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# Pension Risk Transfers: What to Watch Out For

*Will the PRT be financially solid? Will the sponsor be left worse off? How will transferred beneficiaries fare?*

**CORPORATIONS ARE INCREASINGLY** selling their defined benefit plans, or pieces of them, to insurers. This has the advantage of removing a sizable obligation from the balance sheet. But plan sponsors should keep an eye out for potential pitfalls in transfers.

The pension risk transfer movement has evidently

expanded smoothly thus far, as beneficiaries receive insurance company annuities to replace their ERISA-protected, formula-driven payouts from employers. Transfers totaled $50 billion in 2022, far above their 2021 showing ($34 billion) and the previous annual record set in 2012 ($36 billion), LIMRA research found. So what should sponsors be looking out for as the trend progresses? One possible downside centers on a controversial NISA Investment Advisors study that claims some insurers' investments may make them overly risky. Another report, from consulting firm Agilis, questions private equity involvement in PRTs. There are also considerations to weigh involving possible hikes in Pension Benefit Guaranty Corporation premiums and accounting hazards, among other considerations, according to a study from the Segal Group consultancy.

Risk, of course, is the underlying concern for PRTs. Sponsors—who are fiduciaries under the Employee Retirement Income Security Act—must weigh whether they are meeting their obligations to their transferred plan beneficiaries. A transfer involves an insurer taking on investment risk (the assets that are shifted to insurers to cover the beneficiaries' annuities might fail to cover the transferred liabilities) and longevity risk (the annuitants might live longer than actuarial assumptions estimated and thus deplete the assets), notes Scott Hawkins, managing director and head of insurance research at asset manager Conning.

PRTs come in all shapes and sizes. Some sponsors transfer only a portion of their participants, such as former workers now drawing pensions, leaving in the plan those still working, whose retirement payouts are years in the future. Most PRTs are 100% funded, but for the underfunded transfers, insurance providers require sponsors to channel supplementary assets to the insurers to make up the funding deficiency.

## Adequacy of insurer portfolios

Once a PRT occurs, the annuity-paying insurer must be able to cover its obligations to plan participants. NISA Investment Advisors, an asset management firm known for its research capabilities, examined the fixed-income securities that nine of the top PRT providers issued and their spread over five-year Treasurys, as of August 31, 2022. NISA analysts believe, reasonably, that the providers' portfolios have not changed much since then.

At the top of the lineup was New York Life, with a spread of 0.74 percentage points, or 74 basis points. Second best was Prudential, at 76 bps, followed by MassMutual at 84 bps. In the middle were AIG (102 bps), MetLife (106 bps) and Principal (147 bps).

The three with the widest spreads, according to NISA's paper, were Pacific Life (with a spread of 158 bps), F&G (186 bps) and Athene (214 bps). Since then, the spreads have narrowed a bit, but the insurers are still ranked in the same order.

The NISA paper labeled the lowest-ranking three as "questionable." The report spotlighted the 140-bps spread between New York Life Insurance Company and Athene Holding Ltd. to underscore what it sees as greater risk for PRTs done with Athene. An annuity given to a plan participant must be the "safest available," according to a U.S. Department of Labor directive. In NISA's view, "As we move down the list of PRT insurers (ranked by quality), we believe it gets increasingly tenuous to argue a given insurer is indeed 'safest available.'"

Many PRTs are held in "separate accounts" by the insurer—with their own dedicated assets to offset


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liabilities—and insurance companies argue that this practice insulates beneficiaries from whatever is going on financially with an insurer and its general account.

Insurers, of course, reject NISA's analysis. Athene, the lowest-rated company on NISA's list, responds that its creditworthiness is solid, as measured by credit rating agencies. Standard & Poor's, for instance, gives it an A- credit rating, hardly at the top of the heap, but still characterized as "upper medium quality." Other agencies have similar findings. AM Best, which focuses on insurers, gives it an a+ long-term issuer credit rating, the third notch down from the highest position.

Athene notes that, with $19.6 billion in regulatory capital, it is financially strong and easily able to withstand a deep recession: In a downturn equivalent to the financial crisis of 2008 to 2009, the company estimates that it would lose a little less than a quarter of its capital. Athene pointed out that any plan sponsor contemplating a PRT would be advised by an independent fiduciary that would review the insurer's financial condition.

"NISA's analysis ignores respected industry experts and incorrectly uses credit spreads as a proxy for claims-paying ability," said Marty Klein, Athene's executive vice president and chief financial officer, in a statement.

In a broad written rejoinder to the NISA study, Athene also charged that its critic is biased, because NISA is an asset manager and thus suffers from erosion of its business as companies shunt their pension assets to PRTs. What's more, Athene contended that, "while NISA researches corporate credits to inform their asset management, they don't have any material insurance expertise."

Pacific Life Insurance Company, another of NISA's bottom three, replied to the report's findings by saying that concentrating on spreads as a determinant of credit strength is "problematic," as the use of separate accounts, portfolio diversification and its capital, among other factors, are overlooked. The insurers' bonds that NISA studied are securities known as "funding agreement-backed notes," which are supported by insurers' funding agreements and are publicly traded. The insurers argued that FABNs are not very liquid; thus their spreads do not give an accurate reading of creditworthiness. The picture is further muddied by the differing durations of FABNs, Pacific Life stated.

F&G Annuity & Life Inc., the other insurer in the bottom trio, did not respond to requests for comment.

In response to the insurers' comments, NISA CEO David Eichhorn emphasizes the importance of the bond spreads as the best reflection of how the market assesses the insurers' creditworthiness: "The fiduciaries overlook credit measures," he says. He describes NISA's purported bias as irrelevant—"no one is perfect [regarding] ulterior motives," he says—and insists that the facts of the three insurers' risk profiles outweigh any other considerations.

Eichhorn disputes the assertion that FABNs are too thinly traded to be gauged in a spread to Treasury bonds. Using data from FINRA's Trading Reporting and Compliance Engine, he says the insurers have plenty of trading volume, adding that Athene's FABNs had an average daily trading volume of $20 million in 2022.

In addition, he points out that NISA highlights the top three on its list as "clear candidates" for PRT-minded companies to consider. If NISA is out to smear PRT providers, he asks, why is it giving good grades to New York Life, Prudential and MassMutual?

Says Eichhorn, "We don't say, *'Don't* do a transfer.'"

## Private Equity and PRTs

Insurers are increasingly getting gobbled up by PE firms, the Agilis report declares: 117 insurance companies (not necessarily all of them PRT suppliers) were under private equity ownership as of 2020, representing 6.5% of the U.S. insurance industry.

Last year, for example, Apollo Global Management bought Athene. Agilis reports a "relatively high degree of interaction and influence" between the insurer and its parent.

Other PE relationships do not involve ownership. F&G (previously known as Fidelity & Guarantee) has an alliance with Blackstone, which has no equity stake in the insurer but manages the insurance firm's investments.

Private equity incursion into the insurance industry has provoked worry in some quarters that the PE crowd will make PRT annuities riskier for beneficiaries. Is the fretting warranted?

While state regulatory bodies continue to oversee insurers, including PRT providers, Agilis notes that some PE-connected insurers, such as Athene and F&G, use a lot of securitized assets in their general accounts. These assets generally have high credit quality, yet "complexity and reduced transparency mean they may be a higher likelihood of credit quality decline," as compared with more traditional bonds, according to Agilis.


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Athene's Klein, in a statement, defended the use of securitized assets, which his company uses for "diversification, credit enhancement and structural protections," stating, "We believe investment grade structured credit today is a safer credit risk than comparably rated corporate debt." He pointed to a research paper on collateralized loan obligations, a securitized vehicle, by Robert Jarrow, a professor at Cornell's business school, and Donald van Deventer, CEO of the Kamakura Corporation, a risk-management software company. The authors stated that "credit rated CLO tranches are less risky than comparably rated corporate bonds."

To be sure, Agilis' take on PE ownership of PRT-providing insurers is nuanced. It discards suspicions that PE firms extract capital from insurers, thus putting their solvency at risk. Regulators frown upon such practices, the Agilis study notes.

To Agilis, it is "too simplistic" for plan sponsors considering a pension transfer "to penalize an insurer solely because of a PE relationship or ownership." Indeed, state guaranty funds, which support annuitants and other insurance policyholders in the event of an insurer insolvency, give PRTs added security, Agilis maintains.

All states and the District of Columbia have guaranty funds, which take over paying benefits that insolvent insurers used to. (No PRT-issuing insurer has gone bust.) The upshot is that the security of participants' benefits is likely superior "to most corporate sponsored pension plans," according to Agilis. PE's involvement with insurers "requires vigilance, but it does not necessarily result in reduced security for policyholders."

## PBGC Premiums

In this area, some transfer-minded plan sponsors may be vulnerable. The PBGC, a federally chartered organization that backstops failed pension plans, charges DB plan sponsors insurance-like premiums to underwrite its rescue cache. Most single-employer plans are fully funded, and the PBGC imposes premiums based on their number of beneficiaries: a flat, per-person rate of $96 in 2023. For the underfunded pension programs, however, the agency levies extra fees, called variable rate premiums, which vary depending upon the size of the shortfalls. These VRPs are capped at $652 per pension participant.

Sponsors, however, should calculate how much a pension transfer would alter these extra premiums, warns the Segal report. The calculations are not simple, with various factors involved—such as the amount of assets a full plan must shift to an insurer to cover the beneficiaries. When an entire plan is being transferred, not just a portion, the problem is most acute.

Underfunded plans can end up paying higher VRPs if they transfer only a part of their beneficiaries. In an example, Segal showed how a partial transfer of 100 beneficiaries in an 1,100-member plan can cause its VRP to grow more expensive. To make the transfer, the sponsor must shift a bigger portion of its assets to the PRT than a fully funded plan would. That's because the sponsor must fill the underfunding gap, so the transferred participants are covered by sufficient assets to ensure their annuity payments going forward. But the results are fewer assets backing the remaining 1,000 members and an even more underfunded DB plan. So the PBGC increases the VRP rate.

## Accounting Snags

In preparing for a transfer, sponsors sometimes find "large unrecognized losses" that they need to resolve first, says Jarred Wilson, a vice president and consulting actuary with Segal and co-author of its report. In addition, toting up the valuation of future pension payments may saddle a sponsor with unexpected expenses.

Another problem: If the reduction in benefit obligations in a partial transfer is greater than the plan's servicing and interest costs, then accounting rules may require a settlement charge against corporate earnings.

## Impact on Participants

DB plans were created as a perk that generated loyalty from employees to their companies. Transferred plan participants receive the same benefit from the insurers' annuities that they would have under their old DB plan.

But what if the insurer becomes insolvent? The transferred people no longer have the protection of the PBGC. The Segal study points out that "insurance companies don't protect [the annuities] from creditors." States have guaranty funds to pay policyholders stranded in an insurer collapse, yet most "don't guarantee the same level of coverage as the PBGC," the report indicates.

The American Academy of Actuaries says in a briefing paper that PRT annuities in separate accounts provide "those plans' participants with an added layer of protection," as their supporting assets are walled off from the rest of an insurer's portfolio.

For plan sponsors eyeing a transfer, a thorough examination into all the possible drawbacks will be a wise move. ●


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