Prudential

Written Testimony of

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Introduction

I am Phil Waldeck, Senior Vice President and head of Prudential Retirement's $73 billion Pension & Structured Solutions business.

On behalf of Prudential Retirement, I would like to thank the Chair, Vice Chair, and members of the Working Group for the opportunity to appear today to assist the Council in its examination of de-risking issues and related participant protections. As recognized by the Council and confirmed by many of those testifying before the Council, managing retirement-related investment and longevity risks has become increasingly important as well as increasingly complex in today's uncertain and volatile market and economic environment.

This Working Group's topic is of particular interest and importance to Prudential. The company has a long history of guaranteeing pension obligations without fail since 1928, and today, Prudential provides retirement plan services to more than 3.7 million workers and retirees. Independent plan fiduciaries recently selected Prudential as the provider for two of the largest guaranteed pension annuitizations ever to take place in the U.S., involving more than 150,000 pension plan participants; and in 2011, Prudential issued the nation's first pension buy-in contract. In addition, over the past two years Prudential, as a U.S. based offshore reinsurer, has helped secure the pension benefits of more than 120,000 individuals in the U.K. by providing pension longevity reinsurance to U.K. insurers.

In Prudential's 85 years of experience in the guaranteed pension annuity business, we have observed that plan sponsors care about the well-being and retirement security of their participants even as they look for strategies to strengthen their balance sheets. Our role as a provider is to recommend workable solutions for these complex challenges. Given our insurance, pension and actuarial expertise, as well as our investment capabilities and financial strength, Prudential is well-positioned to execute large, complex transactions that help sponsors provide lifetime income to retirees and better manage pension risk.

Our testimony today will address:

- The challenges facing sponsors of defined benefit plans,
- Strategies available to plan sponsors for managing risks,
- Plan sponsor considerations in assessing pension risk transfer options, as well as
- Fiduciary and participant considerations in connection with pension risk transfer strategies; and finally, a few comments on
- The safety of guaranteed annuities.

Plan Sponsor Challenges

Sponsors of defined benefit plans are challenged by a number of unpredictable drivers when managing their pension plans, including market-related risks (such as mismatching of assets and liabilities, low interest rates, credit risk, equity market volatility and currency fluctuations) and liability risks related to the participant population (such as the effects of longevity, salary increases, rates of employment termination, incidence of early retirement and optional benefit elections).

Following unprecedented losses during the financial crisis, sponsors of defined benefit plans are increasingly focused on fulfilling their pension obligations to participants while also achieving greater contribution certainty, reducing or removing financial statement volatility, allowing greater focus on their firms' core businesses, and ensuring strategic flexibility. Several strategies are available to help plan sponsors better manage the risks associated with pension obligations.

Risk Management Strategies

While recent events have highlighted the magnitude of the issue, the growth of pension liabilities has been a concern for defined benefit plan sponsors for several decades. Changes to funding regulations and accounting rules for the disclosure of pension financials have also been catalysts to better manage pension risk. In response, sponsor shifts from defined benefit to defined contribution structures, freezing or closing plans, and adopting liability-driven investment strategies have become common.

As 401(k) plans increased in popularity, many sponsors added matching contribution features to their plans to encourage higher employee retirement savings. At the same time, as sponsors introduced or increased matching contribution obligations, some reduced their commitment to provide benefits through a defined benefit plan. The emergence of cash balance plans was in large part another effort to de-emphasize the pension plan and control volatility.

Following the steep market decline in 2002, employers began to more strongly consider de-risking strategies. Today, 70% of Fortune 100 corporations have either frozen (no additional benefits are accruing in the plan) or closed (no new participants are allowed in the plan but existing active participants continue to accrue benefits) their pension plans.[1] While these strategies are effective in limiting the growth of pension liabilities, plan sponsors still maintain historical obligations.

Plan sponsors are also pursuing investment strategies to help reduce funded status volatility. Liability-driven investment (LDI) strategies, designed to better match the characteristics of plan investments to the underlying liabilities, have been recognized by the Department of Labor and have become very popular with plan sponsors.[2] LDI strategies may include the use of various derivative-related strategies that can be implemented to control risk. While these strategies can help to manage volatility, they also can be complex and challenging to implement, as evidenced by the fact that few of today's plans are well-hedged against market risks.

Recognizing the complexities and limits of liability-driven and derivative-based strategies in managing funding risks, increasingly plan sponsors are now assessing risk transfer strategies that will eliminate some or all of their pension obligations.

[1] See Towers Watson, *Retirement Plan Types of Fortune 100 Companies in 2012*, pages 2-3 (October 2012).
[2] See Advisory Opinion 2006-08A (October 3, 2006).

Strategies to Transfer Risk

Risk transfer strategies have been used for decades to secure pension obligations and to reduce the employer's risk profile. These strategies can be implemented for an entire plan or for a select portion of a plan. For example, while one approach may make sense for the retired population, another may make sense for participants who are not yet collecting their pension, such as participants with deferred vested benefits. This flexibility allows plan sponsors to design a strategy that is responsive to the financial needs of the organization as well as the plan, and may enhance the sponsor's ability to continue maintaining its defined benefit plan for some or all participants.

Risk transfer strategies include buy-outs, buy-ins, lump sum distributions, and longevity insurance.

Pension Buy-Outs

Simply stated, the pension "buy-out" is an insurer's assumption of a plan's benefit payment liabilities via irrevocable, guaranteed group annuities for a specified group of participants. Plan sponsors have used this strategy for decades as a way to fully meet and secure pension obligations, which triggers the settlement of the liability and its removal from the plan sponsor's balance sheet.

While often the result of plan termination, the buy-out strategy has also been used historically to secure a portion of the liabilities of ongoing pension plans. In past decades, it was common for a plan sponsor to purchase annuities for their retirees and/or for a portion of the accrued benefits of non-retired participants. Such transactions, which do not include a plan termination, are often referred to as "lift outs." Many retirees today have some or all of their pension check payable under one of these arrangements.

Historically, buy-outs have been guaranteed by the insurer's general account, meaning the benefit commitments are supported by the general assets of the insurer. In recent years, however, several insurers have begun to offer buy-outs with the additional security of a separate account structure and guarantee. With this solution, assets are held in a separate account where they are protected from the claims of the insurer's general creditors and of other contract holders. In the unlikely event that separate account assets are insufficient to pay promised benefits, the general account of the insurer guarantees any remaining benefit obligations. While the use of a separate account is more expensive than a general account solution, it offers an additional layer of security to participants.

Pension Buy-Ins

The "buy-in," a new solution in the U.S., allows a plan sponsor to transfer risks associated with the pensions for covered participants to an insurer while maintaining the liabilities within the pension plan. With this strategy, the insurer guarantees the benefit obligations of the plan to covered participants, while assets are held in a separate account that is managed by the insurer and guaranteed by the insurer to be adequate to pay benefits. One advantage of the buy-in is that benefit obligations of the plan are guaranteed by an insurer while the transaction remains completely seamless to participants. It should also be noted that plan sponsors often reserve the right to convert a buy-in to a buy-out and, because the contract is revocable, a buy-in will not trigger settlement accounting.

Included with this written testimony is material previously furnished to the Working Group that highlights the structure of a buy-in and how it compares to a buy-out.

Lump Sums

A lump sum distribution allows the participant to elect a one-time payment in lieu of any future benefits. A regulatory framework sets the assumptions (interest rates and mortality tables) that must be used to calculate the minimum amount of the distribution. Although not a common feature of traditional pension plans, a lump sum option may be included as one of the distribution alternatives. The inclusion of a lump sum option for participants who have yet to retire is often considered in connection with a plan termination. More recently, we have seen sponsors of ongoing plans offer lump-sum “windows” where vested terminated participants are given a limited period to elect a lump sum. While lump sums provide participants with added choice and flexibility, they come with the added challenge for participants of managing longevity and capital market risks.

The PPA changed the basis rate for calculating minimum lump sum distributions, meaning that a lump sum distribution is roughly equal to accounting liability. These rules were completely phased-in in 2012, and they represented a substantial change from the prior rules that often produced lump sums well in excess of accounting liability. With expected changes to the mortality table in 2016, lump sum distribution offerings may become more limited.

Longevity Insurance

Pension longevity insurance is a strategy that Prudential has been executing as a U.S.-based reinsurer to assume the pension liabilities of insurers based in the U.K. We believe that such strategies will become available to plan sponsors in the U.S. over the next few years. With a longevity insurance strategy, Prudential, for example, would serve as a primary insurer or as a re-insurer of the risks associated with longer life expectancy. Longevity insurance may be very attractive to employers who have de-risked their pension plans through the use of various investment solutions and now see longevity risk as the largest remaining source of risk in their pension plan. Longevity insurance would offer such sponsors an additional layer of risk protection to help them continue to maintain their pension plans within their risk tolerance. In a typical U.K. transaction, longevity risk is transferred from the insurance company (commonly referred to as the “cedants”) to the reinsurer in exchange for reinsurance premiums. Such strategies deliver the flexibility U.K. insurers need and the additional security their clients require.

Employer Considerations

Increasingly, plan sponsors do not see managing their pension risks as an all-or-nothing decision. In determining what strategy or solution may be most appropriate for a particular plan, its sponsor and its participants, one important consideration is the funded status of the plan and, to the extent that it is underfunded, the ability of the plan sponsor to make cash contributions. It has been our experience that plan sponsors do not want the overall funded status of an ongoing plan to be worse following the purchase of guaranteed pension annuities, as could occur in a partial buy-out, than it was immediately before. Accordingly, for sponsors of underfunded plans, their ability to move forward with a guaranteed pension annuity purchase frequently depends on their ability to make cash contributions to the plan.

Any analysis of pension risk transfer options also involves consideration of the different participant population segments (typically retirees, vested terminated participants, and active participants) to determine the optimal pension risk transfer strategy.

Retiree Segment

In our experience, approximately 50% of a plan's liability is attributable to the retired population. Accordingly, a buy-out option is often the most attractive approach if the goal is to transfer a significant amount of liability. Also, from an economic perspective, pricing is likely to be attractive relative to the liability held on the balance sheet for this population segment.

Vested Terminated Segment

Typically, we find that about 15% of a plan's liability is associated with the vested terminated population, which often involves a large number of participants with small benefits. Accordingly, a complete transfer of the liability associated with vested terminated participants, whether through buy-outs or lump sum distributions, usually translates into significant savings on administrative expenses. Frequently, a plan sponsor can settle via lump sums for about 100% of accounting liability. The cost of a buy-out for this group, on the other hand, is typically at least 20% higher than GAAP accounting liability.

Active Segment

Risk transfer strategies for the active population are usually considered only in the context of a complete termination of the plan. In such cases, the termination may involve a complete buy-out strategy or an offering of lump sum distributions to some or all of the participant population, including the actively employed plan participants. Due to their demographic characteristics, upon plan termination, the considerations for this group will be similar to those for the vested terminated segment.

Fiduciary Considerations

As recognized by the Working Group and by others testifying before the Working Group, decisions to pursue de-risking strategies are typically settlor in nature, whereas implementing those decisions is subject to ERISA's fiduciary requirements. In this regard, ERISA requires that fiduciaries carry out their duties prudently and solely in the interest of the plan's participants and beneficiaries. In the context of de-risking, we have noted the Department of Labor's guidance on liability-driven investment strategies. We also note the Department's guidance set forth in Interpretative Bulletin 95-1 (29 CFR § 2509.95-1) that provides fiduciaries of defined benefit plans directions, in connection with the transfer of benefit liabilities to an annuity provider, for obtaining the "safest annuity available."

Based on our experience, plan fiduciaries take their responsibilities under ERISA quite seriously, and for that reason, we believe the current standards are protective of participant interests and therefore not in need of change or updating at this time with respect to defined benefit plans.

Participant Considerations

Any sponsor review of plan design changes, including potential termination or transfer of benefits obligations, must contemplate the implications for participants. Whether retired, terminated vested, or active, participants are likely to have questions about their options and rights. In our experience, and without regard to any specific legislative or regulatory requirement, plan sponsors routinely take extraordinary steps to ensure participants and retirees have the information they need to understand any changes and to make informed choices when necessary. Typically, these efforts involve employee communication networks, newsletters, and professional support through call centers, all of which are focused on addressing participant questions and ensuring a smooth transition.

It is also clear from our experience as well as various studies that, when provided a choice between taking a benefit in the form of an annuity or a lump sum distribution, many defined benefit plan participants are opting for the lump sum.[3] We also know that most plan participants are not sufficiently well-positioned to manage investment and longevity risks in a manner necessary to ensure their retirement savings last a lifetime.

Last year, this Council recognized the challenges facing participants in defined contribution plans and recommended that Department review, modify, and/or develop regulatory guidance:

> "designed to reduce current barriers faced by fiduciaries, plan sponsors, and service providers in their efforts to encourage participants to develop post-retirement income strategies . . . ."[4]

We believe these same challenges also confront participants in defined benefit plans. For this reason, we encourage the Council to restate and extend to participants in defined benefit plans its 2012 recommendation to remove impediments to educating participants about post-retirement income strategies.

[3] See Employee Benefit Research Institute Issue Brief No. 381 entitled *Annuity and Lump-Sum Decisions in Defined Benefit Plans: the Role of Plan Rules* by Sudipto Banerjee, PhD (January 2013).
[4] See 2012 ERISA Advisory Council Report entitled *Explaining Income Replacement During Retirement Years in a Defined Contribution Plan System.* http://www.dol.gov/ebsa/publications/2012ACreport3.html.

The Safety of Guaranteed Annuities

Guaranteed annuities represent an exceptionally safe and effective means to ensure one's retirement savings last for a specified period or a lifetime.

Prudential has provided guaranteed annuities for pension obligations without fail since 1928. Annuity liabilities are long-term, predictable commitments and life insurance companies are particularly well-positioned to assume longevity risk (through annuities) given their significant exposure to mortality risk (through life insurance). Guaranteed annuities receive full funding from the plan sponsor, meaning that such a transaction is fully funded at a level that exceeds the GAAP accounting liability. Insurance companies are also expert at managing assets to meet very long-term obligations, for example, by investing over 90% of the assets backing annuity obligations in investment-grade fixed income.

In some instances, annuity obligations are designed to provide an additional level of security in the form of a separate account guarantee, where, as discussed earlier, assets are dedicated to the benefit obligations under the contract and managed to match those specific liabilities. The separate account guarantees are further supported by a guarantee from the insurer's general account, including additional capital and surplus to meet these obligations.

Insurance guarantees are subject to strong regulatory oversight, including capital and reserve standards and reserve requirements for separate account liabilities. This oversight includes detailed regulatory reporting obligations and intervention powers for regulators to restore insurers to financial health. State guaranty association coverages also provide additional protections for annuitants, subject to the terms of the contract and state law. Finally, plan sponsors have a clear fiduciary duty when selecting an insurer. In the context of defined benefit plans, the Department of Labor's Interpretive Bulletin 95-1 established the standard by which plan sponsors universally seek to choose the "safest annuity available" to satisfy their fiduciary obligations and to provide retirement security for the plans' participants.

Conclusion

We would like to commend the Working Group for its consideration of this important topic and, again, thank the Chair, Vice Chair, and members of the Working Group for affording Prudential the opportunity to participate in this hearing.

We would be pleased to assist the Council as it continues its deliberations and welcome any questions members may have with regard to today's testimony.