RUSSELL INVESTMENTS RESEARCH

PENSION RISK TRANSFER

A FRAMEWORK FOR A SUCCESSFUL IMPLEMENTATION

Travis Bagley, CFA, Director, Transition Management

Josh Houchin CFA, Senior Portfolio Manager, Transition Management

A pension risk transfer (also known as an annuity buyout) can be one of the most significant events in the lifecycle of a defined benefit plan. Because of the importance and complexity of this transaction, we think it is essential that plan sponsors team up with the right implementation partner to help ensure the smoothest transfer of assets.

To help guide plan sponsors down the path to success, we have crafted a broad framework on how to facilitate the transfer of assets and liabilities from an existing investment portfolio to an insurer or annuity provider, in partnership with an implementation provider. Because a pension risk transfer strategy is complex and multifaceted, the plan sponsor will in most instances hire a consultant to determine the feasibility of a risk transfer strategy for the pension plan. Our framework covers the implementation process after the decision has been made to affect a risk transfer.

To execute a successful risk transfer event, it is important to select the right implementation partner early in the process and well before assets are set to transfer. An implementation partner provides expertise in the form of advice and implementation flexibility during the risk transfer bidding and implementation process. In our opinion, this is crucial as insurers may have different payment options (cash versus securities) and assumptions. Given the complexity of the transaction, analyzing the payment options with other considerations requires a combination of expert specialists to help the plan sponsor choose the optimal risk transfer solution for the plan.

Roles and responsibilities in risk transfer events

There are several different groups involved in the risk transfer process, each with their own roles and responsibilities:

- **Plan sponsor** – The plan sponsor is the primary stakeholder and determines the insurance or annuity provider and the process for transferring assets to them.
- **Buy-out consultant or independent expert** – The buy-out consultant or independent expert assists in the governance structure for decisions while helping plan sponsors understand the process and the responsibilities of the parties involved in the risk transfer process. In most cases, the consultant or expert will assist in the annuity provider selection as the Annuity Placement provider.

- **Implementation partner** – The implementation partner offers expertise in fixed income, equities and derivatives, and also provides advice on controlling risk in the plan while minimizing transaction costs. This is often a transition manager with strong global fixed income and equity portfolio management and trading capabilities.
- **Other providers** – In addition to the independent expert, other providers are responsible for the Department of Labor (DOL) Interpretive Bulletin 95-1 and are focused on ensuring that the annuity provider meets DOL guidance on the impact on participants. There may also be external ERISA counsel and other legal, administration and trustee activities that must be coordinated.

Risk transfer annuity payment strategies

Risk transfers are completed by one of two payment options: 1) a cash payment or 2) an asset-in-kind (AIK) transaction, in which securities can serve as the form of payment. Depending on the size of the payment and insurer's book at the time, pricing can vary between these two payment methods. In general, there are benefits and challenges to each of these approaches. An implementation partner can help add clarity to the complete economics of the bids and, at the time of transaction, manage the risk transfer to minimize this cost and risk. The specific benefits and challenges are as follows:

PAYMENT	BENEFITS	CHALLENGES
Cash	• Simple to coordinate and transfer to insurance company	• Requires liquidation of assets, possibly in a short period of time, potentially increasing transaction costs and risk management
Assets in kind	• Lower risk transfer premium price • Lower transaction costs if assets in existing portfolios can be contributed • Valuation adjustment from bid to mid-point price, which increases the value of assets to transfer to the insurance company, thus lowering the overall cost of the risk transfer	• More complex transaction • Transaction costs must be estimated prior to event to validate best approach • Requires some restructuring to deliver insurer's desired transfer portfolio

Plan sponsors often look first to satisfy the in-kind request of the insurer with all the available plan assets, but in our opinion that is not the best sequence of operations.

Design your portfolio for the remaining plan, *then* identify assets to transfer in-kind to insurer

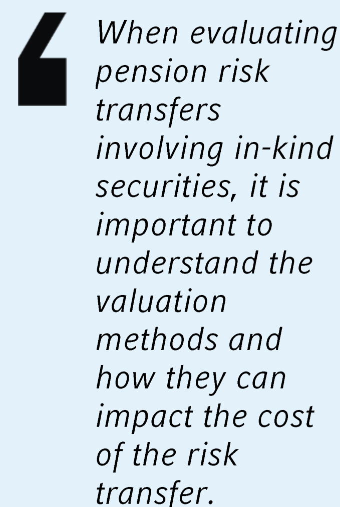
Nearly all risk transfers represent only a portion of the defined benefit plan, not the entire plan. The first consideration is typically formulating a strategy to retain as many assets as possible for the remaining plan. Plan sponsors often look first to satisfy the in-kind request of the insurer with all the available plan assets, but in our opinion that is not the best sequence of operations. The plan sponsor should first identify assets they would like to keep with the ongoing plan and then shop the residual assets to the insurer, not the other way around. Otherwise, the insurer is most likely to take assets that the ongoing plan would otherwise keep and force the plan to later replace those assets, adding additional transaction costs to the ongoing smaller plan.

Once the plan identifies the assets that will be retained, the residual unwanted assets should be shopped to the insurer(s) to see what they would take in-kind. The insurer(s) may want in-kinds and cash, or they may request that a more complete portfolio representation be provided as the AIK portfolio. The plan sponsor will need to purchase securities targeted by the insurer to deliver a low-risk in-kind portfolio, which should allow the insurer to provide a better risk transfer price.

In our opinion, pre-risk transfer implementation planning is very important to the success of the event. The total portfolio exposures, AIK and remaining portfolio must be balanced with a trading strategy that provides the insurer with the needed assets, while positioning the remaining assets to deliver the appropriate surplus risk as the structure of the liability changes.

There are typically three threads in risk transfer implementation:

1. **Implementation strategy of restructure for the remaining portion of the defined benefit plan** – At the moment the risk transfer is executed, the remaining liabilities become a subset of what they previously were. The assets must also be adjusted at the same moment to minimize surplus risk for the continuing plan. Ideally, this would just be a pro-rata slice of the existing pre-risk transfer portfolio. However, in practice, this is almost never the case. The duration and structure of the remaining liabilities is different with the pre-risk transfer portfolio, and adjustments must be made to match the assets to the liabilities—particularly when the private markets portfolio cannot be liquidated, limiting how the plan sponsor can adjust the portfolio.
2. **Identify in-kind assets** – In many cases, there will be multiple insurers bidding for the transfer, and the appetite for in-kinds can differ greatly amongst the insurers. The implementation partner can structure the in-kind discovery process so that it is fair and equitable for all parties involved, maximizing potential in-kinds and reducing the overall cost of the risk transfer for the plan.
3. **Exposure for risk transfer portfolio** – The assets transferred to the insurer for the risk-transfer process can be termed the "risk transfer portfolio." This portfolio may contain existing securities from the plan and cash or duration management investments to minimize risk. This is often a scenario where futures contracts can be employed to manage duration risk for the plan. In some cases, the insurer requests the purchase of an additional set of securities to deliver the appropriate duration-matched portfolio to minimize risk, which in turn may help reduce the plan's cost of the annuity purchase.



Valuation considerations for in-kind transfers

- **In-kind valuation methodology** – The pricing methodology determines how in-kind assets will be valued (bid vs. mid-point pricing) as well as accrued interest and must be agreed upon prior to the transaction.
- **Securities pricing sources** – There are several different potential pricing sources that can be used to value in-kind assets. The plan sponsor and insurer will agree on the pricing source for the assets and the plan sponsor needs to understand how the pricing source may affect the valuation of the assets relative to the plan's current valuation practices.

When evaluating pension risk transfer involving in-kind securities, it is important to understand the valuation methods and how they can impact the cost of the risk transfer. In some cases, this valuation method will benefit the plan sponsor and can reduce the cost of the risk transfer premium for the plan.

Four steps for in-kind risk transfers

Once you have chosen an implementation partner, there are four primary steps for in-kind risk transfers.

1. **Create a list of available separate account assets that can be provided to the insurers to identify in-kind securities**
    - **a.** The plan sponsor will need to begin the in-kind discovery process several weeks before the risk transfer date.
    - **b.** This list should be considered preliminary but will be a good representation of the available assets at the time of the risk transfer.
2. **Consider the remaining or residual portion of the risk transfer portfolio (the in-kind assets only represent a portion of the total risk transfer portfolio)**
    - **a.** Some insurers will simply request cash for the remainder of the risk transfer portfolio. However, this cash portion of the transfer portfolio should maintain the appropriate market exposure until the risk transfer is executed, and any market exposure associated with this cash must be removed at the risk transfer execution time.
    - **b.** The insurer may prefer Treasuries or additional credit positions rather than cash to minimize the opportunity risk relative to the liabilities at the time of the risk transfer. This reduced risk for the insurer commonly should allow for a more competitive risk transfer price and lower costs for the plan sponsor.
3. **Develop an exposure management strategy that will maintain appropriate exposures pre- and post-risk transfer**
    - **a.** The liabilities of the plan are the obligation of the plan right up to the point where the final risk transfer price is determined. The plan sponsor must prepare to quickly adjust the portfolio at the risk transfer execution time.
    - **b.** A futures hedging strategy can be a good option to maintain interest-rate sensitivity and reduce surplus risk during the risk transfer implementation period. The futures hedging strategy allows plan sponsors to begin liquidating illiquid securities earlier, in order to complete by the transfer date.
    - **c.** Existing physical securities and commingled funds are also vehicles that can potentially provide the needed exposures if they have the necessary liquidity to quickly adjust the portfolio at risk transfer execution time.
    - **d.** At the risk transfer execution time, the portfolio must be immediately adjusted to reflect the insurer's desired target risk transfer portfolio. This requires a well-planned implementation strategy that has reviewed liquidity scenarios and designed an executable plan that will minimize opportunity risk and transaction costs.
    - **e.** Of most importance to the plan sponsor, in our opinion, is the portion of the plan remaining with the plan sponsor. It will also need to be adjusted to align with the plan's desired long-term portfolio structure moving forward. This should take place at the same moment the risk transfer execution occurs in order to minimize timing risk for the ongoing plan.
4. **Execute settlement of the risk transfer portfolio**
    - **a.** The settlement process allows for a five-day window between execution and the actual transfer of portfolio assets from the plan sponsor to the insurer. In this period, the implementation partner will settle all the transactions, confirm asset availability and instruct the transfer to the insurer's custodian.

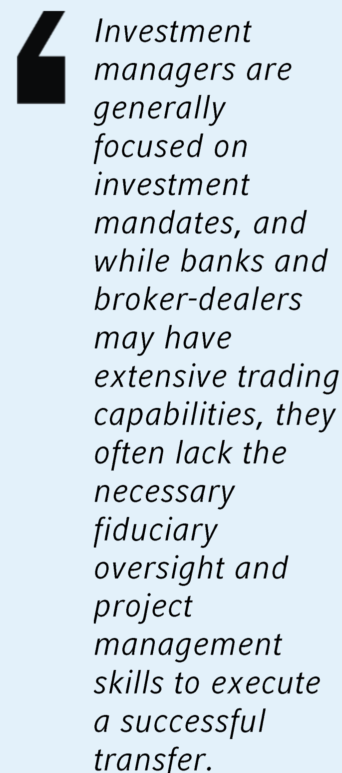
Timing considerations

- **Constructing the risk transfer portfolio** – Once the risk transfer portfolio is known, there can be weeks before the transfer execution date. The risk of adverse market movements can be substantial, so it is important to minimize the risk of the target assets as quickly as possible and build the hedging portfolio.
- **Coupon payments** – During the settlement period of a risk transfer (typically a week), a plan and an insurance company will want to avoid a period of significant coupon payments as they will need to be accounted for and transferred in cash to the insurance company. Avoiding a period of significant principal payments or coupons minimizes the required reconciliation of cash flows.

- **Secondary market liquidity** – If assets do need to be liquidated (for either an all-cash bid or for a partial cash bid—i.e., available in-kind assets that are not selected), the plan will want to do this during a period with sufficient secondary market liquidity. Although one cannot time the market, a plan sponsor can undertake the bidding process during times that avoid low liquidity periods, such as year-end or certain market holiday weeks.
- **Economic announcements** – Avoiding significant economic announcements can also be beneficial as volatility can cause the valuation of assets to vary by pricing vendor. In a more muted volatility environment, pricing volatility is also muted and ensures a more consistent valuation of portfolio assets available for in-kind transfer.

Choosing an implementation partner

Choosing an implementation partner with the right experience and capabilities is essential to a successful risk transfer. Few organizations have the depth and breadth of total plan implementation experience, including portfolio management and trading capabilities with fiduciary oversight, all of which is typically needed to help manage these complex projects. Investment managers are generally focused on investment mandates, and while banks and broker-dealers may have extensive trading capabilities, they often lack the necessary fiduciary oversight and project management skills to execute a successful transfer.



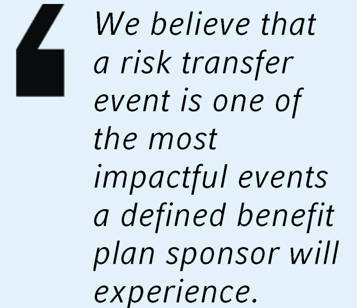
Plan sponsors typically need more than just a transition manager—they need a transition manager with a background in defined benefit plan portfolio management that includes a wide range of trading capabilities: physical, derivatives and currency trading, plus extensive project management experience and a history of managing complex events like risk transfers. Because this is not a common set of proficiencies that investors can find in a single organization, we have laid out the key traits and capabilities we see as essential in a checklist format below.

Here's a checklist to help you select the right risk transfer implementation partner for you:

- ✓ Multi-asset portfolio and risk management capabilities
- ✓ Capabilities to transact in physicals and derivatives in global fixed income, equities and currency
- ✓ Ability to provide fiduciary oversight as an investment advisor, in supplement to the independent experts
- ✓ Extensive experience with liability-driven investing and exposure management
- ✓ Extensive track record of managing complex projects, including risk transfer events
- ✓ Ability to provide pre-event cost and risk estimates
- ✓ Ability to provide post-event performance reporting, including T standard implementation shortfall
- ✓ Access to multiple pricing vendors and experience with comparing valuations
- ✓ Strong project management and communication skills to effectively communicate with plan sponsors, investment managers, custodians, consultants, insurers and other service providers

Conclusion

With all that said, we believe that a risk transfer event is one of the most impactful events a defined benefit plan sponsor will experience. Because of the scale and complexity of the event, several experts are needed to successfully transfer liabilities and assets from a corporate defined benefit plan to an insurance annuity provider. Employing a fiduciary implementation partner to assist with a risk transfer event gives the plan sponsor an investment and operational expert to help minimize the cost of the event and reduce the operational burden to plan staff. An implementation partner maximizes the flexibility in selecting bids in different structures while also assisting with the bid selection and the implementation of the decision. The implementation partner also provides essential expertise and tools to reconfirm the appropriateness of the structure of the defined benefit plan that remains with the corporation after the risk transfer.



We believe the best implementation partner will serve as a seamless extension of the plan sponsor's team, taking on the duty of managing the investment portfolio and executing strategies that minimize risks and trading costs for the plan. The expertise, resources and reporting provided by an implementation partner deliver flexibility and guidance on governance for plan sponsors undertaking a risk transfer event. By working with an implementation provider, a plan sponsor is free to focus on finding the best risk transfer solution for its pension plan.

Russell Investments Implementation Services, Inc., has a unique set of capabilities and experience to help assist large-scale plan changes—including those required for risk transfers—and is well-suited to be the implementation partner for these projects. Feel free to reach out to us for more information.

QUESTIONS?

Call Russell Investments at **800-426-8506** or
visit **russellinvestments.com/implementation**

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