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Pension De-Risking in the United States

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Introduction

"De-risking" is a term much in vogue lately in the United States. Employers have been seeking a way to off-load substantial pension liabilities (which often relate to employees who terminated years ago) in order to improve their balance sheets and streamline administration. Employers that maintain defined benefit pension plans are taking advantage of the market gains that have shored up asset values since 2008 to pay off a portion of the plan's pension obligations and thereby reduce the risk of future market fluctuations, growing PBGC premiums, and the probability of being subjected to longer life-expectancy tables when calculating actuarial equivalents in the future.

The most commonly used "de-risking" technique is to offer immediate lump sums to terminated vested participants and retirees, accompanied, in some cases by a transfer of liabilities for pensions of those who did not accept the lump sum offer (together with an appropriate amount of assets) to an insurance company that agrees to pay the required annuities. This is sometimes called a "liability transfer." General Motors ("GM") and Ford Motor Company led the way in 2012, obtaining groundbreaking private letter rulings from the Internal Revenue Service allowing the payment of lump sums to retirees already in pay status. Ford offered lump sums to 90,000 retirees and terminated vested participants. GM offered lump sums to 42,000 retirees. Also, in 2012, Verizon transferred $7.4 billion (all amounts are in US dollars) in pension liabilities to a single premium group annuity contract from Prudential Insurance Company of America to cover liabilities for approximately 41,000 retirees, without first offering a lump sum cash out.

This article explains some of the considerations in adopting a de-risking strategy.

De-Risking is Appealing

The US private pension system makes employers liable for the adequacy of pension funds to pay in full the benefits accrued under the plan, except in cases of bankruptcy. During the 1990s and early 2000s, many employers "froze" pension plans, either closing them to new entrants or cutting off benefit accruals for all. Freezing the plan is usually the first (and for some employers the only) step in implementing a de-risking strategy. During the years of strong market growth, plan asset values grew faster than liabilities, and many employers enjoyed lengthy

contribution holidays. When the 2007-08 market disruption occurred, asset values suddenly dropped substantially, and plans that had been fully funded became significantly underfunded almost overnight. Employers were faced with enormous, sometimes crippling, pension contribution obligations that had not been anticipated, adversely affecting the company's balance sheet.

In addition to the opportunity to offload liabilities and stabilize required contribution levels, other factors also make de-risking appealing:

- In 2006 legislative restrictions were imposed on payment of benefits from plans that were less than fully funded.[7] Where investments have fared well since 2008, plans are, for the first time in recent years, freed of these distribution limitations, which makes it possible to implement a de-risking strategy.
- The per-participant premium that must be paid to the Pension Benefit Guaranty Corporation[8] ("PBGC") has risen from $31 in 2007 to $49 in 2014 and is scheduled to increase to $57 in 2015 and $64 in 2016. For underfunded plans there is an additional variable premium of $14 for each $1,000 of unfunded vested benefits in the plan, capped at $412 per participant. This premium is due whether the participant is an active employee, a terminated employee with rights to future benefits (a "terminated vested participant") or a retiree drawing benefits. This is a hefty premium, especially for participants with fairly small benefits, the ones employers hope to remove from the plan's books by de-risking.
- Applicable actuarial tables are likely to be revised soon to reflect longer life expectancies, which will have the effect of increasing liabilities. By removing the liabilities now, before new tables take effect, employers will avoid the increased contributions the new tables will no doubt trigger.
- By paying out benefits or transferring obligations to an insurance company, the employer simplifies plan administration. There are fewer people whose addresses, deaths and marital status must be tracked. Knowing a participant's marital status is important for several reasons. Under US tax and labor law rules, before a participant can begin drawing a pension in a form other than the standard joint and spousal survivor annuity, the participant's spouse (to whom the participant is married on the annuity start date) must consent to the alternate form. Also, pensions be divided in a divorce, which required more administration, and new spouses may acquire certain pension rights as well. By reducing the number of plan participants, the employer can streamline plan administration.

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7 "Funded" in this case means the value of the assets equals the actuarial present value of accrued liabilities. The restrictions include a prohibition on paying lump sum and certain other forms of benefits if the plan's funded status is below 60 per cent, and a substantial per-person cap on the amount of benefits that can be paid if the funding level is between 80 and 60 per cent. In addition, benefits may not be paid in a lump sum to the highest paid 25 participants unless then plan is at least 110 per cent funded (or the value of the benefits is 1 per cent or less than the plan's liabilities).

8 The PBGC is a legislatively created agency that insures defined benefit pension payments up to a certain level. The current maximum guaranteed pension (2014) is slightly less than $5,000 per month commencing at age 65.

De-Risking Strategies

Lump sum cash out – The way it works is this: As the first step in a liability transfer, terminated vested participants and (often) retirees in pay status are offered an opportunity, during a limited window period, to choose an immediate lump sum payment that is the actuarial equivalent of their (remaining) pension payments. In the case of terminated vested participants there must also be an opportunity to commence an immediate monthly pension. Active participants are not permitted to be cashed out. Those who elect the lump sum are removed from the pension's books upon payment. For those who do not choose the lump sum or who elect monthly payments, the employer may either continue paying them from the pension's assets or terminate the plan as to those participants and transfer the liabilities to an insurance carrier (together with sufficient assets to fully satisfy the liabilities plus whatever additional premium or administrative fees the insurance company charges). Once the lump sums are paid and/or the liabilities are transferred to an insurance company, the insurance company assumes the risk of market fluctuations, thereby relieving the employer of this risk. Further, once liability is transferred to an insurance company, the benefits are no longer insured by the PBGC and thus the employer (through the plan) no longer will have liability for PBGC premiums. Moreover, any longevity risk is assumed by the participant who agrees to take the lump sum, or by the insurance company that accepts the liability transfer.

Why not just terminate the plan altogether and pay out all benefits? To terminate a plan outside of insolvency of the employer and a takeover of the plan by the PBGC, US law requires full satisfaction of all liabilities. Plans that are being "de-risked" do not have sufficient assets to satisfy all liabilities, but they have enough assets to satisfy a significant portion of the liabilities (i.e. those cashed out or transferred to an insurance company) without reducing the overall funded status significantly for the remaining liabilities. It has also been estimated that about 60 per cent of participants accept the lump sum when offered, but the rate can be expected to be higher among those with smaller benefits and lower among those already receiving a monthly annuity. Thus, to limit the amount of assets needed to make the lump sum payments, some employers may offer the lump sums only to terminated vested participants and not retirees, or they may offer lump sums only to participants who would receive smaller pensions.

Companies that choose to shift liabilities to an insurance carrier are expected to choose the carrier with care. It is generally understood that the decision to transfer liabilities to an insurance company outside the plan is a business ("settlor") decision. Once the decision is made, however, high fiduciary standards apply to the selection of the annuity provider. Regulations on choosing an annuity provider for a *terminated* plan require selection of the "safest annuity available", and include a requirement of obtaining contractual guarantees that the assets behind the annuities be held in a separate account with the insurer. Some practitioners would argue that the "safest annuity available" rule does not apply in a pension de-risking transaction where the plan is not being terminated, but other practitioners disagree. Caution is advised.

Transfer assets and liabilities to an insurance provider – The next step in a liability transfer is that plans will transfer assets allocable to the pensions of retirees and/or terminated vested participants who did not accept the lump sum offer to one

or more insurance companies who agree to provide the required annuities. Although the premium for the annuity policy is substantial (insurance companies expect to be compensated), the investment risk and volatility are effectively shifted from the employer to the insurance company. Participants, who are not given a choice in the matter, may be unhappy at losing the benefit of the PBGC guarantee and being forced to rely on the continuing financial strength of the insurance company for their benefits.

Other de-risking strategies – It should be noted that employers are also using other techniques to reduce the unpredictable volatility of required pension contributions. As noted above, may employers have frozen their defined benefit pension plans. Another technique is to match investment durations with expected maturity dates of the pension obligations. This is a sophisticated investment technique where bonds with laddered maturities are acquired and held as the principal investments of the plan, or as a hedge against volatility in the equity market. This will reduce volatility, but it is a conservative investment technique, and effectively dampens the upside investment potential.

Risks of De-Risking

De-risking is not risk free. Paying lump sums requires plenty of cash. With interest rates remaining low, lump sum amounts are higher than they would be with higher interest rates (and thus steeper discounts). Employers who offer lump sums now assume the risk that if interest rates increase, they could have reduced the pension liability at a lesser cost.

There is also significant legal risk. Complex regulations govern the calculation of the lump sum amounts, participant and spousal consents. And, for participants in pay status, there is an ongoing question of whether it is even permissible to change to a lump sum cash-out. This question has recently been answered in the affirmative in several non-precedential private letter rulings by the Internal Revenue Service. But private employers are well advised to proceed with caution. Policymakers and the general public decry these cash outs as depriving unsophisticated workers and retirees of the safety net of a monthly pension payment. Human nature being what it is, a person who is happy to consent to a lump sum today may be sorry (or his or her spouse may be sorry) not to have a stream of income tomorrow.

Litigation has already begun. When Verizon transferred substantial liabilities for retiree pensions to Prudential Insurance Company, class action lawsuits were brought against Verizon both by participants whose liabilities were transferred (“transferees”) and by participants whose liabilities were not transferred (“non-transferees”). The transferees argued that the annuity contract should have been maintained inside the plan, so that participants’ pensions could continue to be covered by the PBGC guarantee, and in any event, the process used to choose Prudential, they argued, was flawed and a breach of fiduciary duty. In dismissing this claim with prejudice (meaning the plaintiffs may not sue again on the same claims) the court pointed out that in making the decision to transfer liabilities to an annuity contract outside the plan (which is permitted under applicable law) Verizon was not making a fiduciary decision, but rather was making a business decision. The non-transferees argued Verizon breached its fiduciary duties and depleted the (remaining) plan assets by paying an excessive and

reasonable amount to complete the annuity transaction. In April 2014, this class action was also dismissed, but without prejudice. *Lee et al. v Verizon Communications, Inc.* Civ. Action No. 3:12-CV-4834-D (N.D. Tex. 2014).

Summary and Conclusion

A number of very large pension de-risking transactions have occurred in the US, motivated primarily by a desire to improve the sponsoring employer's balance sheet by reducing the overall outstanding amount of pension liability. A series on non-precedential letter rulings issued by the Internal Revenue Service in 2012-2014 removed a technical obstacle to offering to commute pensions in pay status to lump sums. Legal challenges to transferring pension liabilities to insurance companies can be expected to continue. Nevertheless, many more employers, including those with only modest sized pensions, are undertaking or considering undertaking de-risking strategies.

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