Pension Risk Management after the American Rescue Plan Act (ARPA)

- Defined benefit plan sponsors may want to take a fresh look at their pension risk management strategies given the American Rescue Plan Act of 2021 has provided landmark funding relief. Viewed broadly, risk management strategies fall into two categories: risk transfer and risk mitigation.

- Surveys show pension risk transfer activity continues to remain strong. In a 2021 survey of 201 senior executives by CFO Research in collaboration with Mercer, 77% of the respondents said they are likely to offer lump sum options within the next two years; 66% of these executives said they plan to purchase annuities to transfer retiree obligations to insurers within the next 2 years, and 28% foresee their organizations terminating their plans in the next 3-5 years.

- When weighing their options, some employers may find that a targeted hibernation strategy may make sense financially, given they now have a longer period of time to pay off their deficits and accumulate asset returns – and can do so in a less risky manner.

Pension Risk Transfer

- Lump Sum Window
  - Benefit obligation transferred to participants
    - Transfers mortality and investment risk to participants
  - Payout can be based on interest rates in effect at beginning of the year.
  - Settlement often at or near employer's carrying cost

- Annuity Buyout
  - Benefit obligation is transferred to an insurance carrier
    - Retirees only
    - Retirees and deferred benefits
  - Annuity purchase price includes
    - Conservative assumptions
    - Profit margin and other expenses
  - Settlement cost normally exceeds carrying cost

Pension Risk Mitigation

- Risk mitigation involves reducing and managing risk according to each company's risk tolerance.

- Frozen or closed DB plans often employ a risk mitigation strategy known as hibernation.
  - A glide path strategy is used to manage the investments
  - The plan is allowed to run its natural course, de-risking as retiree benefits continue to be paid

- A successful hibernation strategy is often less costly than an annuity buyout as future asset returns are retained in the plan.

- Key priories during a hibernation period include:
  - Minimize residual expenses
  - Maximize asset returns in a low-risk state
  - Minimize capital deployed in excess of pension obligations

* Sources: Milliman article, "To evaluate pension risk transfer plan sponsors need the whole picture"; Mercer report, "2021 Pension Risk Management | CFO Research"