Pension Plan ‘De-Risking’: Strengthening Fiduciary Duties to Protect Retirees

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Executive Summary

The steady decline in traditional defined-benefit pension plan sponsorship by corporate America took another alarming turn for the worse last year when three big blue chip companies moved to “de-risk” their pension promises by transferring billions of dollars in assets either directly to retirees (as lump sum buyouts) or to third party insurance companies (as group annuity buyouts). Although the share of the workforce covered by defined-benefit pensions has shrunk from 62% to less than 19% over the past three decades, retirees already receiving fixed monthly benefits believed that at least they had the security of ongoing protection against default, by the federal Pension Benefits Guaranty Corporation (PBGC), and ongoing disclosures and other fiduciary protections under the Employee Retirement Security Act of 1974 (ERISA). That may no longer be true, particularly if the newest and most abusive “de-risking” strategies are not tempered by the fiduciary obligations proposed in this white paper.

A number of factors have combined in recent years to give employers an incentive to reduce the overall risk and financial statement volatility associated with the accumulated pension liabilities earned by current and retired workers over decades. A 2012 study found that 44% of pension funds surveyed said they were likely to engage in risk transfers over the next two years. This impetus to manage and reduce risk can be positive or negative for plan participants, depending on the approach.

De-risking strategies take one of two forms. First, companies can retain the assets and liabilities in the plan, but change the investment mix to better insulate the company from market movements and even from longevity risk if retirees live longer than expected. This is generally called Liability Driven Investment (LDI) and typically means shifting a far greater proportion of assets into fixed-income securities. LDI strategies can include the purchase of fixed annuity contracts from insurance companies (guaranteed investment contracts, or GICs) that are held as plan assets and do not diminish protections for retirees or other participants. This is referred to as an “annuity buy-in” approach.

A very different approach to de-risking, and the subject of this paper, are strategies that transfer plan assets and liabilities to an insurance company (through an involuntary “annuity buy-out”), or directly onto plan participants (through a voluntary lump sum buy-out). Most alarming was Verizon’s unilateral move last December that transferred $8.4 billion in pension obligations for a select group of 41,000 management retirees to Prudential with little notice and without complying with the laws governing voluntary (standard) plan terminations under ERISA. In Verizon’s case, the 41,000 management retirees were carved out from among more than 91,000 participants and stripped of both PBGC guarantees and other ERISA protections without being given an option to remain in the plan (which continues to pay benefits to other retirees). Direct buy-outs, such as the lump sums offered by GM and Ford last year, are by law voluntary in nature, which reduces the concern since at least retirees have a choice. Even in that situation both adequate disclosure and adequate funding of the plan for remaining participants is vital, particularly for older retirees.

With respect to purchases of fixed-income annuity contracts, the NRLN urges the Department of Labor to amend and extend its “safe annuity” rules relating to the fiduciary standards under ERISA for selecting an annuity provider, as set forth in Interpretive Bulletin 95-1, as follows:

- **If the plan is ongoing and not terminated after review by the PBGC as required by ERISA Section 4041, the plan has a fiduciary duty to continue to hold the annuity contracts as a plan asset,** so that retirees do not lose PBGC or other protections. The issue is unsettled: In *Lee et al. v. Verizon*, the federal District Court concluded in June 2013 that nothing in ERISA either expressly permits or forbids a plan from using an annuity buy-out to involuntarily separate a subgroup of participants from the plan. The IRS should simultaneously provide guidance that the distribution of a group annuity contract is an alternative form of benefit distribution and requires participant consent.

- **Alternatively, the plan sponsor can choose to permanently transfer its liability for individual retirees to a qualified annuity provider, as if the plan were terminated, but only if it complies with one of the following safe harbor requirements:**

    - **The plan obtains the affirmative consent of individual retirees**. Like a lump sum buy-out offer, retirees who do not consent to be transferred to the annuity provider must have the option to remain participants in the ongoing pension plan.
    or
    - **The plan can purchase reinsurance from a separate, highly-rated insurer** that guarantees the payment of benefits, in case of default, of each individual participant's loss to the extent it is not covered by state insurance guarantee associations (SGAs). The protections afforded by SGAs fall far short of PBGC maximum coverage levels and vary widely from state to state.

    - **As part of either safe harbor, two additional protections should be required**:
        - First, the purchase of the annuity contract – and any reinsurance purchased to satisfy the safe harbor above – should be reviewed and approved by the Department of Labor (DOL) based on the criteria in the safe annuity rule adopted in DOL's Interpretive Bulletin 95-1.

        - Second, the plan sponsor should send a formal notification to all plan participants at least 90 days prior to the transaction, with specific disclosures about the impact on participants and on the plan's funding status, as well as any alternatives available to the participant (such as choosing not to participate).

If the agencies do not act, Congress should at a minimum require plan sponsors to maintain back-up insurance, either from the PBGC or a highly-rated reinsurance carrier.

- **In addition, the agencies should require that following any transfer of assets to settle liabilities for a subgroup of plan participants – whether by group annuity purchases or by lump sum buy-outs – the on-going plan must be at least as well funded as it was prior to the transaction.** This ensures that any premium paid to transfer the liabilities associated with a group of retirees does not worsen the funding level for all other participants. This is relevant primarily for group annuity transfer, which are 10 to 15% more costly than the funding liability for the ongoing plan.

- With respect to lump sum buy-outs, DOL should clarify fiduciary responsibilities to make complete and plain English disclosures concerning the financial trade-offs, including tax consequences and the higher cost of purchasing an individual annuity contract.

The whitepaper researched and written for the American Retirees Education Foundation (AREF) is the source of information for this Executive Summary. The AREF expands the research and education reach of the NRLN.

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