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ERISA Advisory Council

Gotbaum Tells Council Lump-Sum Cash-Outs Are Like Cigarettes: Legal but Bad for You

Joshua Gotbaum, director of the Pension Benefit Guaranty Corporation, told the ERISA Advisory Council Aug. 29 that pension plan lump-sum cash-outs to retirees are like cigarettes: They are legal, many people like them and they are bad for you.

Improvement is needed in the disclosures, regulations and education that warn defined benefit plan participants about the risks of taking lump-sum cash-outs, Gotbaum told a packed room at the council meeting. The testimony came during a day of sessions on private-sector pension de-risking and participant protections.

''A lump sum is the opposite of lifetime income,'' Gotbaum said. ''Under current law and regulations, we make it easy for employers to offer lump sums and for employees to take them,'' he added. Since 1997, more than two out of three people have taken the lump-sum option instead of an annuity when given the choice, he said.

There are several reasons lump-sum cash-outs are more popular, Gotbaum said. First, lump-sum cash-outs are cheaper than buying annuities because the market price of annuities has risen, he said. Second, regulatory guidance about offering annuities is not as clear as that for offering lump sums, he said. Employers have a fiduciary duty to select the safest annuity provider, and there is some uncertainty as to what that means, he added. Third, some people have lost faith in all financial institutions, which makes lump sums more attractive, he said.

Gotbaum did not discount offering retirees annuities as a de-risking strategy. He said insurance company annuities are backed by state guarantees, and there is no real difference in risk between being insured by PBGC and by an insurance company. If PBGC ran out of money, even though it is a very small risk, it is not certain that Congress would bail it out, he said. If an insurance company went bankrupt, there are state insurance funds to cover it, he said.

Distribution Risks. Other speakers agreed that there were risks in allowing lump-sum cash-outs to retirees. Karen Friedman, executive vice president and policy director at the Pension Rights Center in Washington, said one problem is that retirees have to invest that lump sum to replicate the security of a pension. In addition, plan participants can be vulnerable to the advice of financial advisers, who have an interest in investing lump sums, she said.

ERISA ADVISORY COUNCIL COVERAGE

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Norman P. Stein, professor of law at Drexel University's Earle Mack School of Law in Philadelphia, said that some retirees might have diminished mental capacity that affects their decisionmaking, might face pressure from children to take a lump sum, and might be preyed upon by unscrupulous financial advisers.

Friedman said there are ''numerous concerns'' about offering annuity transfers. Even though insurance companies are under the eye of state regulators, insurance companies can still fail, she said. Also, if a company's records are wrong and retirees are not paid correctly, she said, which party will be responsible to clear up any problems? In addition, under the Employee Retirement Income Security Act, pension benefits are protected from creditors that seek to garnish or seize retirement benefits, ''but once pensions are sold to an insurance company, the protections are not so clear and it appears that whether or not these benefits can be assigned or alienated is determined by state law,'' she said.

Recommendations. Friedman said the Pension Rights Center recommends that there be a moratorium on offering lump-sum cash-outs or annuity transfers until the Department of Labor and other agencies have put in some protections, such as strengthening fiduciary standards for annuity selection and implementation, requiring that annuity contracts include protections against garnishment and attachment by creditors or bankruptcy trustees, prohibiting insurers from offering lump-sum conversions, ensuring participant protections in cases of benefit disputes, requiring enhanced disclosures in insurance transfers and providing protections in lump-sum cash-outs. ''Our bottom line position

is that DOL has the authority to prohibit'' these lump-sum cash-outs, she said.

David Certner, legislative counsel for AARP, suggested, among other things, that for annuity transfers, DOL should clarify ''safest annuity'' obligations under Employee Benefits Security Administration Interpretative Bulletin 95-1, and plan trustees should be required to purchase and maintain reinsurance of the pension benefits being transferred.

Regarding lump-sum cash-outs, Certner recommended that plans be required to provide clear and complete disclosures, including the pros and cons, comparative value, whether an early retirement subsidy is included and the loss of PBGC insurance.

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