

KEY POINTS:

- Risk transfer transactions are a common tool for plan sponsors to manage a variety of risks associated with defined benefit plans.
- Plan sponsors, participants and fiduciaries, regulators, and policymakers each have unique perspectives on these transactions.
- Longevity and investment risk are key considerations for employers in deciding whether to implement a risk transfer transaction and for participants if they receive a lump sum distribution.
- Increasing PBGC premiums make these transactions more attractive to employers, while the resulting loss of PBGC insurance coverage can be concerning for plan participants.
- Plan participants should receive sufficiently complete and appropriate disclosures to help them make an informed decision.
- Changes in plan funding levels following a risk transfer transaction can also affect the benefit security of participants remaining in the plan post-transaction.



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Issue Brief

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Pension Risk Transfer

The transferring of risk from defined benefit pension plans (often called “de-risking”) has become a focus of pension plan providers, participants, and policymakers over the past few years. The Pension Committee of the American Academy of Actuaries believes that discussion of risk transfer from the perspectives of different constituents affected by these transactions will help to educate plan sponsors, regulators, fiduciaries, and policymakers and provide greater clarity regarding this topic.

The terms “risk transfer” and “de-risking” have been commonly used to describe a number of different transactions undertaken by defined benefit pension plan sponsors. Types of risks addressed in these transactions include the risk that participants will live longer than current annuity mortality tables would indicate (longevity risk); the risk that funds set aside for paying retirement benefits will fail to achieve expected rates of investment return (investment risk); the risk that changes in the interest rate environment will cause significant and unpredictable fluctuations in balance sheet obligations, net periodic cost, and required contributions (interest rate risk); and the risks of a plan sponsor’s pension liabilities becoming disproportionately large relative to the remaining assets/liabilities of the sponsor (e.g., the risk that changes in a plan’s funded status will be of very significant financial consequence to the plan sponsor, potentially causing liquidity problems due to escalating pension contributions, downgrades from bond ratings agencies, or other difficulties obtaining financing).

Risk transfer or de-risking transactions addressing pension plan risks can include:

- a) The purchase of annuities from an insurance company that transfers liabilities for some or all plan participants (removing the risks cited above with respect to that liability from the plan sponsor);
- b) The payment of lump sums to pension plan participants that satisfy the liability of the plan for those participants (either through a one-time offer or a permanent plan feature); and
- c) The restructuring of plan investments to reduce risk to the plan sponsor.

The first two types of transactions do not actually reduce risk (except to the extent that an insurer taking on the liabilities is likely to pursue a lower-risk investment approach), but rather transfer it to another party (e.g., the insurer, or the plan participants)—thus they may be more properly categorized as “risk transfer” transactions. A complete “risk transfer” transaction (i.e., a plan termination) will typically involve annuity purchases and may also involve payment of lump sums (for participants who elect them). This issue brief examines annuity purchases and lump sum payments specifically from the perspective of a single-employer defined benefit plan,¹ and does not address investment restructuring.

This issue brief does not offer a judgment about whether such transactions, on balance, enhance or detract from a retirement system. It instead seeks to provide a factual basis upon which such determinations may reasonably be made. The Pension Practice Council of the American

Academy of Actuaries has sponsored an initiative that identifies characteristics of well-functioning retirement systems called Retirement for the AGES.² Readers may wish to reference this framework when considering the effect of risk transfers.

Generally the constituents concerned with “risk transfer” transactions are:

- 1) Plan sponsors and company owners/shareholders
- 2) Plan participants (and other employees of the plan sponsor)
- 3) Pension plan regulators
- 4) Plan fiduciaries

A detailed discussion of the issues involved in pension risk transfer relative to each of these constituent groups follows.

Plan Sponsors and Their Shareholders

In the United States, employer sponsorship of pension plans is a voluntary undertaking. Historically, companies adopted pension plans for a variety of reasons, including attraction and retention of qualified employees, workforce management, paternalism, employee expectations, and favorable tax policy. In light of the voluntary nature of sponsorship, plan sponsors generally believe that the ability to close a plan to new entrants, reduce or freeze benefits, or completely terminate a plan (after providing for all accrued benefits) if business conditions dictate such actions has been and remains necessary to encourage adoption and continuation of plans (i.e., a rational

¹ Many of the issues discussed will also have applicability to multiemployer or public sector employee pension plans. However, differences may apply (e.g., the existence and/or level of PBGC guarantees) that are not addressed in this issue brief.

² <http://www.actuary.org/Retirement-for-the-AGES>

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business person would not adopt a plan with uncertain future costs and no ability to control those costs if the business can no longer afford them). Thus, when considering the effects of risk transfer on various constituents, it is important to keep in mind that existing regulatory restrictions on unwinding or de-risking plans might further reduce employers' willingness to offer defined benefit plans, and further proposals to restrict employers' flexibility in this area could produce a rush to exit sponsorship of plans.

Changes in the Economic and Regulatory Environment

In the past 25-30 years, changes in the regulatory and economic environment have increased and/or illuminated the risks that defined benefit plans pose to plan sponsors and their shareholders. Some of these changes are as follows:

- Pension-related balance sheet and income statements have become more volatile over the past decades. U.S. generally accepted accounting principles (GAAP) changes such as Financial Accounting Standard (FAS) 87, FAS 88, FAS 132, and FAS 158 call for current interest rates to be used for valuing liability and benefit cost, and for liabilities to be placed directly on the balance sheet. The sustained decline in interest rates has increased balance sheet liabilities, pension costs, and funding requirements.
- The move toward market interest rates and limitations on asset smoothing has introduced greater volatility in minimum funding requirements.
- The existence of the IRC §4980 excise tax on surplus that reverts to the plan sponsor on plan termination (which is 50 percent of the reversion if none of the surplus is used to provide additional benefits to participants, and is in addition to corporate income tax on the reversion) prevents plan sponsors from taking a long-term view on funding, in which they would build up surpluses to reduce volatility in required contributions.

- Regulatory requirements have increased and become more complex, increasing the risks of incurring large costs (e.g., increases in benefits for participants, compliance fees paid to the Internal Revenue Service (IRS), administrative costs to find and process benefit increases for participants owed additional benefits) to fix potentially disqualifying mistakes or misinterpretations of the legal requirements that can be made by even the most diligent plan sponsors.

The negative effects of pension risk and volatility relate directly to the size of the pension liability compared to the size of the organization (e.g., pension liability as a percentage of balance sheet liabilities, or pension cost as a percentage of net income). For sponsors operating in declining industries in particular, pension plan liabilities can become very large relative to a company's market capitalization, greatly exacerbating its risks in sponsoring a pension plan. Many companies in these sectors have significantly fewer active employees than in the past; the active employees therefore produce less economic output to support the plan's required funding, heightening the risk of maintaining plans. For these reasons, financial market analysts have become very focused on legacy liabilities (i.e., liabilities related to participants who are no longer employed, particularly when the group is large compared to the active population and/or the entity is no longer providing defined benefit plan accruals to the majority of its current workforce).

Growing Prevalence of Defined Contribution Plans

The sustained move away from defined benefit plans to defined contribution (DC) plans, especially in younger and faster-growing companies and industries, has put pressure on boards of directors of companies with pension plans to justify to shareholders the business reason for retaining the defined benefit plan risk and volatility and its effect on the company's market capitalization, ability to borrow, price of

credit, and other important conditions affecting the company. Many board members may have had experience as executives of companies that only offer DC plans and may thus have previously examined the issue and concluded that the advantages of defined benefit plans do not justify the risk in specific situations.

The plan sponsor's level of desire to de-risk will typically vary depending on the current status of the pension plan. Retaining the risk is easier to justify when the plan sponsor has decided that maintaining an open defined benefit plan makes sense for its business. However, once a plan sponsor decides to move to a DC plan for future accruals for new employees (and possibly younger or shorter-service current employees as well), difficulties in satisfying the nondiscrimination testing rules will often force a plan freeze within a few years. Once plan accruals are frozen, retaining risk can be especially hard to justify because the plan is no longer a part of the ongoing compensation strategy for any group of employees. Furthermore, a sponsor with a closed or frozen plan has less ability to make use of any surplus generated from excess asset returns and thus is at a greater risk of trapped surplus and excise taxes.³

Pension Benefit Guaranty Corporation (PBGC) Premiums

PBGC premiums have increased significantly in recent years, with the fixed-rate premium going from \$31 per participant in 2007 to \$64 in 2016. Additional increases are discussed occasionally by the administration and in Congress. These higher premiums increase the cost of maintaining a plan and may further tilt the risk/value assessment away from plan sponsorship. In particular, fixed premiums are levied on a headcount rather than a liability-weighted basis. Because a significant percentage of former employees with deferred benefits will select a lump sum if one is offered,⁴ paying high PBGC premiums for large numbers of former employees with (often small) deferred benefits may be difficult to justify.

Timing Considerations

In deciding whether and when to de-risk, plan sponsors consider many factors:

- Some plan sponsors may be waiting until interest rates rise to carry out risk transfer activities. Many others compare the cost of settling today to the economic liability (balance sheet liabilities at low interest rates plus the present value of administrative expenses, investment management fees, and PBGC premiums) and conclude de-risking makes economic sense now.
- With the announcement⁵ by the IRS that updated mortality projections reflecting the RP-2014 mortality tables are not required to be used to determine minimum required lump sums paid during 2017, plan sponsors now have certainty as to the required calculations for lump sums offered during 2017. In determining whether and when to de-risk by offering lump sums to participants, plan sponsors will likely assume that the reported increase in life expectancy will be reflected in minimum required lump sums at some point after 2017. They may also consider what effect the impending change should have on communications with participants about lump sum offers in the interim. However, plan sponsors will also need to consider other factors, such as potential changes in the interest rates used to calculate lump sums.
- The insurance industry may not have the capacity to absorb increased demand for pension settlements. If a plan sponsor waits until interest rates rise, many plan sponsors may seek to place significant blocks of annuities with insurers at the same time, diminishing or even eliminating capacity, or causing insurers to be less competitive with bids. Requirements to buy the "safest available annuity" and related concerns by plan sponsors about whether they are able

³ By law, if a plan has more assets than are needed to satisfy the benefit liabilities, the employer cannot recover the excess assets until the plan has been terminated. At that time, the excess assets can revert to the plan sponsor, but are subject to income tax and significant excise taxes.

⁴ Fifty-eight percent of deferred vested participants in 70 lump sum window offerings elected a lump sum in 2014, according to [a survey](#) from Aon Hewitt.

⁵ [Notice 2016-50](#).

to properly fulfill their duties as fiduciaries in placing the annuities may come into conflict with available capacity in the industry.

- Plan sponsors have in the past offered lump sums to terminated participants with deferred benefits, as they could more easily be offered a lump sum payment than retirees. For a plan sponsor with a large number of such participants in its DB plan(s), lump sum payments can significantly reduce plan liabilities and PBGC premiums. Participants can elect to receive a cash payment directly, or they can roll the distribution into an individual retirement account (IRA) to retain the tax-deferred status of the funds. If they do not wish to manage the money or are concerned about outliving their income, they might decline the lump sum or use it to purchase an individual annuity.

With the publication of IRS Notice 2015-49, the IRS signaled its intent to amend the required minimum distribution regulations under IRC §401(a)(9) to generally prohibit offering a single-sum payment to current payees (retirees or their surviving beneficiaries).⁶ While Notice 2015-49 also signals the IRS' intent to prohibit an election of "other accelerated form of distributions," the focus is on replacing monthly lifetime annuities with lump sum payments. The IRS made the prohibition effective immediately. As a result, future lump sum window programs offered to former employees will generally be limited to those who have yet to begin receiving their monthly payments.

- Participants in poorer health are more likely to elect lump sums (antiselection). Offering a lump sum opportunity to terminated

participants with deferred benefits shortly before purchasing annuities for the participants who do not elect lump sums can increase the price of the annuities, as insurers will reflect the expected greater longevity of the remaining group in their pricing.

- Absent a plan termination, participants under age 62 cannot be offered lump sums while still in service. As a result, plan sponsors may feel increased pressure to voluntarily terminate the plan, particularly if interest rates rise significantly. If the plan is terminated, employees are likely to be offered a lump sum (which may include a direct transfer of the lump sum to a rollover account in the sponsor's DC plan). A significant percentage of active employees usually elect the lump sum.

Alternatively, a plan sponsor might buy annuities to cover participants' accrued benefits, but retain the annuity contracts as assets of the plan (sometimes called an "annuity buy-in"). This approach has some risks, though, because should the plan ultimately be terminated and assets therefore distributed, and the insurer at that point no longer provides the "safest available annuity" as required under the plan termination rules, the annuity contract might need to be unwound and replaced.

Participants (and Other Employees)

Plan participants may have concerns as a result of risk transfer transactions. These include the transfer of longevity risk and investment risk to them when taking a lump sum distribution, as well as whether benefit security is reduced when an annuity contract is purchased (which transfers all risk to the insurer from the plan sponsor). Participants also need to be aware of taxation and investment management issues if electing a lump sum payment.

⁶ Current Section 401(a)(9) regulations generally restrict the ability to change the annuity payment period or provide for increasing benefits, with limited exceptions. For example, a modification to the payment period that would facilitate payment of a lump-sum payment may be made upon plan termination.

Assumption of Longevity Risk (When Taking a Lump Sum)

Participants may have a difficult time understanding whether taking a lump sum is a good choice for them. Considerations include participants' health, uncertain trends in mortality improvement, the availability of other retirement funds, and whether they wish to manage financial investments. Married participants have to consider longevity risk for their spouse as well as for themselves—the spouse may live significantly longer than the participant.

Life expectancy has increased over time. Consequently, the life expectancy reflected in a lump sum distribution may not reflect actual longevity improvements that have occurred if the mandated mortality table has not been updated in recent years. A lump sum may not be in the best financial interest of the participant and his/her spouse if they are in good health. For a participant in poorer health, particularly an unmarried participant, the lump sum may be more economically advantageous and may enable the participant to leave money to his or her heirs.

The requirement to use unisex assumptions⁷ for qualified defined benefit plans may result in lump sums not being a good choice for women because of their longer life expectancy.⁸ By contrast, a male receiving a lump sum might be able to buy a larger annuity in the individual marketplace (where gender-specific mortality is used). However, the pricing of such annuities may still be disadvantageous, due to insurance company expenses, interest, and mortality assumptions used for pricing. These assumptions will differ from those required by IRS to be used to determine lump sums. Finally, insurers generally assume that those who buy annuities in the individual market are healthier than average.

A participant may choose to manage the funds received in a defined benefit plan lump sum in the early period of retirement and purchase a qualified

longevity annuity contract (QLAC) to provide protection against living longer than the average life expectancy. This could be a feasible option if and when the market for QLACs becomes further developed. For example, a participant could use a lump sum to purchase a QLAC that would start payments at age 85, and use the remainder of that lump sum to provide income before age 85.

Possible Loss of Early Retirement Subsidies

Lump sum payments to deferred vested and terminating active participants are permitted to exclude the value of any early retirement subsidy, thereby reducing the value of the benefit a participant receives if a subsidized annuity is rejected in favor of a lump sum.

Changes in Interest Rates During Plan Year of Payout

The interest rates used for calculating lump sum payouts are often determined as of the beginning of the plan year, or even up to several months before the plan year begins. Many of the recent one-time lump sum window offers occurred toward the end of the plan year.

Significant interest rate changes that occur between the plan's interest rate determination date and payout date could create a distortion between the lump sum paid and the market value of the monthly benefit on the date the lump sum is paid. A drop in interest rates between the two dates would create a relative shortfall, while an increase could generate a lump sum in excess of a current settlement value.

Potential Reduction in Plan Funded Percentage Levels After Risk Transfer Transactions

The economic value of a liability can be viewed as the cost of settling that liability in an open market between a willing buyer and a willing seller. Where legal requirements constrain that value (e.g., for qualified pension plans, the required minimum lump sum payable and the requirement to select

⁷ IRC Sections 417(e)(3)(B) and 430(h)(3). See also *Arizona Governing Comm. v. Norris*, 1983.

⁸ The current (2016) mandated mortality assumptions for lump-sum calculations is a 50/50 blend of male and female rates. According to the underlying tables for males and females, at age 65 women are expected to live about two years longer than men.

the “safest available annuity”⁹), those constraints will affect the economic value of the liability. However, some parties (including plan sponsors and regulators) will also be concerned with the effect of the transaction on the funded status as measured for accounting, funding, and PBGC guarantee purposes, which will typically differ from “true economic value” due to the use of various prescribed assumptions to value the liability. Plan participants may be concerned because IRC §436 requires certain restrictions on benefits that can accrue under or be paid from qualified plans and that depend on the plan’s funding level as measured for funding purposes.

The purchase of a group annuity contract for only a portion of plan participants would likely cost more than the amount of IRS funding liability that is removed. Under certain conditions, the same may be true for one-time lump sum window offers at current market interest rates—as happened in early 2016.

Participants who are not included in a group annuity purchase or lump sum offer, or who decline a lump sum offer, may then be left with a lower-funded plan unless the plan sponsor contributes enough to keep the plan funding level up. If the plan sponsor does not do so and the plan is close to a benefit restriction threshold, the remaining participants might also become subject to benefit restrictions.

Possible Reductions in Benefit Guarantee/ Security

Some state insurance guarantees (\$100,000 to \$500,000 in present value) are less than the PBGC benefit guarantees,¹⁰ and guarantees are across all policies held at a single insurer; consequently, participants who already have products from the insurer selected by the sponsor could have lower guarantees in the case of insolvency. The comparability of Employee Retirement Income Security Act of 1974 (ERISA) anti-alienation

protections¹¹ to state insurance regulation protections may vary by state, so once the benefit is transferred outside of the plan it may be subject to claims by creditors of the participant.

Most group annuity products are funded well in excess of 100 percent on a statutory basis and, thus, are less at risk of default in the first place. Furthermore, many of the largest de-risking contracts have been executed with separate accounts, providing those plans’ participants with an added layer of protection.

Participants who are offered a lump sum distribution may elect to receive the lump sum, despite concerns over their ability to invest the money adequately, for a variety of reasons, which may include a lack of trust of the future financial health of the plan sponsor (or a subsequent insurer). Taking a lump sum distribution rather than keeping the benefit within the employer-sponsored plan could be a risk to the plan participant if his or her plan benefit is fully guaranteed by the PBGC, or if the plan participant’s appraisal of the health of the plan sponsor or insurer is not accurate.

Effect of Risk Transfer Options on Other Employees

The potential reduction in the funded percentage (as measured for minimum funding purposes discussed above) in a plan that offers lump sums could increase near-term minimum required contributions and thus place a degree of strain on overall employer financial resources, potentially reducing the ability of the sponsor to fund other benefits or business opportunities. Although the allocation of plan sponsor capital ideally favors the most optimal uses of capital, there may be a temptation for a plan sponsor to follow the lead of other plan sponsors (particularly industry competitors) regardless of how appropriate it is for that specific sponsor.

9 See the discussion of DOL Interpretive Bulletin 95-1 in the *Regulators* section of this brief.

10 *The Nation’s Safety Net*; The Life & Health Insurance Guaranty Association System.

11 The anti-alienation protection provided under ERISA Section 206(d)(1) generally precludes the transfer of a participant’s interest to a third party, with certain enumerated exceptions.

Employees who participate in a different pension plan that doesn't offer lump sum payments may start pressuring the employer to extend the offer to their plan as well, even though their plan's funding level may not support payment of lump sums. This pressure could create a demand on employer finances to make additional contributions if the employer chooses to pay lump sums in other plans. Alternatively, it could be a factor in employee morale if the offer is not expanded to other plans.

Tax Considerations

Participants receiving lump sums will potentially be taxed at higher personal federal and state tax rates (due to a one-time large amount that can place the participant in a higher income tax bracket), and may also be subject to excise taxes on premature distributions, if they do not elect to roll the distributions into a personal IRA or an employer-sponsored tax-qualified plan.

Participants who elect to roll over a lump sum to an IRA or employer-sponsored plan must properly manage required minimum distributions or risk tax penalties.

Post-Lump Sum Investment Considerations

Participants electing a lump sum distribution face the challenge of investing the proceeds in a way that will last a lifetime (or possibly longer, if he or she is married). While some participants may have experience and sufficient knowledge of financial matters, others may have no expertise or experience in that arena. Even more financially astute participants may become less able to effectively manage their assets as they age. Investment management fees for an individual's personal retirement accounts may be higher as a percentage of assets than for institutional funds used by retirement plans, although using index funds may lessen the effect of retail fees, and the participant may be able to roll the lump sum over to the plan sponsor's or another employer-sponsored DC plan.

Those participants face the challenge of managing the withdrawal of assets over their retirement years (the duration of which is unknown). They are effectively self-insuring their own longevity (and, if applicable, that of a spouse). A participant, for example, who experiences investment losses soon after electing a lump sum might never recover, and be forced to spend down personal retirement account assets more quickly afterward. Such losses could significantly increase the likelihood that the participant could outlive his or her income.

Participants may face the temptation of using part of a lump sum to purchase non-retirement income items, to help family members, or for other one-time uses not previously budgeted. In some cases this may make good financial sense (e.g., paying off a mortgage or other debt to free up monthly income for other purposes); however, it can lead to "leakage" of assets from the individual's retirement portfolio that are not made up for through future savings.

Regulators

Defined benefit pension plans are regulated by a number of governmental agencies. These include the IRS, the Department of Labor (DOL), and the PBGC on the federal level. Annuity contracts are regulated by state insurance authorities.

Considerations regarding risk transfer transactions with a regulator's perspective in mind include compliance with appropriate laws and regulations, potential reduction in plan funding levels after risk transfer, and possible reductions in benefit guarantee or security.

Compliance With Appropriate Law and Regulations

Regulators generally are concerned with whether the administration of a plan with respect to lump sum distributions meets all of the applicable regulatory requirements. Examples of these concerns include:

- Does the plan amendment allowing a lump sum comply with IRS guidance, in particular IRS Notice 2015-49?

- Does the plan provide compliant relative value disclosures and notices of the consequences of failure to defer?
- Does the plan provide sufficient information regarding personal federal and state income taxes?

Even where plans comply with all current regulatory requirements, regulators are also concerned with assuring that participant disclosure requirements with respect to risk-transfer transactions remain sufficient and appropriate for the affected participants. A participant's decision to elect a lump sum often involves a large sum of money—among the largest sums the participant may have ever received. Some questions that regulators may be concerned with include:

- Is the choice of language in the required disclosures appropriate to the participants involved?
- Is the level of detail in the disclosures sufficient that a participant (and his/her financial adviser) can make a fully informed choice?
- Are the instructions on how to make a choice clear and complete?

The transfer of pension benefits from the plan to an insurer must comply with the DOL's annuity selection guidelines.¹² These guidelines address such issues as the quality and diversification of an annuity provider's investments, the level of an insurer's capital and surplus, the insurer's guarantees, and the availability of additional protection (and any limits on such protection) through state guaranty associations.

Regulators will also want fiduciaries who also act in a settlor capacity when implementing risk transfer transactions to understand the potential conflicts of interest and make decisions appropriate to these two respective roles. (See Plan Fiduciaries below for additional discussion of fiduciary concerns.)

Potential Reduction in Plan Funding Levels After Risk Transfer Transactions

The purchase of a group annuity contract for only a subset of plan participants would likely cost more than the amount of funding liability that is removed. Even ignoring administrative expenses, an insurer accepting the transfer of risk from a pension plan would typically charge a fee to cover potential adverse experience of the group. Participants who are not included in a group annuity purchase could be left with a lower-funded plan as measured for minimum required funding purposes and as would be measured by PBGC on plan termination. This decrease in plan funding levels exposes participants to additional risk of IRC §436 benefit restrictions and potentially smaller benefits provided by PBGC if the plan were to terminate without sufficient assets to provide all benefits.

The lump sums paid to participants may be greater than the funding liability previously held for those participants. This happens because of differences between the plan funding interest rates and the lump sum payment rates in IRC §417(e)(3), and because of timing differences between the lookback month for determining the interest rates used to calculate lump sums and the plan's annual valuation date. When the plan's funding level is close to a particular IRC §436 benefit restriction threshold, this phenomenon raises potential concerns for regulators:

- Would the plan's funding level be adversely affected by a risk transfer transaction such that IRC §436 restrictions would take effect, and therefore limit the distribution options available to remaining participants?¹³
- Would the plan sponsor be willing and able to make additional contributions to avoid potential benefit restrictions? Note that plan sponsors are not legally required to do so.

¹² [Interpretive Bulletin 95-1](#).

¹³ Other restrictions, such as limitations on plan amendments improving benefits for remaining plan participants, may also apply.

Possible Reductions in Benefit Guarantee/Security Lump sum payments. The election of a partial or complete lump sum payment would result in the reduction or loss of guaranteed lifetime income. When participants take cash distributions, there may be “leakage” of assets if the participants decide to use part of the distribution for non-retirement income purposes. Participants may not be aware of recent increases in life expectancy—they may only look at longevity of prior generations (e.g., parents, grandparents) in making decisions on whether to accept lump sum offers. The annual income level that could be provided by the lump sum may be further reduced due to asset losses (especially in the years immediately following the lump sum distribution), and exacerbated by participants’ lack of preparedness to manage these assets.

Purchases of annuities outside the plan. Some state guaranty associations’ coverages may be less generous than PBGC guarantee levels, at least for some participants. As noted above, guarantee amounts vary by state, ranging from \$100,000 to \$500,000 in cash value per individual and generally are not indexed for inflation, as contrasted with the PBGC guarantees. State guarantees may also offer less protection from a participant’s creditors than the protections provided by ERISA for qualified pension plans.

Changes in the financial health of an insurer after the annuity purchase has been completed (in accordance with DOL Interpretive Bulletin 95-1) may weaken the security and the insurer’s guarantee of benefits in the annuity contract. The transfer or sale of the annuity business to a different, less secure insurer subsequent to the initial transaction is also a cause for concern by regulators, and has been identified as such by the National Council of Insurance Legislators in its resolution regarding best practices for risk-transfer transactions.¹⁴

The sufficiency of state guarantees in the case of a systemic failure (where several insurers concurrently face insolvency) could cause state regulators to re-examine guarantees overall.

Plan Fiduciaries

This section discusses the issues that plan fiduciaries consider when a pension risk transfer program is being contemplated and after it has been announced. Fiduciaries have responsibilities under ERISA and regulations issued by at least three federal government agencies (the U.S. Department of Treasury, the DOL, and the PBGC) to act in the best interest of plan participants.

Many of these fiduciary issues are complex and create challenges for plan sponsors to craft language that plan participants can understand (“plain language” requirements) while conveying a sufficient level of detail so that key issues are properly understood.

Use of Independent Fiduciary for Annuity Purchases

In the largest transactions, an emerging practice is to hire an independent fiduciary to assess whether the risk transfer for the annuity component is prudent in accordance with DOL Interpretive Bulletin 95-1, which outlines the choice of the safest available annuity provider. This process was followed in recent transactions by General Motors, Verizon, Motorola Solutions, Kimberly-Clark, Bristol-Myers Squibb, and WestRock.

Some experts may question whether hiring an independent fiduciary is feasible or affordable for a smaller employer. Will a smaller employer or sponsor know how to find a good adviser? If independent fiduciary advice is not available, is the sponsor equipped to manage a risk transfer transaction on its own?

¹⁴ [“Resolution Concerning Best Practices for Pension De-Risking through Private Annuitization.”](#)

Participant Communications

Lump sum cash-out communication to plan participants and adherence to the multiple agencies' rules in this area are not new to plan fiduciaries. Early retirement incentive programs with one-time lump sum options are also not new. Additional scrutiny has been raised recently with respect to one-time lump sum window offerings to deferred vested participants.

Intrinsic to plan fiduciary responsibility in this regard is that plan fiduciaries not mislead plan participants. In a three-part test (the "serious consideration" test) applied by the U.S. Court of Appeals for the Tenth Circuit (*Maez v. Mountain State Telegraph & Telephone Co.*), "serious consideration" of a change in plan benefits does not exist until (1) a specific proposal (2) is being discussed for purposes of implementation (3) by senior management with the authority to implement the change. According to the court, these three conditions must be satisfied before statements regarding the likelihood or possibility of future plan changes could be considered material misrepresentations and thus could constitute a breach of fiduciary duty.¹⁵ This means that when the point of serious consideration of lump sum offers has been reached, formal and informal communication with plan participants needs to take into account the possibility of plan changes. So, for example, a participant contemplating retirement who asked a plan representative whether a lump sum option is available to them at retirement would have to be told that a deferred vested lump sum window might be offered in the near future for those not already in payment if the "serious consideration" test had already been satisfied.

Fiduciaries may enhance their communication regarding the effect on the participant's personal income taxes if the lump sum is not rolled over, although they tend to avoid crossing over into giving what might be categorized as tax advice. Providing only the IRS model tax notice is the most common approach.¹⁶

Code §411(a)(11) requires plan administrators to disclose to participants the consequences of failing to defer receipt of their benefit from a qualified retirement plan. The IRS has proposed that this notice should cover the following topics:

- The accrued benefit available to the participant if commencement is deferred until normal retirement date;
- The participant's loss of access to other optional payment forms (e.g., annuities other than the Qualified Joint and Survivor Annuity that might have been available at retirement if a lump sum had not been elected);
- The possible loss of early retirement subsidies, if they are not included or fully valued in the lump sum calculation; and
- Any other plan provisions that might affect a participant's decision whether to defer benefits to normal retirement date.

The fiduciary might also consider the following issues in developing participant disclosures:

- Common unknowns—changes in the economic environment affecting discount rates for any lump sum calculations, future increases in life expectancy, and incorporation of future mortality studies into the applicable mortality table;
- Known changes that have occurred in the applicable interest rate or applicable mortality table definitions that will be relevant at the date of the risk transfer;
- Whether to disclose what to expect if a participant does not accept an offer (e.g., if the long-term intent is to terminate the plan and buy annuities for those who do not take the lump sums); and
- Whether language clarifying who is (e.g., plan sponsor) or is not (e.g., a vendor) acting as a fiduciary, along with disclaimers regarding service providers not acting in any fiduciary capacity, may be appropriate.

¹⁵ See also U.S. Court of Appeals for the Third Circuit in *Fischer v. Philadelphia Electric*.

¹⁶ The model notice (most recently published in IRS Notice 2014-74) is intended to meet the requirements of Code §402(f).

In Summary

Pension plan risk transfers have become increasingly prevalent in the past few years—as demonstrated by recent large plan transactions—and according to public reports is under serious consideration by many defined benefit plan sponsors. These transactions need to be carefully considered by all relevant parties—plan sponsors, plan participants, regulators, and fiduciaries.

Risk transfer transactions can help a plan sponsor reduce its pension liability and related expenses, potentially improving the overall financial position of the plan sponsor and benefiting employees in other areas of the business. Plan participants can benefit from risk transfer transactions, whether through the purchase of an annuity insured by a regulated insurance company or by having the option to select a lump sum distribution, if the transactions are designed and implemented thoughtfully and in compliance with all applicable regulatory requirements. The selection of potential risk transfer transaction vehicles (such as lump sums and/or annuity purchases) and which participants to include in the transaction are decisions made by the plan sponsor, acting as a settlor, as part of the design of any risk transfer transaction.

Life and annuity insurance companies are in the business of managing long-term risks, and offer the ability to remove much of the pension risk from plan sponsors. Rigorous steps need to be taken to fully evaluate the insurance company being considered in the selection process so that the ERISA protections under a qualified pension plan are replaced with the required protections under the insurer's annuity contract. When lump sum distributions are offered, it is critical that participants receive information that is sufficiently clear and complete to enable them to make informed decisions regarding whether to accept the lump sum offer. Resources are available for plan fiduciaries to consult in designing the participant communications surrounding the implementation of these programs. The required disclosures—especially those governing lump sum offers—should be reviewed periodically to ensure they remain current and provide plan participants with sufficient information on the options available and the implications of deciding whether to take a lump sum.

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