Advisory Council on Employee Welfare and Pension Benefit Plans

Report to the Honorable Thomas E. Perez,
United States Secretary of Labor

Private Sector Pension De-risking and Participant Protections

November 2013

NOTICE

This report was produced by the Advisory Council on Employee Welfare and Pension Benefit Plans, usually referred to as the ERISA Advisory Council (the "Council"). The Council was established under Section 512 of ERISA to advise the Secretary of Labor. This report examines Private Sector Pension De-risking and Participant Protections. The contents of this report do not represent the position of the Department of Labor (hereinafter referred to as "DOL" or "the Department").

LIST OF COUNCIL MEMBERS

Karen Kay Barnes, Council Chair

Neal S. Schelberg, Council Vice-Chair

Richard A. Turner, Issue Chair

Mary Ellen Signorille, Issue Vice-Chair

Josh Cohen, Drafting Team Member

James English, Drafting Team Member

Paul M. Secunda, Drafting Team Member

Christina R. Cutlip

Ralph C. Derbyshire

Ron Gebhardtsbauer

Cindy Hounsell

David C. Kaleda

Marilee Pierotti Lau

James I. Singer

Gary A. Thayer

ABSTRACT

The 2013 ERISA Advisory Council examined the increased level of activity by defined benefit pension plan sponsors to reduce their risks in order to assess the potential need for further guidance, clarification, and potential educational opportunities by the Department. The Council acknowledged from the outset the important distinction between settlor and fiduciary functions involved in the making and implementation of such plan decisions. The Council sought to identify particular concerns relating to current de-risking strategies that might warrant further guidance, clarification, or education, with particular emphasis on the impact that these strategies might have on participants and their retirement security.

Based upon the testimony received during three days of hearings, the Council is presenting recommendations in the following areas:

- confirmation of the scope of Interpretive Bulletin (IB) 95-1, and possible creation of one or more safe harbors;

- participant disclosures;

- interpretive guidance on the scope of ERISA Section 502(a)(9);

- education and outreach to plan sponsors on issues surrounding volatility in pension plans; and

- collection of information on de-risking transactions.

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Larry Good, EBSA, DOL
DiWeena Streater, EBSA, DOL

Witnesses from June 5, 2013

Joe Canary, EBSA, DOL
Robert Newman, Covington & Burling LLP
Steve Keating, Penbridge Advisors
Evan Inglis, Vanguard
Craig Rosenthal, Mercer, on behalf of American Benefits Council
John Ferreira, Morgan, Lewis & Bockius LLP
Ilana Boivie, Communications Workers of America
Jack Cohen, Association of BellTel Retirees

Witnesses from August 29, 2013

Bill Kadereit, National Retiree Legislative Network
Karen Friedman, Pension Rights Center
David Certner, AARP
Karin Feldman, AFL-CIO
Brendan Maher, University of Connecticut School of Law
Norman Stein, Drexel University, Earle Mack School of Law
Josh Gotbaum, Pension Benefit Guaranty Corporation
Philip Barlow, District of Columbia. Department. of Insurance, Securities and Banking
Peter Gallanis, National Organization of Life and Health Guaranty Associations
Preston Crabill, General Motors
Phil Waldeck, Prudential Financial, Inc.
Naomi Zwerling, MetLife, Inc.

Witnesses from September 23, 2013

Lynn Dudley, American Benefits Council
Kent A. Mason, Davis & Harman, LLP, on behalf of American Benefits Council

Witnesses from November 4, 2013

Karin Feldman, AFL-CIO

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I. EXECUTIVE SUMMARY

The Council heard testimony that confirmed recent increases in defined benefit plan de-risking activity. Recent de-risking activity might be more appropriately referred to as risk transfer, because removal of risk from the plan sponsor often results in a corresponding increase in risk for another party. Those parties are generally either an insurer (in the event of an annuity purchase) or the participant (in the event of a lump sum payment, in which case responsibilities and risks associated with investing and managing the lump sum and satisfaction of retirement income needs fall to the participant). The reasons for this increase in activity may be attributable to several factors ranging from (i) changes to funding rules and accounting standards which cause plan funding volatility and impact on financial statements, respectively; (ii) changes in the interest rates used for calculation of lump sum distributions; and (iii) a general disconnect between the defined benefit plan itself and the employer's current view of its mission.

The Council received written and/or in-person testimony from twenty-two witnesses across a broad spectrum of interested parties, including governmental representatives of the Employee Benefit Security Administration (EBSA) of DOL, the Pension Benefit Guaranty Corporation, and the District of Columbia Department of Insurance, Securities and Banking (DISB), as well as the National Organization of Life and Health Guaranty Associations (NOLHGA), and also representatives from the employee, employer, consultant/actuarial, legal, and insurance communities.

Issues discussed over the course of three days of hearings included:

- Identifying significant factors contributing to the increase in de-risking activity, and ascertaining whether one or more of such factors give rise to the need for regulatory modifications or clarifications, or additional education.

- Distinguishing between the separate roles of settlor and fiduciary, which may be performed by different individuals or by the same person(s), and identifying where those roles might overlap, create conflicts, or give rise to the need for additional disclosure or safeguards.

- Exploring specific de-risking alternatives, including plan provisions for lump sum distributions, annuity purchases, and other alternatives.

- Analyzing the need for participant protections across the range of potential de-risking alternatives.

Based upon the testimony received during three days of hearings, the Council is presenting recommendations in the following areas:

- confirmation of the scope of IB 95-1;

- participant disclosures;

- interpretive guidance on the scope of ERISA Section 502(a)(9);
- education and outreach to plan sponsors on issues surrounding volatility in pension plans; and
- collection of information on de-risking transactions.

II. RECOMMENDATIONS

A. The Council recommends that DOL confirm that IB 95-1 applies to any purchase of an annuity from an insurer as a distribution of benefits under a defined benefit plan, not just purchases coincident with a plan termination. The Council also recommends that DOL consider the development of safe harbors within the scope of the Interpretive Bulletin for such purchases. Such safe harbor(s) could include two or more factors drawn from IB 95-1 and/or the following:

1. Procedural safeguards by the plan sponsor, the insurer, or both, with respect to resolving disputes regarding the benefits to be paid to a former plan participant under the annuity;
2. Contractual provisions, to the extent practicable, which replicate one or more protections that employees receive under ERISA and which are otherwise consistent with the terms of the contract;
3. Requirements for notices and valuation procedures similar to those required for lump sum distributions, if offered under the plan; and/or
4. The anti-alienation provisions of Part 2, Title 1 of ERISA.

B. The Council recommends that DOL require that a defined benefit pension plan providing participants with an option of a lump sum distribution within a specified window, with or without a separate option of the distribution of an annuity described in IB 95-1:

1. Provide similar disclosures to participants, at least 90 days prior to the action to be taken, as would be required under current PBGC termination regulations (29 C.F.R. §§ 4041.23, 24 & 27); and
2. Include in such disclosures relevant information to enable the participant to make an informed election, including where applicable:

a. the potential impact of tax penalties on any past annuity distributions;
b. whether an early retirement or other subsidy is included in the calculation of the lump sum distribution; and
c. an equivalent comparison of a lump sum distribution to the benefit otherwise payable under the plan or under a purchased annuity contract.

C. The Council recommends that DOL consider providing guidance under ERISA Section 502(a)(9) to provide clarity to plan fiduciaries regarding the consequences of a breach of fiduciary duty in the selection of an annuity contract for distribution out of the plan, including guidance for the term "appropriate relief" (e.g., whether monetary relief is available) and under what circumstances "posting of security" generally may be necessary.

D. The Council recommends that DOL provide education and outreach to plan sponsors:

1. On the range of options available for de-risking, including asset-liability matching (also referred to as "liability driven investing," or LDI), purchases and holding of annuities under the plan ("buy-ins"), hedging, lump sum distributions and distributions of annuities from the plan ("buy-outs");

2. On the distinction between settlor and fiduciary functions in de-risking transactions; and

3. On the distinctions between disclosure, education, and advice in assisting participants in making elections of buy-outs in light of current and future guidance from the Department.

E. The Council recommends that DOL consider the potential benefits of collecting relevant information regarding plan de-risking in the form of lump sum windows and annuity purchases outside the context of a plan termination. Such information might include such factors as:

1. Length of lump sum window;

2. Whether the lump sum window was an alternative to an annuity purchase (i.e., an annuity purchase if lump sum not elected);

3. Number and/or percent of relevant cohorts (e.g., term vested participants, retirees in pay status, union participants, etc.);

4. Number and/or percent of eligible participants who elected the lump sum;

5. Number and/or percent of participants who elected the lump sum and elected a direct rollover to another plan or IRA;

6. Dollar value of lump sums and annuity purchases and percent of the assets before and after the transaction(s); and

7. Name of insurance carrier(s) issuing the annuity contracts and/or certificates.

III. BACKGROUND

There has been an increased level of activity by sponsors of single-employer defined benefit pension plans to terminate the plans in their entirety, or purchase annuities and/or offer lump sum distributions to some or all of their plan participants. These participants can include both former employees with vested deferred benefits and retirees currently receiving pension distributions from the plan in the form of an annuity.

This activity is sometimes referred to generally as “de-risking” or “risk transfer.” One of the purposes of risk transfer is to reduce or eliminate the plan sponsor's risk for their current and future liabilities. However, by so doing, it also transfers the risks associated with current or future pension obligations to another party, which is either the participant (in the form of a lump sum), an insurance company (in the form of a distributed annuity), or both.

Commentators have proffered many reasons for this trend in de-risking ranging from plan sponsors’ desires to reduce the impact of the volatility of their pension plan obligations on their financial statements and in their funding requirements; the revised mortality and interest rates in the Pension Protection Act and subsequent legislation providing for pension funding relief; the current interest rate environment; the desire to lower administrative costs, including reduction or elimination of rising PBGC premiums; the current and future funding status of the plan; and/or considerations unique to a specific plan sponsor or industry. And, they have noted, in the case of annuity purchases, the guarantees of the contract issuer as well as state guaranty fund coverage.

Other commentators have voiced concerns for participants ranging from participants’ lack of understanding about the benefits of lifetime income streams; challenges for individuals in investing effectively or in adequately addressing longevity risk; the adequacy, scope and independence of education, counseling, and/or investment advice to participants as to whether they should take the lump sum and where they should invest their distributions; the potential for adverse tax consequences for current retirees who receive a lump sum after commencing retirement distributions; absence of fiduciary and PBGC protections following distributions or annuity purchases; the capacity of insurance companies to support a substantial growth in demand for annuities; the capacity of state insurance guaranty associations to backstop insurance company guarantees to a similar level as current PBGC protections; and potential impacts on employee retirement security and adequacy.

Many plan design decisions (including a decision to offer partial or full lump sums as well as a decision to establish, maintain or terminate a plan) are generally settlor functions which do not give rise to fiduciary responsibilities in and of themselves. Nevertheless, most of the specific actions taken to implement such decisions involve important fiduciary considerations and may significantly impact plan participants.

The Council's examination focused on the following:

A. What are the reasons plan sponsors are choosing to transfer risk? Are there common developments or factors that lead to this decision? Are the reasons more likely to be specific to the circumstances and considerations of the individual plan sponsor? What are the advantages and disadvantages to the plan and plan sponsor? What types of plans and plan sponsors, by size, industry, etc. have adopted "risk-transfer" activities? Is the incidence of plan terminations, plan distributions of annuities, and/or addition or modification of lump sum features in private sector defined benefit plans increasing or is it likely to increase when interest rates rise and/or funding improves?

B. Employers who have adopted de-risking strategies have offered various combinations of lump sum distributions and annuities to subsets of their plan populations. Some employers have chosen to terminate the plan entirely. What are the different alternatives for plans and plan sponsors? Why do they choose these alternatives? What are the factors or criteria used for choosing these alternatives? If plan sponsors do not terminate the entire plan, what is the impact, if any, on the plan and the remaining participants?

C. What are the current requirements and limitations, if any, on the ability of a private employer defined benefit plan sponsor to: (1) add, modify or remove a lump sum (or partial lump sum) option for one or more groups of plan participants, (2) terminate the plan, or (3) distribute annuities for all or a subset of plan participants (including but not limited to the selection of the annuity provider under IB 95-1)? Should DOL consider updates or revisions to any of these rules, requirements, or limitations?

D. Are there unique issues involved in decisions on risk-transfer being made by ERISA plan fiduciaries that also perform settlor functions? Is guidance needed on these issues?

E. What are the interests of plan participants in determining whether to accept a lump sum in lieu of retaining a benefit under the plan? What are the advantages and disadvantages to plan participants? Are there patterns of acceptance or rejection of lump sum options, across specific demographics or account sizes, which may be relevant to the Department in reviewing its rules and requirements?

F. What are the current participant disclosure requirements applicable to each potential change to the plan? Do participants have sufficient information to make an informed choice? Do these requirements adequately protect the interests of plan participants? If not, should there be checklists, model disclosures, or other proposals, which would protect the interests of plan participants while recognizing that plan design, amendment, and termination are essentially settlor functions?

IV. SUMMARY OF TESTIMONY AND COUNCIL DISCUSSION

A. Introduction to Witnesses

The Council heard testimony from twenty-two witnesses on four different days ranging from plan sponsors, service providers, law professors, government officials, individuals and groups representing participant interests. The Council wishes to thank all of the witnesses for their insights and perspectives on the subject of de-risking and participant protections. The breadth and depth of the testimony and expertise has contributed immeasurably to this report.

The Council heard testimony from several witnesses who represent or directly service the plan sponsor community. This included one large plan sponsor, General Motors (GM), which in 2012 implemented one of the largest defined benefit risk transfers. Testifying for GM was Preston Crabill, Director of Retirement, Layoff, and Profit Sharing Plans. From the actuarial side, the Council heard from Evan Inglis from Vanguard and Craig Rosenthal from Mercer and Kent Mason (on behalf of the American Benefits Council). The Council also heard from Steve Keating from Penbridge Advisors, representing benefits consultants. His testimony focused on the reasons plan sponsors were pursuing de-risking, and specifically risk-transfer strategies. Each of these witnesses focused on the various methods by which plan sponsors implemented these strategies and issues they encountered.

Four witnesses provided testimony discussing the legal framework and its impact on de-risking transactions: Robert Newman (Covington & Burling LLP), John Ferreira (Morgan Lewis), Norman Stein (Drexel Law School), and Brendan Maher (University of Connecticut Law School).

The Council also received testimony on two different days from six witnesses representing the interests of employee, retirees, and participants. They were: Ilana Boivie, Research Economist, Communications Workers of America; Jack Cohen, Executive Vice President, BellTel Retirees; David Certner, Legislative Counsel and Legislative Policy Director, AARP; William Kadereit, President, National Retiree Legislative Network; Karin Feldman, Policy Specialist, Benefits & Social Insurance, AFL-CIO; and Karen

Friedman, Executive Vice President and Policy Director, Pension Rights Center. These witnesses generally agreed that de-risking transactions placed participants' retirement security at risk for a variety of reasons and suggested numerous protections.

B. General Observations

The testimony presented to the Council is a classic case of individuals looking at the same evidence and coming to different conclusions. Much of the difference seemed to arise out of differences in perspectives as well as in experiences. However, there was a significant amount of agreement concerning the underlying drivers surrounding de-risking.

The majority of witnesses discussed a number of consistent themes. First, witnesses generally acknowledged that defined benefit pension plans are part of a voluntary pension system, albeit with important legal and contractual duties (including, where applicable, collective bargaining responsibilities) while the plan is being maintained. Second, most witnesses recognized that sponsoring a defined benefit plan can lead employers to experience volatility associated with their pension funding obligations, which can arise from factors not entirely (and sometimes not at all) within their control, with the level of volatility varying among employers and plans and sometimes in relation to the proportionate representation of active and retired participants within the plan. Third, most witnesses recognized that employers have a number of de-risking methods available to them including methods both inside and outside of the plan. Fourth, witnesses agreed that there was an essential distinction between settlor functions, where the employer makes an amendment to the plan to commence the de-risking process, and fiduciary functions, where the employer is subject to ERISA fiduciary standards to implement the de-risking process. Fifth, witnesses generally agreed that it was necessary to provide a transparent procedure by which employees would be appropriately informed of their rights during a pension de-risking process and that any such process should not interfere with employees' accrued pension rights, though there were differences among the witnesses regarding the scope and design of this procedure and process.

1. Reasons Plans are Engaging in De-risking Strategies

a. Participants' Perspective Regarding Defined Benefit Plan De-risking

From the view of the witnesses representing participants, defined benefit plans play a meaningful role in enabling employees to realize a secure retirement. In combination with Social Security, defined benefit plans, as deferred compensation, have assisted workers in maintaining a steady income level throughout their retirement without fear of outliving their assets. Karin Feldman, Benefits and Social Insurance Policy Specialist for the AFL-CIO, supported defined benefit plans as the best means of providing meaningful secure retirement income. She highlighted several factors that she believes makes them sound and cost effective, including professional asset managers, low fees, better returns, lifetime income guarantees, and benefits to disabled workers and surviving spouses.

Although defined benefit plans provide a more secure lifetime income stream to participants, witnesses acknowledged that the number of these plans has been declining over the past few decades. Many of the plans have been frozen (partially or fully), some have been terminated, and others replaced with hybrid plans or defined contribution plans. Witnesses testifying on behalf of participants expressed a strong view that, for the majority of individuals, transferring longevity, investment and interest risks to the individual has made retirement less secure for individuals and de-risking is merely another method for transferring these risks. These same witnesses viewed de-risking accomplished within the plan, such as through purchasing bonds to match liabilities and purchasing annuities, positively. They underscored that such in-plan de-risking alternatives allow the participants to retain ERISA and PBGC protections. In contrast, they expressed concerns with de-risking which results in the participant leaving the plan (through either lump sum payments or annuities). In general, the risks which employers seek to shed are transferred to the participant, an insurance company or both. To underscore this concern, they highlighted a 2013 survey of National Retiree Legislative Network members, which indicated that 96% of those responding were extremely concerned about their financial security, especially in light of the increasing trend toward pension de-risking by plan sponsors. They are concerned that this trend will continue and accelerate the termination of defined benefit plans.

While most of the focus of the testimony of the participant witnesses was on the impact of participants removed from the plan, a number of those witnesses also reminded the Council of potential impacts on participants remaining in the plan. These witnesses were particularly concerned that the plan may become less well funded, especially if such de-risking reduced the funding level for the benefits of remaining participants. Moreover, there is always the possibility that the plan could fall below the 80% funding requirement triggering certain benefit restrictions (e.g., no increases in benefits, reduction or prohibition of new lump sum distributions) go into effect for those left in the plan. More drastically, if the plan falls to less than 60% funded, then benefit accruals must be frozen. Thus, the steps taken to de-risk could potentially have a negative impact on those participants remaining in the plan.

b. Plan Sponsors' View of Defined Benefit Plans

A consistent message from all witnesses was that those plan sponsors engaged in de-risking strategies are looking to reduce their overall exposure to their pension obligations, including the volatility in those obligations, relative to the market value, cash flows and earnings of the company. The primary risks that defined benefit plan sponsors are exposed to are the same as participants who receive a lump sum distribution: (a) interest rate risk, (b) investment and market risks, and (c) longevity risk. Witnesses also testified that plan sponsors face regulatory obligations, risks and administrative costs for maintaining the plan.

i. Disconnect between the plan and the company's current mission

For many plan sponsors, their defined benefit plans are closed to new entrants and/or have frozen accruals for current covered employees. For some companies, the size of the pension obligation is very large and thus has a disproportionate effect on the company's balance sheet. Because of the plan sponsor's view that these obligations are a legacy cost, are not a core company focus for workforce management, and can expose the plan sponsor to significant risks, the testimony indicated that plan sponsors are looking to reduce or remove these risk exposures in the most efficient way possible, while still honoring their legal obligations to pay retirees and their beneficiaries the full benefits earned.

GM illustrates these circumstances. Preston Crabill, GM's Director of Retirement, Layoff, and Profit Sharing Plans, testified that given the changes in auto manufacturing, GM is a smaller company than it once was; yet the amount of its legacy defined benefit obligations are still large. He noted that, although GM had relatively well-funded pension plans, it faced the annual risk that relatively small changes in interest rates or plan actuarial losses (through unexpectedly lower investment returns or otherwise) would create large and disproportionate balance sheet losses and significant funding obligations to its defined benefit pension plans.

ii. Changes to accounting standards and funding rules have increased volatility

Given that plan sponsors engage in de-risking strategies to reduce the impact of volatility in their obligations and funded status, witnesses pointed to legislative and regulatory changes in defined benefit funding rules, as well as changes to accounting standards, as being significant drivers of de-risking decisions. Funding rules and accounting standards require more mark-to-market valuation of assets and liabilities, greater recognition of pension obligations, and funding gaps to be closed more quickly. Thus, the consequence of these risks on pension obligations are felt more quickly, both in terms of cash flow requirements and the financial condition of the plan and plan sponsor.

Witnesses agreed that the Pension Protection Act of 2006 (PPA) has provided the biggest impetus for plans to use de-risking strategies. Among its many provisions, the PPA reduced the smoothing that plans were allowed to use to value their liabilities and their assets, so that volatility in interest rates and the investment portfolio were felt much more quickly in terms of the calculated funded ratio. Further, the PPA set forth higher funding requirements, requiring plans to reach 100% funding within an accelerated period of time relative to requirements prior to its enactment. Finally, the PPA prohibits plans that fall below 80% of the funded ratio from paying out lump sums; those plans that fall below 60% funded ratio must freeze all accruals. Not surprisingly, witnesses testified that plan sponsors did not want to fall below these thresholds.

Witnesses agreed that the Financial Accounting Standards Board (FASB) rules also requiring greater mark-to-market valuation of pension obligations and greater recognition of these obligations on financial statements were significant drivers toward de-risking strategies. Craig Rosenthal from Mercer testified that although FAS-87 mandated that pension costs appear in a company's income statement using prescribed methodologies, for the most part those were based on corporate bond rates and were usually found only in the footnotes of the balance sheet. However, the implementation of FAS-158 in 2006 brought mark-to-market accounting of the pension obligations directly to the balance sheet. Mr. Rosenthal testified that it is anticipated that FASB will implement other requirements to bring accounting standards in the United States more in line with international standards.

At the time new funding and accounting requirements were implemented, as Evan Inglis from Vanguard testified, there was significant volatility in the financial markets. Although interest rates used to value plan pension liabilities have been declining for the last 30 years, the increased cost in pension obligations were masked by very strong market returns, particularly from the equity markets. However, in the early 2000s, interest rates and the equity markets dropped in tandem, with significant negative consequences for plan funding levels. In 2008, both interest rate and equity market returns again fell in tandem with similar results for plan funding. During both periods, plan sponsors were required not only to fund up their plans in a period of economic slowdown, but also to report higher liabilities and expenses to shareholders. These pension obligations were increasingly viewed as legacy costs, sometimes for a growing block of former employees with no role in ensuring the organization's future success. Facing growing levels of market volatility and accounting and regulatory changes, plan sponsors increased their efforts to identify strategies to mitigate and transfer risk.

iii. Favorable interest rate for lump sum calculations

If a defined benefit pension plan offers a lump sum option in lieu of the annuity, these two distribution options must be actuarially equivalent. The PPA revised the method by which actuarial equivalence was calculated for lump sums. Prior to the PPA, lump sums were valued based on a Treasury interest rate, which was lower than corporate bond interest rates used to value the plan liabilities for funding purposes. Witnesses noted that lower interest rates generally result in less discounting of the pension obligation in determining the lump sum value, thus making the lump sums larger and more expensive to the plan. The PPA change to corporate bond rates meant higher discounting rates and thus lower lump sum obligations for the plan. Witnesses noted that prior to PPA, the lump sum could be more than the amount carried as a liability for funding purposes and thus the lump sum payout would negatively impact the funding ratio. However, the PPA rate changes, which were phased in from 2006 to 2012, more closely matched the liability interest rate. Consequently, calendar year 2012 saw heightened activity by plan sponsors in offering lump sum payouts. Plans could pay out lump sums, reducing the size of their obligations, at a lower cost than before the PPA changes.

Not only was 2012 the first year for full phase-in of the lump sum rates, but federal tax rules, which were in existence prior to PPA, allowed the plan to use a 5-month look back rule to set the interest rates used to value lump sums. In 2012, as rates were declining, this rule allowed plans to look back to higher rates as early as August 2011, and thus to pay out smaller lump sums than if they had been required to use more current rates. Witnesses maintained this was a one-time opportunity, as the same federal tax rules also limit the plan's ability to change the methodology for determining the lump sum interest rate.

Witnesses representing the employer and consulting communities emphasized that current de-risking strategies are aimed at reducing the volatility of a plan sponsor's liability. Some of them also argued that pursuing de-risking strategies was critical to the defined benefit system and could actually be helpful in allowing employers to continue to maintain plans for participants still working for employers. Some witnesses believed that if funding levels increase due to better markets and/or higher interest rates used to discount liabilities, de-risking could become more affordable and the number of transactions might accelerate, potentially leading to additional de-risking transactions.

iv. Other factors

Witnesses also testified that PBGC premiums have become more significant and less predictable over the last few years with proposals to significantly increase these premiums. In addition, similar to PBGC premiums, other costs such as recordkeeping are assessed on a per capita basis. Witnesses suggested that one benefit of de-risking, particularly payment of lump sums to terminated deferred vested participants, is to reduce the number of covered participants, thus reducing costs.

Finally, some witnesses pointed to anticipated changes in longevity tables used to value their liabilities. Given the expected increase in longevity used to value liabilities, plan sponsors believe that not only will lump sums be more expensive in the future, but the size of the plan liabilities used to calculate the plan's funding obligations and reported on financial statements will also increase.

c. Perspective of the Regulators and the Guarantors

Testimony of witnesses representing the regulators and the guarantors provided important insight and perspective on the reasons for de-risking and echoed some of the same concerns and perspectives expressed by other witnesses.

i. EBSA

Joe Canary, Director of the Office of Regulations and Interpretations, EBSA, presented the Council with an overview of the issues surrounding de-risking strategies. He highlighted a number of issues that are implicit in de-risking transactions. These included the distinctions between settlor and fiduciary functions; selection of an annuity provider; participant communications; and the importance of lifetime income streams for participants.

ii. Pension Benefit Guaranty Corporation (PBGC)

Josh Gotbaum, Director (CEO) of the PBGC, provided an important perspective on a number of the concerns noted by other witnesses. He observed that current rules appear to incent plans to de-risk and to do so disproportionately with lump sums, because of a combination of regulatory hurdles and cost advantages. He suggested that lump sums are inappropriate for many participants, and likened pension plan lump-sum cash-outs to cigarettes: legal, liked, and bad for you. He also opined that he would like to see fewer incentives for participants to choose lump sum distributions. One suggestion was less criticism of annuities, which might be (unintentionally) causing more individuals to elect a lump sum. To further make the point, he stated that he did not think that a defined benefit plan with a PBGC guarantee was necessarily safer than an insurance company annuity backed by a state insurance guaranty association.

iii. Insurance regulators and state guaranty funds

These witnesses focused on the multiple layers of protections in the insurance and regulatory oversight, as well as the state guaranty protections that provide a further backstop to the interests of plan participants for whom the annuities are purchased. The testimony of Philip Barlow, from the District of Columbia Department of Insurance, Securities and Banking, echoed the general message of Mr. Gotbaum's observations about the relative strength of insurance oversight and protections. He emphasized: NAIC accreditations; restrictions on investment types, investment concentration, and investment valuation; holding company rules; review of material transactions; and the NAIC Financial Analysis Working Group (FAWG) peer review process. The testimony highlighted the regulatory scrutiny of an insurance company's ability to deliver on their obligations of various durations.

Peter Gallanis, from the National Organization of Life and Health Guaranty Associations, testified regarding the strength of the state guaranty funds. The state funds provide a benefit floor, or minimum, with additional benefits payable in excess of the floor based on the level of available insurance company assets in the liquidation. By contrast, PBGC guarantees provide a cap, or upper limit, on the benefits being guaranteed. For both PBGC and state guaranty funds, most participants have benefits below the cap and within the range of the state guarantees. Nevertheless, as he noted, the facts regarding the different federal and state guarantees remain important.

Providing additional perspective, Mr. Gallanis also highlighted a stark contrast between, on the one hand, the hundreds of defined benefit plans that failed during the great recession, and the many companies that failed or received government assistance, with, on the other hand, only six insurance companies, with combined assets under $800 million, that went into liquidation under the state guaranty system during the same period, with most policyholders paid in full. He also noted the favorable discussion of this record in the recent Government Accountability Office report on this same favorable performance of the industry during the economic turmoil of 2008 and thereafter.

2. Methods of De-risking

Testimony established that employers de-risk their pension obligations using a number of internal and external approaches, with internal methods permitting the plan sponsor to reduce many (but not all) of its risks while leaving the participants in the plan. In-plan strategies include restricting participation or accruals, hedging and immunization (both considered liability-driven investing (LDI)), and buy-ins. Options for de-risking outside of the plan, and permanently discharging the employer's obligations, include lump sum offers, buy-outs, and plan termination (including "spin offs"). This section of the report reviews some of the primary approaches currently in use.

a. Freezing Eligibility or Benefits

Witnesses testified that the first step most plans take to lower plan liabilities is to slow or stop future benefit accruals in the plan. Such measures include closing the plan to new entrants; reducing the benefit formula, either for all participants or for new employees; and freezing the plan's future accruals. One or more of these strategies may be undertaken in tandem with the introduction or expansion of a defined contribution plan for some or all of the plan sponsor's eligible employees or the offering of no employer sponsored retirement plan at all. These measures will slow or stop the growth of the defined benefit plan's obligations, possibly replacing them with a new, more predictable contribution obligation for the defined contribution plan. Such steps, however, leave the existing pension benefit promises subject to volatility in interest rates and longevity, perhaps for many years. According to Steve Keating of Penbridge Advisors, roughly one-third of defined benefit plans are frozen today (participants receive no benefit accrual or use of increased salary in the formula). And Vanguard's Evan Inglis also noted that many of these frozen plans ultimately wind up being terminated.

b. Liability Driven Investing (LDI)

Witnesses testified that given the impact of the PPA, as well as the funding rules and accounting standards with the greater use of mark-to-market valuation of liabilities and assets, plans have looked to reduce the volatility in funded ratios by more closely matching the characteristics of their assets with their liabilities. Asset-liability matching is a familiar concept for many businesses, especially regulated businesses generally and insurance companies specifically.

Pension liabilities are valued using a market-based interest rate. Because of the long duration of pension obligations, many plans have a liability duration that often averages 10 years or longer. Longer durations mean that changes in interest rates can have a correspondingly large impact on the value of the liabilities.

Plans implement an LDI strategy to attempt to get more exposure in their portfolio to the types of interest rate risks that correspond to their liabilities. In order to match risks to liabilities, plans increase the total duration of the portfolio by investing in more bonds, longer duration bonds, and bonds with specific characteristics more closely corresponding to the plan's liabilities. While this can help mute the impact of the interest rate risk to plan sponsors, it does not remove the obligations or eliminate all risks and costs to continue the plan. Moreover, LDI may be better suited to larger plans that have the ability to spread such risks across larger numbers of participants than to smaller plans, where variations among a small number of participants can have a disproportionate impact on the plan's funding status.

c. Liabilities Transferred to Insurance Company

In order to further reduce a plan's exposure to the various risks described earlier, the Council received a significant amount of testimony concerning plan sponsors who have chosen to transfer the plan's risks to an insurance company through the purchase of an annuity that matches the payout obligations to the participant. By purchasing the annuity, the insurance company bears the same risks as the plan did: interest rate risk, investment and market risks, and longevity risk. Plan sponsors can either purchase annuities to be held within the plan, or distribute them out of the plan.

In-plan annuities, often referred to as "buy-ins," become a plan asset. Nothing else changes: the plan participant remains a participant covered under ERISA; the plan still pays the participant; plan sponsors continue to pay administrative costs and PBGC premiums for that individual. Such purchases can reduce or eliminate the volatility of the plan's investments, replacing them with the contract's guarantees. If purchased with respect to vested benefits of former employees, buy-ins can function much like the buy-out alternative discussed below. In a buy-in, the plan continues to pay for both the protection of the annuity contract and the protection of PBGC guarantees. Thus far, annuity buy-ins have been very rare in this country, although they have been more popular in other countries such as the United Kingdom.

A buy-out occurs when the plan discharges its obligation by transferring its risk to the insurer by purchasing annuities for the participants. Such purchases, when made outside of the context of a plan termination, generally include the vested benefits of a group of former employees. In two large recent cases (GM, Verizon), the purchase included employees who already had started receiving retirement benefits from the plan.

Following the purchase, the participants' rights and protections are circumscribed by the annuity contract, the financial status of the issuer, and the state guaranty fund protections; in place of the protections of PBGC coverage and the provisions of ERISA (though some ERISA provisions may be incorporated into the contract). Once the transaction is complete, the participant will receive an annuity certificate from the insurance company, will receive payments from that insurer, and will be protected through the state insurance system and state guaranty associations.

As a corollary, the plan sponsor no longer has any ERISA obligations or associated costs. Mr. Keating highlighted a number of possible advantages to the plan sponsor in transferring risk, including: lowering their risk profile; improving their competitive position; removing uncertainty around pension expense; producing more consistent financial results; focusing on their core business; and taking comfort that a highly credit worthy company is taking responsibility for making future payments to transferred participants. Possible disadvantages associated with annuity buyouts included: the loss of liquidity; the increase in leverage associated with purchase costs; and the negative impact on earnings due to settlement accounting.

As noted by EBSA’s Joe Canary, the primary DOL guidance regarding annuity purchases by defined benefit pension plans is IB 95-1, which sets forth multiple factors to be considered by a plan fiduciary (but not safe harbors) with respect to such purchases. The process requires that the plan fiduciary either possess the requisite expertise or engage one or more third parties to provide it. Because of the complexity required in evaluating annuity providers and the structure of the contract, the Council heard testimony regarding the use of consultants and independent fiduciaries to assist in the transaction and the selection of the annuity provider. Mr. Crabill stated that GM relied heavily on the factors listed in IB 95-1. Mr. Crabill testified that GM used an annuity committee to select the independent fiduciary to assume responsibility for the fiduciary decisions described in IB 95-1. He noted that the independent fiduciary, State Street, in turn engaged Oliver Wyman, to advise on the selection of the insurer, including a review of an insurer candidate's capability and safety, and the structure of the insurance contract.

Among other approaches plan sponsors weigh is the use of a single insurance company or multiple insurers to provide the annuities. Mr. Crabill testified that although GM, through its advisors, considered using multiple insurers, their consultants concluded that a single carrier supported by a separate account contract structure was an appropriate choice to protect the interests and benefits of the retirees.

Costs to purchase annuities can vary. Mr. Inglis testified that generally annuities are 5% to 15% higher than the value of the same pension promises under the plan. The higher cost of the annuities generally reflects more conservative discount rates used by the insurer, higher longevity assumptions used by the insurer compared with plan assumptions, and insurance company profits. Witnesses testified that the purchase is still often cost effective for the plan in light of the elimination of administrative costs and PBGC liabilities for those annuitants.

On a historical note, Mr. Keating of Penbridge Advisors stated that in the United States the annual amount of annuity buy-outs has typically been less than $3 billion over the last twenty years; it stood at less than $1 billion annually for recent years before 2012. In 2012, he testified that 98% of all transactions were less than $250 million, with most less than $10 million. However, two of the largest annuity purchases in history occurred in 2012 when GM and Verizon purchased combined $33.6 billion dollars in annuity contracts to settle their liabilities for a large portion of their pension participants.

d. Liabilities Transferred to the Individual

While plan sponsors can transfer their pension obligation risks to an insurance company, they can also transfer their risks through lump sum payments to the participants and beneficiaries. The plan pays to the participant or beneficiary a single payment based on the present value of the promised annuity. Testimony confirmed that defined benefit pension plans are permitted to include lump sum features in their plan, subject to funding adequacy requirements, and that many plans already include such lump sum options, which may be available at any time or only at specific times, such as severance from service or upon attaining retirement age. Nevertheless, testimony also noted that recent developments indicate an increasing incidence of introduction or expansion of lump sum provisions, including lump sum options offered to retirees in pay status.

The Council heard testimony that lump sum distributions can be less expensive to the plan than annuity purchases or maintaining the benefit under the plan, particularly for younger former employees. (Neither lump sums nor annuity purchases are likely to be available to active participants who are continuing to accrue benefits under the plan.) Particularly for those participants with small balances, lump sum distributions reduce the fixed costs associated with administration and PBGC premiums. There was testimony that the offering lump sums could result in anti-selection bias. Those participants who believe they have a lower life expectancy than average, perhaps due to illness or genetic disposition, will elect to take the lump sum, leaving those with higher life expectancies in the plan.

Plans have implemented the lump sum strategy in various ways, frequently by offering the lump sum to a particular group in the plan. By far the most common strategy is to offer a lump sum option to terminated deferred vested participants during an election window. In this scenario, participants and beneficiaries are offered the opportunity to elect a lump sum of their vested benefit if they make a selection within a 60 or 90-day period. Mr. Rosenthal of Mercer estimates that there is a 40-60% take-up rate, which frequently correlates with age, with younger participants being less likely to elect the lump sum. He also saw a positive correlation between the size of the lump sum and the decision to directly roll it over to a tax deferred vehicle (i.e., the larger the amount of the lump sum, the more likely it would be rolled over to an individual retirement account).

A less frequently used strategy is to offer lump sum distributions to retirees already in pay status. In the case of Ford and GM, in 2012 each company received a special letter ruling from the IRS that permitted them to offer certain retirees who were in pay status the ability to elect to receive the remaining present value of their pension payments in the form of a lump sum without violating distribution requirements in the federal tax code. Mr. Crabill testified that GM offered the lump sum option to 44,000 retirees and their surviving spouses. He said that the take up rate was about 30%, resulting in approximately $3.6 billion in lump sum payments.

In order to implement a lump sum window, plan sponsors may hire one or more service providers such as an actuary, a participant investment advisor and/or a benefit consultant.

These providers help the plan sponsor determine whether, and if so how to, offer such a lump sum window; and to calculate the lump sum amounts and interface with the participants through communications, websites, call centers and in-person meetings. (Similar functions can be involved in decisions by a plan sponsor to include a more general lump sum feature in the plan, as well as to calculate individual lump sums.) Witnesses representing or servicing the plan sponsor community acknowledged that the choice of a lump sum does transfer all the associated interest, market and longevity risks to the individual, who now must manage the money themselves or work with an advisor. They also acknowledged that lump sum payouts are not always required to include the value of an early retirement subsidy, which is another cost-savings to the plan and a disadvantage to the recipient. The Council received conflicting testimony as to whether current rules already require the disclosure of the presence or absence of this subsidy in the lump sum calculations.

3. Other Issues Plans/Plan Sponsors Consider In De-Risking Transactions

a. Settlement accounting

Some transactions, specifically those that involve plan terminations, require "settlement accounting." Mr. Keating testified that many plans have substantial unrecognized actuarial losses, classified as accumulated other comprehensive income/loss. When a plan is terminated, the company needs to immediately recognize any losses on its financial statements. The testimony was mixed on plan sponsor's reactions to this requirement. Some plans want to avoid any impact on their financial statements, so they will consider approaches like lump sum windows and annuity buy-ins. Other plans are willing to show losses on their statements, but would rather do it all at once.

b. Liquidity and Characteristics of the Defined Benefit Plan After the Risk Transfer

The Council heard testimony on the impact of risk transfer strategies on the plan and remaining participants. Longevity increases, interest rate sensitivities, liquidity in the remaining plan assets and reduced amount of assets, all may impact the plan, resulting in, among other things, changes to the duration of the plan and a negative impact on the funded status of the plan.

c. Data Clean-up

Several witnesses testified about the importance of making sure plan data was "clean" before conducting a risk transfer transaction. This includes making sure addresses are correct, beneficiary information is up to date, and employment records are accurate. This data is important in terms of communicating to participants and making sure liabilities are valued accurately.

d. Fiduciary v. Settlor Functions

With regard to the legal framework surrounding these pension de-risking strategies, the testimony established that the appropriate framework shifted based on whether it was an in-plan or external strategy. In-plan strategies are a plan investment, so plan sponsors have fiduciary obligations, including the obligations to act in the best interests of plan participants and beneficiaries as well as with a duty of care consistent with a prudent fiduciary in similar circumstances. In particular, it was noted that DOL Advisory Opinion 2006-08A addresses fiduciary obligations in the context of liability-driven investing and states that, "nothing in ERISA limits a planned fiduciary's ability to take into account the risks associated with benefits liabilities." In contrast, the decision to pursue an out-of-plan de-risking strategy is a matter of plan design and is thus a settlor function (though this settlor distinction was criticized by Professor Stein where the plan design decision clearly harms the plan's participants). Under the settlor-function doctrine, such decision-making by plan sponsors is not subject to ERISA fiduciary requirements. Once the plan sponsor has decided to pursue an external de-risking strategy, the implementation of that strategy is again subject to fiduciary obligations.

The Council heard testimony from several witnesses on how plan sponsors manage their fiduciary duties and obligations. Witnesses testified concerning the necessity of being clear in what capacity the individual is acting and the use of outside advisors and independent fiduciaries to support them. For example, Mr. Crabill testified that GM hired an independent fiduciary in recognition of this potential conflict to assist in negotiating with the insurance company. To further separate functions, GM also decided that those who hired the independent fiduciary would not be involved in the negotiations.

e. Participant Protections

Witnesses generally agreed that it was necessary to provide a transparent procedure by which employees would be appropriately informed of their rights during a pension de-risking process. Significantly, all witnesses agreed that any such process should not interfere with employees' accrued pension rights. There was, however, disagreement about the scope and design of this procedure and process.

f. Annuities

Participant witnesses raised various concerns when a plan sponsor de-risks through the purchase of annuities. First, such de-risking effectively ends any PBGC and ERISA fiduciary protections of a participant's benefits following the transaction, replacing them instead with the contractual protections of the annuity contract, the regulatory protections of state insurance law regulation and oversight, and a state guaranty backstop if, and when, the first two fail. Moreover, when a participant has been transferred from a defined benefit plan to a private annuity, that participant no longer has the protections of ERISA, such as fiduciary duty and annual disclosure reports, but instead must rely on the terms of the annuity contract. In addition, while ERISA protects the qualified pension benefits from claims of creditors, testimony to the Council was not definitive as to the extent to which states, as well as current bankruptcy laws, similarly protect annuity payments.

Second, while the life insurance companies from which annuities currently are being purchased are generally viewed as financially strong, in the past even some companies which have been viewed as financially solid have gotten into financial difficulty. Participant witnesses pointed to the dramatic events of 2008 that led to the government bail-out of large banks and corporations, and the failure of Lehman Brothers. Participant witnesses also pointed to the 1991 failure of Executive Life (which, as noted by other witnesses, also pre-dated much of the enhanced insurance regulatory oversight of the past two decades). Nevertheless, it was also true that the ratings companies had given Executive Life stellar ratings until shortly before it collapsed, and it took years to sort out compensation to those insureds.

Participant witnesses noted that state guaranty funds are not advance-funded. Moreover, the specific amounts of state guarantees depend on the insured's state of residence and the amount of state guarantees vary, with all states providing a base amount of guarantees and many states, having adopted newer NAIC models, providing higher guarantees. If both were to be viewed as a ceiling on the benefits payable, the most protective of the state guarantees would be less than that provided by PBGC. This variance in state guarantees leads to the possibility that two annuitants – equal in all respects except for the states in which they live – could experience very different levels of protection. However, as noted by Mr. Gallanis, state guarantees serve as a floor, rather than a ceiling, with annuitants frequently recovering well in excess of the floor amounts identified in the state guarantees. He noted specifically that high levels of state and NAIC oversight, including early intervention while the company's assets still cover much and perhaps all of their obligations ("asset coverage percentage") could result both in annuitants receiving their full benefit, even in excess of the benefit guaranteed by PBGC, through the combination of state guaranty minimums and the additional asset coverage percentage.

Another question that was raised regarding annuity purchases was market capacity. Two participant witnesses questioned whether insurance companies had sufficient capacity to absorb a continued surge in de-risking activity as a result of the historically large annuity purchases by GM. The Council received limited testimony on this question, neither favorable nor unfavorable, other than noting that (a) capacity may expand to meet demand; and (b) insurance regulatory oversight was likely to provide early indicators of potential capacity issues for an individual company.

A number of participant witnesses also asked how disputes are handled, particularly mistakes made during the purchase of the annuity contract. One example was: Who will be responsible if the participant's age or service is incorrect and what impact will this have on the participant's benefit? Witnesses noted that some annuity contracts clearly addressed these types of questions and encouraged others to do so as well. Participant witnesses also expressed concerns that the insurance company itself might take steps to de-risk, such as offering a lump sum to the annuitants, although other witnesses noted that this would require a contract provision from the outset. If this should occur, the participant witnesses questioned how the lump sum amount would be calculated, what disclosures would be required, and whether spousal consent would be necessary.

Professor Maher did not believe that any and all de-risking transactions are necessarily a bad deal for beneficiaries merely because of the loss of PBGC and fiduciary protections, and that state guarantees, whether old or new, plus state contract law on remedies, could be as attractive or more attractive to employees.

g. Lump Sum Distributions

Participant witnesses generally focused on two de-risking alternatives – lump sum distributions and annuity purchases. Many participant witnesses regard lump sum distributions as less desirable than an annuity, except in the unusual situation where the individual and the spouse have a short life expectancy. The reasons for this disfavor are not new, but have been supported by these witnesses' own experiences.

Participant witnesses echoed one central conclusion, which they believed many participants do not understand. A lump sum comes with many of the risks which caused the employer to de-risk in the first instance – the risk of investment losses, the failure to meet investment objectives and the risk of outliving the invested lump sum. Added to this is the risk the monies will be spent early on non-retirement purchases and thus will not be available when needed for their retirement.

Participant witnesses stated that most participants do not have the understanding, experience, or expertise to manage investments or even select an investment advisor, especially in comparison to a plan's investment manager. Moreover, because a participant's investment time frame is shorter than that of a plan, they are less able to weather the volatility of the markets. Further, because participants are individuals, they are likely to pay more for investment advice and asset management, thereby leaving them with less for the long term. There is neither a PBGC guarantee nor a state guarantee associated with a lump sum distribution. In addition, participants considering receipt of a lump sum must consider carefully the personal tax consequences, both at the time of the receipt and afterwards.

Some participant witnesses assisted retirees in pay status who recently had been offered lump sum distributions. These witnesses observed that these offers caused great distress and anxiety among the retirees. These retirees often had taken their time to plan their retirement and now had to decide, in a short period of time, whether to accept a lump sum. The witnesses noted that some of those making these decisions were old, more vulnerable to pressure from relatives and investment advisors and, in some cases, diminished in their capacity to weigh the pros and cons of the options.

Because of the interest rate assumptions defined benefit plans are now allowed to use in their calculation of lump sums (which plan sponsors have argued are more consistent with the assumptions for funding the plan), the amount of the lump sum is less than the participants would have received if the prior interest rate rules from previous years were in effect. "Indeed," as NLRN observed, "it's no coincidence that the first large-scale lump sum buy-out offers (GM and Ford) occurred in 2012, since that is when the Pension Protection Act's less generous lump sum calculation were fully phased in." In addition, the law permits a plan to exclude the amount of an early retirement subsidy in the lump sum calculation even when an individual would receive the subsidy in an annuity from the plan. This aspect engendered much discussion among the Council. David Certner of AARP stated that in order to choose the lump sum offer participants generally had to choose the option against their best interests.

The Council heard broadly divergent opinions over the desirability of such lump sums being offered, especially to retirees already receiving annuities. Some witnesses thought it was best to give employee and retirees options, allowing them to make decisions based on their specific needs and circumstances, and thought employees could make the appropriate choices given the right information. And one retiree testified that he should have been given the option of a lump sum, but was not. In contrast, others referred to lump sums as "the devil," and the offering of lump sums to current retirees already receiving plan pensions as "corporate elder abuse" and "the most cynical and worst of all pension abuses that have emerged post-ERISA." For his part, Professor Stein testified that, everyone besides those who are terminally ill, or almost everyone else who selects a lump sum, will be forfeiting a substantial portion of their retirement savings. He based his comments on conclusions from some behavioral economists, that individuals have difficulty accurately discounting future payments and thus over-value lump sums. Another issue raised by some of the witnesses was the role of a financial advisor in providing education or recommendations regarding the lump sum option and the extent to which any advice (as contrasted with education) could involve a conflicting interest in favor of the lump sum.

C. Discussion of Proposed Recommendations to the Council

Witnesses offered numerous and divergent recommendations, ranging from take no action, to disallowing one or more (or all) de-risking transactions, and many proposals in between.

Two of the legal witnesses who represented employers (Mr. Newman and Mr. Ferreira) favored a minimalistic approach. While not eschewing all regulation, Mr. Newman suggested any future guidance should be practical, should be necessary, and should be done while keeping in mind what ERISA already requires of fiduciaries and that such obligations do not mandate a single result. Mr. Ferreira, based on his belief that his clients and most employers seek to do right by their employees in these circumstances, suggested that caution be exercised before DOL take any regulatory actions since defined benefit plans already "have been regulated out of existence."

Participant witnesses made numerous suggestions concerning potential participant protections in the case of annuity purchases, intended to improve the transparency of the transaction to the participants, including:

Require participant consent to an annuity distribution;

Clarify the "safest annuity" obligations under IB 95-1;

Provide further guidance on what constitutes a thorough investigation and analysis of an annuity and what standards constitute "safest" available annuity;

Redefine the annuity selection standard to the "most protective" annuity, and/or require a third party to certify the qualifying annuity providers;

Require use of a separate account for purchased annuity contracts;

Require reinsurance for purchased annuity obligations, potentially from the PBGC;

Restrict the annuity issuer from unilaterally offering lump sum options;

Require annuity contracts to include protections against garnishment and attachment by creditors or bankruptcy trustees; and

Develop dispute resolution process in the event a participant has a dispute.

A number of these recommendations were incorporated in whole or part into the Council's recommendations, while others were either answered by other witnesses or simply were not accepted by the Council. For example, other witnesses noted that neither ERISA nor the Code provided authority to prohibit lump sums or to impose a consent requirement on annuity purchases, although it was noted that some plans provide participants with an election between a lump sum and an annuity distribution at retirement. Witnesses also noted that IB 95-1 already includes separate accounts as a factor to consider under the safest available annuity standard; the Council noted that the same considerations involved in large plans like GM are not necessarily applicable or appropriate for all plans. Additionally, Mr. Gotbaum noted that the PBGC does not have authority to provide reinsurance to insurers.

The Council heard testimony from opposing positions on the question of whether the DOL should provide for a notice and comment period prior to acting on proposals for additional guidance on (1) fiduciary/settlor functions in these transactions, (2) expansion of IB 95-1, and (3) needed participant disclosures relating to elections of lump sum distributions. The Council unanimously agreed that any such changes should be made prospectively only.

With respect to the form of guidance, Council members recognize that the administrative process for determining how guidance should be issued is in the purview of the Department. The Council members also recognize the importance of obtaining input from the public, particularly with respect to significant changes in existing law. At the same time, the Council recognizes that immediate guidance might be needed in certain areas.

In situations where plans de-risk by offering participants lump sum pay-outs, some of the witnesses representing participants recommended that DOL should:

> Require plans to make independent, non-conflicted, objective advice available to participants;
>
> Require steps to be taken to mitigate and prevent undue influence; and
>
> Prohibit the offering of lump sum buy-outs to retired participants.

Other witnesses noted, however, that a plan is not required to provide specific education or advice, and that existing prohibited transaction guidance already imposes requirements for avoiding or eliminating conflicts in the case of advice. Other more general suggestions were that DOL should:

> Issue guidance to clarify that any worsening of plan funding by virtue of de-risking is a fiduciary violation;
>
> Require disclosure of the impact of de-risking on other benefits, such as retiree health insurance;
>
> Require adequate protection of spousal rights; and
>
> Require reporting to the federal government of all de-risking transactions.

The majority of witnesses agreed that plans and plan sponsors should be transparent with the plan participants and include appropriate disclosures. The Council heard a significant amount of testimony concerning the types, content, and timing of disclosures.

Where a participant is offered a choice between an annuity and a lump sum, participant witnesses stressed the importance of full and complete disclosure to participants of the pros and cons of the choices they are being offered and adequate time to make this vitally important decision. Bill Kadereit of NLRN suggested that DOL clarify fiduciary responsibilities to include providing thorough plain English disclosures concerning the financial trade-offs, including tax consequences and the higher cost of purchasing an individual annuity contract. Karin Feldman of the AFL-CIO suggested that checklists of issues or worksheets might be helpful. Karen Friedman of the Pension Rights Center urged that disclosure requirements be made more robust, in order to caution retirees against investment risks, tax consequences, loss of federal insurance protections, and the consequences of waiving spousal benefits. David Certner of AARP argued that participants should receive disclosures about how much less they will typically receive with a lump sum than an annuity or pension. These witnesses agreed that DOL should test any draft documents to ensure they are appropriately designed and understandable.

Participant witnesses asserted that such disclosures should be sent in paper form, by mail, and not electronically. The Council heard testimony from plans and plan sponsors agreeing with this suggestion; most plans scrubbed their data prior to the transaction to ensure it would have accurate addresses. Participants would be notified by a post card that information about the de-risking transaction would be forthcoming. This also gave plans an opportunity to update addresses again. If there was a lump sum offer, it was sent in paper form, by mail, because that was the delivery method to which the most participants were the most likely to respond.

Participant groups suggested that the content of the disclosures should include:

> Pros and cons of lump sum offers including an explanation of interest, investment and longevity risks;
>
> The value of the lump sum being offered as compared to the value of the promised pension benefit. By so doing this should quantify the amount the participant would "lose" (if applicable) by taking the lump sum;
>
> An indication whether an early retirement subsidy is included in the calculation of the lump sum, and if not, the value of the lost early retirement subsidy;
>
> The fact that the PBGC is no longer insuring the pension;
>
> Any tax consequences of accepting a lump sum; and
>
> Any spousal notices and required consents.

Even if the de-risking transaction did not require participants to make a choice, such as the transfer of their annuity to an insurer, the participant witnesses believed that participants should receive certain disclosures so that they would understand the transaction and the potential problems if the insurer should become insolvent.

Participant witnesses felt strongly that, given the consequences of the decisions being made, the amount of time afforded in the recent high profile transactions was inadequate. Mr. Certner suggested that participants should have at least 30 days' notice that an option is going to be offered, then at least 90 days to make a decision and at least one or two weeks cooling off period, similar to the Age Discrimination in Employment Act (ADEA), in which they can change that decision.

IV. RATIONALE FOR COUNCIL RECOMMENDATIONS

A. IB 95-1

DOL IB 95-1 sets forth six factors that fiduciaries should consider when selecting an annuity provider for such a transaction. DOL has referred to this obligation as one to select the "safest available annuity" unless under the circumstances it would be in the interest of participants and beneficiaries to do otherwise. Relying solely on ratings provided by insurance rating services is not sufficient. Testimony raised questions about the applicability of IB 95-1 to plan de-risking transactions (although testimony from EBSA seemed to presume that it applied), and also noted the absence of safe harbors in IB 95-1. Testimony also noted additional considerations that might be considered for such safe harbors, in addition to those already listed in IB 95-1. The Council agreed that these additional factors may be appropriate for inclusion in one or more safe harbors, along with existing factors outlined in IB 95-1. The Council agreed unanimously that all guidance should be clearly prospective in its application.

B. Disclosures

Based on the testimony from numerous stakeholders, it became clear to the Council that comprehensive and accurate disclosures are essential so that participants and beneficiaries have all of the information necessary to make informed decisions concerning their choice between a lump sum distribution and an annuity (whether under the plan or through an insurer). Understanding longevity, investment, and interest risks are crucial to making this informed decision. This information is particularly important for those participants already in pay status because of the potential financial and emotional impact of the decision process. Of course, plan communications must be objective, and not biased by the employer's objective of accomplishing the de-risking transaction, in order for the plan fiduciaries to meet their fiduciary obligations. In this connection, the Council has recommended that the disclosure include an "apples to apples" comparison of the dollar value of the lump sum distribution to the dollar value of the benefit otherwise payable under the plan or under a purchased annuity contract. The Council contemplates a comparison similar to that proposed under the IRS regulation governing disclosures of relative values.

Three issues were of particular concern to the Council. The first was whether participants understand that if they are eligible for an early retirement subsidy when they chose an annuity, they could lose that subsidy if they chose a lump sum distribution. For some participants, that amount could be substantial. Consequently, the Council has recommended that disclosures include a statement as to whether an early retirement subsidy was included in the calculation of a lump sum distribution (for those plans that offer such a subsidy).

The second issue was whether participants' understood if tax penalties were due on past annuity distributions. Clearly, any tax consequences may have a significant impact on their choice. Thus, the Council recommends that this tax information be provided to participants.

A third issue was that participants and participant groups testified that generally 60 days was insufficient time to make an informed decision. The Council agrees that participants and beneficiaries should receive disclosures at least 90 days prior to any transaction occurring in order to ensure that participants and beneficiaries have adequate time to make an informed decision. This is particularly important for those participants in pay status.

On a more general note, the Council suggests that DOL consider holding focus groups among affected participants to determine which disclosures and what formats are the most helpful to participants. The Department should test draft disclosures to ensure they are appropriately designed and understandable.

C. Fiduciary Liability for Annuity Selection

ERISA Section 502(a)(9) provides that a participant, beneficiary, a plan fiduciary, or DOL may bring a civil action for appropriate relief, including the issuance of a security bond for the harm caused by the fiduciary breach. Section 502(a)(9) accomplishes two important purposes: (1) it requires employers to follow fiduciary standards in purchasing annuities for participants and beneficiaries of the plan; and (2) where the fiduciary standard is breached, it provides a remedy.

A majority of the Council believes that fiduciaries and plan sponsors would be assisted if the Department provided guidance indicating the circumstances in which it might seek to exercise its authority under section 502(a)(9), that is, when will the Secretary take action for breaches of fiduciary duty under section 502(a)(9) and what type of remedy will the Secretary seek. One dissenting vote believed that because section 502(a)(9) was a civil enforcement provision, the Department should not issue guidance, but should have flexibility on how and when it would use the provision.

The Council noted that even if a fiduciary breach has been established in connection with the purchasing of annuities, there is very little guidance in case law or elsewhere concerning what remedies are appropriate for such a breach. Given that "appropriate relief" and "security bond" are undefined terms in the statute, the Secretary has the authority to provide guidance to further define and elucidate these statutory terms. The Department could issue guidance defining what "appropriate relief" might mean in various fiduciary breach scenarios involving annuity purchasing, including defining circumstances under which the issuance of a security bond may be appropriate.
For these reasons, the Council recommends that the Department should consider elaborating on these issues under section 502(a)(9) of ERISA.

D. Education and Outreach to Plan Sponsors

During the testimony, a number of issues were discussed that lead to the Council deciding to recommend that DOL provide education and outreach to plan sponsors. Much of the testimony from the plan sponsors and benefit consultants focused on the use of lump sum distributions and annuity purchases; there was somewhat limited testimony on the use of other strategies to de-risk. Because the Council heard that plan sponsors were concerned about volatility, the Council voted, with one dissent, to recommend that the Department provide education and outreach on the range of all available options including lump sum distributions and buy-outs. The dissent contended that there was no need for the Department to provide information about lump sums and annuity buy-outs and that this could be construed as an endorsement. The rationale for this recommendation was that the Council is concerned that small to medium size plan sponsors might not realize that there are options other than lump sum distributions to mitigate the risk in their defined benefit pension plans.

The testimony predominately indicated that while the decision to de-risk and offer lump sum options and buy-outs is a settlor function, the implementation of such a decision is a fiduciary one. However, there are some areas where education and outreach on whether a particular action is a settlor function would be helpful, as would guidance on fiduciary implementation issues. It would enable plan sponsors and plans to ensure that they are cognizant of their rights and responsibilities.

Other issues upon which the Council spent considerable time were the distinctions among disclosures, education and advice. If participants decide to choose a lump sum option, they must decide how they will handle the distribution. For example, participants need to decide the following: will they roll the distribution over to an individual retirement account; what are the personal tax consequences of the decision; if they roll it over, how will they invest it; how will they decide to draw down the lump sum so they do not outspend it? Many plan sponsors provide disclosures, call center services, and other "advisors." Although the Council recognizes that some of these issues may be encompassed in the Department's proposed changes to the regulation on the definition of fiduciary and accompanying guidance, the Council believes that it would be helpful for the plan to know where the line is between advice and mere education, and thus suggest that DOL provide education and outreach on these issues to plan sponsors and participants.

E. Collection of De-risking Data

The Council believes that it may be helpful to collect data on de-risking transactions to assist the Department in identifying any trends in regard to these transactions. This need became particularly evident as the Council found it difficult to obtain accurate information about the number and method of de-risking transactions for specific time periods.

The Department could use this information in various ways. For example:

- Substantial lump sum activity might underscore the importance of lump sum disclosures, and any pending lump sum disclosure guidance (or it may merely reflect dynamics within certain employers);

- Substantial annuity purchases from the same insurer(s) might indicate emerging market limitations (or it may merely reflect successful marketing and/or competitiveness).

Additional data might form the foundation for assessing the level of de-risking activity and identifying potential areas of concern. Generally, enhancing transparency and accountability is beneficial for the retirement system, as a whole, and to participants, in particular.

Although the Form 5500 could be used to collect this information, as it is the primary source of information concerning the operation, funding, assets, and investments of pension plans, it is not the only method for collection of information. The Council thought it appropriate to have DOL determine the best method of collection, as well as the specific pieces of information to be collected depending on how the Department might use the information. In addition, the collection vehicle could be coordinated with the Internal Revenue Service (IRS) and the Pension Benefit Guaranty Corporation (PBGC), keeping in mind its potential use by other federal agencies, Congress, and the private sector in assessing employee benefit, tax, and economic trends and policies. Moreover, such coordination might be necessary if the information is collected on Form 5500, which is an interagency form.

F. Intergovernmental Cooperation

Some de-risking transaction issues overlap among the three agencies responsible for overseeing ERISA-sponsored retirement plans. Other issues are discrete to a specific agency, but might impact the decisions which plan sponsors, plans, insurers and participants make. Regardless of the issues, coordination among the agencies to provide a holistic response would be most beneficial to the involved parties.

The Council had significant discussion concerning the potential tax implications of accepting a lump sum distribution when participants were already in pay status. The issues included whether the lump sum could be rolled over without immediate payment of taxes, and if an annuity distribution began before age 55, whether the 10% penalty must be paid on the lump sum distribution. Although the Council recognizes that these questions are not within the Department's jurisdiction, the Council believes that this information is necessary in order for a participant to make an informed decision. If, for example, a participant who began receiving monthly income payments from a pension plan at age 54, and then at age 60 was offered a $500,000 lump sum distribution, would not want to pay $50,000 in a penalty to the Internal Revenue Service, if that was required under the Code.

Another Treasury/IRS issue upon which the Council spent a considerable amount of time was the effect of the 80% funding rule on de-risking transactions. In particular, some Council members were concerned that the plan would end up funded below the 80% requirement after de-risking transactions. That requirement prohibits an amendment to a defined benefit plan which increases the plan's liabilities due to the establishment of a new benefit (which a lump sum distribution to deferred vested terminated participants frequently is) if the adjusted funding target attainment percentage is less than 80 percent or would be less than 80 percent, taking into account the amendment. ERISA

§§ 206(g)(2)(A) & 303(d)(2), 29 U.S.C. §§ 1056(g)(2) & 1083(d)(2). Some Council members pointed out that a plan usually makes additional contributions before a de-risking transaction to ensure that the plan remains above the 80% funding mark.

A few Council members also raised concerns about the applicability of non-discrimination rules and about plan qualification under Code § 415 (individual limits on qualified plan benefits) and Code § 404 (limits on employer deductions).

The Council commends DOL for its participant education efforts surrounding lifetime income stream versus lump sum distributions in the defined contribution plan context. The Council believes that de-risking transactions, which also offer the choice of a lump sum distribution, underscore the necessity for the Department's continued work in this area. The Council also recognizes that the PBGC and the Treasury/IRS have been working to make the choice of a lifetime income stream easier to make. The Council believes that continued coordination among all of these governmental agencies could be fruitful in increasing participants' understanding of the benefits of a lifetime income stream.

VI. CONCLUDING OBSERVATIONS

After receiving testimony from diverse stakeholders and extensive and spirited deliberations, the Council attempted to balance the voluntary nature of the pension system with the need for participant protections where the plan sponsor has decided to transfer risk to the participants and/or insurers.

The Council believes that clarification of the scope of IB 95-1 to include de-risking activity outside the scope of plan termination would be beneficial to plan sponsors and participants. The Council also recognized the importance of balancing competing considerations such as the speed of providing guidance and the importance of public input. For example, discussion noted that spirited public dialog regarding any proposed safe harbors, within the scope of the Interpretive Bulletin, would contribute further to the proper implementation of any new standards the Department of Labor was considering establishing.

Similar to previous Councils, this Council believes that the prospect of a participant not maintaining a lifetime income stream as part of his or her retirement plan is a serious issue. Participants need to understand and make informed decisions regarding a lump sum distribution, including the fact that participants might outlive their assets. On the other hand, for some participants, lump sums may be an appropriate option. One obvious example of this is if they have a terminal illness. Consequently, providing clear, accurate and comprehensive disclosures to participants on the choice of receiving a lump sum distribution versus an annuity (whether from the plan or from a private insurer) is crucial in order for participants to make an informed choice for their retirement security.

Many members of the Council agreed with PBGC Director Josh Gotbaum's assessment that for a good portion of participants, lump sum distributions are not in their best interests. Although the Council was split on the precise scope of such a conclusion, it did suggest that a future Advisory Council might consider examining the reasons participants choose lump sum distributions; the steps that could be taken to increase participants' understanding of longevity, investment and interest risks for both defined benefit and defined contribution plans; and policies that could reduce the incentives that cause them to choose lump sum distributions over annuities. This would clearly fit into the Department's work on lifetime income streams and continue the work other Advisory Councils have completed, including last year's report by the Council, "Examining Income Replacement."

The additional recommendations offered by the Council further underscore the opportunities to provide further participant protections as well as further clarity in the administration of existing ERISA protections.

Finally, given the overlapping jurisdiction of governmental agencies on these issues, the Council suggests that DOL forward this report to the PBGC and the IRS/Treasury for their review in considering whether it necessary for them to take any action on de-risking transactions. One particular concern the Council had was the potential tax implications for the plan and/or for the participant of the election of a lump sum distribution when the participant is in pay status. Clarification of this and other potential tax implications would be helpful to both plan sponsors and participants.

The Council's modest efforts here only highlight the importance of continuing conversations between stakeholders concerning lifetime income streams versus lump sum distributions and the impact on participants' retirement security and the American economy. Consequently, the Council suggests that these issues remain ripe for review by the Council in subsequent years to survey the state of the industry, the response of stakeholders in the benefits community, and current problems.

The Council respectfully commends its recommendations to the Secretary, which will bolster his efforts to promote and protect benefit plan security for participants and beneficiaries. Beyond the utility of the recommendations, the Council hopes that its exploration of the issues surrounding de-risking will be of interest and assistance to all stakeholders.