2013 ERISA Advisory Council
Private Sector Pension De-risking and Participant Protections
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Executive Summary

In my view, there is no compelling need for any additional regulations or other guidance regarding pension de-risking transactions such as optional lump-sum payouts and partial annuity purchases. Rather, existing regulations and guidance provided by the Department of Labor (the "Department") and the other federal agencies that regulate private pensions are sufficient to ensure that the interests of participants in connection with these transactions are adequately protected.

Introduction

I would like to thank the Council for giving me the opportunity to participate in these hearings. I have been practicing in the employee benefits area for about 30 years. Among other things, I represent a number of companies throughout the country that sponsor qualified defined benefit plans, ranging in size from $100 million to $15 billion, and I have advised many of them on pension de-risking issues and transactions.

The issue of pension de-risking is critical to private-sector sponsors of qualified defined benefit plans. The "perfect storm" in 2008 and 2009 -- precipitous declines in asset values, combined with steep drops in interest rates and the resulting significant increase in pension liabilities -- was a tipping point for many pension plan sponsors, particularly since it came on the heels of significantly increased funding requirements as the result of the Pension Protection Act of 2006 ("PPA '06"). Many of those plan sponsors, especially those with closed and frozen plans, have decided that they can no longer tolerate extreme volatility in pension funding, and the resulting adverse impacts on their companies' cash flow, reported financial performance, and compliance with financing agreement covenants. These concerns become especially compelling when the plan sponsor is competing with businesses that do not face these problems, such as companies without pension plans or companies that have already engaged in a de-risking transaction.

As the economy and their business results have improved, plan sponsors have taken advantage of those improvements, and relatively low costs of capital, to fund their pension plans more aggressively, and to restructure their pension investments so that their investment performance more closely matches the changes in the plan's underlying liabilities, rather than simply seeking to maximize return. At the same time, many plan sponsors have decided that an effective way to manage their pension funding risk is to shrink the size of their pension liabilities, relative to the size of the sponsor's balance sheet, by using plan assets to satisfy those liabilities. They have done so either through the payment of optional lump-sum distributions to certain participants or through the purchase of guaranteed annuities covering some portion of the plan's liabilities.

[1] Note: The views expressed herein are the individual views of the author; they do not represent any statement on behalf of Morgan, Lewis, any of its clients, or any other organization.

This pension de-risking trend should be viewed by the federal government and by participants and their advocates as, overall, positive. This trend will help to reduce the threat of distress terminations of underfunded plans, with the potential loss of participant benefits and increased financial stress on the PBGC. In addition, the offering of optional lump-sum distributions gives participants the flexibility to retain a guaranteed lifetime income or, should they choose to do so, to take the present value of their benefit, roll it into a qualified defined contribution plan or an individual retirement account and benefit from future positive investment performance in excess of the conservative interest rates used to determine their lump-sum values. The ability to take a lump-sum distribution may be a particularly valuable option for participants who suffer from health conditions that limit their life expectancy.

I will leave it to other commentators to share their views on how widespread this trend is, and which types of companies and industries are currently engaging in these activities. As noted, I would view this trend as positive for participants and for the federal government. In addition, as discussed in more detail below, there are already significant protections in place for participants regarding optional lump-sum distributions and partial annuity purchases, and I do not believe that any additional regulations or guidance are needed.

Settlor vs. Fiduciary Functions

Before discussing the specifics of optional lump-sum distributions and partial annuity purchases, I would like to focus briefly on the issue of settlor vs. fiduciary functions. The Department has provided in the past significant guidance on this issue, such as the Erlenborn[2] and Maldonado[3] letters, as well as a number of advisory opinions[4]. That guidance makes clear that deciding whether to amend a plan to offer an optional lump-sum distribution, or whether to effect a transfer of assets and liabilities to a third-party annuity provider, is a settlor decision, but the plan fiduciaries are responsible for ensuring that implementation of the decision is carried out prudently and in the participants' best interests. (See also the Department's Interpretive Bulletin 95-1 on annuity purchases in defined benefit plans, 29 C.F.R. §2509.95-1.) I do not think that there is any need for additional guidance in this area.

Optional Lump-Sum Distributions

Traditional defined-benefit pension plans[5] generally did not offer participants the option of taking their payments in the form of a lump-sum distribution, other than small benefit cash-outs. There was no legal prohibition with offering lump sums, but important practical concerns tended to preclude them. One of the most important of those concerns was that lump-sum distributions traditionally resulted in an actuarial loss to the pension plan, because they were required to be determined, under Internal Revenue Code Section 417(e), using mandated interest rates that were significantly lower than the rates (based on high-quality corporate bonds) used to value the plan's liabilities. For many years, lump-sum distributions were determined based on PBGC interest rates; beginning in 1995, lump-sums were determined using the 30-year Treasury rate.

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[2] Information Letter from Dennis Kass to John Erlenborn, March 13, 1986, available at http://www.dol.gov/ebsa/regs/ils/il031386.html.

[3] Information Letter from Elliott Daniel to Kirk Maldonado, March 2, 1987, available at http://benefitsattorney.com/wp-content/uploads/MaldonadoLetter.pdf.

[4] See, e.g., DOL Advisory Opinion 2001-01A; DOL Advisory Opinion 97-03A.

[5] I.e., final average pay or dollar multiplier plans, as opposed to "hybrid" plans like cash balance or pension equity plans that typically are designed to provide the option of receiving a lump-sum distribution at retirement or termination. However, hybrid plans may have grandfathered or merged participant groups with traditional formulas that are not provided access to optional lump-sum distributions.

However, several recent developments have made the provision of optional lump sums more prevalent in traditional defined benefit plans. First, PPA '06 amended the provisions for payment of lump-sum distributions under Code Section 417(e) to provide that the interest rate used for determining lump-sum distributions would be essentially the same long-term corporate bond rate used by the plan for purposes of determining its funded status. This PPA '06 change was phased in over five years, beginning in 2007, such that for calendar-year plans, it became fully applicable in 2012. As a result, for the first time in the 2012 plan year, the payment of lump-sums became "neutral," from a liability standpoint, compared to making payment in the form of an annuity (though, of course, paying out 100% of the participant's benefit as a lump-sum distribution in a plan that is less than 100% funded does cause a slight decrease in the plan's current funded status).

PPA '06 also imposed funding-based limits on the payment of lump sums; those limits restrict a plan from paying a full lump-sum unless it has an adjusted funding target attainment percentage ("AFTAP") of at least 80%. However, the accelerated funding required by PPA '06, combined with favorable capital markets performance in the last two years and the interest-rate relief provided by Congress in enacting MAP-21 in 2012[6], have combined to push many defined benefit plans well over the 80% AFTAP target, thus allowing them for the first time since PPA '06 to offer full lump-sum payments. In addition, as noted earlier, sponsors have become keenly interested in de-risking strategies, and one of those strategies is to shrink the size of the plan relative to the sponsor's total corporate balance sheet; paying optional lump sums helps to accomplish this goal. Finally, the material increases in PBGC insurance rates in recent years have provided an economic incentive to reduce the number of covered plan participants, thus reducing PBGC premiums (while also reducing the PBGC's potential future liabilities).

Under current law, the offering of lump-sum distributions comes with a number of safeguards designed to protect participants' interests. First and most important, lump-sum distributions of benefits with a present value above the "cash-out" limit ($5000) are optional; no participant can be compelled to take a lump-sum distribution without his or her consent (and, if married, without the written consent of his or her spouse). Second, for vested participants who do not have the current right to commence their benefit in the form of an annuity ("deferred vested" participants), a plan offering them an optional lump-sum distribution must also offer them an immediate annuity, in the plan's "normal form" (generally, a single-life annuity for unmarried participants and a qualified joint and survivor annuity for married participants). Deferred vested participants offered an optional lump-sum also retain the right to a deferred annuity under the plan's existing terms.

Third, any offering of an optional lump-sum distribution must be made on a non-discriminatory basis; while a plan sponsor has the flexibility to target the lump-sum offering to a select group of participants (e.g., deferred vested participants vs. those in pay status, or a subgroup of participants in particular "legacy" plan formulas resulting from plan mergers), the offering cannot be made currently or effectively available to participants in a manner that skews in favor of highly-compensated current or former employees. Incidentally, many plan sponsors limit the availability of optional lump sums in order to avoid a material impact on the plan's funded status, to avoid triggering settlement accounting (which can cause the accelerated recognition of investment

[6] The Moving Ahead for Progress in the 21st Century Act (P.L. 112-141), was signed into law by President Obama on July 6, 2012. Among other things, it allowed pension plans, in determining their AFTAP for minimum funding, temporarily to use interest rates higher than the current market rates by establishing a "corridor" based on historic long-term rates.

losses on the company's financial statements), and to limit the administrative burden and expense of making the offering.

Fourth, the offering must be accompanied by detailed disclosures designed to ensure that the participants understand the nature and impact of the choice they are being offered. In addition to detailed information on the various alternatives they are being offered (i.e., lump-sum, immediate annuity), the participants must be provided a "relative value" disclosure that sets forth any material difference in value between the lump-sum benefit they are being offered and any of the alternative available annuity options.[7] They must also be provided a "Notice of Consequences of Failing to Defer Receipt of Distribution," which provides additional information regarding the effects of their election to accelerate the payout of their benefit rather than deferring payout until the plan's normal retirement date (e.g., loss of eligibility for retiree health coverage, early retirement subsidies or social security supplements, or any adverse impact on the benefits of rehired participants who failed to defer distribution).[8] And they are required to receive a "402(f)" notice setting forth in detail the tax impact of the various choices they are being provided (including the fact that they can roll over their lump-sum distribution to an eligible retirement plan to avoid immediate taxation).

Optional lump-sums are often provided as "window" benefits, i.e., they are made available only during a limited period of time (30-90 days). This is done in order to allow for greater control over the size, scope and cost of offering the optional lump-sum; it can be targeted to a specified group of participants, with predictable costs based on known interest rates and with a limited effect on the plan's current funded status and the company's financial statements. In my experience, plan sponsors and administrators providing an optional lump-sum window generally offer information to eligible participants in addition to the required regulatory disclosures, including the availability of a call center to answer questions concerning the offering (such as how to make the election, the tax implications, etc.) While many participants offered a lump-sum distribution as part of a window do accept the offer, a substantial percentage (in my experience, 40-60%) do not, which indicates that participants are thoughtfully considering their options and making the decision that best suits their individual needs.

As noted earlier, I do not see the need for any additional required disclosures in connection with the offering of lump sums. To the contrary, given the comprehensive existing disclosure requirements, any additional required disclosures would only risk confusing participants. The only observation I would make in this regard is that the Department should consider carefully the potential impact on participants being offered optional lump-sum distributions of issuing any regulatory guidance that may impact participants' ability to obtain professional investment advice concerning their distribution options, including rollovers.

Partial Annuity Purchase

As noted earlier, sponsors are exploring various ways to shrink the size of their pension plans in advance of full termination, as part of a de-risking strategy, and a number have determined to do so by transferring a portion of the plan's liabilities to an insurer through the purchase of a group annuity. Partial liability transfers are not uncommon; for example, plan sponsors often transfer a portion of a plan's assets and liabilities to a successor plan as part of a corporate transaction, such as a spin-off or divestiture.

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[7] See Treas. Reg. (26 C.F.R.) §1.417(a)(3)-1(c)(2).

[8] See Proposed Treas. Reg. §1.411(a)-11(c)(2), 73 FR 59575.

The decision to effect a partial annuity purchase, like the decision to cause a transfer of assets and liabilities in connection with a corporate transaction, is a settlor decision, but it must generally be carried out in a manner that complies with ERISA's fiduciary responsibility provisions. The participants in this case need not be offered any choice regarding the annuity purchase, since it does not affect their benefits in any material way; rather, the annuity purchase must preserve the amount of their benefits and all protected benefits, right and features under the plan (such as available optional forms of distribution if the participants are not already in pay status). For this reason, the purchase is not subject to the same detailed advance notice requirements that would apply to an optional lump-sum distribution. However, participants involved in an annuity purchase typically would receive communications both from the plan and from the insurer either in advance of or shortly after the purchase, including notice from the plan that the liability has been transferred and that the individual is no longer a plan participant (and that, for participants in pay status, checks will begin coming from the insurer at a specified date), and an annuity certificate from the insurer acknowledging that the former plan participant has a legally enforceable right to benefits from the carrier and the amount of the benefit that has been annuitized.

As is the case with optional lump-sum distributions, partial annuity purchases are subject to significant protections for participants under existing law. As noted, any such transfer must be implemented in a manner that is consistent with ERISA's fiduciary responsibility provisions. In addition, any such purchase that does not fully protect all of a participant's benefits and rights under the plan could constitute an impermissible cutback or forfeiture and could threaten the qualified status of the plan, as well as give any adversely affected participant the right to bring a claim against the plan to seek additional benefits. Assuming that no such cutback or forfeiture takes place, participants whose benefit liabilities are transferred to an insurer are no worse off, and in fact are arguably better off, than they were before the transfer. Once the transfer is completed, their benefit is fully funded and guaranteed by a highly-rated insurer, without any risk of benefit loss as the result of a potential distress termination of the plan and the application of PBGC guaranteed benefit limits. Their benefit liability post-transfer is backed up not just by the assets of the insurer, which is subject to comprehensive state regulation, but also by state insurance guaranty associations. Moreover, if the plan fiduciaries do not act prudently in selecting the insurer, the affected participants or the Department may challenge that selection as a breach of their fiduciary duties. Plan fiduciaries, mindful of their responsibilities in this regard, routinely follow the Department's guidance from Interpretive Bulletin 95-1 on annuity purchases under defined benefit plans, including the use of independent advisers with expertise in annuity purchases.

Recognition of the safety of transferring liabilities to insurance carriers through annuity purchases is built into ERISA; annuity purchases are the only permitted method of satisfying a qualified defined plan's liabilities upon termination under Title IV (other than the payment of lump sums). This expression of Congressional confidence in insurer-provided annuities has been borne out by almost 40 years of experience; while numerous pension plans have terminated over those years without full funding, with resulting losses of participant benefits in a number of cases, I am not aware of a single situation in which an insurer's financial failure has caused the permanent loss of any former pension plan participant's benefits.

Current law and guidance are sufficient to ensure that participants' interests are fully protected. Moreover, the PBGC has the regulatory authority to police partial annuity purchases that they believe are made in anticipation of a plan termination and are intended to evade the more detailed notice and PBGC supervision requirements of Title IV of ERISA that apply to a

termination.[9] The federal agencies should be cautious about taking any actions that would discourage annuity purchases of this type, which, for the reasons described above, are beneficial to both participants and the PBGC.

[9] See 29 C.F.R. §4044.4(b).