De-risking Alternatives for Plan Sponsors – Compliance Requirements

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Overview

- Trends in Pension Plan De-risking
- In-Plan Investment Strategies
- Lump Sum Windows and Annuitization
- Benefit Accrual and Plan Freeze
- Plan Spin-Offs and Terminations
- Additional Considerations
Trends in Pension Plan De-risking
De-risking Trends

• History:
  • The concept of de-risking is only a few years old
  • In 2012, Ford Motor Company offered a lump sum window to retirees and former employees
  • Later that same year, General Motors and Verizon conducted annuity buy-outs
  • These actions removed billions of dollars in pension obligations from the companies’ books
  • Countless companies have since engaged in de-risking activities
De-risking Trends

• De-risking trend is expected to continue

• However, the climate may become less favorable to de-risking in future years
  • New mortality tables
  • Increased regulation and disclosure of de-risking activities
  • Market slowdown
De-risking Trends

- New Mortality Tables
  - Society of Actuaries put out new mortality tables for defined benefit pension plans in 2014
  - These tables are expected to cause a significant increase in employers’ funding obligations
  - Increased plan asset levels and ever-increasing PBGC premiums are other factors that will continue to make de-risking attractive
De-risking Trends

• De-risking regulatory initiatives
  • PBGC now requires plan sponsors to report de-risking information
  • Government Accountability Office (“GAO”) recommends that plan sponsors report to the DOL regarding de-risking transactions, and provide detailed participant disclosures
  • GAO also recommends rules concerning interest rates used for lump sum valuations, and timelines for adopting updated mortality tables
De-risking Trends

• De-risking regulatory initiatives
  • Advisory Council on Employee Welfare and Pension Benefit Plans recommendations
    • Enhanced fiduciary standards
    • Enhanced participant disclosures
      • Include information regarding potential tax penalties, whether an early retirement or other subsidy is included in the calculation of the lump sum distribution, and a comparison of a lump sum distribution to the benefit otherwise payable
  • Disclosures are likely to become more onerous
  • Possible restrictions surrounding interest rates and mortality tables
In-Plan Investment Strategies
In-Plan Investments

• Pension Buy-Ins
  • Plan sponsor pays premium to an insurer
  • Insurer pays income stream to the plan
  • Income stream matches the pension benefits being paid out
  • Pensioners continue to be plan participants
  • Does not remove liabilities from the plan
  • Insures a portion of the plan’s liabilities
  • Removes risk of market volatility for the applicable portion of the assets
In-Plan Investments

• Pension Buy-Ins
  • Advantages
    • No settlement charge
    • No additional funding required
  • Disadvantages
    • PBGC premiums and administrative costs do not decrease
In-Plan Investments

• Fiduciary Responsibilities
  • Loyalty
  • Prudence
  • Exclusive Benefit of Plan Participants
  • Administer the Plan in Accordance With Its Terms
  • Others
In-Plan Investments

• Liability-Driven Investing (“LDI”)
  • Investing the plan’s assets to close its funding gap
  • Focuses on matching the plan’s assets to its liabilities
  • Various methods available
  • Review and revise Investment Policy Statement
  • Conduct due diligence to select an investment manager
In-Plan Investments

• Liability-Driven Investing ("LDI")
  • Important considerations
    • Will the plan terminate?
    • Will the plan become frozen to participants or accruals?
    • What is the plan’s funding goals?
    • How much volatility is acceptable?
In-Plan Investments

• Liability-Driven Investing (“LDI”)
  • Consider current funded status of the plan
  • Well-funded plans may focus on minimizing funded status volatility and preserving current funding level
  • Defined benefit plans have unique characteristics as compared to other investors
  • LDI takes interest rate into account
  • Devise LDI strategy using plan’s predicted cash flow needs
In-Plan Investments

• Liability-Driven Investing (“LDI”)
  • The goal is to pay for all of the plan’s current and future liabilities
  • Matches the plan’s liabilities with assets of same duration (“immunization”)
  • Example: An LDI strategy might focus on matching the duration of the plan’s liabilities and the bonds in the portfolio. If long-duration bond prices decrease due to interest rate increases, the liabilities of the plan should also decrease
In-Plan Investments

• Hedging
  • Investing to offset negative events
  • Used to mitigate funding volatility
  • Goal is to reduce risk, not maximize gains
In-Plan Investments

• Liability-Driven Investing Disadvantages
  • “Locks in” funded status—and that’s not always a good thing
  • Loss of opportunity to benefit from a rising market
Lump Sum Windows and Annuitzation
Lump Sum Windows and Annuities

• Short of terminating a plan, sponsors can reduce liabilities and volatility by offering lump sum cash settlements or insurer provided annuities
Lump Sum Windows

• A plan may offer lump sums to participants who are eligible to receive distributions
• The decision to offer lump sums is settlor in nature and not subject to fiduciary requirements
• However, the implementation of this strategy is fiduciary in nature subject to ERISA fiduciary rules
Lump Sum Windows

• Important considerations:
  • Whether to make the availability of the lump sum temporary or permanent
  • What parameters to affix to the lump sum window
  • Who will be eligible for the window?
    • Terminated vested participants
    • Retirees in pay status
  • Updates to mortality tables
  • Plan funded status
  • Administrative costs and burdens
Lump Sum Windows

• Notice and Consent Requirements
  • For the lump sum election to be effective, the plan sponsor must provide notice of:
    • The financial effect and relative value of optional forms of benefits
    • Rollover rights
    • Right to defer benefit commencement
    • Must obtain consent to distribute
    • May need to obtain spousal consent
      • Don’t forget about QDROs
Lump Sum Windows

• Government Accountability Office Report on Private Pensions makes the following recommendations:
  • Improved oversight by requiring plan sponsors to alert DOL when they implement lump sum windows
  • Coordinate with Treasury to clarify guidance on information plan sponsors provide to participants
  • Treasury should reassess regulations governing relative value statements, as well as interest rates and mortality tables used in calculating lump sums
Lump Sum Windows

- Potential for litigation?
- *Adams v. Sun Company*
  - Plan sponsor amended plan to offer lump sum window of annuities to terminated vested participants
  - Participant materials indicated that the window was a “one time” opportunity
  - In connection with a sale of the plan sponsor, a second opportunity for a lump sum was provided
  - Between the first and the second window, interest rates fell, resulting in larger lump sums for the second group
  - The participants in the first group sued for breach of fiduciary duty under ERISA for failing to disclose that a second window would occur when the first window was communicated
Annuitization

• Instead of and/or in addition to providing lump sums, an employer may also purchase an annuity contract

• The annuity provider is then responsible for paying participants

• The decision to offer annuity contracts is settlor in nature and not subject to fiduciary requirements

• However, the selection of annuity providers is a fiduciary act that must be taken with the utmost care
Annuitization

• Full risk transfer—can take the form of a pension buyout where a plan sponsor transfers all risk to an insurance company in exchange for a lump sum payment. Typically seen in plan terminations

• Partial risk transfer—can also take target-specific liabilities
Annuitization

• The selection of an annuity provider is a fiduciary function
• Under Interpretive Bulletin 95-1, fiduciaries must consider the following factors when selecting the “safest available annuity”:
  • the quality and diversification of the insurer’s investment portfolio;
  • the size of the insurer relative to the proposed annuity contract;
  • the level of the insurer’s capital and surplus;
  • the lines of business of the insurer and other indications of an insurer’s exposure to liability;
  • the structure of the annuity contract and guarantees supporting the annuities, such as the use of insurance company separate accounts; and
  • the availability of additional protection through state guaranty associations and the extent of the guarantees
Annuitization

• Plan sponsor may use an independent fiduciary to avoid conflicts of interest when the same individuals act in corporate and fiduciary capacities

• An independent fiduciary can
  • Advise the fiduciaries charged with selecting the annuity
  • Be the final decision-maker on the annuity provider
Annuity Selection

• Plan sponsor must make sure that all documentation during annuity selection process clearly reflects the differences between fiduciary and non-fiduciary activities

• Plan sponsors must ensure that any actions taken are permitted/reflected in plan documents and procedures

• Critical to have clear delegation of authority for all actions taken

• Follow plan documents, charters, and policies
Annuitization

• **Pros**: The plan sponsor is no longer required to pay PBGC premiums and funding risks and liabilities related to participants are eliminated

• **Cons**: Risk of potential liability for fiduciaries who select annuity provider
Annuitization

• Potential for Litigation?
  • *Lee v. Verizon* actions
    • Through the purchase of a group annuity contract Verizon transferred significant pension liabilities to the Prudential Insurance Company of America
    • In first action, participants sought declaratory and injunctive relief to prevent purchase of the group annuity contract arguing that:
      • Plan sponsor failed to disclose in SPD that it retained the right to transfer pension obligations to an insurance provider
      • Plan sponsor breached fiduciary duties
      • Plan sponsor discriminated against affected retirees
Annuitization

• In the second action, a new set of claims by participants whose benefits were not annuitized alleged that plan sponsor breached fiduciary duties and depleted the plan’s assets by paying an excessive and unreasonable amount of expenses to complete the annuity transaction

• The district court allowed the participants to amend their pleadings

• District court has ruled against the plaintiffs

• Currently pending before the Fifth Circuit
Benefit Accrual and Plan Freeze
Change Benefit Accrual Rules

• An employer can amend a plan to reduce future benefit accruals
  • Change benefit formula
  • Move to a cash balance plan arrangement
  • Freeze the plan
• Make sure the amendment does not cut back benefits
• Follow plan procedures
• Notify participants of the change
Plan Freeze

• *Plan Freeze.* A plan may be amended to freeze as to participation ("soft freeze") and/or benefit accruals ("hard freeze")
• The decision to freeze a plan is settlor in nature and not subject to fiduciary requirements. However, the implementation of this strategy is fiduciary in nature subject to ERISA fiduciary rules
Plan Freeze

• Implementation:
  • Advance notice of reduction of future benefit accruals must be provided to participants, beneficiaries, alternate payees, and union representatives
  • Notice must be provided at least 45 days before plan amendment is effective (15 days for plans with fewer than 100 participants)
  • Plan document must be amended—make sure proper procedures are followed!
  • May create issues under IRC nondiscrimination rules
    • IRS has provided limited relief in this area
Plan Freeze

• **Pros**: Reduces long-term costs and volatility by ceasing benefit accruals

• **Cons**: The plan sponsor continues to pay PBGC premiums, continues to assume the risk for all participants, and maintains the administrative burdens associated with maintaining a plan
Plan Spin-Off and Termination
Plan Spin-Off and Termination

- Whereas annuitization of retirees is a “lift-out” (see Verizon), another approach is to break the defined benefit plan into two plans (see GM and Motorola Solutions).

- A plan sponsor may spin-off a portion of the plan, thus creating two plans. Then one plan continues on (and perhaps further de-risks) while the other plan is terminated.

- May reduce litigation risk, as more law exists as to how plan assets are allocated between the two plans.
  - If a plan is not fully funded (most plans), assets are allocated among priority categories.
Plan Spin-Off and Termination

• The decision to spin off and terminate a portion of the plan is settlor in nature and not subject to fiduciary requirements. However, the implementation of this strategy is fiduciary in nature subject to the aforementioned rules.

• From an HR perspective, retirees will improve position with benefits now backed by a highly rated and regulated insurer, while remaining participants will benefit from smaller / de-risked plan.
Plan Spin-Off and Termination

- With respect to the terminated plan, the plan sponsor is no longer required to pay PBGC premiums and the funding risks and liabilities related to those participants are eliminated.

- Funding considerations:
  - Terminated plan needs to be fully funded (at least) to terminate and annuitize.
  - Remaining plan may need additional contributions to further de-risk.
Plan Spin-Off and Termination

• Two Plans – practical and fiduciary implications
  • Plan documents
  • Investment Policy Statements
  • Investment Management Agreements
  • Unwinding investments for spin
  • Other
Plan Termination

• A plan sponsor can settle pension liabilities by voluntarily terminating the plan. The decision to terminate the plan is settlor in nature and not subject to fiduciary requirements.

• However, the implementation of this strategy is fiduciary in nature subject to the aforementioned rules.

• The plan sponsor must fund the plan to the extent necessary to fund liabilities. Payments made to participants via the purchase of annuity contracts.
  • Same issues as discussed earlier (safest annuity available; independent fiduciary).
Plan Termination

• Generally, the plan termination process takes many months and involves a large number of steps, including the following:
  • Take appropriate corporate action to terminate the plan
  • Determine investment strategy during termination process
  • Amend the plan to provide for the termination
  • If plan has not been frozen, provide participants with notice of the freeze
  • Provide participants with notice of intent to terminate
  • Prepare IRS determination letter and provide notice to interested parties
  • Provide notice of plan benefits to participants
  • Submit standard termination to the PBGC
Plan Termination

• And more!
  • Obtain PBGC approval (deemed) and favorable IRS determination letter
  • Distribute required participant disclosures
  • Obtain all necessary consents (including spousal consents)
  • Contribute all amounts necessary to fund the plan
  • Purchase annuities
  • File post-distribution certification with the PBGC
  • Expect a PBGC audit of plan documents, list of participants, data supporting
Additional Considerations
Non-Qualified SERPS

• Many companies maintain a nonqualified SERP that works in conjunction with the qualified defined benefit plan

• What effect does de-risking the qualified plan have on the SERP?
  • Amendments required?

• Section 409A Issues:
  • “Linking” time and form of payment between the qualified and nonqualified is prohibited by Section 409A
  • Distributions from a terminating SERP generally must be delayed 12 months and must be completed within 24 months after termination
  • Take advantage of grandfathering rules
    • Is the SERP subject to Section 409A entirely or in part (“grandfathered”)?
Non-Qualified SERPS

• Other Tax Issues
  • Deductible under Section 162(m)?
    • If accelerating distributions to active employee, may lose deduction
  • State source rules?
    • If accelerating distributions, SERP may no longer meet 10-year distribution rule and subject SERP to tax in multiple states

• Right to amend/terminate?
  • Unilateral contract theory
  • Read your SERP document!
Multiemployer Plans

• Although de-risking strategies apply to single-employer plans, employers that participate in multiemployer pension plans (i.e., union pension plans) may be able to reduce withdrawal liability risk through the use of legal restrictions on payment amounts with respect to such plans

• Depending on contractual obligations, employers may be able to slowly reduce base units without triggering a current withdrawal
  • Upon future withdrawal, liability (which looks to base units) may be decreased

• In event of withdrawal, employers may be able to negotiate lesser amount with trustees of multiemployer plan
Questions?
Thank You.

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