Retiree Carve Outs - The What’s, Why’s and How’s of Pension Plan Annuity Purchases – Part 3

This article is the third in our three part series that discusses why pension plan sponsors are turning back to an old idea, Annuity Purchases. Our first article set the stage by explaining what an annuity purchase involves, addressed the risks and costs pension plans pose to their sponsors, and explained how annuity purchases mitigate those risks and costs.

Our second article addressed the specifics around why so many plan sponsors are purchasing annuities, how to analyze whether an annuity purchase makes sense, and the profile of sponsors that may, or may not, be good candidates.

Our third, and final, article discusses the process of annuity purchases and how you can optimize results.

How do we select the right annuity provider? DOL 95-1!

Selecting an annuity provider for any type of pension plan annuity purchase is a fiduciary responsibility that the plan sponsor must take very seriously. In 1995, the Department of Labor published Interpretive Bulletin 95-1, which “provides guidance concerning certain fiduciary standards ... applicable to the selection of an annuity provider for the purpose of benefit distributions from a defined benefit plan ... when the plan intends to transfer liability for benefits to an annuity provider."

Commonly referred to as DOL 95-1, the bulletin explains that selecting an insurer to transfer benefit liabilities is a fiduciary decision. As such, plan fiduciaries must act in the best interest of plan participants in selecting the insurer that can provide the “safest annuity available.” DOL 95-1 also requires that plan fiduciaries “conduct an objective, thorough, and analytical search for the purpose of identifying and selecting providers from which to purchase annuities.”

The DOL’s 95-1 procedures provide a framework for fiduciaries to evaluate potential insurers capable of providing the safest annuity available. The framework consists of:

- Conducting an objective, thorough, and analytical search
- Evaluating a number of factors related to an annuity provider’s claims paying ability and creditworthiness
- Relying on insurance rating agency services not being a sufficient analysis

It should be noted that after a fiduciary has gone through their due diligence they may conclude that more than one insurer is able to offer the safest annuity available.

The factors that are spelled out in DOL 95-1 that fiduciaries should analyze include:

- Investment portfolio quality and diversification
- Size of the insurer and size of the annuity contract relative to the size of the insurer
- Capital and surplus levels
- Lines of business of the insurer and exposure to liability
- Annuity contract structure
- State guarantees

Meeting the DOL 95-1 standards is a critical part of the process of selecting the annuity provider.
Implementing a successful annuity purchase
There are a number of critical steps and considerations that plan sponsors need to address in order to successfully implement an annuity purchase:

1. **Decide on an annuity purchase partner(s)** – Selecting an annuity provider is a fiduciary responsibility, which means the sponsor must be prudent in the process they undertake. Since almost all sponsors do not have the expertise to execute a proper process, prudence requires that the sponsor employ a partner in helping them execute an appropriate process. Not all service providers are created equal in the annuity purchase space. It will be important for the plan’s fiduciaries to select a provider that will give them a fair price and help them reach the appropriate conclusions from the analysis. One specific consideration is whether or not your provider will act as a co-fiduciary. This is a key distinction, and one that warrants attention. A co-fiduciary will be more thorough in their due diligence of the insurers since they will also be on the hook if anything were to go wrong with the process of selecting the safest annuity available.

   For large annuity purchases, plan fiduciaries may consider hiring an independent fiduciary to make the ultimate annuity provider selection. Recently, the use of an independent fiduciary has come down market and we have seen sponsors use these services for transactions as low as $100M. Again, the selection of the independent fiduciary is still a plan fiduciary decision and the decision should be given scrutiny and stand up to the typical fiduciary standards of care. What will be interesting to see is how the various insurers decide to work with annuity placement providers under the DOL’s new fiduciary rule. It is not unfathomable that many of the insurers will restrict who they provide annuity quotes to based on the company’s due diligence process and fiduciary considerations.

   Typically, service providers fall into one of two categories: broker or consultant. Brokers usually get paid on commission and specialize only in placing the annuity contract. Consultants will be able to help with the big picture analysis in addition to placing the annuity contract.

   At the end of the day, plan sponsors will want to make sure they’ve partnered with someone with both a deep understanding of the annuity purchase marketplace and the ability to analyze the liability and investment implications of doing an annuity purchase.

2. **Understand the financial implications** – As discussed in our second article, understanding the impact on cash contributions, balance sheet liabilities, income statement impact and administrative cost savings (i.e., PBGC premiums, audit fees, recordkeeping fees) is a critical step in going through the annuity purchase process.

3. **Prepare your data** – Having clean data is key to placing a successful annuity purchase. Clean data entails:
   - A current listing of all retirees in the annuity purchase group that includes each retiree’s benefit amount and form of payment. For forms of payment with certain periods, sponsors need to make sure they have a record of the date that the certain period started or will start.
   - Indicative data is complete and correct (e.g., name, date of birth, address)
   - Social Security Numbers for the retiree, and their beneficiary (if they have survivorship benefits), are available. Check Social Security Numbers against public death records to confirm that beneficiaries are still alive.
   - For forms of payment that includes a survivor benefit complete information on the beneficiary is vital.
Check with the plan's trustee/custodian to get a listing of all withholdings and payment method information. For participants that use direct deposit for their monthly retirement payments, make sure you can get the proper ACH information from the bank.

Going through the process of collecting the right data at the start of the process will help reduce the transition time needed by the insurer and will help you get better pricing. Other data considerations that may be helpful in the process include items such as:
- Current ZIP code
- Job title/classification
- Job description

These will help the insurer more effectively price the annuities based on their mortality assumptions.

4. **Insurer due diligence** – As discussed above, the DOL’s 95-1 procedures provide a framework for fiduciaries to evaluate potential insurers capable of providing the safest annuity available. The framework consists of:
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Beyond what is specified in the DOL 95-1, it will be helpful for plan sponsors to look at service performance, plan participant support, etc. in evaluating the quality of the potential annuity providers.

It should be clear that in order to effectively analyze the criteria, it will be paramount to hire an expert who can dive into the details and who understands both the insurer metrics as well as the plan sponsor objectives.

5. **Bid process and timing** – Beyond the due diligence, having a solid process for running the annuity placement bid can mean better pricing. This is a balancing act that your service provider will have to juggle. On the one hand, they want to make sure that the plan sponsor gets the best price possible. On the other hand, they have to make sure that their bid process is fair and balanced in order to maximize the number of insurers willing to bid – which in turn creates competition and ultimately better pricing. It’s important to note that insurers value some processes over others – another reason to make sure your service provider has a sound, respectable process with proven results.

From a timing perspective, the fourth quarter is typically the busiest for insurers. This can pose difficulties for getting enough insurers to bid on annuity placements in order to get competitive quotes. Insurers are limited by their human capital, and at the end of the year, they tend to become very selective in the placements that they will bid on. The first half of a calendar year tends to be the quietest for insurers, which means executing an annuity placement early in the year can help bring more insurers to the table and increase the likelihood of receiving competitive quotes. The third quarter does start to get busy for insurers, but there is generally still sufficient capacity to get most, if not all, of the applicable insurers to provide annuity purchase bids.

6. **Transfer of payments to the insurer** – Once an insurer is selected and a bid price is agreed upon, the next step is to transfer the annuity purchase premium. It is important to make sure your investment consultant is kept
For more information, visit our website at www.psolve.us or get in touch with your P-Solve consultant.

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