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WORKPLACE BENEFITS

A primer on pension risk transfers

Pension risk transfers (or PRTs) have existed for decades. Ten to 15 years ago, lump sum windows were the most common type of settlement. More recently, the annuity transfer market has grown to become the dominant form of PRT. The topic of transferring pension risk may be well understood by those familiar with the concept. To the uninitiated, though, the reasons for undertaking a PRT and how to go about the process can be less clear. This paper seeks to explain at a high level the primary types of PRTs available to plan sponsors.

Background

As the name implies, a pension risk transfer is a project that moves pension risk from one party to another. More specifically, PRTs address pension funded status risk. This includes both market-related risks (such as interest rates) and demographic risks (such as mortality) that are inherent to pension liabilities. To address funded status risk, a PRT shifts a portion of both the assets and liabilities to another party. This transfer should result in the plan sponsor experiencing less funded status risk and lower administrative costs. Identifying the counterparty and the method of risk transfer is what defines the different types of PRTs available.

The act of paying lump sums or purchasing annuity contracts aren't new concepts in the pension world. However, 2012 was a particularly notable year for risk transfers, as both Ford and Verizon completed large-scale PRTs. Since then, many other plans have followed suit, with the annuity transfer market growing significantly over the last decade. Recently, jumbo deals have represented a large portion of total liabilities transferred. Notably, AT&T's $8 billion transaction in 2023 and IBM's $6 billion transaction in 2024 garnered headlines.

Beyond interest in de-risking, premiums payable annually to the Pension Benefit Guarantee Corporation (PBGC) are another key driver of PRT appetite among plan sponsors. PBGC premiums are annual fees for what's essentially an insurance program. If a plan faces bankruptcy or insolvency, the PBGC will take over the failing plan and guarantee at least a portion of the prior benefits payable to the plan's participants. Sharp increases in PBGC premiums over the last 15 years have made pension risk transfers more attractive.

The market has been growing steadily, but recent litigation may give some plan sponsors pause. In 2024, 12 lawsuits were initiated and are alleging a breach of fiduciary duty regarding the selection of the annuity provider involved in the PRT. While it's too early to say how these cases will be resolved, we believe that carefully fulfilling fiduciary obligations is as important as ever when considering a PRT project.

PRT options

Historically, various PRT methods were conceptualized and executed, but three PRT options have become the popular frontrunners recently:

- Lump sum windows
- Annuity purchases
- Plan terminations

Type	Lump sum window	Annuity purchase	Plan termination
Popularity	●●○	●●●	●○○
Cost as a percentage of affected liability	●○○	●●○	●●●
Project length	●●○	●●○	●●●
Impact on PBGC premiums	●●○	●●○	●●●

Source: Bank of America. Actual experience will vary.

Lump sum window

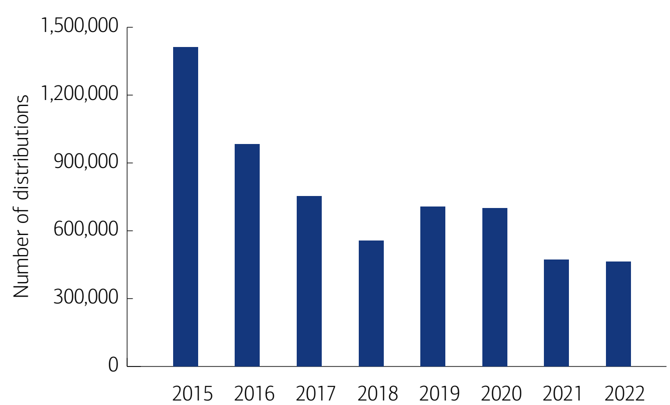
This PRT represents a transfer of risk to the plan participants. It's executed by paying inactive plan participants their entire future pension benefit in an immediate single sum. This type of project is generally offered on a one-time basis but can be added as an ongoing option as well.

To execute a lump sum window, the sponsor extends the lump sum opportunity to a group of participants. Each individual participant can choose to accept the lump sum or decline it. If participants decline the lump sum, they'll receive their unchanged and regularly scheduled benefit at a future date. If participants accept the lump sum distribution, they surrender their status as a plan participant in exchange for a single sum representing the value of their share of the plan assets. For the plan sponsor, this reduces plan headcount, which reduces PBGC premiums and may reduce funded status risk depending on which participants accept the lump sum offers.

Lump sum windows have been popular historically because they're relatively inexpensive to offer. The plan assets paid as lump sums usually reduce the plan's market liability on a one-to-one basis. Actual experience varies, though, due to a variety of factors. These include the demographic information of participants electing lump sums as well as changes in interest rates between the time of the lump sum calculation and the date of payment.

Recent data available from the U.S. Department of Labor's Form 5500 may suggest that lump sum windows are becoming less popular since their peak.

Lump sums paid, count of distributions



Source: U.S. Department of Labor Form 5500 — Schedule R. Data as of 02/27/2025.

Risk management options other than PRTs

- Liability-driven investing (LDI)
- Spinoff termination
- Goal-based contribution strategy
- Borrowing to fund
- Cash balance conversion
- Liability-insured investment contract
- Longevity insurance

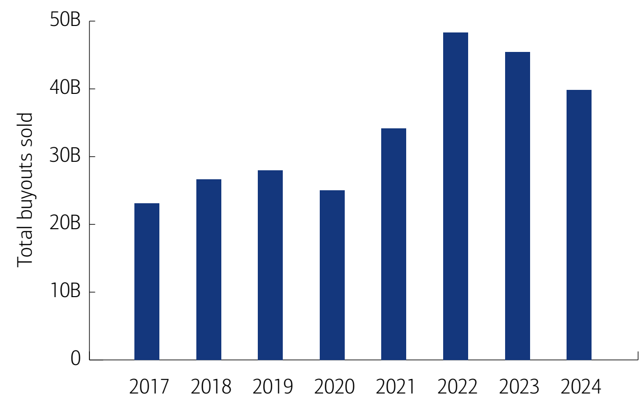
Annuity purchase

This PRT represents a transfer of risk to an insurance company and is sometimes called a partial buyout. It's executed by contracting with an insurance carrier to shift a previously agreed-upon group of plan participants from the plan to the carrier at a set price on a specific date.

To execute an annuity purchase, a plan sponsor would approach various insurance carriers and request that they bid on an annuity contract covering a group of employees. If the contract is executed, the sponsor pays the contract price, and the carrier takes over administration of current and future benefits for the affected group of participants. Plan participants have no choice in this type of PRT — the transaction occurs at the plan sponsor's discretion. For the plan sponsor, this reduces the plan headcount, which reduces PBGC premiums and may reduce funded status risk depending on which participants are transferred to the insurance carrier. Annuity purchases are popular because of the certainty they offer to plan sponsors. Plan sponsors know how many participants will be transferred and at what price. Survey data made available by the LIMRA Secure Retirement Institute indicates that the annuity transfer market is growing.

The tradeoff for certainty is that the contract price may be higher than 100% of the market value of the liability to be transferred, depending on the demographics of the plan participants in question. That said, annuity premiums have decreased over the last several years for retiree-only deals as new insurers have entered the market.

Single-premium buyouts, assets sold; full calendar year



Source: LIMRA Secure Retirement Institute Group Annuity Risk Transfer Survey. Data as of 02/27/2025.

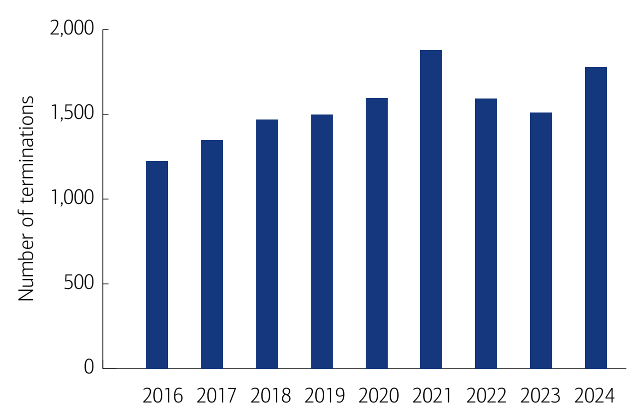
Termination

This PRT represents a transfer of risk to various parties. It's executed by transferring a plan's liabilities in their entirety using any available options.

Plan termination is the most comprehensive PRT. It's also the most expensive. The process of plan termination often involves a combination of the previously discussed PRTs. Ultimately, annuities must be purchased for all participants in the plan at the time of termination. This is sometimes called a full buyout. To reduce the number of annuities that must be bought at a premium, a lump sum window is commonly offered before termination. Multiple insurance carriers can be leveraged for large annuity contracts, and regulatory paperwork must be filed with the IRS and PBGC. Once all the liabilities have been settled, the plan is formally terminated. This eliminates funded status risk for the plan sponsor, completely transfers all pension risk, and eliminates PGBC premiums. While this is frequently the most desired outcome for plan sponsors, it also tends to be prohibitively expensive. To afford termination, plan assets generally need to be at least 102% to 110% of the market liability, which is often approximated as the plan liability calculated using U.S. generally accepted accounting principles (U.S. GAAP) or International Accounting Standards (IAS).

Data made available in the PBGC annual reports for fiscal years ending September 30 indicates that voluntary terminations remain steady, with little growth in recent years. The vast majority of those terminations are for small plans, though there's been some recent uptick in termination activity among larger plans as well.

Terminations, count of PBGC standard terminations completed*



*PBGC Annual Reports are published by fiscal year ending September 30.
Source: Pension Benefit Guarantee Corporation (PBGC) Annual Reports.
Data as of 02/27/2025.

Eight other considerations when exploring PRTs

1. **One-time costs.** PRTs are designed to save PBGC premiums over a long time horizon, but up-front administrative expenses can quickly diminish those savings.

2. **PBGC premium types.** The PBGC charges flat rate premiums based on headcount and variable-rate premiums based on plan funded status. An approach that works for one plan may not make sense for another.

3. **Economies of scale.** Some service providers may charge flat fees or provide reduced service charges based on attaining certain criteria. Legal, accounting, actuarial, and investment fees could increase per person or per basis point as the plan's headcount, liability or asset value decreases.

4. **Targeting small benefits.** A PRT's financial viability is almost always linked to a reduction in future PBGC premiums. When undergoing a PRT, targeting participants with small benefits will yield greater future cost savings. As the benefit amount increases, the per participant cost savings decreases quickly.

5. **Plan life cycle.** PRT projects are most effective when considered holistically. PRT types may differ for plans that will terminate in a few years versus those taking a hibernation approach.

6. **Nondiscrimination.** When targeting participants with small benefit amounts, ensure that the offering won't result in discrimination issues for the plan.

7. **Settlement accounting.** PRTs can and often do trigger settlement accounting, which may result in undesirable settlement charges on financial statements.

8. **Fiduciary and settlor obligations.** Individuals operating as either a fiduciary or settlor on the plan sponsor's behalf have various duties they're expected to fulfill. These individuals must be aware of their roles and responsibilities.

Conclusion

Pension risk transfers are well established in the current market but are not a one-size-fits-all solution. By understanding the basics of how and why a PRT can be beneficial, plan sponsors can effectively add another tool to their defined benefit plan toolbox.

For more information, contact your Bank of America representative.