United States Government Accountability Office
GAO
Report to Congressional Requesters

March 2009

DEFINED BENEFIT PLANS

Proposed Plan Buyouts by Financial Firms Pose Potential Risks and Benefits

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GAO-09-207

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Highlights

Highlights of GAO-09-207, a report to congressional requesters

Why GAO Did This Study

Some U.S. financial and pension consulting firms have recently proposed alternatives to terminating a defined benefit (DB) pension plan and contracting with insurance companies to pay promised benefits. In their proposals, a plan sponsor would typically transfer the assets and liabilities of a hard-frozen DB plan—one in which all participant benefit accruals have ceased—along with additional money, to a financial entity, which would become the new sponsor. Such buyouts would have implications for participants, plan sponsors, and the Pension Benefit Guaranty Corporation (PBGC), the federal agency that insures private DB plans. This report addresses the following questions: (1) What is the basic model of proposed sales of frozen DB plans to third-party financial firms and how does it compare with a standard plan termination? (2) What are the potential risks and benefits of plan buyouts for participants, PBGC, plan sponsors, and other stakeholders? To address these questions, GAO reviewed proposed models for plan buyouts and analyzed regulatory and statutory issues associated with terminations and buyouts. GAO also interviewed labor and pension advocacy groups, pension regulatory agencies, and pension experts.

What GAO Recommends

GAO is not making any recommendations.

To view the full product, including the scope and methodology, click on GAO-09-207. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov or Jospeh Applebaum at (202) 512-6336 or applebaumj@gao.gov.

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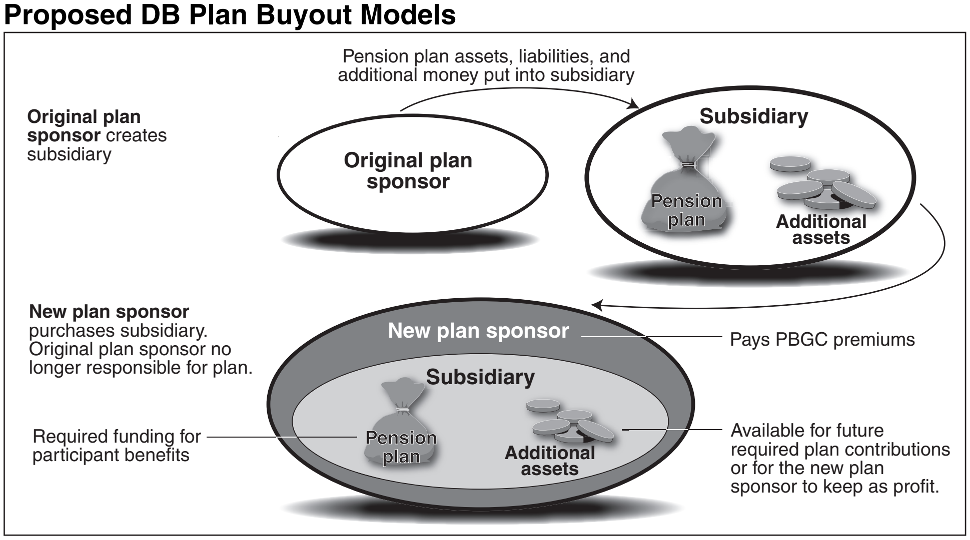
Proposed Plan Buyouts by Financial Firms Pose Potential Risks and Benefits

What GAO Found

In proposed DB plan buyouts, a third-party financial company would take over sponsorship of a hard-frozen plan from the original sponsor, in exchange for money to compensate for plan underfunding, expenses, and risk. As with a standard plan termination, the objective of a buyout would be to allow the original sponsor to shed its obligations to the plan, but potentially at lower cost and possibly with greater flexibility. In buyout proposals, the new sponsor would assume all plan responsibilities and PBGC guarantees would continue to apply to plan benefits. In comparison, a standard termination ends the plan, and an insurance company contracts to pay accrued benefits to participants (to the extent participants' benefits are not paid out by the plan as part of the termination); PBGC guarantees no longer apply, but state guarantees do. Insurance companies generally must comply with state-based risk-based capital requirements, which may provide safeguards against insurer insolvency and protections for pension benefits paid this way.

In some cases, plan buyouts could increase the security of DB pensions by allowing weak sponsors to transfer plan sponsorship to firms with stronger financial backing and improved plan management. However, buyouts would sever the employment relationship between sponsors and participants, possibly eroding incentives to manage the plan in the interests of participants. Buyouts could increase the risk of a large claim against PBGC by increasing the concentration of assets and liabilities held by a single sponsor or sector. They could also lead to conflicts between agencies regulating financial companies and those regulating pensions. In August 2008, the Internal Revenue Service issued a ruling declaring that a DB plan that was bought out by a nonemploying entity would not qualify for tax preferences under current law.

Proposed DB Plan Buyout Models



Sources: GAO analysis of proposed DB plan buyouts, Art Explosion (images).

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Abbreviations

DB	defined benefit
ERISA	Employee Retirement Income Security Act of 1974
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
IRC	Internal Revenue Code
IRS	Internal Revenue Service
NAIC	National Association of Insurance Commissioners
NOLHGA	National Organization of Life and Health Insurance Guaranty Associations
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
PBGC	Pension Benefit Guaranty Corporation
PPA	Pension Protection Act of 2006
PPF	Pension Protection Fund
UK	United Kingdom

United States Government Accountability Office
Washington, DC 20548

March 16, 2009

The Honorable Charles B. Rangel
Chairman
The Honorable Dave Camp
Ranking Member
Committee on Ways and Means
House of Representatives

The Honorable Sam Johnson
Ranking Member
Subcommittee on Social Security
Committee on Ways and Means
House of Representatives

The Honorable Earl Pomeroy
House of Representatives

In recent years, a number of prominent U.S. employers have terminated their defined benefit (DB) plans.[1] Other pension plan sponsors have frozen their plans, either by closing them to new participants or by slowing down or ceasing the accrual of additional benefits to existing participants. Provisions of the Pension Protection Act of 2006 (PPA),[2] which established more stringent plan funding requirements, and recent Financial Accounting Standards Board (FASB) standards,[3] which require additional financial reporting for DB plan sponsors, place more requirements on DB plan sponsors and could possibly lead to more freezes and terminations in upcoming years.

A sponsor generally may terminate a DB plan and shed all plan responsibilities either by hiring an insurance company to pay all accrued

[1]In a defined benefit plan, pension benefits are typically set by formula, with workers receiving benefits upon retirement based on the number of years worked for a firm and earnings in years prior to retirement. DB plans must make available a joint and survivor life annuity to retiring participants—a series of periodic payments that begin at retirement and continue through the life of the participant and, at the death of the participant, to the surviving spouse.

[2]Pub. L. No. 109-280, 120 Stat. 780.

[3]Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 158," Financial Accounting Series No. 284-B, September 2006.

benefits to participants through a group annuity contract or, if the plan permits, by paying the benefits owed in a different form (such as a lump-sum distribution).[4] In recent years, some U.S. financial institutions and at least one pension consulting firm have proposed an alternative to this "standard" termination model in which a plan sponsor would engage a financial entity to take ownership of the assets and liabilities of a hard-frozen DB plan, or one in which all participant benefit accruals have ceased, with the financial entity becoming the new sponsor. Such transactions carry potential risks and benefits for participants, plan sponsors, and the Pension Benefit Guaranty Corporation (PBGC), the federal agency that insures private pension benefits. Government officials, pension advocates, and some academics have expressed concerns that these new arrangements would place the responsibility for managing DB plans on firms that have no employment relationship with the participants, and potentially increase the risk of losses to participants and PBGC; proponents argue that such arrangements will improve the security of benefits and provide better overall plan management. In August 2008, the Internal Revenue Service (IRS) ruled that such DB plan buyouts by a nonemploying entity would not qualify for tax preferences under current law, effectively prohibiting this new type of arrangement.[5] At the same time, the Department of the Treasury (Treasury) issued guidelines, developed with the Departments of Labor (Labor) and Commerce (Commerce) and PBGC, that could be used to shape legislation that would allow tax preferences for such nonemployer plans, should Congress choose to do so.[6]

[4] 29 U.S.C. § 1341(b)(3)(A).

[5] Rev. Rul. 2008-45, 2008-34 I.R.B. 403, available at www.treas.gov/press/releases/reports/hp1110revrul200845.pdf. The IRS is not aware of any buyouts covered by the revenue ruling that have occurred in the United States. However, some plan buyouts through noninsurance entities have occurred in the United Kingdom. See appendix I for a discussion of British pension buyouts.

[6] Treasury Press Release HP-1110 (Aug. 6, 2008). According to Labor, neither the IRS ruling nor the pension regulatory agencies have addressed the application to buyouts of title I of the Employee Retirement Income Security Act of 1974, which establishes vesting, funding and other pension plan requirements, or title IV, which establishes pension plan termination insurance. If a post buyout arrangement sponsored by a nonemployer entity fails to constitute an "employee benefit plan" under title I, for example, entities engaged in such transactions may be subject to state regulation, possibly creating an additional disincentive for engaging in such a transaction.

In light of these issues, you requested that we examine these proposed transactions in greater detail. Specifically, this report addresses the following questions:

1. What is the basic model of proposed sales of frozen DB plans to third-party financial firms and how does it compare with a standard plan termination?

2. What are the potential risks and benefits of plan buyouts for participants, PBGC, plan sponsors, and other stakeholders?

To learn about proposed plan buyouts by third-party sponsors in the United States, we interviewed individuals from several financial institutions and from a pension consulting firm that have publicly expressed an interest in engaging in such transactions. We also reviewed and assessed literature from these companies describing their proposed business models for plan buyouts. We spoke with pension practitioners and government representatives in the United Kingdom (UK) to identify and analyze plan buyouts that have taken place there, as well as to discuss the British pension regulatory structure and pension plan governance.[7] To compare proposed buyouts with plan terminations, we spoke with officials from IRS and pension and bank regulatory agencies, from insurance companies and organizations, and from companies proposing buyout models.

To analyze key regulatory and statutory issues associated with DB plan buyouts and identify the potential impact of buyouts on participants, PBGC, plan sponsors, and other stakeholders, we interviewed representatives from labor and pension advocacy groups, pension experts, pension regulatory agencies, and the Federal Reserve Board (FRB) and the Office of the Comptroller of the Currency (OCC). We also discussed the nature of current government oversight of insurance companies that issue group annuities for terminated plans with insurance industry experts and regulators, and we reviewed rules describing the regulatory safeguards and benefit guarantees for group annuities issued by insurers. Finally, we reviewed laws governing the sponsorship of pension plans and relevant government statements regarding plan buyouts. We did not assess Treasury's suggested guidelines for buyouts issued concurrently with the August 2008 IRS revenue ruling.

[7]For more detail on DB buyouts in the United Kingdom, see appendix I.

Results in Brief

In proposed DB plan buyouts, a plan sponsor would transfer plan assets to another entity, typically a financial company, that would become the new plan sponsor. Plan buyouts would typically target plans that are hard-frozen—in which participants no longer accrue benefits—and therefore present relatively limited sources of risk in meeting funding targets. However, soft-frozen or active plans, in which some or all participants continue to accrue benefits, could also be potential buyout targets, although these plans would create problematic incentives in that the new sponsor would be funding ongoing benefits for employees of another company. In buyout proposals, the new sponsor would receive cash to cover any plan underfunding plus additional money to compensate for risk and administrative costs, which could be kept outside the plan. A plan buyout, like a plan termination, would be intended to allow the original sponsor to shed all obligations to the plan, but at potentially lower cost and possibly with greater flexibility. However, buyouts would differ in key ways from terminations, including the treatment of the plan, applicable regulatory requirements, protection of plan benefits, and fiduciary responsibilities. Under buyout models, the plan would remain ongoing and, presumably, all existing pension regulatory requirements would continue to apply to the plan and sponsor. By comparison, in a standard termination, paying plan benefits becomes an obligation of the insurance company, which is under state insurance regulation. States generally require insurance companies to meet specific risk-based capital levels to help ensure their solvency. PBGC guarantees would continue to apply to accrued benefits in bought-out plans, whereas state insurance guarantees generally would apply to annuity payments to participants of standard terminated plans

Plan buyouts by financial companies could, in some cases, improve benefit security for participants and PBGC, but also pose some key risks that might be difficult to anticipate and mitigate. Plan buyouts could increase the security of DB pensions for participants if they allowed weak sponsors of underfunded plans that would not choose to do a standard plan termination to transfer sponsorship to a company with stronger financial backing and financial management expertise. PBGC would also benefit from continuing to receive premiums for bought-out plans, unlike terminated plans. However, even with continued pension regulation and oversight in place, plan buyouts could create risks for participants, PBGC, and other pension stakeholders. For example, the new sponsor assuming responsibility for paying plan benefits would not have an employment relationship with participants, raising concerns about its incentives to manage the plan in the interests of participants. Buyouts could also increase the concentration of liabilities held by a single sponsor if that sponsor took over a number of large plans, potentially increasing PBGC's exposure to risk should the new sponsor encounter financial problems. PBGC may, under its current authority, have a limited ability to prevent buyouts that may increase risk of losses from terminations. Plan buyouts may also create potential regulatory conflicts between the goals of agencies regulating financial sponsors and those regulating pensions.

Background

By many measures, PBGC-insured private sector DB plans have been in decline since the 1980s. As of 2007, companies sponsored around 30,000 DB plans, down from over 114,000 in 1985.[8] The total number of participants in these plans rose from 38 million to 44 million over this time period, but according to the most recent data available, the percentage of the active workforce covered by a DB plan fell from 31 percent in 1985 to 17 percent, as of 2005. Also, the percentage of DB participants who are retirees has grown steadily, to where they made up over one-quarter of all DB participants in 2005. PBGC has seen its net financial condition hurt by losses from the termination of large underfunded plans this decade. After reporting a surplus as recently as 2001, PBGC's insurance programs reported a combined net accumulated deficit as high as $23.5 billion in 2004 before improving to over $11 billion as of the end of fiscal year 2008.[9]

Under the U.S. voluntary, tax-preferenced pension system, employers can choose to form, terminate, or freeze plans. Both plan terminations and freezes can reduce potential retirement income from DB plans for future retirees. A termination occurs when a sponsor ceases to operate a plan and agrees to disburse all accrued benefits to participants, whereas a freeze limits or halts some or all future pension accruals for some or all participants. Under the Employee Retirement Income Security Act of 1974 (ERISA), the primary federal law governing DB plans, plan sponsors may terminate a fully funded plan (called a standard termination) by purchasing a group annuity contract from an insurance company, under

[8]Some DB plans are not covered by PBGC insurance: for example, plans sponsored by professional service employers, such as physicians and lawyers, with 25 or fewer employees.

[9]This figure reflects the value of program assets less the current value of future benefit obligations for terminated plans and net claims for those deemed likely to default for both the single- and multiemployer insurance programs. PBGC noted in its fiscal year 2008 Annual Management Report that "since the close of the fiscal year, there continue to be significant events in the economy and financial markets that may impact the financial statement measurements going forward."

which the insurance company agrees to pay all accrued benefits, or, if the plan permits, by paying participants the benefits owed in a different form, such a lump-sum distribution.[10] If the plan does not have sufficient assets to pay all vested benefits owed to participants, and a company is in financial distress, the sponsor may file for a "distress" termination with PBGC. Under these circumstances, PBGC pays benefits to participants up to specified limits,[11] using its own assets and any remaining assets in the plan.[12] PBGC may also initiate termination of a plan if a plan cannot pay benefits when due or if the loss to PBGC is expected to grow unreasonably without termination.[13] From 1990 to 2006, sponsors voluntarily terminated over 61,000 sufficiently funded single-employer plans.

A plan freeze limits some or all future pension accruals for some or all participants, but does not terminate the plan. Freezes can take various forms: a soft freeze, which closes the plan to new entrants and may limit benefit accruals based on a component of the benefit accrual formula; a partial freeze, which changes the plan's benefit formula to reduce future accruals for a subset of active participants; and a hard freeze, which ceases all future accruals, with no additional benefits granted for future years of service or salary gains for any workers. A recent GAO survey found that 21 percent of all active participants in single-employer DB plans are affected by a freeze, with hard freezes accounting for about half of all freezes (although larger sponsors are significantly less likely to have a hard-frozen plan than smaller ones).[14] A separate PBGC study found that

[10]29 U.S.C. § 1341(b)(3)(A).

[11]PBGC's single-employer insurance program guarantees participant benefits up to $4,500 per month for age-65 retirees of plans terminating in 2009, with lower guarantees for those who retire before age 65. With a joint annuity with 50 percent survivor benefits for a spouse of the same age, the age-65 monthly guarantee limits are $4,050 for plans terminating in 2009. Younger workers whose plans terminate receive lower guarantee levels: The guarantee for a 55-year-old retiree in 2009 is $2,025 per month, and $1,125 per month for a 45-year-old.

[12]In a distress termination, PBGC also tries to collect plan underfunding from employers and shares a portion of its recoveries with participants and beneficiaries.

[13]29 U.S.C. § 1342(a).

[14]See GAO, *Defined Benefit Pensions: Plan Freezes Affect Millions of Participants and May Pose Retirement Income Challenges*, GAO-08-817 (Washington, D.C.: July 2008). For earlier GAO work on frozen plans, see GAO, *Private Pensions: Timely and Accurate Information Is Needed to Identify and Track Frozen Defined Benefit Plans*, GAO-04-200R (Washington, D.C.: Dec. 17, 2003).

14 percent of plans were hard-frozen as of 2005, with a nearly 50 percent increase in frozen plans since 2003.[15]

Some pension experts expect plan freezes and terminations to persist or increase in the near future, partly because of recent changes in pension requirements. The PPA tightened certain funding rules for DB plans,[16] which may discourage some sponsors from continuing to operate a plan or offer ongoing benefits accruals.[17] The PPA reduced the period allowed for filling in funding shortfalls from up to 30 years to 7 years. Previous funding requirements had allowed sponsors to smooth DB plan asset values over 5 years, and use a 4-year average of interest rates to measure plan liabilities, rather than reporting assets and liabilities based on current market measures; this helped dampen plan funding volatility from year-to-year swings in market conditions. The PPA reduced the smoothing period for reported assets to 2 years, and reduced the period for averaging interest rates used to measure liabilities to 2 years, changes that could increase the volatility of reported plan funding. In addition, new accounting standards will require DB sponsors to report their pension liabilities and assets on their balance sheets in more transparent ways than in the past. In a recent GAO survey, the primary reasons cited for freezing plans were the cost of plan contributions and the volatility of plan funding.[18] About a third of sponsors of frozen plans in the survey said they will ultimately terminate the plan, and over 60 percent were unsure of their future course. Outside experts are also not optimistic about DB plans in the near future: One study by McKinsey & Company predicts that 50 to 75 percent of all private sector DB assets will be in frozen or terminated status by 2012. Another, by Watson Wyatt, stated that plan freezes and terminations may have declined in 2007 after a peak in 2006; however, turmoil in the financial markets in 2008, with plummeting values in stocks, could severely

[15]Summary of study in "Hard-Frozen Defined Benefit Plans: Findings for 2003, 2004, and Preliminary Findings for 2005" in PBGC, *Pension Insurance Data Book 2006* (Washington, D.C.: 2007).

[16] PPA §§ 102 and 112, 120 Stat. 789-809 and 833-846.

[17]ERISA minimum plan funding rules say that a sponsor must annually fund the plan's "normal cost," the amount of earned benefits allocated during that year, plus a specified portion of other liabilities that may be amortized over a period of years. For more on plan funding, see GAO, *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, GAO-05-294 (Washington, D.C.: May 2005).

[18]For more on the GAO survey, see GAO-08-817 and GAO, *Survey of Sponsors of Large Defined Benefit Pension Plans*, an E-supplement to GAO-08-817.

negatively affect the funding of many DB plans, and could lead to increased plan freezes or terminations if required contributions rise significantly. The recently enacted Worker, Retiree, and Employer Recovery Act of 2008 provides DB sponsors with some temporary relief from some of these new requirements in response to the current financial crisis.[19]

On August 6, 2008, IRS issued a revenue ruling declaring that the transfer of a pension plan to "an unrelated taxpayer," without the concurrent transfer of significant business assets, operations, or employees, such as in a merger or business acquisition, would violate the "exclusive benefit" rule of the Internal Revenue Code (IRC).[20] This rule provides that any pension plan must be operated for the exclusive benefit of a sponsor's employees and their beneficiaries.[21] This means that under current law, generally any plans transferred to a nonemployer sponsor would not receive the same tax benefits an employer-sponsored plan would, including but not limited to the tax deferral on sponsor contributions and the return on plan assets. According to the Treasury Department, as a result of this ruling, companies will be unable to take over any pension plans, frozen or active, except as part of a business merger or acquisition.

Proposed Plan Buyouts Would Offer Sponsors an Alternative to Standard Plan Terminations, with Significant Differences

Under proposed models for DB plan buyouts, a plan sponsor would transfer plan assets, along with funds to cover any plan underfunding, plus additional money to compensate for risk and administrative costs, to a financial company. The financial company would become the new plan sponsor, taking over all obligations of the original sponsor. These types of buyouts would typically, but not necessarily, target hard-frozen plans, or portions of plans, in which participants are no longer accruing benefits, limiting some of the incentive problems of having a plan sponsor who is not the participants' employer. The new sponsor would be able to keep money above the minimum funding levels required by ERISA outside the plan and eventually keep whatever money in the transaction was not needed to pay for plan funding and expenses. A plan buyout, like a standard plan termination via an insurance company, is intended to allow

[19] Pub. L. No. 110-458, §§ 101(b), 121, 202 and 203, 122 Stat. 5092, 5093-97, 5113-14 and 5117-18.

[20] Rev. Rul. 2008-45. See app. II for further discussion of the IRS ruling and Treasury guidelines.

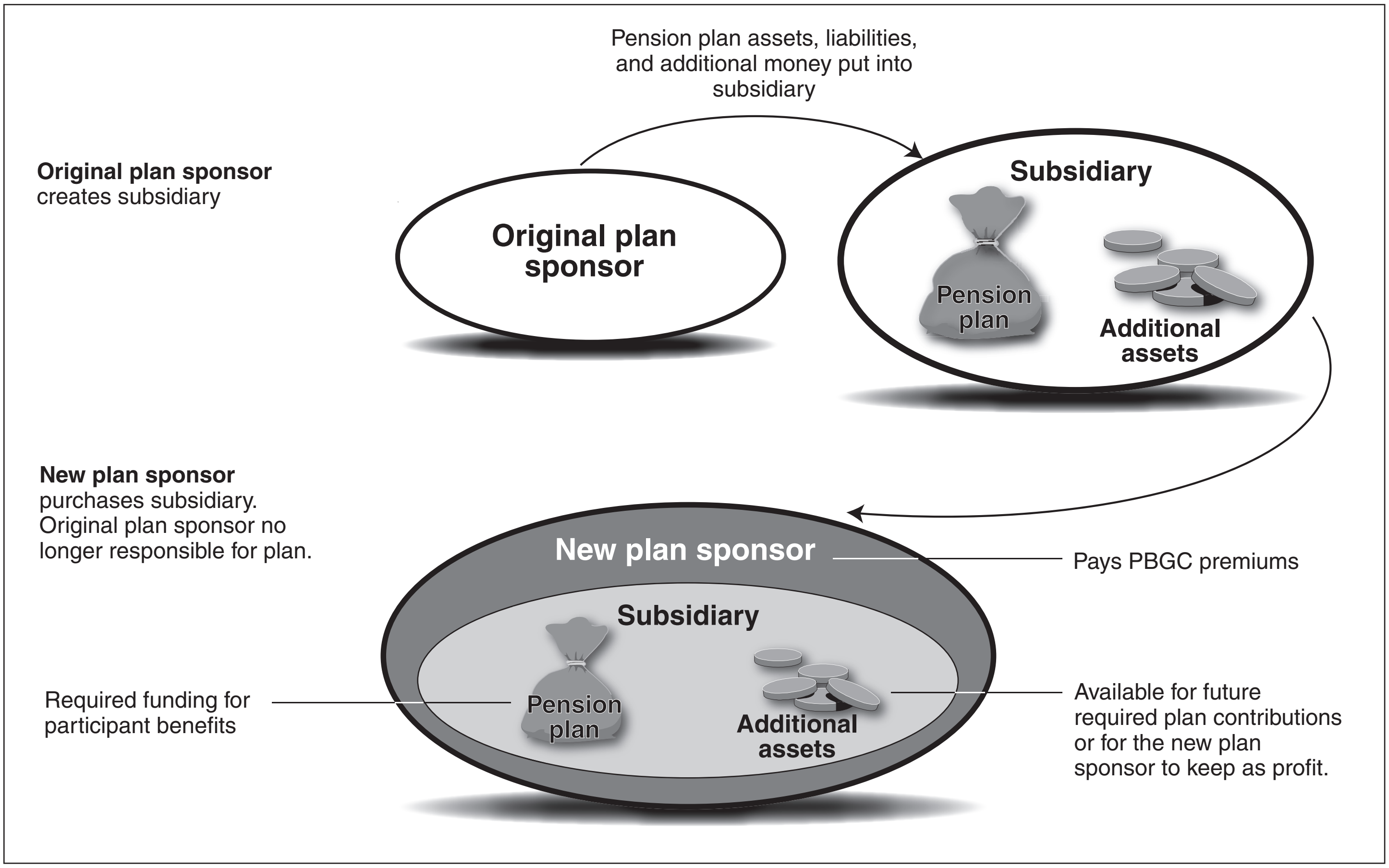
[21] 26 U.S.C. § 401(a)(2).

the sponsor to transfer all plan responsibilities to another company, but possibly at lower cost than a termination. In addition, the sponsor taking over the plan would face different regulatory requirements than an insurance company contracting to pay benefits from a terminated plan, including different oversight, financial requirements, and benefit guarantees.

Proposed Plan Buyouts Seek to Offer Alternative to Termination, with Possible Flexibility and Cost Advantages to Plan Sponsors

While there are different models for DB plan buyouts, the basic transaction would involve the transfer of the assets and liabilities of a pension plan from a plan sponsor to a financial entity. The original sponsor would set up a corporate subsidiary, into which it would put the pension plan (see fig. 1). The original sponsor would arrange for the pension assets to be held by or transferred to a trust designated by the subsidiary; in addition, it would transfer to the subsidiary enough cash or other assets to cover any plan underfunding. It would also provide additional money to cover the new sponsor's administrative costs and to compensate for the risk associated with plan sponsorship, which could be kept outside the plan. Risks include factors that could affect the future value of plan assets and liabilities, such as investment performance, interest rates, or mortality rates. The subsidiary could also include a relatively small number of employees from the original sponsor, such as those administering the plan. The financial company would then take over ownership of the subsidiary and become the new plan sponsor. The objective of the original sponsor, the employer, would be to shed all of its sponsorship responsibilities and liabilities.

Figure 1: Proposed DB Plan Buyout Models



Sources: GAO analysis of proposed DB plan buyouts, Art Explosion (images).

The distinction between assets in the plan versus those outside represents a key detail of any plan buyout. In general, if a sponsor withdraws excess assets from an overfunded DB plan, this action would trigger a 50 percent excise tax as a "reversion," in addition to corporate income tax.[22] Money outside the plan would be available for future contributions to the plan if additional funding is needed; however, should the new sponsor be successful at growing plan assets up to a level sufficient to pay accrued benefits and administrative expenses, the company may be able to keep

[22]26 U.S.C. § 4980(d). Under certain circumstances, the excise tax is 20 percent or inapplicable at all when excess assets are transferred to retiree health accounts. 26 U.S.C. § 420(a)(3)(A).

this money as profit without this money being subject to the reversion tax. Thus the new sponsor, similar to any sponsor, has an incentive to keep as much money as possible outside the plan itself while meeting ERISA minimum funding requirements.[23]

Representatives of firms that have expressed an interest in taking over plans said that their firms would most likely target slightly underfunded plans.[24] It would, most likely, be difficult for the sponsor to include enough cash to convince a financial entity to take over a plan that was below 80 percent funded in a buyout, considering the funding gap and the premium the new sponsor would charge to take over the plan. They also said that hard-frozen plans would be the simplest types of plans to buy out. In a hard-frozen plan, the absence of future benefit accruals for salary increases and time of service limits potential sources of funding uncertainty. However, even in a hard-frozen plan, changes in interest rates or mortality assumptions could increase or decrease the valuation of plan liabilities, and investment performance can affect plan asset levels, possibly triggering additional contributions to maintain plan funding at legally required levels. Buyouts would not necessarily be limited to hard-frozen plans; however, transferring sponsorship of an active or soft-frozen plan would be more complicated, since participants would continue to accrue benefits in these plans. This would create a problematic incentive for the new sponsor to freeze the plan and cease all accruals in order to avoid paying ongoing benefits to participants that work for another firm. If buyouts were allowed to include soft-frozen or active plans, explicit regulation or contractual language would likely be required to assure ongoing benefits and applicable ERISA protections to participants.

From the point of view of the plan sponsor, a buyout would serve a function similar to plan termination, since in both cases an objective of the sponsor is to shed responsibilities associated with the plan. Buyouts seem

[23]Plans below certain funding levels, designated under the statute as “at risk,” have to meet additional, stricter actuarial assumptions. 26 U.S.C. § 430(i) and 29 U.S.C. §1083(i). In addition, plans that do not meet certain funding levels could face additional restrictions, such as possible prohibitions on benefit increases or lump-sum distributions. 26 U.S.C. § 436 and 29 U.S.C. § 1056(g). The Worker, Retiree, and Employer Recovery Act of 2008, however, provided some plans with temporary relief from some of these provisions. Pub. L. No. 110-458, §§ 101(b) and 203, 122 Stat. 5092, 5093-97 and 5118.

[24]Overfunded plans could possibly also be targeted for buyouts, with the new sponsor paying the original sponsor for the overfunded assets, less any fees for administrative costs and risk. However, the original sponsor could possibly face a reversion tax on any money received in the transaction for plan assets in excess of its liabilities.

to offer two potential advantages to the sponsor: flexibility and cost. A plan buyout could offer flexibility if sponsors were allowed to shed only a portion of a plan, rather than terminating the entire plan. For example, a sponsor could segregate the benefits for retirees or former employees and sell this "legacy" portion of a plan to a new sponsor, with assets moving to the new sponsor to cover only the benefit liability for these participants; a buyout of this kind would resemble that of a hard-frozen plan in that benefits for retirees and separated employees have ceased accruing. If this arrangement were allowed, the employer could then keep its current workers, or active participants, in the original plan that it continues to sponsor.[25]

Buyouts may also cost the sponsor less than a termination of the same plan. This cost difference may reflect the differences in assumptions appropriate for an ongoing plan, which would be the case for a buyout, as opposed to a terminating plan whose benefits an insurance company would contract to pay. The financial entity taking over sponsorship of an ongoing plan would be taking on liabilities recorded at "current liability"—that is, using the assumptions for discount rates, smoothing, mortality, and other factors as prescribed by ERISA funding requirements for ongoing plans. ERISA funding rules allow sponsors to report measurements of plan assets based on an average over a designated period of time and of liabilities using an average of recent interest rates. Using such smoothed values dampens the year-to-year volatility in funding levels and required contributions compared with using current market values. In contrast, an insurance company prices a plan's liabilities based on assumptions appropriate for a terminating plan, or "termination liability." An insurance company may also consider in its price the risk of future improvements in mortality beyond those currently projected and the risk of taking on the obligation to pay benefits without the possibility of collecting future premiums. Other differences between insurance company prices and current liability could include (1) a more conservative rate-of-return assumption reflecting the investments used to support annuities, (2) an underlying interest rate used to value liabilities based on current market values rather than smoothed values, and (3) an assumption that participants in a terminated plan will retire somewhat earlier than those in an ongoing plan.[26] It is unclear to what degree the assumptions a firm

[25]Sponsors could achieve a similar effect by purchasing annuities for retired participants.

[26] Insurance companies that offer life insurance may also consider the partial hedge that this insurance provides against the longevity risk inherent in issuing annuities.

taking over an ongoing plan would reflect current liability or termination liability, but prospective financial sponsors said they expected to be able to compete with plan termination prices.

From the acquiring sponsor's point of view, a plan buyout could offer access to new investment capital, although with the restrictions facing all DB plans regarding ERISA funding requirements and the tax on the reversion of plan assets. Buyouts could also provide a strategy for funding multiple plans by merging the assets and liabilities of an underfunded plan with the excess assets of a similarly overfunded one. While any sponsor can merge plans, buyouts might facilitate such a strategy. On net, the change in risk of underfunded benefits might be balanced across the participants in underfunded and overfunded plans, but workers whose previous sponsor had funded a plan to ensure that benefits would be paid might not favor their plan's surplus funding other workers' benefits at their expense.

Plan Buyouts Would Differ in Key Ways from Plan Terminations

While proposed plan buyouts are intended to provide a similar function to plan sponsors as plan terminations, they differ in many important ways, including the treatment of the plan, applicable regulatory requirements, protection of plan benefits, and fiduciary responsibilities (see table 1). Fundamentally, a plan buyout differs from a termination because the buyout treats the plan as an ongoing concern, while a termination ends the plan. In a buyout, the new sponsor would presumably have to fund the plan according to ERISA minimum funding requirements and make all plan disclosures. The sponsor would pay PBGC premiums, and PBGC guarantees would continue to apply to plan benefits.[27] Oversight of the plan would remain within the jurisdiction of federal pension regulatory agencies: PBGC, Labor, and Treasury.

[27]In 2009, PBGC charged a flat rate premium of $34 per participant in a single-employer program plan, and $9 per participant in a multiemployer plan. These rates are indexed to the growth in the average national wage. In addition, sponsors of single-employer plans with unfunded vested benefits pay $9 per $1,000 of underfunding.

Table 1: Comparison of Key Characteristics of Plan Buyouts and Terminations

Characteristic	Proposed plan buyouts	Plan termination with insurance company
Treatment of plan	Treated as ongoing arrangement	Plan terminated or closed, and all accrued benefits are contracted to be disbursed
Measurement of plan's liabilities at time of transaction	Current liability, calculated using ERISA assumptions for ongoing plan[a]	Termination liability, using actuarial assumptions appropriate for annuities to close out plan
Asset requirements to fund pension promises	Based on ERISA funding rules; regulated financial institutions may have to hold capital against the plan liabilities, depending on risk factors	Based on National Association of Insurance Commissioners' risk-based capital rules
Relevant regulatory agencies	PBGC, Labor, Treasury[b]	State insurance departments
Guarantor of participant benefits	PBGC	State insurance guarantee funds
Guarantee limits	Up to $54,000 maximum annually[c]	Up to at least $100,000 cash value for annuities[d]
Fiduciary responsibility of sponsor in choosing purchasing entity/provider	Unclear[e]	Must pick "safest available annuity" provider

Sources: GAO analysis of proposed buyout models, ERISA, PBGC guarantees, and NAIC guidelines.

[a]A new sponsor would have to fund the plan based on ERISA current liability; it is unclear which assumptions the acquiring entity would use to price the liabilities in the buyout.

[b]Banking activities by regulated financial institutions may in addition be regulated by the Federal Deposit Insurance Corporation, Office of Thrift Supervision, OCC, FRB, and state agencies.

[c]For a 65-year-old retiree in a plan terminating in 2009, with lower guarantees for younger workers. Retirees may receive more than the maximum guarantee if they earned a higher benefit and the plan had sufficient assets to pay benefits beyond the guarantee.

[d]State guaranty associations can levy other insurance companies to collect additional money to pay policyholders.

[e]According to Labor, discretionary activities that relate to the formation rather than the management of plans generally are not fiduciary activities subject to Title I of ERISA, except in the context of multiemployer plans. These so-called "settlor" functions include decisions relating to the establishment, design, and termination of plans. See Labor, letter to John N. Erlenborn from Dennis M. Kass (March 13, 1986); letter to Kirk F. Maldonado from Elliot I. Daniel (March 2, 1987); and Advisory Opinion No. 97-03 (January 23, 2007). The extent to which buyouts involve settlor as opposed to fiduciary activities is unclear.

In contrast, a standard plan termination ends the plan itself. If the sponsor purchases an insurance company annuity contract, payment of plan benefits that are covered by the contract becomes the obligation of the insurance company, which is regulated by state insurance bodies. State regulation of insurance companies is grounded in statutory valuations of an insurer's assets and liabilities and risk-based capital requirements, as laid out by the National Association of Insurance Commissioners (NAIC), the organization of state insurance regulators. Risk-based capital refers to the amount of assets an insurer holds in order to ensure that it can pay its obligations, which in this case would mean the accrued benefits in the plan. Regulators set the amount of risk-based capital a firm must hold depending on different categories of risk, including asset risk, insurance risk, interest rate risk, and business risk, with firms deemed to hold riskier obligations or operations forced to hold more assets against those risks.[28] Because asset risk is one of the risk categories considered by regulators, insurance companies have an incentive to invest conservatively. NAIC guidelines suggest that an insurer hold total capital levels of at least 200 percent of the minimum risk-based capital requirements to avoid any corrective action. If the insurance company has total capital levels below this percentage, regulators could take a variety of corrective actions, ranging from requiring the company to report how it intends to raise its capital levels to a state takeover of the insurer.

In a buyout, depending on the institutional nature of the purchasing entity, the new sponsor may also face capital requirements. For example, regulators for banks and other regulated financial institutions, including OCC, FRB, the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS), look at capital and leverage ratios to assess whether banks are holding enough capital based on those identified risks to ensure the safety and soundness of the banks and bank deposits.[29]

Government guarantees backing up plan benefits would also differ under buyouts and terminations. With plan buyouts, PBGC would continue to guarantee benefits for participants of bought-out plans in the event the

[28]Asset risk refers to the risk of default or loss of value in assets the insurer owns, including affiliated businesses. Insurance risk refers to the possibility of higher-than-expected claims, such as, in this case, having to pay out benefits for longer periods of time because of above-average life expectancy. A company faces interest rate risk if it could incur losses in assets relative to liabilities if interest rates move in a particular direction. Business risk represents general uncertainty about the revenues or costs a particular insurance company or industry can expect.

[29]Some financial institutions, such as hedge funds or private equity firms, may be managed to be exempt from some requirements of federal securities law and regulations that apply to other investment vehicles. For more on "alternative" investment vehicles, see GAO, *Defined Benefit Pension Plans: Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity*, GAO-08-692 (Washington, D.C.: Aug. 14, 2008).

new sponsor could not pay because of financial distress.[30] In contrast, for benefits paid by insurance companies following plan terminations, state insurance commissions maintain guaranty funds, funded by insurance companies (on a post insolvency basis), which can be used to pay policyholders in the event of insurer insolvency. Guarantee limits vary by state, but all states provide coverage of up to at least $100,000 per beneficiary for annuities, according to the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA). This limit would not be as high as PBGC guarantees for distress-terminated plans for some beneficiaries, but NOLHGA claims that guarantees have allowed over 90 percent of policyholder benefits to be paid in full during past insolvencies, similar to PBGC's success to date in covering pension benefits in distress terminations. Partly, this is due to assessments the state guaranty associations can levy on other insurance companies to collect additional money to pay policyholders.[31]

In addition, sponsor fiduciary requirements could differ between buyouts and terminations. Pension plan sponsors have a fiduciary duty to manage plans solely in the interest of plan participants and beneficiaries.[32] While the decision whether or not to terminate a plan is generally viewed as outside the management of a plan and not covered by this duty, should a decision be made to terminate a plan, the selection of an annuity provider is a covered fiduciary duty. Labor has interpreted this duty as generally requiring DB plan sponsors to choose "the safest available annuity" and has published explicit factors for sponsors to consider when making such a selection.[33] According to insurance representatives with whom we spoke, this has typically meant that AA-rated companies or stronger have

[30]PBGC's single-employer insurance program covers benefits of up to about $4,500 per month for a 65-year-old participant whose plan terminates in 2009, with lower guarantees for younger retirees. A recent PBGC study found that its guarantees fully covered the benefits of 84 percent of participants in PBGC-trusteed plans for distress terminations from 1990 to 2005.

[31]GAO highlighted concerns in 1992 about the failure of insurance companies and the adequacy of protections for policyholders whose insurance companies fail. See GAO, *Insurer Failures: Life/Health Insurer Insolvencies and Limitations of State Guaranty Funds*, GAO/GGD-92-44, (Washington, D.C.: March 1992).

[32]29 U.S.C. § 1104.

[33]29 C.F.R. 2509.95-1(c) (2008). In contrast, the PPA required Labor to issue regulations to clarify that the safest available annuity standard and its related factors are not applicable to defined contribution plans. PPA § 625, 120 Stat. 980. The final regulation, which became effective December 8, 2008, was published on October 7, 2008. 73 Fed. Reg. 58,445.

dominated the DB plan termination market. Further, a purchase of an annuity by a sponsor of a terminating plan establishes an "irrevocable commitment," as required by ERISA, that all plan benefits will be paid.[34] While it is possible that similar fiduciary standards could apply in the case of DB plan buyouts by financial entities, the law, having not contemplated such transactions, does not specify explicit standards.[35]

Some Plan Buyouts Could Benefit Participants and PBGC, but in General Pose New Risks

DB plan buyouts by financial companies could, in some cases, improve the security of benefits. Those buyouts in which weak sponsors of underfunded plans, who otherwise would choose not to terminate, transferred their plans to companies with stronger financial backing and superior pension financial management could improve plan funding and decrease the risk of distress termination. PBGC would, in addition, benefit from the continued premiums new sponsors would pay for insurance on their plan benefits, as opposed to premiums ceasing when a plan is terminated. However, these advantages would seem to apply in only a small subset of potential buyouts, and would likely provide limited upside for participants and PBGC. Further, plan buyouts could create risks for various pension stakeholders. For example, the new sponsor assuming responsibility for paying plan benefits would not have an employment relationship with participants, raising concerns about its incentives to manage the plan for the exclusive benefit of participants. Buyouts may also raise risks to PBGC, depending on the structure of the transaction, in that a financial sponsor taking on several plans may become weak, and PBGC may have limited authority to intervene to prevent risky buyouts. Further, the recent financial crisis has highlighted the emergence of serious and previously unforeseen risks with financial companies, even among firms that had been considered strong. Buyouts by financial sponsors may also create regulatory ambiguities and conflicts between the goals of agencies regulating financial sponsors and those regulating pensions. (See table 2 for potential risks and benefits of plan buyouts.)

[34] 29 U.S.C. § 1341(b)(3)(A).

[35] See note e in table 1.

Table 2: Potential Positive Outcomes and Risks Associated with Plan Buyouts

Category	Potential positive outcomes	Potential risks
Benefit security	Risky plans move from financially weak to strong sponsors.	Financial strength of new sponsor deteriorates quickly.
Sponsor-participant relationship	New sponsor provides improved plan management and administrative services.	Possible mismatch of incentives of new sponsor; participants might not like plan administration moving to another unfamiliar firm; IRS ruling rejected bought-out plans as tax-preferred employer plans.
Pension plan management	Superior financial management compared with original sponsor; additional capital requirements for regulated financial institutions.	Mismatch of incentives to manage plan in interests of participants; possible merging of over- and underfunded plans.
PBGC	PBGC continues to receive premiums on plans that otherwise may have been terminated.	Could increase the concentration of plan liabilities held by a single sponsor or sector, raising PBGC's exposure; PBGC may have limited ability to prevent risky buyouts.
Effects on future termination	Large, well-capitalized controlled group protects PBGC against major claims.	Limited or no capital outside plan in controlled group provides little financial security for plan.
Regulatory issues	Financial regulation improves benefit security compared with that of some sponsors.	Ambiguities about some benefits; possible conflict between pension and financial agency goals.
Effect on DB sponsors	Reduced cost and greater flexibility in shedding liabilities; ability to shed "legacy" portion of a plan.	May encourage sponsors to freeze plans.

Source: GAO analysis of proposed DB plan buyouts.

Some Plan Buyouts by Financially Strong Sponsors Could Increase Benefit Security for Participants and PBGC

Advocates of allowing pension plan buyouts point to a potential "win-win-win": more options and lower cost for sponsors who wish to shed their pension plans, more security for participants than a weak sponsor can provide, and reduced risk of large claims from distress terminations for PBGC. Plan sponsors could benefit from buyouts if they provide a cheaper means for shedding a pension plan than terminating the plan through an insurance company. Buyouts could also allow sponsors to shed just a portion of the plan while maintaining sponsorship for a smaller plan. To the extent that the lower cost of plan buyouts reflects a competitive advantage over a plan termination without increasing pension risk, buyouts can be viewed as a beneficial financial innovation.

Buyouts could add security for plan participants if the new sponsor can manage plan assets and liabilities better than the original sponsor, if the original sponsor could not terminate the plan. The financial backing of the assets of a large, diversified, and well-capitalized parent company or of large amounts of investment capital could better ensure that assets will be available to pay promised benefits. It could also lower the likelihood that PBGC would face a future claim from distress termination, since a stronger sponsor would be in a better position to keep the plan funded and be less likely to face financial distress than a weaker one.

Pension Buyouts by Financial Entities May Pose New Risks and Regulatory Challenges

While buyouts could provide more security for plan benefits in some cases, they may also create new risks that could adversely affect benefit security. These include the severing of the plan from a direct employment arrangement between employer and employee, the ability of PBGC to monitor and intervene in buyouts that could have adverse implications for participants and PBGC, and potential conflicts and issues between the regulatory missions of PBGC and various financial regulators.

Buyouts would affect the relationship between sponsor and participant by separating it from an employment arrangement, possibly raising concerns about the management of participants' pension benefits and the long-term effect on the DB system. With an employer-sponsored plan, the financial fate of the plan depends to a large degree on the financial fate of the company, since a healthier company is better able to fund its DB plan and the plan will not endure a distress termination as long as the company thrives. Opponents to buyouts contend that even in the case of a frozen plan, an employer sponsor, as opposed to a third-party sponsor, has a greater incentive to manage the plan in the interests of its employees because it has an incentive to maintain a good working relationship with them. In addition, a frozen plan that remains within the firm has at least the chance of being "thawed," especially within a collective bargaining agreement.[36] Workers may also have a relationship with plan administrators within their own company, and may worry about addressing concerns when dealing with administrators of a new sponsor outside their company. Further, the option of plan buyouts for frozen plans as a less expensive alternative to plan termination may provide an incentive for existing sponsors to freeze their plans, an act that could reduce future retirement income for participants.

[36]A recent GAO survey found that less than half of sponsors with frozen plans have a firm idea of the anticipated outcome for their largest frozen plans. Among these sponsors, a very small number anticipated thawing their plan and about one-third said they would eventually terminate their largest frozen plans. In contrast, nearly half said they would keep the plan frozen indefinitely. Another 14 percent reported that it was too early to make a decision or that they were uncertain what the outcome will be. See GAO-08-817.

Buyout proponents argue that the employment relationship plays a diminished role in hard-frozen plans, which would be the primary target of buyouts. Because these plans offer no future accruals, they serve a very limited ongoing function of providing benefits to employees, and therefore likely do not play a strong role in attracting or retaining workers. As one advocate also pointed out, DB plans can change sponsorship as a result of company mergers or acquisitions, which could result in a situation where the new sponsor becomes responsible for managing the benefits of a participant it has never employed (such as a worker who has left the firm prior to the merger and change of sponsor). However, the IRS ruling suggests that the underlying employment relationship between plan sponsor and participant is fundamental to the rationale for the tax-favored status of qualified plans.

The buyout of plans by a nonemployer may also create some perverse incentives or ambiguities in applying rules that guide how the sponsor may interpret participant benefits or rights. One key issue concerns whether a participant who had not yet reached the minimum service time with his employer would continue to accrue service time after the plan changes sponsors. For example, a plan may require a minimum of 5 years of service to be able to qualify for benefits upon retirement. A worker may have 4 years working for an employer when the company sells its pension to a financial entity, which would become the new sponsor. If the participant continues to work for another year, he would have 5 years of service with the employer, but not with the sponsor, and therefore it is possible the sponsor would claim that the participant has not vested.[37] Similarly, should an active or soft-frozen plan be bought out by a nonemployer, there would be a potential question of whether a participant would continue to accrue service time after the transfer of sponsorship. Other benefits, such as shutdown benefits—significant early retirement benefits triggered by layoffs or plant closings—may be affected by decisions by the employer, who would no longer be responsible for paying the benefits, creating an incentive mismatch between employer and sponsor unless the plan was amended explicitly to address this.

[37]Where a plan sponsor sold part of its business but retained the pension plan, a federal appeals court has ruled that additional service with the new employer need not count toward years-of-service requirements for early retirement. *Dade v. North Am. Philips Corp.*, 68 F.3d 1558 (3d Cir N.J. 1995). According to Treasury, full vesting applies to plan benefits in a termination, but would not necessarily apply to a buyout.

Arranging a DB plan buyout in situations where participants and beneficiaries are covered by a collective bargaining agreement may involve overcoming additional challenges. Under federal law, “wages, hours, and other terms and conditions of employment” are mandatory subjects of collective bargaining.[38] Case law has established that employee pension benefits are generally subject to mandatory collective bargaining.[39] On the other hand, courts have recognized that terms and conditions of employment do not encompass every employer decision or management function that may have an indirect impact upon or be of interest to employees.[40] One expert with whom we spoke was unsure whether the sale of a pension plan from an employer to a third-party sponsor would be considered negotiable under a collective bargaining agreement. The outcome in individual cases may depend on the specific facts and circumstances involved, including the terms of any applicable union contracts.

Buyouts would have an ambiguous impact on PBGC’s financial position and risk. PBGC would benefit if a plan buyout moved a plan from a financially weak sponsor to a stronger one with a better ability to fund the plan sufficiently because PBGC would take a loss if it had to take responsibility for paying benefits of an underfunded plan that closed in a distress termination. In addition, PBGC would benefit from continued premium payments by the new sponsor, compared with the original sponsor terminating the plan. However, buyouts would be unlikely to involve the weakest and riskiest plans —proponents of buyouts with whom we spoke said that the plans financial companies would most likely target would be only slightly underfunded. Large, more severely underfunded plans held by weak sponsors, which present the biggest risk of a large claim on PBGC’s assets, would seem to be an unlikely target for buyout because of the amount of cash a prospective financial sponsor would require to agree to take over the plan. It therefore seems unlikely that the buyouts would help rescue the riskiest plans or reduce PBGC’s overall risk significantly, unless a buyout prevented the future erosion of plan funding in large plans.

[38] 29 U.S.C. § 158(d). Separate collective bargaining requirements apply to railway and airline workers. 45 U.S.C § 156.

[39] *E.g.*, *United Brick & Clay Workers v. International Union of Dist. 50, etc.*, 439 F.2d 311 (8th Cir. Mo. 1971).

[40] *E.g.*, *Westinghouse Electric Corp. v. NLRB* 387 F.2d 542 (4th Cir. 1967).

More important for PBGC, seemingly strong companies buying out plans may not remain financially strong. The current turmoil in the financial markets, which has led to the failure of financial institutions and direct federal financial assistance to others, provides clear evidence that the financial strength of a firm or industry can quickly deteriorate. Even if the financial sponsor appeared to be stronger than employers from whom it purchased DB plans, plan buyouts could move multiple plans from several firms in different industries to the control of one firm or industry. This could increase the magnitude of future losses to PBGC and participants should that sponsor or industry find itself in financial distress.

For PBGC, the potential risk associated with any particular DB plan buyout depends in part on the structure of the new sponsorship. A large financial company, such as a bank or an investment bank, might choose to set up a subsidiary explicitly to sponsor bought-out plans. If the parent financial company owns at least 80 percent of the subsidiary containing the plan, then the subsidiary would generally be within the financial company's "controlled group."[41] This would mean that the parent company could be liable for supporting the pension plan should the plan terminate with insufficient assets to pay accrued benefits. However, a firm conducting a buyout could transfer plan assets and liabilities to a separate subsidiary or investment vehicle outside the parent company's controlled group. In this case, the larger parent may not be legally liable to the pension plan if the plan became underfunded or the sponsor suffered financial distress, possibly increasing the risk of lost participant benefits or losses to PBGC in the event of a plan termination. Therefore, the structure of the sponsorship of any plan may affect the potential risk to PBGC.

According to PBGC officials, the agency's ability to prevent buyouts that increase risk to itself and the DB system relies on statutory provisions permitting PBGC to involuntarily terminate a plan and to seek recovery from plan fiduciaries who engage in transactions to evade plan liability. PBGC officials indicated, however, that those provisions could be of limited value when applied to buyouts. The first provision authorizes PBGC to institute proceedings to involuntarily terminate plans in certain specific circumstances involving a sponsor failure to comply with funding

[41] 29 U.S.C. § 1301(a)(14) and 26 C.F.R. § 1.414(c)-2 (2008).

laws or anticipation of such failure.[42] The second permits PBGC to recover from persons entering into transactions for the purpose of evading liability in connection with a plan termination.[43] This provision was intended to deter attempts by plan sponsors to shift pension obligations to weak companies.[44] Because it could result in original plan sponsors being liable for plan obligations as if a plan buyout had never occurred, it may discourage plan sponsors from selling plans to a new sponsor that is obviously not financially sound. However, PBGC officials stated it would still be very difficult and costly to prevent risky buyouts because PBGC faces a heavy burden of proving that one of the triggering criteria has been met, and could involve protracted litigation. Further, under the first provision a forced plan termination would still likely lead to losses, and under the second provision PBGC has only a 5-year window to prove that a transaction was conducted to evade liability. Other former PBGC officials with whom we spoke thought that PBGC probably had the ability under its current authorities to craft rules to prevent buyouts that would increase the risk of losses to the agency.

Regulated financial firms face capital requirements designed to try to ensure the safety of bank deposits and assets. While these requirements could provide additional security for plan benefits if they improve the likelihood of ongoing solvency for the sponsor, the oversight goals of banking regulatory agencies may conflict with those of the pension regulatory agencies. Bank regulatory agencies, such as OCC or FRB, seek

[42]Specifically, PBGC may institute such proceedings if (1) a plan has not met the minimum funding standard under the IRC or has been mailed a notice of tax deficiency under section 6212 under the IRC; (2) a plan will be unable to pay benefits when due; (3) a plan distribution of $10,000 or more is made to a plan owner, not by reason of death, and the plan immediately thereafter has nonforfeitable benefits that are not funded; or (4) the possible long-run loss to PBGC "may reasonably be expected to increase unreasonably" if a plan is not terminated. In addition, PBGC is required to terminate a single-employer plan that does not have the assets available to pay benefits currently due. 29 U.S.C. § 1342(a).

[43]Specifically, it provides that if the principal purpose of a person entering into a transaction is to evade such liability and the transaction becomes effective during the 5 years prior to plan termination, the person and members of such person's controlled group are subject to the same liability as a contributing plan sponsor. 29 U.S.C. § 1369. Person is defined to include partnerships, joint ventures, corporations and other entitles, as well as individuals. 29 U.S.C. § 1002(9). With respect to a single-employer plan, controlled group generally means a group of (natural or corporate) persons under common control. 29 U.S.C. § 1301(a)(14)(A). Common control is determined as set out in regulations under the IRC to include such corporate forms as parent-subsidiary, brother-sister, and combined groups of trades or businesses. 29 U.S.C. § 1301(a)(14)(B) and 26 C.F.R. § 1.414(c)-2 (2008).

[44]H.R. Rep. No. 99-300, at 304.

to ensure that the activities of a banking institution do not create undue risk for the safety of the depositors and the soundness of the banks. Therefore, if a banking institution wanted to take over the sponsorship of a pension plan, financial regulatory agencies may need to ensure that plan sponsorship does not unduly increase the risk to the bank, and especially to bank depositors. This might take the form of shielding bank assets from liability for pension plan underfunding. This would seemingly conflict directly with the interests of PBGC, which would want assets of the sponsor beyond the plan itself available to cover pension obligations before allowing a distress termination. This regulatory conflict would have implications for the security of plan benefits under a new sponsor following a plan buyout if some of the assets of a large financial sponsor were shielded from potential pension liability. Such a conflict may lead to the perverse result that regulated, well-capitalized banking entities might be barred from participating in DB plan buyouts while financial entities that may be exempt from some securities laws and regulations, such as hedge funds, would not. On the other hand, it is possible that OCC or FRB might conclude that the financial company has sufficient assets outside of its banking activities to provide financial support for plan funding, or that the structure of the buyout provides sufficient protections for banking assets, and allow the banking entity to take over a plan.[45]

Plan buyouts might place additional demands on pension regulators to enforce current rules. Financial entities taking over plans in buyouts may offer investment services or asset-liability management geared toward DB plans. As plan sponsors themselves, they could theoretically hire a related subsidiary to provide these services, but doing so could present a conflict of interest between their role as sponsor and as investment manager. ERISA generally prohibits a range of transactions that could trigger conflicts of interest but there are a number of specific exceptions.[46] It is unclear if plan buyouts will make it more difficult to monitor such

[45]The Citigroup purchase of the Thompson Regional Newspaper pension plan in the UK illustrates this potential regulatory conflict. Under section 23A of the Federal Reserve Act, FRB reviewed actions of a nonbanking subsidiary that might pose a risk to Citigroup's banking unit. 12 U.S.C. § 371c. Citigroup received a ruling from FRB determining that the pension buyout transaction in question qualified as an allowable financial activity as a bank holding company. This permitted Citigroup to move forward with the acquisition of Thompson's pension plan. However, FRB required Citigroup to secure a letter of assurance from the UK Pensions Regulator that assets under its banking unit, Citibank, would be exempt from any calls on Citigroup resources in the event of the pension plan becoming insolvent. See app. I for further discussion of this ruling.

[46]29 U.S.C. §§ 1106 and 1108.

transactions. A second source of potential oversight difficulty concerns the excise tax on plan reversions. A sponsor of an overfunded plan could attempt to extract excess plan assets, which would typically be subject to an excise tax, by selling the plan to a financial sponsor in exchange for cash or assets reflecting the plan surplus (less fees the new sponsor might collect to take over the plan). IRS officials with whom we spoke mentioned that buyouts could possibly make enforcing the reversion tax more complicated, particularly if the transaction included the transfer of some business assets.

Concluding Observations

The recent IRS ruling and legislative efforts to address the nation's financial difficulties have pushed DB plan buyouts off the immediate policy agenda. At first glance, buyouts in and of themselves seem to be a minor issue. With a primary target market of sponsors of slightly underfunded, hard-frozen plans, both the direct benefits and costs of such transactions appear comparatively small. To the extent that a buyout results in a stronger sponsor of the pension plan, the buyout could make participant benefits more secure and reduce PBGC's financial exposure somewhat. Sponsors would certainly benefit from the increased choice they would have in being able to shed their pension liabilities, presumably at reduced cost compared with standard termination through insurance companies. If such buyouts represented new level-playing-field competition to insurance terminations, with no added risk to participants or to PBGC, they could be seen as a financial innovation that increased flexibility and lowered cost to DB sponsors.

The troubling aspects of DB plan buyouts involve risks that may be difficult to foresee or quantify now or at the time of any particular transaction. It is unclear to what extent buyouts would cost less than standard plan terminations simply because of differences in regulations facing financial institutions and insurance companies providing similar services to plan sponsors instead of from economic efficiency. Further, the current economic downturn has laid bare the current weaknesses and imperfections of financial regulation, with banks and insurance companies previously considered to be sound and well capitalized suffering catastrophic losses.

Plan buyouts, as proposed by potential sponsors, would likely provide very limited upside for participants, since PBGC guarantees have covered the overwhelming majority of participant benefits in DB plans that PBGC has taken over. They may offer cost savings and flexibility to sponsors, but they would appear to offer few advantages for benefit protection over plan terminations already recognized by ERISA. Although it is possible that the current financial crisis could uncover weaknesses in the regulation of annuity providers for terminated plans, the potential advantages appear to be limited to a very narrow set of scenarios in which a buyout by a strong sponsor rescues the plan from a distress termination and saves participants from lost uninsured benefits. Even to the extent they are a successful model, buyouts could erode worker retirement benefits by encouraging plan freezes by sponsors wishing to avail themselves of this option. For PBGC, the gains in security would also likely be small, since only mildly underfunded plans are likely to be targeted for buyout, although it is possible that some buyouts could prevent further erosion in plan funding. Whatever the ultimate effect buyouts would have on benefits security or plan sponsorship, it seems likely that they would change the traditional role that DB pensions play as a benefit employers provide directly to their employees. One's evaluation of buyouts may depend on the degree to which DB plans are defined by the employer-employee relationship, and not just on the monetary value of the benefits.

Agency Comments

We provided a draft of this report to the Department of Labor, the Department of the Treasury, IRS, and PBGC, all of whom provided technical comments that we incorporated as appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution until 30 days after the date of this letter. At that time, we will send copies of this report to the Secretary of Labor, the Secretary of the Treasury, the Director of PBGC, appropriate congressional committees, and other interested parties. We will also make copies available to others on request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you have any questions concerning this report, please contact Barbara Bovbjerg at (202) 512-7215 or Joseph Applebaum at (202) 512-6336.

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made contributions are listed in appendix III.

Barbara D. Bovbjerg, Director
Education, Workforce, and Income Security Issues

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Applied Research and Methods

Appendix I: UK Experience with Noninsured Plan Buyouts Provides Only Limited Regulatory Lessons for the United States

The United Kingdom (UK) has in recent years seen a marked increase in defined benefit (DB) plan sponsors closing their plans. British plan experts and policy makers with whom we spoke estimated that terminations are expected to involve assets of £10 billion in 2008. Most of these closeouts have been conducted by insurance companies in ways similar to pension terminations in the United States, with sponsors terminating their plans and purchasing group annuities from insurers to pay plan benefits. However, a few have involved noninsurance entities. In 2007, two financial firms, Citigroup and Pension Corporation, took over control of four defined benefit plans with a value of £4.5 billion collectively. Citigroup's purchase of the plan sponsored by Thompson Regional Newspapers most clearly resembled the structure of models proposed by U.S. firms: Thompson created a subsidiary, into which it put its pension plan plus additional assets, and Citigroup purchased this subsidiary and became the plan's new sponsor. Citigroup pointed out some benefits of this buyout for all parties involved, including the facts that Thompson was a relatively weak sponsor and the investment strategy proposed by Citigroup was conservative in nature.

To take over the Thompson pension plan, Citigroup had to obtain approval from both U.S. and United Kingdom regulatory agencies. The Federal Reserve Board (FRB) approved the plan buyout while making it clear that its approval was limited to the specific conditions of this deal, involving a hard-frozen, fully funded plan in which the plan assets equaled or exceeded the value of future plan benefit payments.[1] Citigroup proposed that this deal be done through a nonbank subsidiary, and FRB wanted to know if this transaction posed any risk to subsidiary groups, Citibank in particular.[2] We were told that, under UK law, the corporate control group of a subsidiary would be liable for any losses the pension plan might incur, meaning that the Pensions Regulator, the main British pension regulatory agency, could seek recovery from the U.S.-insured depository institution of Citibank in the event that something went awry with the fund. FRB

[1]Citigroup, Inc., 93 Fed. Res. C16 (2207)

[2]Section 23A of the Federal Reserve Act (12 U.S.C. § 371c) and Regulation W (12 C.F.R. pt. 223 (2008) impose quantitative and qualitative limits on covered transactions between a depository institution and its affiliates. Covered transactions include, among other things, an extension of credit by a depository institution to an affiliate and the issuance of a guarantee by a depository institution on behalf of an affiliate. The limitations in section 23A and Regulation W provide important protections against a depository institution suffering losses due to covered transactions with its affiliates, and also limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net.

officials indicated that they would have serious concerns about allowing a U.S. banking institution to subject itself to the liabilities of a pension plan acquired by a subsidiary. In order to secure final approval from FRB, Citigroup had to receive written assurance from the Pensions Regulator that Citibank assets would not be pursued in the event of the plan becoming insolvent. The Pensions Regulator agreed to grant this exemption for a period of 5 years.

While that buyout contained features similar to those in U.S. proposals, there are inherent structural differences between the UK and U.S. pension regulatory systems that appear to limit the lessons from the UK experience for the United States. Officials told us that, unlike American plans, British defined benefit plans are managed by separate boards of trustees rather than plan sponsors. Trustees have the power, for example, to constrain plan sponsors from employing any investment strategy that may lead to undue risk for the participants or the British federal pension insurance fund, the Pension Protection Fund (PPF); in contrast, U.S. plans are not required to have any such governance body. Furthermore, according to pension experts, the tax on plan reversions in the UK is significantly lower than in the United States, and Citigroup made clear its intent to keep any remaining surplus after either paying all promised benefits or terminating the plan through an insurance company. This source of profit would not be available in the United States because of the size of the reversion tax.

Additionally, the Pensions Regulator has powers that allow for flexibility and give strong protection to plan members. As the DB plan buyout landscape continues to evolve, the Pensions Regulator has the power to intervene when it believes a noninsurer transaction might put plan members and the PPF in jeopardy. The Pensions Regulator has already shown its willingness to engage in such intervention during the Pension Corporation's buyout of the telecommunication firm Telent. In contrast to Citigroup, the Pension Corporation acquired pension plans by gaining an interest in the original employer sponsor. These takeovers more closely resembled a merger and acquisition transaction than they did a pension plan buyout. In this case, the trustees of the Telent pension plan claimed that the interests of the Pension Corporation were not aligned with those of the trustees and plan members. Some believed that the Pension Corporation's sole interest in acquiring Telent was to seek higher returns from the fund as a means of profit for the corporation, rather than for the members. The Pensions Regulator agreed with the trustees and exercised its power by installing three additional independent members as trustees, thus preventing the Pension Corporation from gaining control of the board. In addition to showing the powers of the Pensions Regulator, this instance also illustrates the relative importance of UK trustees. It was the trustees that first notified the Pensions Regulator about the potential risk being imposed on members.

Appendix II: Internal Revenue Service 2008 Revenue Ruling on Defined Benefit Plan Buyouts

On August 6, 2008, the Department of the Treasury and the Internal Revenue Service (IRS) issued Rev. Rul. 2008-45.[1] This ruling decided whether DB plans bought out by third-party sponsors complied with or violated the "exclusive benefit" rule of the Internal Revenue Code (IRC). This rule provides that in order to constitute a qualified plan, a pension plan must be operated for the exclusive benefit of a sponsor's employees and their beneficiaries.[2]

The ruling declared that the transfer of a pension plan to "an unrelated taxpayer," without the concurrent transfer of significant business assets, operations, or employees, such as in a merger or business acquisition, would jeopardize a plan's tax qualification. IRS contrasted the transfer of a sole pension plan with the transfer of a plan in connection with the acquisition of business assets or operations, and held that since a plan in the first instance would no longer be maintained by an employer to provide retirement benefits for its employees and their beneficiaries, it would not satisfy the rule. The ruling further held that this would still be the case if the purchasing company has "some employees…or some business assets or operations transferred, where substantially all of the business risks and opportunities" relate solely to the buyout of the plan itself. This means that under current law any plans transferred to a nonemployer sponsor would not receive the same tax benefits an employer-sponsored plan would, such as the tax deferral on sponsor contributions to the plan and on the return on plan assets. According to Treasury, as a result of this ruling, companies will be unable to take over any pension plans, frozen or active, except as part of a business merger or acquisition.

Advocates of buyouts said that they believed the IRS ruling was broader in its coverage of all third-party buyouts than it needed to be under the law and inconsistent with prior rulings on plans that change sponsors. Instead, they thought the ruling should have left open the possibility of case-by-case IRS approval pending an evaluation of whether a buyout benefited participants or the Pension Benefit Guaranty Corporation (PBGC).

Concurrent with the ruling, the Department of the Treasury issued a set of principles, with input from the Department of Labor, Department of

[1]See IRS Rev. Rul. 2008-45, Aug. 6, 2008, available at www.treas.gov/press/releases/reports/hp1110revrul200845.pdf

[2]26 U.S.C. § 401(a).

Commerce, and PBGC, that might guide Congress should it decide to write legislation that would permit pension plan buyouts.[3] These include the following: (1) companies should give advance notice of plan buyouts to participants and regulators; (2) only financially strong entities in well-regulated sectors would be permitted to acquire a pension plan in a plan buyout transaction; (3) the parties to the transaction would be required to demonstrate that participants' benefits and the pension insurance system would be exposed to less risk as a result of the buyout, and that the buyout would be in the best interests of the participants and beneficiaries; (4) limitations on buyouts would be imposed to limit undue concentration of risk; (5) transferees and members of their controlled groups would assume full responsibility for the liabilities of transferred plans and would comply with post-transaction reporting and fiduciary requirements; and (6) subsequent buyout transactions for a plan would be subject to the same rules as the original buyout.

[3]Treasury Press Release HP-1110 (Aug. 6, 2008).

Appendix III: GAO Contacts and Staff Acknowledgments

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