



TESTIMONY OF

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ON BEHALF OF

AARP

ON

**PRIVATE SECTOR PENSION DERISKING
AND PARTICIPANT PROTECTIONS**

SUBMITTED TO THE

**ERISA ADVISORY COUNCIL
U.S. DEPARTMENT OF LABOR**

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Introduction

On behalf of our more than 37 million members and all Americans age 50 and older, AARP appreciates the opportunity to testify today on so-called Pension Derisking.

AARP is a nonprofit, nonpartisan organization that strengthens communities and fights for the issues that matter most to families, including healthcare, equal employment opportunity, and retirement security. For decades, AARP has worked to preserve and strengthen defined benefit pensions as well as the Employee Retirement Income Security Act's (ERISA) protections for pension participants and beneficiaries. Defined benefit pension plans have proven themselves to be reliable, efficient, and vital mechanisms for ensuring retirement income security for American workers and their families.

Such plans, however, increasingly have been supplanted by defined contribution arrangements such as 401(k)-type plans, which shift all of the asset-building, investment, and longevity risk to employees. Twenty-five years of experimentation with shifting the risk for retirement security from employers to individual workers is contributing to a generation of retirees who are at high risk of accumulating too few assets, and too many who will simply outlive the assets.

It is against this backdrop of decades of "derisking" that companies that still sponsor defined benefit pensions are seeking ways to further derisk – including by targeting retirees in pay status — without going through standard plan termination procedures. Because plans are not required to be fully funded to initiate this type of risk transfer, "derisking" is a way for plans to shed pension obligations and ERISA responsibilities, but at a reduced cost compared to their obligations under a standard termination.

In his statement to the Council in June, Robert Newman summed up the results of derisking thusly: "After an individual's pension benefits are settled, the individual ceases to be a participant in the plan, ERISA ceases to govern the benefit, and the PBGC no longer insures the benefit."¹ From a retirement security point-of-view, these are precisely AARP's concerns with derisking. This may be a *de*-risking for the plan sponsor, but transactions that transfer pension obligations to insurance companies or, in the case of lump sum buyouts, directly to the participants, is a *risk-shift* — in many cases a *risk increase* — for everyone else. As a result, on the flip side of these "derisking" transactions, participants and beneficiaries may have less valuable benefits and fewer rights. Because these transactions represent risk transfers from participants' perspective, these buyouts² should more properly be referred to as "risk transfers" rather than as "deriskings."

Each type of buyout raises its own issues. Lump sum offers, *especially* to retirees in pay status, cause the greatest alarm for AARP because they tempt participants to accept a smaller and less secure form of payment that will likely be an inferior deal compared to

¹ Testimony of Robert S. Newman, Covington & Burling, *Private Sector Pension De-Risking and Participant Protections 2*, Hearing before U.S. Dept. of Labor ERISA Advisory Council (June 5, 2012), available at <http://www.dol.gov/ebsa/pdf/covingtonburling060513.pdf>.

² It is important to note that AARP is not objecting to transactions that seek to reduce the volatility and loss risk of assets in the plan, otherwise known as "annuity buy-ins" or "liability-driven investing." Our concerns are with buyout transactions that *transfer* the liability to a third-party, i.e., the participant or an insurer.

their pension annuity. And while the purchase of group annuities from an insurance company at least maintains the value and reliable income stream of a pension annuity, it does raise questions about the back-up protections in place if the annuity provider fails. In addition, there are some issues that arise with both types of pension divestiture. For example, what impact does the offloading of pension obligations have on the funding level of the plan and the participants who remain? And, how well are spousal pension rights, a critical element of women's retirement security, preserved?

"Derisking" is happening in a regulatory environment without clear and adequate protections for participants and beneficiaries. The Department of Labor (DOL) needs to use its existing authority to better protect participants, and do so with more than just improved disclosures. AARP therefore urges this Council to recommend to DOL that it act to replicate ERISA protections in these transactions to the greatest extent possible. In addition, needed protections that are outside DOL's scope of authority should be referred to other appropriate agencies for prompt action.

Group Annuity Contracts

Derisking transfers participants out of their pension plan, and in so doing transfers them out of one regulatory regime — federal protections under ERISA — into another regulatory regime — state regulation of insurance — which varies widely from state to state. Although participant protections under ERISA are far from perfect, the state insurance regulatory scheme falls short of ERISA protections in several respects.

At the outset, AARP has considerable concerns about the *capacity* of insurance companies at the receiving end of these transactions, coupled with questions about whether regulators are adequately and consistently assessing or regulating the increased risk exposure. Insurance companies, even very large ones, can fail. If the case of Executive Life³ is not instructive enough, one need only look back to the recent financial crisis. While AIG received the most notoriety, it was not the only insurer at risk. Several of the largest insurance companies, including Prudential, Hartford, and others, were on the Department of Treasury's critical list, and there were substantial fears of potential default.⁴ Hartford was downgraded,⁵ and has since divested itself of its annuity line of business.⁶

³ The failure of Executive Life in the spring of 1991 was "the largest failure of a life insurer in history." R. Rosenblatt, "Insurer's Failure Ensnarers Thousands of Casualties: Executive Life: Pension payments have been slashed. A crisis of confidence threatens the industry," *Los Angeles Times* (May 17, 1991), available at http://articles.latimes.com/1991-05-17/news/mn-1874_1_executive-life. In the immediate aftermath, retirees' annuities were cut by about one-third, and it took years to sort out compensation. Even then, many never recovered their losses. L. Girion, "'Little People Floundering' from Executive Life Losses: While the legal process drags on, many policyholders must contend with sharply reduced annuity payments," *Los Angeles Times* (Apr. 28, 2002), available at <http://articles.latimes.com/2002/apr/28/business/fi-execlife28>. See also n. 19, *infra*.

⁴ See S. Harrington, "Prudential, Hartford Bond Risk Falls as U.S. Weighs Insurer Aid," *Bloomberg* (Oct. 27, 2008), available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=anfZ.jLQTu_s&refer=govt_bonds.

⁵ "Fitch Downgrades Hartford's Ratings; Outlook Negative," *Bloomberg* (Feb. 9, 2009), available at http://www.bloomberg.com/apps/news?pid=conewsstory&tkr=HIG:US&sid=atzk_ajc9DFY

Prudential, a dominant player in derisking transactions,⁷ may be well-capitalized at the moment, but it has been designated as a “systemically important financial institution” by the Financial Stability Oversight Council (FSOC),⁸ which means the FSOC believes Prudential already poses a systemic risk to the financial system and is too interconnected with the financial system to fail. Prudential is challenging the designation,⁹ but if anything, its recent acquisition of enormous pension obligations¹⁰ makes it *more* imperative, not less, that FSOC ensure that Prudential is adequately capitalized, with sufficient liquidity to cover its annuitants.

Under the Employee Benefits Security Administration’s (EBSA) Interpretive Bulletin 95-1, plan sponsors that are transferring liability for the payment of defined benefits to an insurance annuity provider have a fiduciary duty to select the “safest” annuity provider.¹¹ However, the parameters of this duty are not clear, and while several relevant factors are specified,¹² none of the factors contain actual standards that are tantamount to “safety.” Instead, fiduciaries are advised to “obtain the advice of a qualified, independent expert.”¹³ This guidance is necessary since most plan fiduciaries are not likely to be in a good position to accurately assess the safety of an annuity provider on its own. And while an insurer may meet the standard today, there is no assurance the insurer will continue to meet that standard in the future.

Moreover, should any of these insurance companies become insolvent, the state regulatory system for insurance companies contains several shortcomings from a participant-protection perspective. First, these guaranty associations are not advance-funded like the Pension Benefit Guaranty Corporation (PBGC) and Federal Deposit Insurance Corporation (FDIC)¹⁴ are. Insurance annuities are essentially self-insured by the

⁶ M. Hofmann, “Hartford to focus on property/casualty lines: Insurer yields to pressure to cut life, annuity business,” *Business Insurance* (March 25, 2012), available at <http://www.businessinsurance.com/article/20120325/NEWS04/303259978#>

⁷ Prudential, *Creating a Clear Path to Pension Plan De-Risking: Pension Risk Transfer Strategies* 5 (Mar. 2012), available at <http://www3.prudential.com/email/retirement/IMFPWeb/prt/0218926-00002-00.pdf> (Prudential is “the second-largest manager of U.S. pension buy-outs”).

⁸ National Retiree Legislative Network, *Pension Plan ‘De-Risking’: Strengthening Fiduciary Duties to Protect Retirees* 15-16 (), available at <http://www.nrln.org/flyin%20whtpprs/De-risking%20White%20Paper.pdf> (citing D. Douglas, “Prudential enters uncharted legal realm by appealing its regulatory label,” *The Washington Post* (July 3, 2013), available at http://www.washingtonpost.com/business/economy/does-prudential-have-a-chance-of-beating-the-systemically-important-label/2013/07/03/9f3f22f8-e3ed-11e2-80eb-3145e2994a55_print.html).

⁹ Z. Tracer & T. Catts, “Prudential Will Appeal SIFI Designation; AIG, GE Will Not,” *Insurance Journal* (July 3, 2013), available at <http://www.insurancejournal.com/news/national/2013/07/03/297487.htm>

¹⁰ L. Boselovic, “‘De-risking’ trend grows,” *Pittsburgh Post-Gazette* (Oct. 21, 2012), available at <http://www.post-gazette.com/stories/business/opinion/heard-off-the-street-de-risking-trend-grows-658449/#ixzz2dDSY2VLg>. (“In the past, companies took about \$1 billion in pension obligations off their books annually by striking deals with insurance companies. This year one insurer, Prudential, agreed to take on more than \$30 billion in just two transactions.”)

¹¹ 29 C.F.R. § 2509.95–1(c), available at <http://www.gpo.gov/fdsys/pkg/CFR-2011-title29-vol9/pdf/CFR-2011-title29-vol9-sec2509-95-1.pdf>.

¹² *Id.*, at § 2509.95–1(c)(1-6).

¹³ *Id.*, at § 2509.95–1(c)(6).

¹⁴ Admittedly, both of these agencies are *underfunded*. The PBGC’s single- and multi-employer insurance funds are both running deficits, in significant part due to the financial dislocations caused by the financial

companies themselves, through state guaranty associations (SGA). If an insurer fails, and other prior remedial steps are insufficient,¹⁵ the losses are covered by assessments against the other insurance companies doing business in the state. If several companies fail or come to the brink at the same time, as was the case during the recent financial crisis, this system might not provide a sufficient backstop.

In addition, the amount of insurance provided by SGAs is quite limited, and varies from state to state, ranging from a total of \$100,000-500,000.¹⁶ This may sound like a quite a bit of coverage, unless one remembers that a pensioner with a very modest \$20,000/year pension could hit their limit in just five years in a state with a \$100,000 limit, a limit that might actually be smaller when discounted for present value.¹⁷ True, the PBGC's insurance is also limited, but it provides up to \$57,477.24 *per year* (at age 65, more at older ages, less at younger ages),¹⁸ for as long as the pensioner lives. In the case of the failure of Executive Life, the California State Auditor found that, due to a variety of reasons, policyholders incurred significant losses compared to the amounts they were promised and for which they were ostensibly insured.¹⁹ State variation could also mean that pensioners from the same plan but who live in different states might receive different levels of insurance protection, creating inequities that would not be an issue under federal law.

Finally, it is critical to look beyond the initial derisking transaction itself and address what happens after these former pensions have been transformed into insurance annuities and are no longer subject to ERISA's mandates. Insurance companies could engage in practices and transactions that could additionally harm annuitants. Indeed, insurance companies are themselves in the midst of doing their own derisking. For instance, as noted earlier, Hartford has exited the annuity business altogether,²⁰ and Metlife is apparently engaging in "[r]isk-lessening strategies [that] include raising fees, reducing benefits and clamping down on overall sales. ... [Moreover,] ... the firm has considered *whether to*

crisis. See PBGC, *FY 2012 PBGC Exposure Report* (undated), available at <http://www.pbgc.gov/documents/2012-exposure-report.pdf>. Premiums were increased in the same "MAP-21" legislation that is now being credited for triggering much of the recent derisking activity. The FDIC's reserves were also eroded during the financial meltdown; it is in the process of rebuilding its reserves. FDIC, *The Deposit Insurance Fund*, available at <http://www.fdic.gov/deposit/insurance/index.html>.

¹⁵ According to the National Organization of Life & Health Guaranty Associations (NOLHGA), the process of addressing insolvency is quite complicated. It involves efforts to rehabilitate the insurer's financial position, liquidating and managing whatever assets are left, and attempting to transfer the failed company's policies to healthier insurers. After all these efforts, the state guaranty association pays whatever monthly annuity amount that was promised, up to the state limit.

¹⁶ NOLHGA, *Benefit Limits at a Glance* (as of Jan. 1, 2013), at http://www.pensionrights.org/sites/default/files/docs/annuity_limits.pdf.

¹⁷ See NOLHGA, *State Laws and Provisions Report* (current as of Jan. 1, 2013), available at <http://www.nolhga.com/factsandfigures/main.cfm/location/lawdetail/docid/8>.

¹⁸ PBGC, *Maximum Monthly Guarantee Tables*, at <http://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html>.

¹⁹ See Cal. State Auditor, *Department of Insurance: Former Executive Life Insurance Company Policyholders Have Incurred Significant Economic Losses, and Distributions of Funds Have Been Inconsistently Monitored and Reported*, (Jan. 2008), Report 2005-115.2, available at <http://www.bsa.ca.gov/pdfs/reports/2005-115.2.pdf>.

²⁰ "The Hartford does 'something drastic,' will exit annuity and life insurance businesses," *Investment News*, at <http://www.investmentnews.com/article/20120321/FREE/120329980>.

tender buyout offers to VA holders" (emphasis added).²¹ In other words, DOL could require the plan to select the safest annuity provider and provide a variety of disclosures, only to see the insurance company turn around and offer *its* annuitants lump sum buyouts, with no requirements for important disclosures, consents, and form-of-payment protections such as qualified joint-and-survivor annuities (QJSAs). Or, insurance companies could transfer the annuity to some less safe annuity provider; there would no longer be any ERISA fiduciary duty to plan participants, because there is no longer any plan. AARP does not want to see important long-term ERISA protections eroded through derisking efforts that simply increase the risk for pensioners.

Recommended Safeguards

1. Clarify "safest annuity" obligations under the EBSA Interpretive Bulletin.

Insurers do not have unlimited capacity; that capacity should be quantified and qualified. Plan fiduciaries should have more concrete guidance on what steps constitute a thorough investigation and analysis, and what standards constitute "safest." Given the PBGC's experience with this line of business in terminations, perhaps it could assist with identifying standards to accompany the factors laid out in IB 95-1. It would also make sense to have some agency independent of the plan sponsor to certify the safety of annuity providers; this could be the PBGC, EBSA, or Treasury. Fiduciaries required to select the safest provider would then have a firmer basis on which to make their decision, and participants would have a firmer basis on which to hold fiduciaries accountable.

2. Keep assets separate from other lines of business.

For added protection, the contract between the plan sponsor and the annuity provider should require the insurer to place the assets received from the plan into a separate account, as was done in the Verizon derisking, as a matter of course. Keeping the pension assets transferred to the insurer separate from the assets of other lines of business would help prevent the assets from being commingled or depleted to cover losses in some other line of business or to hedge bad bets the insurer may have made with other products. Then, if the insurer is ever in financial distress, the funds to pay annuitants would be segregated and thus more likely to be available for their designated purpose. As the insurer's capacity declines, the more assets the insurer should have to set aside to cover the promised benefits.

3. Require reinsurance.

First, the contract should provide that the pensioner-annuitant's pension benefits shall be insured at the limit provided in the annuitant's state of domicile, or in the state in which the insurance company is headquartered, whichever is higher. To the extent that this requires the pension plan to pay more to the insurance company, that should happen, and the funds should be put into the separate account discussed above.

²¹ M. Wood, "Will MetLife join VA buyback movement?," *LifeHealthPro* (May 22, 2013), available at <http://www.lifehealthpro.com/2013/05/22/will-metlife-join-va-buyback-movement>.

Second, the disclosures provided to participants should be very clear about the amount of protection potentially lost in the transfer. In Verizon's disclosures, for example, the company disclosed that people's pensions would no longer be insured by the PBGC, that they would be insured by SGAs, and that each state association had its own limits. However, there was no indication that these limits may very well be inadequate to fully cover losses in the event of insurer insolvency.²² The plan sponsor should be required to disclose that participant's state limit (and the insurer's headquarters state limit), how many years of that participant's pension benefits would be covered under it, and the amount of income that the specific state(s) would provide. If the state insurance only covers the present value of the annuity and not the full amount, that should also be disclosed.

Third and most important, as part of their fiduciary duties, plan trustees should be required to purchase and maintain reinsurance of the pension benefits being transferred. The rationale for requiring reinsurance of pension benefits in this scenario is straightforward: participants and beneficiaries are losing valuable PBGC insurance protections, the SGAs provide less, and the plan should cover the gap. This reinsurance should top off SGA insurance levels to ensure participants and beneficiaries receive insured benefits, equivalent in both amount and duration, to PBGC levels. It should also guarantee coverage in the event that SGAs are overwhelmed by multiple failures.

The PBGC would be the logical agency to handle the reinsurance.²³ It already has the institutional expertise, the procedural apparatus, and the participant-service experience to handle this function. The derisking pension plan should be required to continue to pay premiums to the PBGC for as long as the participant and any beneficiaries are alive. If the risk of insurer failure is genuinely low, and SGAs can handle most losses, then the premium could be expected to be fairly inexpensive, and the obligation to insure its former participants would wind down over time. AARP recognizes that part of the motivation for plans to derisk is to eliminate the expense of PBGC premiums, but participants should not lose this most fundamental and important ERISA insurance protection. Plans should remain responsible for this insurance. The PBGC should set the amount of the premium at a level sufficient to cover its secondary liabilities and to at least partially if not fully mitigate the burden that the loss in premium income places on the PBGC's remaining plan

²² Verizon, *Questions and Answers About the Pension Transfer* 10 (undated), available at http://www22.verizon.com/investor/DocServlet?doc=pension_transfer_faq.pdf.

²³ Others have suggested similar protections, instituted for individuals who purchase annuities in the private market using the proceeds of their retirement savings accounts, and possibly administered by other agencies such as the FDIC. See, e.g., W. Gale, D. John, et al., *New Ways to Promote Retirement Saving* 28-31 (AARP Public Policy Institute, Oct. 2012), available at http://www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/new-ways-promote-retirement-saving-AARP-pp-econ-sec.pdf. Other agencies such as the FDIC or the Consumer Financial Protection Bureau could also be candidates to handle the reinsurance function here, but AARP believes the PBGC would be the most appropriate in this context. This may require legislation. "Nowhere in ERISA is the PBGC authorized to pay benefits upon occurrence of any other event [besides termination], such as the failure of an insurance company." Remarks of Angela J. Arnett, [then] Assistant General Counsel of the PBGC, "Is There Life after Executive Life? Retirement Plan Participants and the Guarantees of Insurance Companies" 18, *Record of Soc'y of Actuaries* 727, 729 (1992), available at <http://www.soa.org/library/proceedings/record-of-the-society-of-actuaries/1990-99/1992-1993/january/rsa92v18n1b17.aspx>.

sponsors who are counting on the agency to have an adequately funded single employer insurance fund.

4. Require the derisking contract to contain further constraints on the insurer.

It is not sufficient to require plan sponsors that wish to derisk to provide a wide array of consumer disclosures and to pay benefits according to the plan's terms, and then permit insurers to engage in "derisking" steps of their own, with none of the protections that accompanied the main transaction. A regulatory structure so easily bypassed is no regulatory structure at all.

Participants stand to lose important rights in the derisking transaction. Hence, the contract itself should require the insurer, *in all respects*, to replicate and abide by the same rules and to handle its payment responsibilities in the same manner as the plan sponsor was required to do under ERISA.²⁴ Just as the derisking contract requires the insurer to pay the amount of benefits accrued in the forms payable by the plan, the contract should also forbid the insurer from engaging in any buyout derisking maneuvers of its own – no lump sum buyouts, and no further transfers of the group annuity contract to another insurer without the same fiduciary duties to select the safest annuity provider attached. These rights should be enforceable by the participants and beneficiaries as third-party beneficiaries of the contract, individually or as a class, and by state attorneys' general or by any appropriate state or federal regulatory agency.

Lump Sum Cashouts

Under a pension derisking arrangement that consists of a purchase of insurance annuities (assuming no solvency problems or derisking moves by the insurer itself), participants at least still receive the pension benefit they were promised, and the security of a monthly benefit that cannot be outlived. What has been particularly disturbing about some of these transactions, such as the GM and Ford deriskings, however, are the offers of lump sum cashouts, especially to retirees who are already in pay status, and possibly have been for decades.

The fact is, most retirees are typically better off in retirement with a defined benefit pension annuity than they are with a lump sum. Study after study demonstrates that retirees who have defined benefit pensions are far less likely to outlive their assets or fall into poverty.²⁵ As succinctly noted by the Pension Rights Center, "[t]he only situations in which a lump sum should be seriously considered are if you are in poor health, you don't expect to live long, and you will not have a surviving spouse who will need lifetime income; or if you

²⁴ It may be too obvious to mention, but because not all annuity products are covered by state guaranty associations, GAO, *Insurance Markets : Impacts of and Regulatory Response to the 2007-2009 Financial Crisis* 9 (June 2013), available at <http://www.gao.gov/assets/660/655612.pdf>, the annuity provider should be required to certify to the plan sponsor that the annuity product being purchased is, in all respects, covered by all state guaranty associations.

²⁵ See F. Porell & D. Oakley, *The Pension Factor 2012: The Role of Defined Benefit Pensions in Reducing Elder Economic Hardships* 23, (National Institute for Retirement Security, July 2012), available at http://www.nirsonline.org/storage/nirs/documents/Pension%20Factor%202012/pensionfactor2012_final.pdf.

already have a substantial nest egg or other secure source of adequate income, such as a spouse's pension.²⁶ In fact, to move in the direction of more lump sums flies in the face of the recent rulemaking work done by DOL, Treasury, and others within the Administration aimed at providing more information about and opportunities for lifetime income streams, including annuitization.

Not only are lump sums less secure, the amounts being paid to retirees in the form of a lump sum cashout are substantially lower than the expected value of their pension.²⁷ The higher interest rate assumptions enacted in the Pension Protection Act of 2006 (PPA),²⁸ enhanced by the interest rate averaging provisions of the Moving Ahead for Progress in the 21st Century Act (MAP-21) enacted last year,²⁹ mean that plans can offer a greatly discounted lump sum amount; they can assume the participant will achieve a greater investment return at those higher interest rates. According to Vanguard's testimony at the Council's June hearing, "[a] lump sum is significantly less expensive [for the plan sponsor] than purchasing an annuity (even as part of group annuity contract) for a participant – roughly 15% to 30% cheaper depending on circumstances.³⁰ Plan sponsors are able to cash-out at a substantial discount,³¹ at the expense of participants and beneficiaries. Lump sum offers to nonretired participants such as deferred vesteds can be lower for other reasons as well, such as not including the value of any early retirement subsidies, which can represent a significant loss in value. And these calculations do not include the fees a lump sum recipient can expect to pay when they rollover that sum. Thus, just to come out even with the defined benefit they gave up, participants would need to achieve investment returns that cover both the interest rate assumptions and the expense of fees.

In addition to reduced value, offers of lump sums to people already retired and living on their pension can be greatly disruptive and distressing. These individuals and their beneficiaries have already made their elections at retirement, with months and even years to contemplate and plan the best decision on forms of payment. By contrast, these lump sum cashout offers reopen that decision under the pressure of a short time frame. Many

²⁶ Pension Rights Center, *Should you take your pension as a lump sum?*, available at <http://www.pensionrights.org/publications/fact-sheet/should-you-take-your-pension-lump-sum?gclid=CM361PHEh7kCFQ2f4AodtIsAKA>.

²⁷ See, e.g., the sample calculation by the National Retiree Legislative Network, *A Defined Pension Benefit Buyout Information Sheet 2* (May 2012), available at <http://www.nrln.org/documents/NRLN%20PENSION%20BENEFIT%20BUYOUT%20INFORMATION%20SH EET.pdf>. Under this example, a retiree who took a lump sum would receive only \$258,000, versus the \$456,000 they could be expected to be paid over their lifetime under the pension annuity.

²⁸ Pension Protection Act of 2006, 120 Stat. 780, 919-921, Secs. 301-303 (2006).

²⁹ Moving Ahead for Progress in the 21st Century (MAP-21), Pub. L. No. 112-141, 126 Stat. 405, 850-53, Secs. 40221-22 (2012).

³⁰ Testimony of Evan Inglis, The Vanguard Group, *Private Sector Pension De-risking and Participant Protections 5* (June 5, 2013), available at <http://www.dol.gov/ebsa/pdf/vanguard060513.pdf>.

³¹ Plans also save on administrative costs and PBGC premiums when a participant accepts a lump sum. According to Prudential, these savings amount to about \$2,000-3,000 per participant, per year. Prudential, *Retirement Plan Strategies: De-risking Pensions—Emerging Opportunity through Lump Sum Cash-Outs under the Pension Protection Act of 2006*, at 7 (undated), available at <http://news.prudential.com/images/20026/WhitePaper.pdf>.

GM & Ford retirees reported stress, sleeplessness and anxiety over making the "wrong" decision.³²

It must also be noted that this high pressure decision is coming at a potentially vulnerable time: older retirees may be experiencing health problems, including diminished capacity, or they may be subject to undue influence or coercion from family members who are having financial difficulties or simply want an inheritance. Seniors are often the victims of scams and fraud, including by family members. It would be a tragedy if a pensioner agreed to a lump sum, only to see it misappropriated by an exploitive family member or lost in a consumer scam.

Despite the significant rights at stake, and the importance of making good decisions under pressure, the disclosures required to be provided in the event of a lump sum cashout offer are inadequate. The IRS private letter rulings that gave rise to the ability of plans to offer lump sums to retirees in pay status indicated that the standard spousal consents must be obtained from all relevant spouses past and present, but it does not appear that any special spousal disclosures are required to accompany the lump sum offer. It also appears that the current relative value regulations apply to alternative offerings to retirees, but it does not appear expressly required for the participant and beneficiaries to receive disclosures about how much less they will typically receive with a lump sum, and all of the significant advantages and disadvantages of accepting or rejecting it. It would also appear that the plan sponsor need not disclose the lost value of early retirement subsidies to those nonretired participants who accept a lump sum.³³

Large companies such as GM, Ford, and others have a greater ability to provide disclosures and access to information, and they have greater resources to afford multiple mailings, call centers, counselors, etc. Smaller and medium size firms that choose to derisk may not have the resources to provide adequate information, or may have greater incentives to cut corners. Disclosures and counseling should be a more detailed and required part of cashouts, not an act of generosity by the plan sponsor.

Closely related to the importance of complete and accessible disclosures is the need of participants to have access to free, independent, and objective expert advice from a source with only their interests at heart. One of the IRS private letter rulings indicated that the company seeking to offer lump sums represented that it would provide "optional financial counseling" by what it considered to be "a highly qualified and reputable financial

³² See M. Chapman, "Retirees Wrestle with Pension Buyout from General Motors," *New York Times* (July 18, 2012), available at http://www.nytimes.com/2012/07/19/business/retirees-wrestle-with-pension-buyout-from-general-motors.html?pagewanted=all&_r=0.

³³ Some have contended that, under current law, participants must receive a "Notice of Consequences of Failing to Defer Receipt of Distribution," which provides additional information regarding the effects of accepting a lump sum on important considerations such as loss of eligibility for retiree health coverage and early retirement subsidies. See Testimony of John G. Ferreira, Morgan, Lewis & Bockius LLP, *Private Sector Pension De-risking and Participant Protections 4*, (June 5, 2013), available at <http://www.dol.gov/ebsa/pdf/morganlewis060513.pdf>. But this requirement is only proposed, it is not yet "current law." See *Notice to Participants of Consequences of Failing to Defer Receipt of Qualified Retirement Plan Distributions; Expansion of Applicable Election Period and Period for Notices*, 73 Fed. Reg. 59575 (Oct. 9, 2008).

advisor."³⁴ However, there was no indication in the letter rulings that the IRS was requiring the provision of such counseling, nor were there any requirements that the advice be from an independent and unconflicted source. Participants who are offered lump sums should be protected from outright marketing and inappropriate "advice" by financial services providers who have their own financial interests to encourage lump sums — again without adequate disclosures about the self-interest of that advisor and the fees involved.

Finally, there are outstanding issues related to the individual tax treatment of lump sum cashouts, especially for retirees in pay status and for retirees in plans that provide for retirement at ages earlier than 59½. The IRS private letter rulings indicated that the minimum distribution rules would not be considered violated as to retirees in pay status, hence no 10 percent excise tax would be triggered, and the amount taken as a lump sum would not be taxable as gross income as long as the payment was rolled over into an IRA.³⁵ But both rulings also indicated that the IRS was taking no position on the federal tax consequences of the transaction under other provisions of the Code, and other than the excise tax, neither the retroactive nor the prospective tax consequences to various groups of participants of taking lump sums were discussed.

Recommended Safeguards

1. Require plans to provide clear and complete disclosures, in hardcopy form.

Adequate disclosures should be required by DOL as part of the plan sponsor's fiduciary obligations to protect participants and beneficiaries and should not be up to the discretion of the plan sponsor. To help ensure that disclosures are written with the participants' interests paramount, DOL should draft model disclosures and checklists, where appropriate, for plans to use. The disclosures needed to ensure that participants and beneficiaries have the information they need to make the best-informed decisions about lump sum cashout offers include:

- *Pros & cons* - A description of the advantages and disadvantages of taking a lump sum, with an explanation of the odds of outliving assets, earning a market return that compensates for the discounted lump sum, etc. This disclosure should be drafted by EBSA in the form of a model disclosure.
- *Comparative value* - A comparison of the value of the lump sum being offered as compared to the value of the promised pension benefit over the participant's and surviving spouse's joint life expectancies, and quantifying the total amount the participant and beneficiary would potentially lose by taking the lump sum.
- *Early retirement subsidy* - A clear statement on whether the lump sum includes the value of an early retirement subsidy and the portion of the value of either a lump sum or the pension annuity that it represents. If the value of the early retirement is being lost by virtue of electing a lump sum, that fact and the amount should be expressly stated.
- *PBGC insurance* - A disclosure that taking a lump sum means the loss of PBGC insurance, a valuable and fundamental protection that applies to pension benefits.

³⁴ IRS Priv. L. Rul. 1228045 at 3 (April 19, 2012), available at <http://www.irs.gov/pub/irs-wd/1228045.pdf>.

³⁵ IRS Priv. L. Rul. 1228051, at 13 (April 19, 2012), available at <http://www.irs.gov/pub/irs-wd/1228051.pdf>.

In addition, it should be disclosed that replicating that protection by purchasing an individual retirement annuity on the private insurance market will cost much more.

- *Spousal notices & consents* - Participants and beneficiaries should be treated separately for disclosure purposes and be entitled to their own disclosures, because there may be differences between the participant and beneficiary as to the preferred form of payment, or the participant and beneficiary may be divorced and living at different addresses.³⁶ The spousal consent should be in writing and notarized, with the spouse's actual written signature so that it is capable of authentication. If former spouses are beneficiaries, they too must consent to a lump sum.

Moreover, these disclosures should be provided in paper form and sent by mail. Despite lobbying by the financial services industry for permission to send out all required pension plan notices and consents in electronic form by default, and claims that electronic communications are just as or even more effective than paper and regular mail, it turns out that in the derisking context – where the industry wants to ensure that participants receive, read, and act on a communication -- paper and the US mail is the vehicle of choice. According to Aon Hewitt, "high touch" communications such as phone calls, postcards, and mailings with "paperwork" led to higher election rates of lump sums.³⁷ Towers Watson reports that they "mailed more than one million communication pieces on lump sum offers, and freely admitted that "mailing printed information to eligible participants' homes is still³⁸ the best method" to communicate with plan participants, using formal letters and postcards, election kit mailings, and reminder postcards.³⁹ No one advocates counting on email communications.

2. Require plans to make independent, unconflicted, objective advice available.

The suggestion above that DOL draft model disclosures is one way participants can receive unbiased information about the choices that lay before them, but participants also need access to independent, unconflicted advice. Plan sponsors may maintain that the disclosures, call center services, and "advisors" they supply are providing only information, not advice, and thus they are not liable for the results of that advice. Whether called advice or counseling, however, AARP has consistently asserted that investment advice must be subject to ERISA's fiduciary rules, based on sound investment principles and protected from conflicts of interest, and the standards governing industry practices involved in

³⁶ The question of whether participants and beneficiaries should also be entitled to different forms of payment is addressed below.

³⁷ Aon Hewitt, *Pension Settlements Through Terminated Vested Lump Sum Windows: Insights into Plan Sponsor Experience* 7-8 (Feb. 2012), available at <http://www.hekblog.com/wp-content/uploads/2013/03/Pension-Settlements-through-TV-Windows-3-18-13.pdf>.

³⁸ AARP notes the use of the word "still" in Tower Watson's report, conceding that hard-copy mailings have *always* been the best way to communicate about pension plan information. AARP consistently finds a preference for paper and snail mail in our surveys. See generally, AARP, *Paper by Choice: People of all ages prefer to receive retirement plan information on paper* (2012), available at http://www.aarp.org/content/dam/aarp/research/surveys_statistics/consume/2012/Paper-by-Choice-People-of-all-ages-prefer-to-receive-retirement-plan-information-on-paper-AARP.pdf.

³⁹ Towers Watson, "Pension De-Risking through Lump Sum Offers" 2-3 (*Viewpoints* newsletter) (May 15, 2013), available at <http://www.towerswatson.com/en/Insights/Newsletters/Global/strategy-at-work/2013/Viewpoints-QA-Pension-De-Risking-Through-Lump-Sum-Offers>.

rendering investment advice should be fair, clear and easy to understand. As the fiduciary, the plan sponsor should be responsible for making an affirmative effort to contact the participants and let them know what is available rather than waiting for them to call, and it should make unconflicted advice available free of charge to participants and beneficiaries.

3. Require protections to mitigate and prevent undue pressure.

The periods of time during which participants are being given notice of derisking transactions and in which to make important decisions about their financial security are in many cases too short. Participants and beneficiaries should be given at least 30 days' notice before a derisking can begin, and at least 90 days from when the window opens to when it closes. There is a significant amount that must be done in this period — reading disclosures, researching details, reaching the plan to ask questions and get answers, consulting advisors about what the decision would mean, getting feedback from family and friends, etc. Moreover, because this decision is momentous and irrevocable, participants should be given a one- or two-week cooling off period afterward in which they can change their decision.

Steps are also needed to help protect against undue influence and misappropriation. One minimal way to help protect against these concerns would be to require the retirees to have their election witnessed by the Plan Administrator or notarized, as is currently done with spousal waivers of QJSAs. Notaries are supposed to "require the presence of each signer and oath-taker in order to carefully screen each for identity and willingness, and to observe that each appears aware of the significance of the transaction requiring a notarial act."⁴⁰ A more effective step would be to require the plan sponsor's chosen, independent counselor to make an in-person visit or conduct a telephone interview of every retiree-offeree who has been collecting a pension annuity for 5 years or longer, in order to assess the participant/beneficiary's knowledge of the advantages and disadvantages, apparent capacity to make an informed decision, and whether there are any family members who are pressuring or trying to persuade the participant/beneficiary to take the lump sum. Requirements to screen and supervise transactions like these have a precedent: they were required as part of a settlement by the Minnesota Attorney General with Allianz Life Insurance Company following the companies' high-pressure sales of often-unsuitable annuities to seniors.⁴¹

4. Require all lump sum offers to be accompanied by disclosures on the tax consequences of accepting a lump sum.

DOL should recommend that the IRS immediately clarify the tax treatment of lump sum cashouts in a derisking context and prepare readable disclosure language. Then, DOL should require the distribution of tax information as part of the fiduciary's obligations. If the

⁴⁰ National Notary Association, *The Notary Public Code of Professional Responsibility* 10-13 (July 2009), available at http://cdn.nationalnotary.org/resources_for_notaries/Notary_Code.pdf.

⁴¹ T. Lee, "Allianz suite settlement may bring refunds," *Star Tribune* (Oct. 8, 2007), available at <http://www.startribune.com/business/11244996.html>; B. Ruiz Switzky, "Allianz Life Insurance agrees to \$10M settlement over California annuities," *San Francisco Business Times* (Feb. 14, 2008), available at <http://www.bizjournals.com/eastbay/stories/2008/02/11/daily63.html?s=print>.

tax disclosures are not made, the pension plan sponsor should be obligated to pay any additional taxes and penalties levied against the participant/beneficiary.

Cross-Cutting Issues with Derisking

With all of the focus on the impact of derisking on participants and beneficiaries, it is easy to forget that there is still an ongoing plan that has not been terminated, and that those participants and beneficiaries are also in need of protection in these transactions. AARP's concern, and one that has been voiced by others as well, is the negative impact that derisking can have on the funding level of the ongoing plan. With a standard termination, the plan must be fully funded to cover all promised benefits. Yet, with these deriskings, plans that are minimally funded at 80 percent are permitted to offer lump sum cashouts. This is in spite of the fact that the annuity buyouts may be quite expensive, as the plan must pay a premium over and above the likely cost of paying benefits to cover the insurer's profit and the risks being assumed by the insurer.

If the plan *becomes* underfunded as a result of the derisking, it would be compelled under the PPA to take certain remedial actions. Some actions are centered on the employer, such as being required to make more contributions to the plan. However, some measures could hurt the retirement security of remaining participants, such as having to suspend future benefit accruals. In fact, a plan could derisk and then use the consequent underfunding as the basis for PPA-required measures that undercut the participants' benefits.

Disturbingly, it is not at all clear that "derisking" even succeeds in reducing the exposure to risks of underfunding that supposedly drive the entire derisking enterprise. One study found that annuity buyouts can actually expose plans to even more risk:

"...[T]he post-buyout downside risk is larger because the liabilities remaining have a longer duration, the service cost compounds the effect and the funded status is lower because additional assets need to be transferred to an insurer as a premium for taking on the liabilities. ... In the case study, expected pension contributions by a company in the 10 years following a buyout are actually greater than just keeping all the pension assets. The reduction in administrative costs and Pension Benefit Guaranty Corp. premiums that come with a buyout 'honestly doesn't make that much of a difference,' Ms. Franceries said. While there would be fewer members in a plan, premiums would increase because the plan would have a lower funded status."⁴²

⁴² K. Olsen, "Pension buyouts might increase risk for plan, report finds," *Pensions & Investments Online* (June 26, 2012), available at <http://www.pionline.com/article/20130626/dailyreg/130629922>. The study cited is J.P. Morgan Asset Management, *Pension Pulse - Special Edition* (Spring/Summer 2013), available at http://www.jpmorganinstitutional.com/directdoc/jpmorgan/am/ia/documents/2013_pension_pulse_summer.

In any case, it is difficult to square how taking steps that *worsen* a plan's funding level or expose it to greater risks is consistent with the goals of ERISA or the fiduciary obligations of the plan trustees.

Another concern that cuts across both forms of buyout derisking is the impact that it could have on participants' and beneficiaries' retiree health and other related benefits. In some retiree health plans, vesting in retiree health is tied to vesting in the pension plan. Thus, depending upon how the retiree health plan is structured, it is possible that participants who are derisked out of the pension plan — either by virtue of taking a lump sum or by being transferred to an insurance annuity provider — could lose another very important retirement benefit. Retirees who may already be receiving retiree health benefits are especially at risk. Because lump sum cashouts are voluntary, any loss of retiree health by virtue of the derisking can be avoided. However, those being derisked into an insurance annuity apparently have no choice in the matter, and may be derisked out of their retiree health through the back door. A related issue that deserves more attention is the impact that taking a lump sum could have on a participant's eligibility for income-based benefits, such as Medicaid. For example, by converting a stream of income into a large asset, the lump sum might prevent a participant in need of long-term services and supports from qualifying for Medicaid, or at least it would take much longer to qualify.

Finally, ERISA contains several important provisions that protect the rights of spouses, surviving spouses, and former spouses. It requires married participants to take their pension in a form that provides a survivor pension to the spouse, unless the spouse provides written consent to waive that right. It provides that the QJSA must be the most valuable benefit. And, it provides for the recognition of divorce court orders that award a pension share and/or survivor pensions for former spouses; once the order is recognized, the plan is required to pay benefits directly to the spouse, without the former spouse having to go after the participant-spouse for the payments.

It is not at all clear to what extent, if at all, spousal rights are adequately protected in derisking transactions. The IRS rulings that gave rise to the recent derisking rush indicated that plans offering lump sum buyouts to retirees must obtain written consent from the spouse, and from a former spouse if there is one,⁴³ to be able to switch to the lump sum form, because such a switch would extinguish rights to a survivor pension for the surviving spouse or former spouse. The requirements to execute new spousal consents are wholly appropriate in this situation.

But because the rulings are focused on lump sums for retirees, there is no discussion of spousal rights in the case of a buyout annuity transaction. If the plan is doing an annuity buyout for retirees, and the participant's spouse has died since retirement, does the participant get a new election opportunity for a single life annuity? What if the derisking occurs prior to retirement — and then the employee marries, and dies before retirement — is there a Qualified Pre-retirement Survivor Annuity (QPSA) provided by the insurer? If not, this would constitute the loss of a valuable benefit that should be compensated, or at least disclosed.

⁴³ IRS Priv. L. Rul. 1228045 at 4, *supra* n. 34, and IRS Priv. L. Rul. 1228051, at 12, *supra* n. 35.

There are also issues related to divorce. Case law would seem to hold that, once a pension annuity is transferred to an insurer, ERISA no longer governs; instead, state law does.⁴⁴ Are annuity providers required to honor Qualified Domestic Relations Orders (QDROs) and pay former spouses directly? In the Verizon derisking, for instance, the company agreed to handle post-derisking divorces by working with the participant and ex-spouse to split benefits according to any court order.⁴⁵ But what are the annuity provider's *legal obligations* in this case? DOL should require ERISA-type protections and require plans to explain these protections in disclosures.

Recommended Safeguards

1. Issue guidance to clarify that *any* worsening of plan funding by virtue of derisking is a fiduciary violation.

Plans that want to engage in any form of buyout derisking should be required, as condition of being permitted to do so, to maintain the funding level of the plan at a level at least equal to or better than the level of funding before the derisking. Before engaging in a derisking transaction, plans should be required to "fund up" the plan exclusively through employer contributions. Worsening the condition of the plan that remains should be deemed a violation of the plan fiduciaries' duty to manage the plan for the exclusive benefit of the participants and beneficiaries. DOL should issue guidance to clarify this point.

2. Require prominent disclosures on impact on retiree health insurance, if any, particularly in communications about lump sums.

DOL should require plan sponsors to include prominent disclosures about any consequences of the transaction for the participant's rights to retiree health and related benefits under the plan. For those offered lump sums, these disclosures should be required to accompany every communication about electing a cashout. Plans that are considering derisking and whose retiree benefit plans are structured to make entitlement to retiree health contingent upon being a plan participant should be required to amend their plans accordingly to preserve retiree health for all who vested in those benefits. Plans should also be required to provide basic disclosures on how lump sums might impact eligibility for means-tested benefits such as Medicaid.

3. Require adequate attention to and protection of spousal rights.

A derisking plan should be required to provide, separately to the participant and all beneficiaries, thorough disclosures that address how benefits will be handled in various scenarios involving the timing of the derisking vis-à-vis retirement, marriage and remarriage, death, divorce, etc. Moreover, as a matter of contractual obligation, the insurer should be required to handle all matters related to surviving spouses and former spouses in accordance with and as if under ERISA. Thus, it should be obligated to provide QPSAs

⁴⁴ See e.g., *Hallingby v. Hallingby*, 574 F. 3d 51 (2d Cir. 2009).

⁴⁵ Verizon, *Questions and Answers about the Pension Transfer*, at 14, question 7.2 (Oct. 24, 2012), available at http://www22.verizon.com/investor/DocServlet?doc=pension_transfer_faq.pdf.

and QJSAs under the same circumstances that they would have been available under the pension plan. In the case of divorce, the insurer must provide benefit information to the former spouse's attorney, honor the QDRO, and pay benefits in accordance with a court order directly to the former spouse.

Conclusion

The trend of some large companies – including many who played a critical role in building a large and stable middle class in this country – to shed their pension obligations and shift their long-time former employees into a likely less secure position in retirement is a lamentable development. The goals of ERISA and retirement security policy generally is headed in the wrong direction when federal protections for pension participants and benefits can be spun off into other systems that lack the same measure of income security. This latest form of pension risk shifting only reinforces AARP's strong belief that we need to address the growing retirement crisis in America – indeed, the growing need for, and importance of, Social Security is due in part to the dissipation of other sources of retirement income that workers can count on.

In the meantime, DOL should undertake a robust interpretation of its authority and do all it can to maintain or replicate ERISA rights in derisking transactions. In addition, although DOL does not have the authority to act on all issues that need to be addressed, the ERISA Advisory Council and DOL should make additional recommendations, where appropriate, and send its report to other federal agencies with jurisdiction, including the IRS, the PBGC, and the Federal Reserve Board.

Once again, AARP appreciates this opportunity to provide its views to the ERISA Advisory Council on so-called pension derisking, and we are happy to answer any questions.

Appendix

Summary of AARP Recommendations

AARP urges the ERISA Advisory Council to recommend to DOL that it act to replicate ERISA protections in these transactions to the greatest extent possible.

Group Annuity Contracts

1. Clarify "safest annuity" obligations under the EBSA Interpretive Bulletin
2. Keep assets separate from other lines of business
3. Require reinsurance
4. Require the derisking contract to contain further constraints on the insurer

Lump Sum Cashouts

1. Require plans to provide clear and complete disclosures, in hardcopy form, regarding the:
 - a. Pros & cons of accepting a lump sum
 - b. Comparative value of a lump sum vs. the annuity benefits
 - c. Fact and amount of any loss of early retirement subsidies or other benefits
 - d. Loss of PBGC insurance protections
 - e. Spousal pension rights
2. Require plans to make independent, unconflicted, objective advice available
3. Require protections to mitigate and prevent undue pressure
4. Require all lump sum offers to be accompanied by disclosures on the potential tax consequences of accepting a lump sum

Cross-Cutting Issues with Derisking

1. Issue guidance to clarify that *any* reduction of plan funding by virtue of derisking is a fiduciary violation
2. Require prominent disclosures on impact on retiree health insurance, if any, particularly in communications about lump sums
3. Require adequate attention to and protection of spousal rights