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## I. Introduction

I am pleased to testify before the ERISA Advisory Council on the important topic of pension plan de-risking. Employers that sponsor defined benefit plans confront volatility associated with their pension obligations for financial accounting and pension funding purposes. In many cases, the effect of this volatility on a company's books can be significant. Oftentimes, the volatility is associated in large part with legacy liabilities − liabilities for pension benefits earned years or even decades ago, and much if not most of these benefits are currently being paid to retirees in the form of annuities. In light of the significant amount of these liabilities, many sponsors are considering ways to "de-risk" and reduce or eliminate the volatility associated with pension obligations.

My testimony will address methods of pension de-risking, the legal framework for pension de-risking, and some policy guidelines for any regulatory initiative involving pension de-risking.

## II. Methods of Pension De-Risking

De-risking strategies generally fall into two categories: in-plan strategies and settlements outside the plan. Currently, these strategies include the following:

| In-Plan Strategies | Settlement Strategies |
|---|---|
| • hedging | • lump sum offering |
| • immunization | • annuity certificate distributions |
| • investing in annuity contracts | • plan termination (including spin-off/termination) |

In-plan strategies focus on investment of plan assets. Hedging involves investing to offset some of the factors that drive funding volatility, such as changes in interest rates. Immunization (or liability-driven investing) matches the risk and duration of the plan's investments more closely with the plan's liabilities, so that asset values will move in tandem with liabilities, and cash flows from investments will correspond to benefit payments. Investing in an annuity contract (also known as an "annuity buy-in") involves the use of plan assets to purchase a group annuity contract that is held by the plan to fund benefit payments: the insurance company makes annuity payments to the plan as the plan makes payments to participants. In each case, the plan remains liable to participants to pay pension benefits.

Settlement strategies, on the other hand, discharge the plan's obligations to participants. A plan may not require participants to take lump sum pension distributions (except small pensions), but a plan may offer a lump sum distribution option to deferred vested participants or, in some cases, retirees. In a transaction involving the distribution of annuity certificates (also known as an "annuity buy-out"), the plan purchases a group annuity contract from an insurance company and distributes certificates that enable the participants to enforce their rights to benefits directly against the insurance company. The annuity purchase transfers to the insurance company the plan's liability to provide benefits to the participants who receive annuity certificates. A similar annuity purchase is made when a plan terminates. A plan sponsor may terminate only a part of a plan (for example, the part that covers retirees) by first spinning off the portion of the plan in a spin-off/termination transaction.

## III. Legal Framework for In-Plan Strategies

Because in-plan strategies focus on plan investments, a decision to pursue an in-plan de-risking strategy is a fiduciary one. Fiduciary decisions are subject to ERISA's duty of prudence as well as the duty of loyalty, which requires the fiduciary to act solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable plan administration expenses. ERISA § 404(a). ERISA also requires a fiduciary to diversify the investments of a plan to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so. ERISA § 404(a)(1)(C).

In a 2006 opinion letter (DOL Op. Ltr. 2006-08A), the Department of Labor considered whether a fiduciary may consider the liability obligations of the plan and the risks associated with such liability obligations in determining the plan's investment strategy. The Department observed that nothing in ERISA limits "a plan fiduciary's ability to take into account the risks associated with benefits liabilities." The Department concluded that a fiduciary would not violate his or her duties under ERISA "solely because the fiduciary implements an investment strategy for a plan that takes into account the liability obligations of the plan and the risks associated with such liabilities and results in reduced volatility in the plan's funding requirements."

## IV. Legal Framework for Settlement Strategies

Unlike the decision to pursue in-plan strategies, the decision to pursue a settlement strategy is a matter of plan design. After an individual's pension benefits are settled, the individual ceases to be a participant in the plan, ERISA ceases to govern the benefit, and the PBGC no longer insures the benefit. Likewise, the plan no longer pays PBGC premiums with respect to the benefit. Whether to distribute lump sums or to annuitize benefits by distributing annuity certificates or terminating a plan therefore involves a fundamental question for a plan settlor: When to cease maintaining all or a portion of a pension plan? *See generally Beck v. PACE Int'l Union*, 551 U.S. 96 (2007) (the decision whether to maintain pension liabilities in an ERISA-covered pension plan or to remove pension liabilities from ERISA coverage is a settlor decision).

By contrast, the implementation of a settlement strategy is a fiduciary matter, subject to the duties I previously referenced. Implementation could include providing information to participants, calculating benefits, preparing and submitting filings to the government, and, in the case of an annuitization strategy, selecting an insurer and annuity contract.

Below I describe some of the key legal requirements associated with each settlement strategy.

**A. Lump Sums**

One way to reduce volatility associated with pension obligations is to offer lump sums to participants and beneficiaries who are eligible to receive pension distributions. For example, a plan might offer lump sums to former employees who have deferred vested benefits. Often, however, a large portion of a plan's liability is associated with retirees who are currently receiving annuities, but offering lump sums to retirees generally is prohibited under IRS regulations (unless the plan is terminating). Treas. Reg. § 1.401(a)(9)-6, Q&A-1(a). Last year, the IRS released two private letter rulings (PLRs 201228045 & 201228051) permitting lump sum offers to retirees currently receiving annuities. In each ruling, the IRS noted that regulations permit a change in annuity payments if the plan is amended to provide increased benefits. The IRS concluded that a one-time offer of a lump sum to retirees would be treated as a benefit increase resulting from a plan amendment. Importantly, the IRS emphasized that its conclusion was based on the fact that the lump sum offer was available only for a limited period of time. In one ruling, the lump sum offer was available during a period that would not exceed 90 days; in the other ruling, the offer period would not exceed 60 days.

In the recent rulings governing lump sum offers to retirees, the IRS noted that converting an on-going annuity payment to a lump sum would establish a new annuity starting date. As a result, to offer a lump sum to retirees, a plan must also offer other forms of payment that must be available at any annuity starting date. Required forms for a married participant include a qualified joint and survivor annuity and a qualified optional survivor annuity. A plan would also be required to provide disclosure to participants regarding the financial effect and relative value of the optional forms being offered.

In addition, the spousal consent rules would apply. The IRS stated that a retiree's current spouse at the time of the new annuity starting date must consent to a lump sum distribution. In addition, a plan might need to obtain the consent of a retiree's former spouse, if the retiree has remarried since the pension began to be paid. The IRS observed in one of the rulings that, absent an election, the pension would continue to be paid without change, indicating that if the former spouse's consent could not be obtained where required to distribute a lump sum, the benefit would neither be distributed in a lump sum nor be converted to a new annuity form. For example, if a retiree is remarried and the benefit is currently being paid in the form of a qualified joint and survivor annuity with the former spouse as the joint annuitant, offering a lump sum does not mean that the default form of payment following the offer (absent the appropriate consents) is a new qualified joint and survivor with the retiree's current spouse as the joint annuitant. Instead, payments continue as before, and the former spouse remains the joint annuitant.

**B. Distribution of Annuity Certificates**

Another way to reduce volatility associated with pension obligations is to distribute annuity certificates to plan participants. An individual's benefit ceases to be covered by an ERISA-governed plan if:

> (1) the entire pension benefit is "fully guaranteed by an insurance company, insurance service or insurance organization licensed to do business in a State";
>
> (2) the individual's rights to the benefit "are legally enforceable by the sole choice of the individual against the insurance company, insurance service or insurance organization"; and
>
> (3) a "contract, policy or certificate describing the benefits to which the individual is entitled under the plan has been issued to the individual."

DOL Reg. § 2510.3-3(d)(2)(ii).

In practice, the plan purchases a group annuity contract, and the insurer distributes annuity certificates under the contract to the covered individuals. A plan may not make the annuity purchase, however, unless the plan is at least 80% funded. Code[1] § 436(d).

As I previously mentioned, the selection of the annuity contract is a fiduciary act. In an Interpretive Bulletin, the Department of Labor issued guidance on the legal standard ERISA imposes on a plan fiduciary's selection of an annuity provider. DOL Reg. § 2509.95-1 (Mar. 6, 1995). According to the Department, the "fiduciaries choosing an annuity provider for the purpose of making a benefit distribution must take steps calculated to obtain the safest annuity available, unless under the circumstances it would be in the interests of participants and beneficiaries to do otherwise." DOL Reg. § 2509.95-1(c). The Bulletin identifies six factors that fiduciaries should consider in selecting an annuity provider and notes that "[r]eliance solely on ratings provided by insurance rating services would not be sufficient to meet" the safest available annuity requirement. *Id.* The six factors are:

(1) the quality and diversification of the annuity provider's investment portfolio;
(2) the size of the insurer relative to the proposed contract;
(3) the level of the insurer's capital and surplus;
(4) the lines of business of the annuity provider and other indications of an insurer's exposure to liability;
(5) the structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts;
(6) the availability of additional protection through state guaranty associations and the extent of their guarantees.

[1] "Code" refers to the Internal Revenue Code of 1986, as amended.

The Department of Labor further noted that "[a] fiduciary may conclude, after conducting an appropriate search, that more than one annuity provider is able to offer the safest annuity available." *Id.*

Courts, however, have not always accepted the "safest available" standard. For example, in one case, a Fifth Circuit panel was "not persuaded that . . . fiduciaries [have] the obligation to purchase the 'safest available annuity' in order to fulfill their fiduciary duties. . . . The Bulletin's standard focuses on the quality of the selected annuity. The standard we apply focuses instead on the fiduciary's conduct. It requires that fiduciaries keep the interests of beneficiaries foremost in their minds, taking all steps necessary to prevent conflicting interests from entering into the decision-making process." *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 298 (5th Cir. 2000); *see also Riley v. Murdock*, 83 F.3d 415 (4th Cir. 1996) (declining to apply the "safest available" standard).

**C. Plan Termination (Including Spin-Off/Termination)**

As an alternative to a distribution of annuity certificates, an employer may settle pension liabilities by initiating a formal plan termination. Assuming that the employer is not in severe financial distress, the termination must follow ERISA's standard termination procedures. The employer must make all contributions to the plan that are necessary to discharge the plan's liabilities. ERISA § 4041(b)(1)(D). In a standard termination, the plan's liabilities may be discharged in two ways: (1) the payment of lump sum distributions to participants, and (2) the purchase of annuity contracts. ERISA § 4041(b)(3)(A); PBGC Reg. § 4041.28(c). A terminating plan may, but is not required to, offer lump sums to participants. However, the plan may not require participants to accept lump sums, unless the present value of the participant's benefit is $5,000 or less. Code § 411(a)(11). For those participants who do not elect to receive a lump sum, or if the plan does not offer a lump sum payment, the plan must purchase an annuity contract that provides the benefits offered under the terms of the plan. If the participant is already in pay status, the annuity contract continues to provide the form of benefit the participant already is receiving at the time of the plan termination.

If an employer wishes to terminate a plan only with respect to a portion of the plan's participants, the employer must spin off the portion of the plan being terminated in order to separate this portion from the ongoing plan. ERISA and the Internal Revenue Code provide rules to determine how assets are divided when a portion of the plan is spun off and terminated. *See* Code § 414(l) (a parallel requirement appears in ERISA § 208). Unless the spun-off portion is de minimis (generally less than 3% of the plan's assets), the assets must be allocated between the spun-off plan and the ongoing plan on a "termination basis." Treas. Reg. § 1.414(l)-1(n). Allocating assets on a "termination basis" means allocating assets to fund the benefits that would be provided exclusively by plan assets (without additional contributions from the employer) upon a plan termination. Treas. Reg. § 1.414(l)-1(b)(5)(i). If the plan is not fully funded – meaning the assets are not sufficient to pay 100% of all of the benefits – assets are allocated among priority categories set forth in section 4044 of ERISA. If the original plan does not include employee contributions, retirees whose benefits have been in pay status for at least three years will be in the highest priority category, while most of the active employees will be in a lower priority category.

A formal plan termination requires a plan to provide notices to the PBGC and plan participants, including: a notice of intent to terminate, to be provided to participants before the proposed termination date (PBGC Reg. § 4041.23); a standard termination notice, consisting of the PBGC Form 500, to be filed with the PBGC (PBGC Reg. § 4041.25); a notice of plan benefits, describing the benefits of each participant (PBGC Reg. § 4041.24); a "notice of annuity information," identifying the insurer providing the terminal annuity and applicable state guaranty information, (PBGC Reg. § 4041.27); a "notice of annuity contract," which includes a copy of the annuity contract or certificate, (PBGC Reg. § 4041.28(d)); and a "post-distribution certification," consisting of PBGC Form 501, to be filed with the PBGC after the last distribution date for any affected party (PBGC Reg. § 4041.29).

As with the distribution of annuity certificates, a plan termination involves the purchase of an annuity contract and the distribution of certificates to individuals covered by the annuity contract. The selection of the annuity contract is a fiduciary act, and ERISA's fiduciary duties govern, although a fiduciary's considerations might differ in the context of a plan termination as compared with the an annuity purchase by an on-going plan.

## V. Policy Guidelines for Future Regulation

While I am not proposing that the Department of Labor (or any other entity) provide any additional specific guidance in the area of pension de-risking, I offer the following principles to guide any future regulation of the area:

***1. The ability for employers to pursue de-risking strategies is important to the defined benefit plan system.*** The foundation of the employer-provided retirement system is its voluntariness. Nothing underscores this feature more than an employer's ability to leave it. But, beyond merely being able to leave the system, de-risking can help an employer maintain a defined benefit plan. As I previously mentioned, the financial volatility associated with sponsoring a defined benefit plan stems largely from legacy liabilities. If an employer can "de-risk" the legacy liabilities − whether using an in-plan strategy or a settlement strategy − the employer need only manage its on-going (or normal) pension costs. In this manner, de-risking in essence can place defined benefit plans on the same footing as defined contribution plans: in both cases, the retirement plan's demands on the employer relate primarily to funding on-going accruals.

***2. Guidance should be practical.*** There are a myriad of regulations and duties associated with pension de-risking, only some of which I covered in my testimony. De-risking is complicated, and any regulatory guidance should be precise and administrable. An example of such guidance is a private letter ruling issued by the IRS last year (PLR 201228055), addressing the common concern in annuitizations with the quality of the plan's data. Especially in large pension plans, data corrections can occur months or even years after a plan terminates and an annuity contract has been purchased. In the ruling, the IRS considered a situation in which a plan terminated, an employer contributed additional funds to the plan to cover the cost of the annuity premium, and more than a year later, the insurer discovered data errors. As a result of corrections in the data, the insurer refunded a portion of the premium to the plan. The IRS concluded that the premium refund could be returned to the employer as having arisen due to an "erroneous actuarial computation." However, the ruling held that the premium refund would not be considered a reversion subject to an excise tax because the refund occurred due to a prior "mistake of fact." The IRS ruling therefore explains how to handle data corrections following an annuitization.

***3. Guidance should be necessary.*** As I previously noted, employers are subject to a substantial body of regulations governing pension de-risking − and even more regulations governing defined benefit plans generally. Undoubtedly, the burden of regulation has contributed, in part, to the substantial decline in defined benefit plans. To be sure, many regulatory requirements provide important protections for employees and retirees. Indeed, before imposing any additional requirements on employers, it would be important to identify specific areas, if any, where these protections are not already sufficient.

***4. ERISA requires fiduciaries to act prudently but does not mandate a single result***. When considering how ERISA regulates a fiduciary's responsibilities in pension de-risking, it is important to keep in mind that ERISA requires fiduciaries to discharge their duties with ''care, skill, prudence, and diligence.'' ERISA § 404(a)(1)(B). It does not require that any one action be taken over another. *See generally* J. Vine, "Prudent Investing," 38 Tax Mgmt. Comp. Plan. J. 1 (Jan. 1, 2010). Two fiduciaries might, acting prudently, reach two different conclusions, and yet both fulfill their obligations to act with care, skill, prudence, and diligence. Accordingly, any regulation addressing a fiduciary's duties under ERISA should focus on the fiduciary's decision-making process, and not require a single result of that process.