

segregated from the insurer’s general account and are protected from creditors. By utilizing an insulated separate account of the insurer, the plan sponsor can provide further safety for participants.

For most transactions, the sponsor assumes the fiduciary role or shares that role with a consultant or annuity placement specialist. Recently, for larger transactions, sponsors have hired independent fiduciaries to protect the best interests of participants.

Once the buy-out transaction is imminent, the plan sponsor will decide upon an announcement strategy. In the past, most plan sponsors announced the agreement and closing of a transaction simultaneously. However, in recent years, sponsors engaging in large transactions have announced their intent to close and locked in pricing and contract terms several months prior to the transaction close. This allows time for the sponsor to receive any necessary governmental approvals, conduct lump-sum programs, continue to clean up data, and position the asset portfolio prior to closing.

Finally, once the buy-out transaction is complete, documentation of the process should be finalized.

Administration

This workstream entails evaluating the insurer’s capabilities to administer the payment of pension benefits and provide related customer service in accordance with industry best practices.

This workstream also covers the transition of administrative services to the insurer. During the transition of administrative services, the insurer will work with the DB plan’s current recordkeeper. To ensure the transition of benefits administration goes smoothly, the insurer is likely to undertake a mock conversion process, whereby the insurer conducts a test run a month or two before final takeover to make certain all payments are being accurately calculated and transitioned.

Communication

The final workstream involves establishing effective messaging for key stakeholders, both internal and external. Clear communication with plan participants is critical. The plan sponsor will need to provide information to participants as to why the change is being made and what to expect going forward. They may also wish to communicate the shift from an ERISA plan that has protective coverage from the PBGC to an insurer that holds reserves and capital to support each individual participant guarantee, and that has protective coverage from state guaranty funds.⁸

Coordinating with the plan sponsor and current recordkeeper, the insurer will develop a robust communication strategy to explain the process to plan participants. Typically, this will include welcome packages and customer

support for participants. If the buy-out is part of a plan termination, special care should be taken to assure that notices required as part of the termination are included in participant communication planning. Additionally, when the buy-out transaction is completed, each participant will receive a group annuity certificate from the insurer.

A communication strategy for shareholders and the investor community may also be designed to alert them to the de-risking solution being undertaken. Orchestrating communications requires care and thoughtful timing so that no material non-public information is released. A public relations strategy should be designed as well. Finally, communication with the plan sponsor company's board of directors throughout the process is important to provide progress updates and secure the necessary approvals.

CONCLUSION

Executing a buy-out transaction can significantly reduce or eliminate future pension plan risk for plan sponsors. Following a structured process and working with an experienced insurer are key to accomplishing a smooth pension risk transfer. Whether a buy-out is imminent, a few years away or only a consideration, there are steps a plan sponsor can take today to ensure that the process goes smoothly when and if a buy-out solution is pursued. Plan sponsors can start now by taking action to get their data and governance process in order, and to conduct an initial high-level feasibility assessment of a potential risk transfer transaction. Given the many high-profile pension risk transfer buy-out transactions that have occurred since 2012, as well as ongoing funded status volatility and increasing PBGC premiums, plan sponsors in large and mid-size firms are finding their boards of directors eager to understand the process and potential cost of executing a buy-out solution.

⁸ CAMRADATA Analytical Services, "The Fiduciary's Role in the Termination of Single Employer Defined Benefit Plans: A Practical Guide," June 2012.



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