VOLUME 78 ◆ NUMBER 8

Employee Benefit Plan Review

Pension Derisking Options

By Katrina L. Berishaj and Jeremy Gottlieb

Q We have a well-funded defined benefit pension plan and are looking to derisk. What are common derisking options?

A In a defined contribution plan, such as a 401(k) plan, the employee, the employer or both contribute to a participant's individual account under the plan, and the participant receives the balance in their account, which is based on contributions plus or minus investment gains or losses. A defined contribution plan does not promise a specific amount of benefits at retirement. A defined benefit pension plan, on the other hand, provides participants with a guaranteed specific retirement benefit amount during retirement. As such, the employer, as opposed to the employee, bears the investment risk.

Defined benefit plans can result in significant liabilities for an employer. With increased life expectancy, interest rate volatility, volatility in equity markets and increasing Pension Benefit Guaranty Corporation premiums, pension risks have increased over the years.

However, market performance in recent years has resulted in healthy funding levels for many defined benefit plans. Moreover, interest rate volatility and a potential market downturn are a real concern. Consequently, many defined benefit plan sponsors and fiduciaries have begun to consider options to lock in funding levels and secure their obligations. Liability-driven investing (LDI) strategies and pension risk transfer (PRT) are two common derisking strategies for pension plans. It is important to remember that for pension plans subject to the Employee Retirement Income Security Act (ERISA), these derisking strategies can be subject to the fiduciary duties of ERISA.

The goal of LDI with respect to a defined benefit pension plan is to ensure that the plan has sufficient income-generating assets to satisfy paying out the participants over a long period of time, while also minimizing the risk that the plan will not be sufficiently funded. LDI is not intended to generate high returns but is instead intended to ensure that the assets are sufficient to meet the liabilities of the plan, which are the current and future payments made to retirees. In general, using LDI, plans increasingly allocate to fixed-income portfolios. Although the return on investment is generally lower than would be with an aggressive investment strategy, the risk is significantly minimized, ensuring that the pension plan will be able to meet its obligation of paying employees during retirement. Importantly, LDI does not reduce the size of the plan's liabilities or reduce the administrative costs of the pension plan. Additionally, LDI is a fiduciary investment decision, and the U.S. Department of Labor's (DOL) Advisory Opinion 2006-08A recognizes that investment fiduciaries may consider a

plan's liabilities in managing a plan's assets.

Pension risk transfers can come in various forms. The most common are buy-in annuity and buy-out annuity. A buy-in annuity is an investment that shifts some portion of plan assets to an illiquid investment (annuity) that matches certain liabilities (*e.g.*, a segment of participants in payout status). A buy-in annuity is typically a group annuity contract held as an asset of a pension plan, and the benefit obligations remain on the plan sponsor's balance sheet. As such, the plan retains fiduciary and administration obligations with respect to participants whose benefits may be covered by the annuity. A buy-in annuity generally manages interest rate risk and possibly mortality risk, and typically reduces volatility of investment risks and funded status but may result in reduced returns. Like LDI, a buy-in annuity does not reduce the size of the plan's liabilities or reduce administrative costs of the plan and is subject to applicable fiduciary law.

On the other hand, a buy-out annuity is a group annuity contract wherein a pension plan fully transfers pension plan assets and liabilities to a third-party insurance company, and the insurer is fully responsible for the administration of such benefits. Unlike LDI and a buy-in annuity, a buy-out annuity does reduce the size of the plan's liabilities. Because the pension benefit obligations are fully transferred from the pension plan, the obligations are removed from the plan sponsor's balance sheet. Additionally, the third-party insurer maintains administration obligations with respect to participants whose benefits are covered by the buy-out annuity. Affected individuals are no longer participants in the plan, and their recourse is against only the annuity provider under state law. Importantly, while it is a company (i.e., settlor) decision to transfer plan liabilities to a third-party insurer, the implementation of such decision and the selection of an annuity provider are fiduciary decisions, which raise significant fiduciary considerations.

ERISA fiduciaries are required to conduct an objective, thorough and analytical search to identify and select providers for annuities. Fiduciaries should evaluate a potential annuity provider's creditworthiness, risk of bankruptcy or default and ability to pay claims. This is because the insurer will likely have to make payments to participants and beneficiaries many years into the future. Fiduciaries should also evaluate the features of the annuity contract, such as surrender charges, to ensure that the annuity is appropriate.

The regulations promulgated by the DOL provide that defined benefit ERISA fiduciaries should also consider:

- The quality and diversification of the annuity provider's investment portfolio;
- The size of the insurer relative to the proposed contract;
- The level of the insurer's capital and surplus;
- The lines of business of the annuity provider and other indications of an insurer's exposure to liability;
- The structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts; and
- The availability of additional protection through state guaranty associations and the extent of their guarantees.

Finally, such fiduciaries have a duty to select the safest available annuity provider unless, under the circumstances, it would be in the interests of participants and beneficiaries to do otherwise.

Katrina L. Berishaj, managing counsel in the Washington, D.C., office of Stradley Ronon Stevens & Young, LLP, and co-chair of the firm's fiduciary governance practice, advises financial services clients, including banks, trust companies, broker-dealers, investment advisers, insurance companies and institutional investors, on issues arising under the fiduciary and prohibited transaction rules of the Employee Retirement Income Security Act and the Internal Revenue Code. Ms. Berishaj, who is the Ask the Expert columnist for *Employee Benefit Plan Review*, may be contacted at kberishaj@stradley.com. Jeremy Gottlieb, an associate in the firm's investment management practice in Philadelphia, PA, may be contacted at jgottlieb@stradley.com.

Copyright © 2024 CCH Incorporated. All Rights Reserved.
Reprinted from *Employee Benefit Plan Review*, October 2024, Volume 78, Number 8, pages 10–11, with permission from Wolters Kluwer, New York, NY, 1-800-638-8437, www.WoltersKluwerLR.com