

Risk transfer potholes



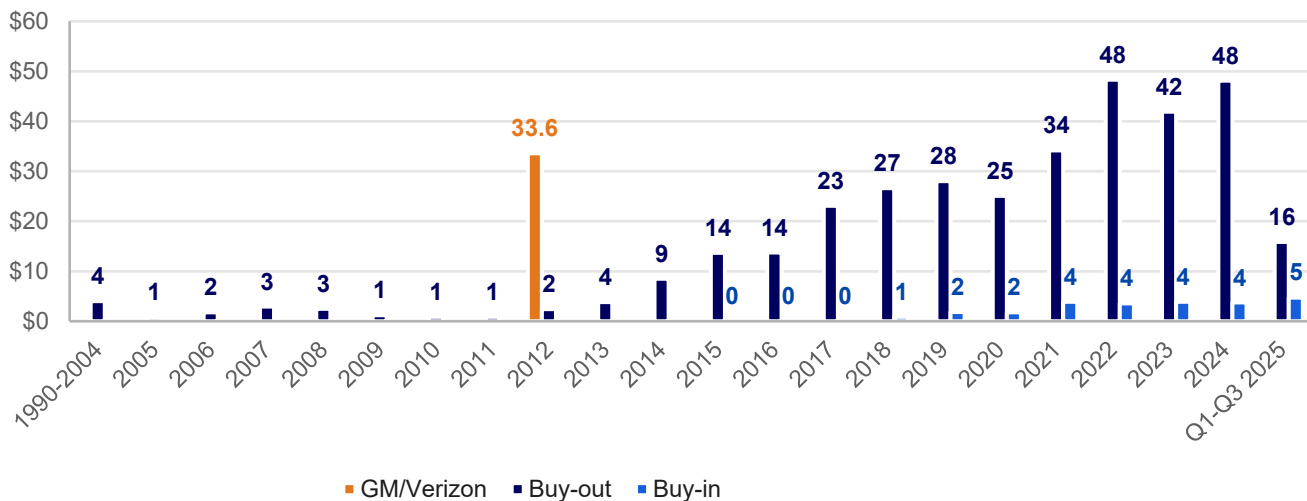
How to avoid them or brace for impact

Justin Owens, CFA, FSA, EA, Senior Director, Co-Head of Total Solutions

Pension risk transfer¹ has evolved from a niche strategy into a mainstream tool for defined benefit plan management. The modern market for these transactions began in 2012, when several large corporate sponsors—including Ford, General Motors, and Verizon—executed landmark risk transfer initiatives involving lump-sum cashouts and annuity purchases. Prior to that period, annuity purchases were infrequently used, as illustrated in **Exhibit 1**.

Since 2012, adoption has accelerated meaningfully, with transaction volume reaching highs in 2022 and again in 2024. This sustained increase reflects growing sponsor familiarity with the strategy, improved market capacity, and a broader acceptance of risk transfer as a component of long-term pension risk management.

Exhibit 1: U.S. pension annuity purchase transaction volume



Source: LIMRA Secure Retirement Institute

Lump sum offers were also relatively uncommon before 2012. Following changes to lump sum conversion rules enacted under the Pension Protection Act (PPA), combined with a declining interest rate environment in 2012 (as well as in several subsequent years), lump sum offers became more widely adopted.



Since 2012, most mid to large-size U.S. corporate defined benefit (DB) sponsors have pursued at least one form of risk transfer, and many have considered additional transactions proposed by their plan actuary or other advisors. Sponsors are often challenged with determining when, and under what circumstances, risk transfer is appropriate. These decisions can be consequential, and are not always straightforward.

Interest in annuity purchases also appears likely to persist, particularly as [funded status levels](#) have improved in recent years. Sponsors continue to evaluate opportunities to reduce the overall risk profile of the plan to the organization, and to reduce the plan's footprint on the organization.²

In this paper we seek to highlight potential challenges and red flags sponsors may encounter when evaluating pension risk transfer strategies. As much of the *low-hanging fruit* of risk transfer opportunities has already been picked, we have observed that some advisors have become more creative and aggressive in pushing risk transfer when not necessarily warranted or in the long-term best interest of the sponsor. Having a broader understanding of what issues may arise will help plan sponsors know when risk transfer makes sense.

Low-hanging fruit

Pension risk transfer can offer clear and tangible benefits in the form of cost savings and administrative simplification. One commonly cited advantage is the reduction in PBGC premiums. Sponsors pay a PBGC flat-rate premium every year for each plan participant, regardless of the plan's funded status. As a result, the flat-rate premium has increased from \$35 per participant in 2012 to \$111 per participant in 2026 (a 217% increase), with future increases indexed to inflation.

Reducing participant headcounts through lump sums or annuity purchases directly lowers this recurring cost. The economics can be particularly compelling for participants with relatively small benefits, where the cost of transferring liabilities is modest. Sponsors may also realize incremental savings from administering a smaller participant base, including reduced plan administration expenses.

The risk transfer transactions that tend to be the most economically and fiduciary-appropriate typically involve **well-funded plans** executing an annuity purchase for a select cohort of retirees that receive favorable pricing (such as retirees with low benefits), or offering lump sum cashouts during periods of favorable rate trends. These transactions rarely have adverse long-term consequences, which is probably why many have completed these projects already.

The analysis, however, becomes more complex when the plan is underfunded.

Having a broader understanding of what issues may arise will help plan sponsors know when risk transfer makes sense.

Pursuing risk transfer while underfunded

Risk transfer transactions can present meaningful challenges for poorly funded DB plans. In most cases, risk transfer is best evaluated as part of a long-term endgame strategy, or as a targeted tool to simplify plan structure without materially impairing plan economics. Plans that remain underfunded have not yet reached that stage and typically need every available dollar to help generate returns to reduce their funding deficit.

Underfunded plans hoping to reduce cost with risk transfer should consider making a one-time contribution to offset the negative impact the risk transfer is likely to have, making sure that the funded status percentage is at least as high as it was prior to the transaction. In most cases, sponsors are better off deferring the risk transfer until their funded status has improved.

The following example illustrates this dynamic. Plan A holds \$80 million in assets against \$100 million in liabilities, corresponding to an 80% funded status on a mark-to-market basis. Suppose Plan A completes a \$20 million annuity purchase *at par* pricing (i.e., the assets and liabilities are the same). The portfolio is expected to return 7% per year. How will this transaction affect their funded status percentage, and how much more will it cost over the long-term to fully fund the plan?

The results are summarized in [Exhibit 2](#). These numbers incorporate PBGC flat rate premium savings, as well as the one-time transaction costs associated with the annuity purchase.

Plans that remain underfunded... typically need every available dollar to help generate returns to reduce their funding deficit.

Exhibit 2: Cost savings for reducing PBGC head counts

	Pre-Annuity Purchase	Post- Annuity Purchase
Assets (\$M)	80	60
Liabilities (\$M)	100	80
Funding deficit (\$M)	20	20
Funded status	80%	75%
Expected return	7.0%	7.0%
Expected annual return (\$M)	5.6	4.2
Estimated years to become fully funded	13	14
Estimated contribution requirements before fully funded (\$M)	6.2	8.8
Total expected flat-rate premiums over the next 15 years (\$M)	1.4	1.1

Source: Russell Investments calculations

Notice that while PBGC flat-rate premiums declined by 20% with the annuity purchase, the estimated contribution requirements increase by more than 40%, and the expected time to full funding extends by one year. Although the plan is smaller in size, the plan is still left with the same deficit of \$20 million, leaving fewer assets to generate returns to close the gap. Over time, this shortfall is addressed through higher sponsor contributions.

Before focusing too much on fee or cost savings with risk transfer, sponsors should ensure that the full long-term economic impact on the plan aligns with their endgame objectives. Alternatively, sponsors that strongly favor risk transfer in an underfunded position might consider contributing sufficiently to maintain the plan's funded position without harming the long-term economics of the plan.

Misunderstanding plan termination cost

The plan termination process can be both time-consuming and costly, and it typically involves a number of uncertainties that cannot be fully resolved until the later stages of execution. For example, a key factor in final pricing for a plan termination is knowing how many non-retirees will elect to take a lump sum. Higher lump sum election rates generally reduce the volume of annuities that must be purchased and can lower overall cost. Lower election rates may require the sponsor to purchase a larger amount of annuities at less favorable pricing.

Another complexity can arise when a plan has already offered lump sums, or certain targeted annuity purchases have taken place on the population. Any of these can increase the ultimate cost of plan termination as the insurer will take these factors into account when pricing annuity purchases.

For some sponsors, plan termination is the clear long-term objective. In most cases, it is important to approach the process with a realistic understanding of the potential cost and resources required. Early in the process, plan termination costs are typically expressed in a range rather than a single point estimate. While preliminary analysis may highlight the lower end of the range, actual outcomes may differ, and final costs may not be known until late in the execution process. A prudent approach is to maintain sufficient financial flexibility to address potential costs of the high end of the range.

Sponsors should also exercise care when reviewing analyses that compare the cost of plan termination compared to the cost of maintaining or hibernating the plan. These analyses may rely on present value estimates of future expenses, such as PBGC premiums, investment management fees, and uncertainties like asset/liability mismatches. In reviewing this type of analysis, investment committees may wish to consider the following questions:

- Are active management fees offset by expected outperformance of benchmarks?
- Are expected future investment returns reflected as a potential offset to projected costs?
- Has the impact of fixed income managers' ability to partly or fully offset the impact of credit migration been reasonably incorporated?
- Are potential adjustments to mortality assumptions applied in a balanced and supported manner?

Before focusing too much on fee or cost savings with risk transfer, sponsors should ensure that the full long-term economic impact on the plan aligns with their endgame objectives.

- Is the liability estimate based on a discount rate using a broad market of bonds or a more selective group of bonds (which is typically harder to match with actual investments)?

While plan termination may be a strategic priority of the sponsoring organization, a fully informed comparison may show that the incremental cost relative to a maintain-or-hibernate approach is material and warrants careful consideration.

Lump sums in a rising rate environment

For many plans, lump sum conversion interest rates are established for an entire plan year based on rates just before the plan year begins. As a result, lump sum amounts remain fixed for the year. However, lump sum cashouts can trigger settlement accounting, which will value the transaction based on rates at the time of payout. This creates an interest rate arbitrage opportunity (from the sponsor's perspective) when rates are falling.

In a declining rate environment, lump sums can be paid at an interest rate higher (leading to lower lump sums) than the current market rate, which leads to an accounting *gain* (increasing corporate earnings). Conversely, executing a lump sum cashout during a period of rising rates—such as in 2022—will likely lead to a *loss*.

Given the uncertainty around the future path of interest rates, sponsors considering a lump sum cashout can use a *wait-and-see* approach for pulling the trigger on the project, observing the path of rates. For those considering plan termination, which is likely to include a lump sum cashout, sponsors should understand the sensitivities of interest rate movements to their termination estimates and budget accordingly.

While plan termination may be a strategic priority of the sponsoring organization, a fully informed comparison may show that the incremental cost relative to a maintain-or-hibernate approach is material and warrants careful consideration.

Settlement charges

As stated above, risk transfer transactions often trigger settlement accounting, which is basically a remeasurement considering the reduction in size of the plan. For plans using U.S. GAAP for accounting, when the sponsor is holding a large unrecognized pension loss, a risk transfer will generally force a portion of that loss to be recognized on the income statement immediately. This may have a sizeable negative impact on the earnings of the organization. For non-U.S. accounting (that is already more marked-to-market oriented), sponsors must immediately recognize the gain or loss associated with risk transfer.

Settlement accounting can be avoided by using a *buy-in* annuity purchase, which is treated like a fully hedged investment without formally removing any liability from the plan. However, a buy-in does not reduce PBGC premiums, at least until the buy-in is converted to a buy-out.

At par quotes

It is common to settle retiree obligations at a cost similar to or less than the associated plan liabilities, but sponsors should make sure to know what the quote represents. Is the premium being quoted relative to the accounting liability at a certain point in time? If so, is the discount rate basis selective, or representative of the total bond market? Also, preliminary cost estimates can change when final pricing is quoted, and sponsors should be prepared for this possibility.

Hedge ratio drops

When retirees are removed from the plan, the duration of the liabilities will likely increase (since retirees have the lowest duration of all plan participants). Without asset allocation changes and assuming an immediate rebalance to investment targets, the hedge ratio of the plan will likely decline after the transaction. In advance of and through the annuity purchase, sponsors should ensure they adjust the LDI strategy to align with hedge ratio objectives.

Actuarial assumptions impact

Depending on the group that is offloaded from the plan, actuarial assumptions (e.g., mortality) may need to change in future valuations. For example, if mostly blue-collar workers are impacted by the annuity purchase, the actuary may find it more appropriate to assume a white-collar version of mortality for the remaining participants, which will increase liabilities and lower funded status.

Asset-in-kind discounts

Under some circumstances, insurers will choose to receive assets in-kind as part of the annuity purchase premium, leading to some efficiencies as full liquidation of the premium is avoided. Successful in-kind payments require careful coordination between the insurer, investment managers, and transition managers—and this may require months of preparation. The larger the transaction, the more likely that some in-kind payments will be possible.

Sponsors should not assume their portfolio necessarily holds all the assets the selected insurer will want to take. Since the insurer is often not selected until just prior to the annuity purchase transaction, coordinating and selecting desirable holdings can be a challenge, particularly for smaller transactions. Sponsors can pursue in-kind payments but should not assume any discount will necessarily come until the insurer has agreed.

It is common to settle retiree obligations at a cost similar to or less than the associated plan liabilities, but sponsors should make sure to know what the quote represents.

Investment strategy for the liabilities to be transferred

When plan sponsors engage in risk transfer, the time horizon for that portion of their liability changes. This can mean a shift from a long-term, return-focused total portfolio, to a highly hedged short-term portfolio for the selected group that will be transferred. Without changing the investment strategy, the impact of the risk transfer may be larger than expected due to an unexpected drop in asset levels.³

For annuity purchases, the selected liability would usually be hedged with duration-matched LDI, while lump sums are best hedged with cash, once the payment amount can be estimated.

Selecting the insurer

Price will (and should) be an important factor in choosing an annuity provider, but annuity contracts are not a homogenous commodity. Understanding and valuing the financial strength and proven reputation of the provider is important too. Consider if the insurer would be providing the *safest annuity available* under DOL 95-1, where it also states that plan fiduciaries are responsible for “conduct[ing] an objective, thorough and analytical search” when selecting an annuity provider. This search needs to include analysis of the insurer’s investment portfolio, among other aspects, which an independent expert can assist in evaluating.⁴

Sponsors ought to also be comfortable with the anticipated experience participants will have with the insurer, who will be solely responsible for administering benefits to the sponsor’s former employees.

Recognize the natural attrition of the plan

While risk transfer can accelerate the removal of plan participants, it is important to recognize that a closed and frozen pension plan is going to naturally get smaller on its own over time. In fact, our asset/liability projections routinely show that frozen plans can reduce in size by 30-40% over just a 10-year time period.

If sponsors allow the plan to run its normal course, they preserve assets in the plan and avoid paying for risk transfer above the associated liability. Given the current regulatory environment, which provides flexibility in how pension funding shortfalls are recognized and amortized, the risk of contribution surprises is lower, making the long-term management of a pension plan more tenable for the sponsor.

Given risk transfer is here to stay, sponsors should be aware of which risk transfer opportunities may be attractive, and which strategies to avoid as they work toward their DB plan endgames.

Final thoughts

Risk transfer transactions can help decrease future costs to the plan sponsor and reduce the footprint of the plan on the organization. Many sponsors have successfully pursued these strategies while others have been left worse off because of them. Given risk transfer is here to stay, sponsors should be aware of which risk transfer opportunities may be attractive, and which strategies to avoid as they work toward their DB plan endgames.

¹ Owens, Justin. (2023, November). "Pension risk transfer options and considerations". Russell Investments Research.

² Owens, Justin. (2025, March). "\$20 billion club: 2025 update". Russell Investments.

³ Owens, Justin. (2026, April). "Defined benefit plan terminations: Funding and investment strategies". Russell Investments Practice Note.

⁴ See Department of Labor Interpretive Bulletin 95-1



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