

**2013 ERISA Advisory Council  
Private Sector Pension Plan De-risking and Participant Protections**

**August 29, 2013**

Good day, members of the Council. My name is Naomi Zwerling. I am a Vice President in Corporate Benefit Funding at MetLife, our Americas Business area responsible for, among other things, group annuity based solutions for both funding and de-risking defined benefit (DB) plans. I am here today to testify on behalf of my company. MetLife is a leading provider of employee benefits and has been committed to the retirement business for over 90 years, issuing the industry's first group annuity contract to fund a defined benefit plan in 1921. Today, MetLife guarantees income payments to more than 1 million plan participants, most through group annuity contracts issued in connection with DB plans.

We welcome the opportunity to be part of this hearing today and appreciate your inviting us to testify. We believe that we have a unique perspective to share as a result of both our long history as a pension benefit provider and the insights we have to share from the annual pension risk behavior research we have conducted over the past five years among sponsors of the largest U.S. DB pension plans. We believe that the Council's work is critical to maintaining and strengthening the fundamental structure of the defined benefit plan system as well as the ability of such plans to continue to enable retirement security for plan participants in the years to come.

The number of DB pension plans in the U.S. stands at 25,607, covering 12.7 million active and an additional 20.7 million inactive participants at the end of 2011, the most recent year for which consolidated data is complete<sup>1</sup>. As such, it is clear that DB plans represent a core element in the fabric of retirement security for millions of Americans.

That is not to say that DB plans have not undergone significant changes over the past decade, and particularly following enactment of the PPA in 2006 and the financial crisis that began in late 2007. According to the Pension Benefit Guaranty Corporation (PBGC), the DB system has had between 1,100 and 1,800<sup>2</sup> plans undergo standard terminations each year since 2000, affecting a total of 1.2 million participants, of whom 674,000 were active. While this has affected fewer than 1% of single employer DB participants each year, and while the great majority of terminations occur among very small plans, this indicates that voluntary plan terminations are well established as part of the ebb and flow of DB plans. Second, the PBGC categorizes DB plans where some or all of the participants have a cash balance structure rather than all having a traditional benefit formula as "hybrid" plans, and as of the end of 2010, the most recent year for which this data is available, some 42% of DB plan participants were covered under plans where at least some participants had been transitioned to the cash balance benefit formula.

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<sup>1</sup> PGGC

<sup>2</sup> PBGC data, Forms 5500, through 2010; the high point for standard terminations from 2000 – 2010 was 1,863 in 2000; the low was 1,100 in 2005.

Movement to a cash balance structure is generally done to remove the volatility from plan contributions within a DB structure, which reduces the risk of maintaining the plan. Together, these statistics suggest that de-risking among plan sponsors is a well-established part of the fabric of the DB plan system.

With over \$36 billion in transferred DB liabilities, MetLife is one of the leading providers of pension risk transfer solutions. MetLife's group annuity assets are over \$100 billion in total, \$84 billion of which are associated with contracts issued to qualified plans.

Our comments today seek to provide a provider's perspective on pension risk transfer – what it is, its purpose, how it has evolved, how it is used in practice today, how well it meets its objectives, and key considerations in designing financially sound de-risking programs that are effective for both plan sponsors and plan participants. This backdrop is important in understanding the concerns that have arisen with an increasing number of recent transactions and the implications of those concerns for sponsors seeking to balance settlor and fiduciary functions.

### **What is Pension Risk Transfer, and where did it come from?**

Pension risk transfer is not a new concept, but rather is best thought of as an integral part of the qualified plan system. Retirement income benefits originated many decades before ERISA as a way for companies to manage their workforces, enabling an orderly transition between generations of workers and in the process, setting expectations that persist today about retirement age. While early retirement plans were not required to be funded, those that were funded were provided through the purchase of group annuity contracts, under which the employer paid an insurance premium each year and which in turn provided a pension income benefit when each worker reached retirement age. Under this system, companies paid for the future benefits during the years their employees were still working. In effect, these promises were transferred at the time they were made, as future benefits were earned by the employees. The group annuity reserves were held by insurance companies in their General Accounts, and the carriers were responsible for providing the benefits to the employees at retirement. Under this initial approach, all of the risks were effectively transferred from the plan to the insurance company as benefits were earned.

ERISA's passage in 1974 brought intended uniformity and introduced participant protections such as vesting and minimum funding requirements, but at the same time ushered in a new regulatory approach to the operation of qualified plans. As the asset management industry developed in the 1980s and as insurance carrier regulation discouraged holding equity assets in insurer General Accounts, a new model of pension plan management arose that became the prevailing model from the late 1980's up until the financial crisis began in 2008. Under this regime, pension income benefits could be "self-insured" by the plan, and asset management of contributions could be handled as a distinct activity. This approach largely supplanted the fully insured model of previous decades. The PBGC was founded in order to provide for situations where a plan sponsor became bankrupt and involuntarily ceased its existence. The stage was set for

the growth of the asset management model, which was further supported by several factors:

- Recognition by plan sponsors that de-coupling asset management from the provision of benefit payments created the potential for more sponsor control over investments and expenses;
- Concerns about access to assets, if insurers were to experience financial difficulty; and
- The rise in popularity of Modern Portfolio Theory<sup>3</sup>, which focused on the efficient frontier and led to wide adoption of the Total Rate of Return (TROR) as a primary metric. When dovetailed with the advent of required minimum contributions, this played a key role in facilitating the growth of the DB asset centric model.

Over time, the opportunity represented by the large pool of DB plan assets, hitherto primarily managed by insurance companies, gave rise to a proliferation of new asset management providers, and by the time the Pension Protection Act (PPA) passed in 2006, this had become the predominant model of pension plan management. Insurers continued to participate in this market in one of two ways: (1) through offering Group Annuity Contracts that provided access to various investment management styles and (2) by providing fully insured contracts in the event of voluntary plan terminations.<sup>4</sup>

There have been three prior concentrations of pension risk transfer, before the current market dynamic: in the 1980's, in 2000 and in 2005. The drivers behind each were distinct:

1980s: pension risk transfer transactions took the form of “buyouts”, in which overfunded plans were terminated in order to generate assets then used for other corporate purposes. These tended to be very large plans, and before the reversion tax was added in 1989, funds not needed to secure an annuity contract to satisfy the plans obligations could be put to any other corporate purpose without penalty. The reversion tax enacted in 1989 effectively ended this practice.

2000: Reaction to increasing regulatory requirements led a wave of small plans (mostly under 100 participants) to end their plans voluntarily.

2005: Anticipated PPA changes resulted in a second wave of small plan terminations, as well as large plan changes such as including cash balance benefit structures, closing plans to new hires, and freezes at current plan benefit levels.

The pension risk transfer transactions that have occurred post-PPA and post-financial crisis are not driven by the same factors as the prior actions, and are not taking the

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<sup>3</sup> Not until the crash of 1987 did risk get Wall Street's full attention. By then, Modern Portfolio Theory had become a widely accepted and widely used technique. In 1990, 38 years after Markowitz' dissertation was published, he shared the Nobel Prize for Economics.

<sup>4</sup> Note the distinction between involuntary plan terminations, which occur because a sponsor is **unable** to continue the plan, and voluntary plan terminations, which occur when a sponsor is **unwilling** to do so.

same forms. The current emerging pattern reflects a new framework for understanding risks, is focused on large rather than small plans, and may take the form of partial risk transfers, buy-ins and multiple transactions rather than, or in advance of, standard plan terminations. In our view, this change in risk framework is fundamental and permanent, and as such is a sustaining driver behind the current transactional dynamic. This is the focus of the balance of our testimony.

### **Buyer Observations: PRBI Results 2009 – 2013**

MetLife has been formally tracking pension risk management trends and developments among sponsors of the largest US Defined Benefit (DB) plans for the last five years. Introduced in 2009, our US Pension Risk Behavior Index<sup>SM</sup> surveys plan sponsors and measures their collective attitudes about 18 investment, liability and business risks to which their DB plans are exposed. Originally designed to encourage public dialogue about pension risk related issues for plan fiduciaries, the study has helped sponsors to develop a new framework for understanding pension risk and to identify early warning signs of gaps in pension risk management gaps. Comprised of an index and analysis, the study measures the extent to which sponsors are managing the risks they deem most important and examines patterns of interconnectedness between risk attitudes and behaviors.

Over the five-year period, the findings of the U.S. PRBI study have chronicled plan sponsors' shift away from an asset- and returns-centric approach toward managing their plans with a more balanced mindset that takes into account both the liability and asset sides of the pension risk management equation.

Highlights of each year's results indicate how this progression has taken place:

- In 2009, plan sponsors were almost exclusively focused on the asset side of the asset-liability equation;
- In 2010, as the economy was struggling, in the course of just one year, plan sponsors were open to a potential reconsideration of the importance of all risks, placing nearly equal importance on all of the risks;
- In 2011, as the economy started to stabilize, plan sponsors were showing signs of differentiating among the risk factors, and were beginning to look at assets in the context of liabilities;
- In 2012, rather than returning to the asset-centric, total rate of return focus seen in the inaugural study, a more balanced focus on assets and liabilities had continued to advance, suggesting that a new trend might be taking hold; and
- The 2013 study indicates that this balanced mindset has deepened, and is driving the current shift from analysis and planning to action.

The rankings of the most important risk factors in 2013 bear this out. Underfunding of Liabilities and Asset & Liability Mismatch were ranked first and second in importance of the 18 risks, respectively. This liability-related focus is quite different from the inaugural

study, when two investment-related risks – Asset Allocation and Meeting Return Goals – topped the importance rankings.

Notable as well is that in 2013, sponsors ranked the two risks ranked 1<sup>st</sup> and 2<sup>nd</sup> in importance in only 12th and 13th place among all 18 risks in terms of how successfully they were able to manage them. This helps shed light on the confluence of forces that has increased sponsor awareness of the nature and interrelationship of the risks associated with their plans. Although equity markets have rebounded and the Dow Jones Industrial Average has recently reached a record high, plan sponsors are still grappling with how best to maintain minimum funding levels at a time when pension benefit obligations are climbing. This is due, in large part, to the persistent low interest rate environment that has resulted from U.S. monetary policy intended to support the post-recession economy. Market and regulatory uncertainty are also factoring into their decision-making processes.

It is clear to us that plan sponsors have a new mindset. Today, most are fully engaged in the active management of their pension risks and the impact of the pension plan on its business overall has the sustained attention of senior-level officers. In our new study, nearly 4 in 10 plan sponsor respondents (38%) indicated they had taken or were planning to take action to de-risk their plans, and about two-thirds of that subset referenced lump sums as an element of their action plan (about 25% of respondents overall). This is consistent with a recent Aon Hewitt study of 230 U.S. employers with DB plans<sup>5</sup>, which found more than one-third (39%) are somewhat or very likely to offer terminated-vested participants and/or retirees a lump sum payout during a specified period in 2013. This includes 14% who are very likely to select this option and 25% who are somewhat likely.

In short, companies are looking to reduce their pension liabilities and the associated risk because extreme market volatility and a persistent low interest rate environment have made managing DB assets and liabilities very challenging for sponsors. As funding levels have remained stubbornly low, even when large new contributions have been made, many are understandably concerned about and consistently focused on managing their plans' contribution and funded status volatility. Both types of volatility impact a variety of corporate performance measures, and help explain what is behind this impetus to action on their DB plan(s). With an effective action plan, such as isolating and then transferring pension risk to an insurer, a plan sponsor may be able to take a big step toward reducing a plan's volatility, improving funded status and restoring some stability to the company's balance sheet. It also provides companies greater flexibility to focus on core businesses.

This active management is behind the new term “de-risking”, coined to describe the manner in which plan sponsors are managing these risks, which is quite a stark contrast with 2009, where “active management” referred to an investment management style.

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<sup>5</sup> Aon Hewitt Survey, 1Q 2013: 2013 Hot Topics in Retirement.

## **Role of Group Annuity Contracts: Evolving to Serve Multiple Purposes**

It is very important to keep in mind the voluntary nature of the qualified DB plan system in the U.S. While sponsors that do provide a plan are required to operate it within proscribed parameters designed to help protect plan participants, those parameters apply only to the extent that the employer elects to continue sponsoring the plan. This is a core and necessary element of a voluntary system that enables balance between the sponsor's right to operate a plan or not, and participants' reliance on earned benefits. Accordingly, it is necessary to provide for the inevitable contingency that a sponsor becomes unwilling or unable to continue to provide a plan. ERISA and the PBGC provide a voluntary plan termination structure for the former and a distress termination structure for the latter.

As the focus of the Council's concern is primarily on voluntary transactions, we note that this structure provides two long-standing avenues for sponsors to utilize – lump sum cash settlements and insurer provided annuities. These have formed the starting point for current sponsor de-risking action plans, when sponsors seek to reduce risk more than is possible through changes to plan investments.

Group annuity contracts have been a recognized and important element of the qualified DB system since PBGC and ERISA came into being, to facilitate an orderly transition of plan terminations that occur in the normal course of business. Insurance companies are uniquely suited for this responsibility since they are regulated for long term solvency and their core business is pooling risks. Group annuity contracts do facilitate standard plan terminations, but increasingly they also provide solutions that stop short of termination. This can be helpful in preserving the DB system by enabling sponsors to reduce volatility to a manageable level by mitigating or reducing risk.

Following is a brief overview of the major ways in which group annuity contracts offered by insurance companies can be used to reduce sponsor risk while safeguarding plan participant benefits. Today's de-risking may be thought of as a continuum of choices and series of steps or actions, rather than yesterday's once and done plan termination. The major thrusts of these actions include matching assets to liabilities, and understanding the plan's current and expected exposures, which typically include equity investment, interest rate and in the future, early retirement and longevity risks.

- **Pension Buyout**

One way to remove all DB pension risks is by transferring the liabilities to an insurance company through a well-established procedure known as a "pension buyout". A traditional pension buyout usually involves an annuity contract that transfers all future mortality, longevity, expense, early retirement, market and investment risks to an insurance company in return for a single lump sum payment. It allows plan sponsors to remove volatile and expensive pension liabilities from their balance sheets, while at the same time ensuring that pension benefits for current

and future retirees – and their beneficiaries – are properly protected. This is the type of pension risk transfer that is generally done in conjunction with a plan termination.

- **Partial Risk Transfer**

Partial Risk Transfer is a risk reduction solution that can be used with both active and frozen DB plans. It may be used as a way to offload a risk (or risks) that the sponsor can easily identify, or those risks with which they are least comfortable. This solution is also very flexible – if a plan risk can be identified and quantified, it can probably be transferred. Some common examples include benefits for a plan's current retirees, current terminated-vested liabilities, or even particular "tail risks," such as an increase in early retirement elections or future longevity improvements. Depending on the risks transferred to the group annuity contract, PBGC premiums may be reduced.

- **Buy-In: Annuity as a Plan Asset**

A third option for plan sponsors to consider is to buy a group annuity contract as a plan asset. Annuities have a return profile similar to other fixed-income investments, but can uniquely mitigate risk by providing a guaranteed cash flow perfectly matched to a segment of pension liabilities. As with partial risk transfer, various segments of the pension risk can be immunized through the annuity asset. Unlike a buyout or partial risk transfer, the plan would own the annuity and generally no settlement of the liability would occur, which would mean that the sponsor would not be subject to settlement accounting and the purchase would not generally be an impact on the funded status. While relatively new in the U.S., a similar strategy has been used widely in the United Kingdom. In this case, the plan continues to pay PBGC premiums.

- **Group Annuity Contracts and Liability Driven Investing**

One of the earliest recognized forms of Liability Driven Investing (LDI) is a bond portfolio with a series of durations set to match a given set of cash flows intended to approximate those of a plan. Such "indemnified portfolios" can be an effective way to mitigate some risks, such as interest rate risk, provided that the investment strategy is executed well and that the cash flow estimates are accurate. In practice, such strategies alone are not able to fully account for inevitable deviations from expectations around both assets and liabilities. When an annuity-based product for a portion of the defined cash flows is added as part of the overall LDI strategy, the effectiveness of the program may be increased very significantly. A formal full or partial risk transfer may be viewed as an LDI solution that sharply reduces the probability of future mismatches.

When a group annuity contract secures some part of a qualified plan benefit, the carrier's financial strength comes into play. Generally, the carrier financial rating is at

least as high as, and is often higher than, the plan sponsor's, ensuring that the participants whose benefits are secured through a group annuity carrier guarantee have a generally greater level of security than those remaining in the active ongoing plan, as is discussed below. Consider the following:

- Financial strength of carriers selected under the Department of Labor's (DOL) Interpretive bulletin 95-1 guidance is generally among the very highest in the entire life insurance industry;
- Even if a carrier's financial rating is the same as the credit rating of the sponsor, the benefits are secured by a firm whose core business is guarantees, and whose risks are much more diversified, than can be the case even with the largest and most well-funded of single employer plans;
- All insurance carriers are regulated for long term solvency, and this regulation continually evolves to reflect market changes and developments; and
- For a guarantee to a participant to be compromised, the entire insurance firm would need to fail, and even then the guaranty association would provide a backstop funded through insurer assessments.

For all of the above reasons, a risk transfer to an insurance company, where the same benefits earned are preserved in exactly the same form, does not represent a risk transfer to the participant in any way, but does facilitate the ability of a sponsor to responsibly reduce its pension plan risk. The discussion below addresses the role of the PBGC, and the circumstances under which it comes into play.

We wish to clearly distinguish this set of facts from a lump sum offer made to participants, which if taken transfers risks from the employer to the participant. Whereas a commercial insurer is very well equipped to take on risks for which its business is designed, it is difficult to argue that an individual participant is similarly situated. We note that while accepting a lump sum offer is a participant's decision, it is also the case that, unless the information about the consequences of the decision that the plan sponsor provides is framed in lifetime income terms, most plan participants will take a lump sum rather than an income stream in the mistaken belief that it has the greater value. As is discussed in more detail below, participants tend to underestimate future income needs and overestimate the wealth effect a lump sum offer conveys, which can encourage behavior inconsistent with long term income needs.

## **Pension Risk Transfer and Fiduciary Responsibility**

In the U.S., the plan sponsor has both a settlor and a fiduciary role. As settlor, the plan sponsor has the right to amend the plan and can decide to terminate it. These actions relate to "what" decisions, such as whether and what type of plan will be provided. These are business decisions and are determined by the sponsor's business goals and priorities. The plan sponsor is also the plan's primary fiduciary<sup>6</sup>, which relates to "how"

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<sup>6</sup> Plan sponsors may retain the services of one or more service providers, who may also be fiduciaries to the plan with respect to the services provided.

decisions, such as how the plan's assets will be invested and how the plan, once established, will be managed. Put another way, the decision to change the way benefits are provided - such as through a group annuity contract purchase - will usually be a sponsor business decision. Deciding which carrier to retain is a sponsor fiduciary decision. This distinction is critical to understanding and properly evaluating plan participant considerations when various types of de-risking actions are undertaken by a plan sponsor. While fiduciary decisions are required to be made in the best interests of plan participants, settlor decisions consider instead the interests of the business, where employee concerns are one of many factors, rather than the primary factor in the decision.

## **Key Plan Participant Considerations**

Retirement security is central to participant considerations, and has two major dimensions. The first is form of benefit and the second is the security of the benefit promise.

- **Considerations Related to Benefit Form**

MetLife has previously testified before this body<sup>7</sup> on the importance of retirement income, and of plan sponsor actions that our research shows are correlated with participant awareness and appreciation of an income form of benefit from qualified retirement plans. Only a minority of sponsors have taken such actions.

Current benefit statement disclosures generally do not support or advance income awareness. We note that the DOL's Advance Notice of Proposed Rulemaking, which has been proposed in part to address this problem, just completed its comment period on August 7, 2013, and there remain a number of steps before basic income equivalency disclosures become part of Defined Contribution (DC) plan statements in some form. DB plan benefit statements are required much less frequently than DC statements, and in the case of participants with a hybrid benefit formula, generally provide information only in terms of an accrued account balance similar to DC plans.

It is well established that most participants are unable to translate an accumulated value into an income equivalent, and without framing the offer in terms of lifetime income, will take a lump sum rather than an income stream in the mistaken belief that it has the greater value.<sup>8</sup>

This is relevant when a de-risking plan includes a current lump sum settlement to plan participants in lieu of a future retirement income benefit. Lump sums became more financially attractive to plan sponsors with the now phased in change from a 30-year Treasury rate to a corporate bond rate for lump sum pricing, so this form of

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<sup>7</sup> ERISA Advisory Council Testimony on Retirement Income Practices, 8/28/2012 hearing.

<sup>8</sup> Brown, Jeffrey R., Kling, Jeffrey R., Mullainathan, Sendhil and Wrobel, Marian V., Framing Lifetime Income (May 2013). Available at <http://www.nber.org/papers/w19063>.

benefit offer – which is a settlor function - is currently common as one part of a de-risking plan.

While it is worth noting that only the DB participant can waive his or her right to receive an income form of benefit, lump sum offers are not generally communicated in a manner consistent with income oriented framing or positioning. Except when a DB benefit is required to be communicated in an income form, such as in a periodic benefit statement or in required plan termination communications for a traditional benefit formula plan, an income equivalent is generally not provided. In either case, the advantages of a guaranteed retirement income form of benefit may not be clear to participants, especially when retirement income education is not generally a part of ongoing benefit plan communications. We note that while the decision to offer lump sums is a settlor function, the way in which the offer is made and communicated is a fiduciary function, and as such should be carried out in the best interests of participants without regard to the sponsor's financial interests in the outcome.

- **Considerations Related to Benefit Security**

Currently in the market, and in the ERISA Advisory Council's June 6 hearing on this matter, there have been frequent comments about comparing the strength of the insurance industry's State Guaranty Association and the PBGC's pension benefit guarantee. We respectfully suggest that this comparison is both incorrect and incomplete, as it takes both of these entities out of the actual context in which they operate. Instead, the correct comparison is between the guarantee of the plan sponsor, backstopped by the PBGC under certain specified circumstances, versus the guarantee of the insurance company, with the State Guaranty Association coverage under certain specified circumstances.

The sponsor of a defined benefit plan has the responsibility to set aside assets within the plan to pay promised benefits to participants. While an adequate level of funding is a goal of DOL regulation, funding rules for plans recognize that the plan is a very long-term obligation of what is presumed to be a healthy, ongoing company. Thus, regulations allow plans many years to make contributions to make up "underfunding" – the extent to which assets fall short of future liabilities – which generally makes sense. After all, funding ratios improve "automatically" if stock markets rally (boosting assets) and interest rates climb (shrinking liabilities). Further, requiring companies to keep their plans fully funded at all times could require massive contributions that would then become trapped in the plans as surplus assets through normal market fluctuations, which in turn could have impacts like reducing investments in the company and initiating layoffs given scarce capital and the practical process of operating a business. Funding regulations operate on an incentive system, with current tax benefits for contributions and financial and administrative penalties for underfunding. They also rely on implicit assumptions that a sponsor firm will continue to be a going concern, and that it intends on providing the benefits. PPA regulations set reasonable limits on assumptions, and tax law

prevents removing funds once contributed to the plan for any purpose other than benefit payments. At their core, plan funding regulations effectively represent a balance between the voluntary nature of the plan system and reasonable plan participant protections. For all of these reasons, a sponsor is permitted to “insure” a plan for its own participants, but is not permitted to do so for unrelated entities as a commercial business.

A well-funded plan gives plan participants additional security relative to a less well funded one. While the sponsors of both are required by law to fully fund their plans over time, the better funded one is less subject to business reverses that could make future contributions more difficult for a firm. That said, a plan sponsor can, while operating within these requirements, maintain an underfunded plan, have a high equity allocation, and operate without risk charges or capital requirements.

It is important to note that, as long as the sponsoring firm remains in business, participants have no insurance or security other than their plan’s assets, and the sponsor’s ability and willingness to continue the plan and to make contributions. Its ability to do so may be loosely correlated to its credit rating. Should such an employer decide to no longer sponsor a plan, it is required to fund up the plan so that a fully funded plan can be administered by an insurance company, settled through lump sum payments to participants or a combination of both. The only time that a PBGC guarantee becomes effective is if the sponsor ceases doing business as an enterprise, and a court determines that the plan is underfunded. This is called a distress termination, and these are generally administered by the PBGC because a commercial provider cannot assume a liability without adequate consideration being paid. In a distress termination, lump sums are not offered.

By comparison, a life insurance company, which is a commercial business designed to provide long term guarantees as a core competency, is regulated for long term solvency. Carriers are required to maintain what, in sponsor terms, would be a consistently overfunded ratio at all times, backed by an asset portfolio that matches assets to the liabilities, and maintain extra capital for extreme market scenarios as a matter of normal business. On top of this, the only carriers eligible for consideration under the DOL’s IB 95-1 standard, widely used by sponsors in DB carrier selection for de-risking, are the very strongest in the entire industry, generally with AA ratings for financial strength. For perspective, of all firms rated by S&P, less than 5% are rated “AA” or higher, and less than a quarter are rated “A” or higher. Overall, 47.4% carry investment grade ratings, with over half of all rated firms either below investment grade or not rated.<sup>9</sup> Among the S&P 500 Index firms, less than 5% are rated “AA” or higher, 33% are rated “A”, and 50% are rated “BBB”, for 88% investment grade overall.<sup>10</sup>

We note that because the insurance industry is regulated for solvency, no carrier is permitted to include the state guaranty system as an element in any of its product

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<sup>9</sup> 2012 Annual US Credit Default Study and Rating Transitions, S&P, March 20, 2013.

<sup>10</sup> Standard & Poors, Global Fixed Income Research & S&P Capital IQ, June 20, 2013.

offerings. In the event that an insurance carrier fails as a going concern, the guaranty association represents the last of a long series of steps that together are designed to ensure that all of the carrier's contractual obligations are met. The detailed information insurers are required to provide quarterly to regulators enable early detection of financial difficulties far in advance of risks to the carrier's overall operation. All of these steps ensure benefits are paid as contracted. Only if these steps end in receivership do the guaranty association and its statutory benefit limits become effective. The guaranty association is funded by assessments to carriers, if needed. The same solvency requirements that govern company operations, reserve levels and cash flow testing provide each state insurance regulator with an excellent, current and accurate view of the capital adequacy of the carriers operating in its state to cover a required assessment if one should be needed.

Plan participant confusion about the nature of insurance company guarantees is understandable; even experts may not correctly differentiate between the ability of an insurer to meet its contractholder claims and the ability of a firm to pay its bondholders, but the difference is quite significant, and the power invested in the insurance commissioner over insurers ensures that the interests of covered contract holders are primary for all of the benefits promised by the contracts.

In terms of benefit amounts, PBGC and state insurance maximum amounts are not easily comparable for several reasons, including the following:

- The PBGC expresses its maximum benefits in terms of income and is based on a normal retirement age of 65<sup>11</sup>. The state insurance limits are generally expressed in terms of a fixed present value (PV), regardless of age. Accordingly, if each were converted to the terms of the other, the PBGC PV would be much lower at younger ages and much higher at very advanced ages, where the effect with the state insurance limits is the reverse;
- The actual amount a participant could receive in any case is the amount earned under the plan. If the PBGC assumes the plan in a distress termination and the benefit earned is higher than the PBGC maximum, the benefit paid is reduced to the PBGC maximum level at that time. . The amount paid by the insurer is not limited when the benefit responsibility is transferred to the carrier, but is retained at 100% of the accrued level; and
- PBGC coverage comes into play, along with its limits, only if the sponsoring firm goes out of business. As long as the firm remains a going concern, there is no backstop other than the plan sponsor. The possibility that insurance company guaranty association coverage could come into play is much more remote, and even in these cases, funds may be available from the failed insurer's estate to cover benefit payments for a lengthy period before any guaranty funds might be needed. Further, it is also possible for sponsors to split the insurance responsibility between two strong carriers, further reducing any remaining risk that all future benefit payments will be reduced.

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<sup>11</sup> PBGC maximum benefit amounts are adjusted for early retirement, if applicable to a specific participant,

The bottom line is that plan participants are generally at least as well, and arguably more robustly, protected by the combined guarantee of the insurance company, its regulatory regime and the State Guaranty Association, and especially so in the case of a carrier in a DB risk transfer transaction.

## **What Can the ERISA Advisory Council and the DOL Do Now?**

Recent plan sponsor de-risking programs have raised the question of whether some form of additional regulation is necessary, and if so, for which types of actions and for what purpose. We believe that the well-established and historically very effective role that group annuity contracts play when a sponsor decides it can no longer sponsor a DB plan has worked well and is a crucial element in the structure of the voluntary qualified plan system. We also note that the Agencies have developed very detailed communication and disclosure requirements when a formal plan termination takes place. This said, there are two factors not generally present when the current disclosure rules were developed. The first is that the rules implicitly assumed that a plan termination was the precipitating event and outcome; the second was that an income form of benefit was the prevailing benefit form. What is different about today's transactions, in addition to the compelling business drivers behind them, is that in a multiple de-risking transaction steps affecting different classes of participants may take place without a plan termination, and lump sums are far more prevalent today than in the past as an optional form of benefit. These three developments, taken together, have created a new context in which plan participant communications and disclosures may be evaluated.

We offer the following observations and suggestions for the Council to consider as it focuses on potential recommendations to the Secretary of Labor.

### **1. Consider providing guidance to sponsors on best practices for separating settlor and fiduciary functions when evaluating PRT transactions.**

While the legal framework establishing settlor functions and fiduciary activities is well established, the current generation of transactions may create heightened sensitivity to potential conflicts of interest as they are executed. For example, while *a decision to add a lump sum window or offer lump sum settlements* to one or more classes of participants is a plan design (and therefore settlor) function, the sponsoring firm has a clear financial interest in maximizing the number of participants electing to accept the offer. It is important that sponsors developing such plans recognize that *communicating the offer*, on the other hand, is a fiduciary function, and a plan fiduciary should be aware that the way in which the offer is framed can have a very significant effect on the elections made. As a pension risk transfer provider, we see this firsthand, as the group annuity contract is generally placed to cover the residual balance of the benefit payment obligations when it is combined with a lump sum offer. Additional guidance could be provided for plan sponsors that highlights that certain types of settlor decisions may create fiduciary challenges, and may be helpful in ensuring that those charged with

fiduciary responsibilities are not also responsible for the financial outcome of the de-risking program adopted, whether through separation of functions or use of an independent fiduciary for certain activities. Similarly, developing a best practices resource for plan fiduciaries charged with implementing de-risking programs may be helpful in enabling them to carry out their responsibilities effectively.

**2. Extend participant disclosure rules to include equivalent monthly income for DB plans with lump sums as an optional benefit form, and in conjunction with lump sum offers.**

Full or partial lump sum forms of payment began to be added to significant numbers of DB plans in the 1990's, often to facilitate the early retirement incentives common to that time period. Once added, these optional forms of benefit are classified as protected benefits, and so have been available to generations of retirees not separating from service under an early incentive program. It has been well documented that , in general, the majority of participants will elect a lump sum over an income stream form of benefit for reasons including (a) the feeling of immediate wealth it creates; (b) the perception of financial freedom it generates; (c) the belief that it is a better financial deal than an income stream; (d) the assumption that it will provide an equivalent amount to live on as withdrawn instead of paid as an income benefit and (e) an assumption that if they can invest it, they will have more control over the returns, among other reasons. While a partial or lump sum may be perfectly appropriate for participants in some instances, research has shown convincingly that when individuals believe they are making a consumption decision rather than an investment decision, their behavior often reverses, suggesting that what is communicated can have a significant effect on the outcome. One action the DOL could consider is including DB plans in the lifetime income disclosures already in development for DC plan benefit statements.

**3. Expand Interpretive Bulletin 96-1 guidance to extend its framework to distribution planning, which will benefit both DB and DC plans where an employer sponsors both.**

Similarly, an expansion of IB 96-1 to cover distribution planning regardless of type of qualified plan could benefit retirement income education more broadly, as this is important and relevant for any plan whose benefit is currently constructed or designed to be paid as an accumulated balance.

## **Conclusion**

In summary, we conclude with the following points:

- MetLife believes that group annuity contracts and the companies that issue them are a critical and integral part of the ongoing voluntary qualified plan benefit system;

- Group annuity contracts have played an important role for 90 years in securing pension income benefits to American workers and their families, and we believe that they have an equally important role to play today;
- We believe that group annuity products available today have incorporated decades of practical experience, through good markets and bad, and offer a unique value proposition to defined benefit plan sponsors and their participants. We do not believe that any changes to IB 95-1 are necessary; and
- We believe that when pension risk is transferred to a group annuity provider, through a full or partial risk transfer, the benefit promise is strengthened, and that partial risk transfers that are properly constructed can help enable plan sponsors to continue plans they otherwise might want or need to terminate.

We would like to thank the Council for examining this topic and for inviting us to testify today. I would be happy to answer any questions you may have on MetLife's behalf.