CANNEX

May 28, 2015

2015 ERISA Advisory Council
Model Notices and Disclosures for Pension Risk Transfers
Testimony of Gary Baker
On Behalf of CANNEX Financial Exchanges

Thank you for the invitation to appear before the U.S. Department of Labor's Advisory Council on Employee Welfare and Pension Benefit Plans. My name is Gary Baker and I am President of CANNEX Financial Exchange's U.S. Operation.

CANNEX is an independent provider of pricing and valuation services in the retirement market in both the United States and Canada. No financial institution holds any shares in the company and no CANNEX employee or shareholder receives any income from the sale of financial products. For over 30 years, our core business has been providing a central exchange for guaranteed rates and payouts for a variety of financial products, including annuities. Similar to the NYSE, our primary service in the U.S. is an independent and central exchange for pension annuity quotes and illustrations. This service also creates income benchmarks and indices that support a variety of retirement education and guidance tools in the market. The overall philosophy of CANNEX is to provide transparency with regard to competing products. Our clients include all of the major insurance carriers who manage their annuity guarantees directly on our platform, to over 300 distribution firms who represent over 250,000 financial advisors as well as call centers, 401(k) Rollover operations, academia and the media.

Two years ago, CANNEX purchased the QWeMA Group which was founded by Moshe Milevsky, a leading international expert on pensions and annuities. Dr. Milevsky has since joined the CANNEX board. With this acquisition, CANNEX also provides analytic and consultative services focused on the valuation of annuity guarantees as well as processes that support the allocation of financial products in support of retirement income. This includes the development of model portfolios that combine both annuities and investments.

Our experience provides us with insight as to the various practices and programs deployed across the U.S. market as financial institutions use components of our services to support their own proprietary retirement programs and platforms. Today I'd like to share some current practices that may help in providing plan participants the necessary information to make an informed decision when presented with a lump sum offer as part of a pension risk transfer.

Challenges in Understanding & Evaluating Retirement Income Options

Our clients are continually challenged with providing both investors and their advisors with the necessary information to understand the basic nature of retirement income planning let alone gaining an awareness of the various product options at their disposal. Managing an investment and savings program is basic math compared to the calculus required to effectively manage a retirement income process. However, the market seems to be making improvements that simplify the decision making tools and processes without having to expose investors to the complexities under the hood.

Even with such improvements, we feel there are still a few fundamental principles that are necessary to help guide the decision participants need to make regarding their retirement portfolio:

- **A Fluid Planning Horizon** – The magical age of 65 has provided a simple and clear milestone for the average participant to calibrate their retirement savings strategy. If by chance something goes wrong along the way they can make a course correction and recalibrate their plan, assuming they are young and healthy enough. Unfortunately, a majority of retirement income guidance and education tools force the participant to state a target age for income planning. Is it 80? 90? 100? Life expectancy isn't a planning horizon. Lifetime income products and pensions are built to insure you against the uncertainty as to when you will pass away through the use of actuarial tools. Decision making guidelines and tools should align with the actuarial process as well. In other words, there should be no need to choose a target date for when you will die. This should be computed under the hood for you.

- **Longevity Risk Aversion** – Whereas market risk aversion relates to the level of tolerance an investor can stomach in a fluctuating market, longevity risk aversion relates to the personal belief or attitude of how long you think you will live. This has implications on how much you will initially spend in retirement. Our research suggests that these risks are somewhat correlated. Someone who is risk adverse will most probably choose a conservative portfolio of investments while anticipating lower market returns. As a result, the rate of spending from that portfolio will tend to be lower as well. Similarly, someone who believes they will live a long time will also spend less early in retirement knowing that their portfolio has to last for quite some time. Intuitively, they may also plan to reduce their spending over time, if necessary, as their attitudes and beliefs evolve about their own mortality. Therefore, on a general level, your preferences for investment allocation may mirror what your view is of your own longevity.

Helping Participants Make Informed Decisions

The following are examples or suggestions of practices that can help with evaluating both the competitiveness as well as the risk of the Lump Sum offer.

1. Comparison of Rates & Valuation

"Is the Plan Giving You a Good Offer for Lump Sum vs. Lifetime Payment?"

When a Lump Sum window is in effect, the participant must determine whether or not the lump sum dollar amount is a fair offer compared to the monthly payment amount of the annuity offered by the plan. This assessment can become even more daunting when the participant is presented with two annuity payment options – one for an immediate payout and another for payments to start at a time in the future such as the retirement age for the plan.

Even if the technical assumptions were disclosed relative to the interest rates, mortality projections, and expenses used in the calculation, very few participants would possess the necessary level of financial literacy or capability to derive an informed assessment of the lump sum offer. For most consumers, the relationship between a single large dollar amount versus a small monthly income payment for life is not an intuitive comparison. In fact, our clients have found that it can be downright disappointing to learn that $100,000 will only translate to a monthly check of $500.

a. Comparison to Retail Market

The simplest way to provide context on an offer is to supply a quote on how much monthly income the proposed lump sum amount can purchase in today's retail market (or conversely, how much premium would it take to buy the annuity payment offered by the plan). CANNEX currently supports similar processes where we either produce a batch of participant specific calculations for statements or we provide the engine for a real time online calculator that a user would access to conduct their own research. In either case, these calculations typically reflect the actual average payout of the 5 most competitive income products available that day in the market.

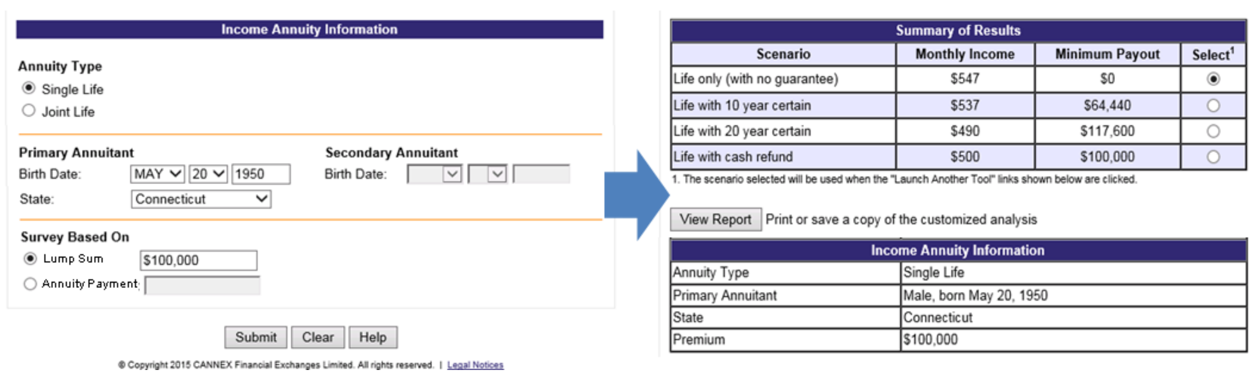
This comparison could be provided as a disclosure directly on the letter containing the offer to the participant. Otherwise, the letter could provide a link to an independent website where the participant can enter the lump sum amount (along with other basic inputs such as their current age) and get an up to date quote of what is available in the market.

Exhibit A: Disclosure Example:

Name: Jane Doe (Age 55)
Lump Sum: $217,500

Monthly Income Start	*"Next Month"*	*@ Age 65*
XYZ Defined Benefit Plan	$1,563	$1,910
Retail Market Average	$1,114	$1,370

Exhibit B: Website Example:



Chances are that the monthly payout amount provided by the plan will be superior to what can be purchased in the retail market due to lower distribution expenses and other institutional parameters. Even though the relative value of the lump sum compared to a monthly payout is not made clear to the typical participant (i.e., the conversion rate), the purchasing power of what the plan would likely provide versus the retail market would provide a good indicator as to the strength of their current position within the plan.

b. Comparison within Pension Market

Another potential comparison could involve producing a common benchmark for within the Pension industry itself. One best practice can be found recently in the retail market. In 2010, leading insurance carriers and advisory firms formed an industry working group to define a standard methodology for the market valuation of an annuitized asset. Advisory firms wanted this valuation so that they could account for the full portfolio of assets being managed on behalf of their clients when assets included annuities. Instead of using existing valuation methods for annuities such as a statutory reserve amount, firms wanted a dynamic valuation that would be representative of the market like all other assets held by a client.

The valuation methodology assumes no projections off of a common mortality table (A2000), no fees or expenses are applied, and an "pension annuity" yield curve is used to define the long term discount rate. This yield curve represents the average crediting rate used by insurers in the industry to support pension annuity guarantees and is derived on a daily basis by CANNEX. A spread from the U.S. Treasury is also provided as a benchmark with this new pension annuity yield curve. Each carrier ultimately manages their own pricing and competitiveness; however, they understand that advisors and clients need a common benchmark to evaluate guarantees regardless of the provider. Also, some clients held more than one pension annuity since they diversified their risk across multiple carriers.

Exhibit C: Pension Annuity Yield Curve

Valuation Date: January 2, 2015

	Pension Annuity Yield Curve	**U.S. Treasury Yield Curve**	**Spread**
1 Year	0.91	0.22	0.69
5 Year	2.76	1.61	1.15
10 Year	2.76	2.12	0.64
30 Year	3.87	2.69	1.18

Source: CANNEX Financial Exchanges

One potential solution would be for the industry to define a similar basic valuation methodology for benchmarking and comparison of lump sum proposals. Given that plan sponsors currently have such a wide latitude on choosing the specific interest rate used for calculating the lump sum offer (and given that the window may be relatively short), it may be best to refer the participant to a link on an independent website where they can enter the monthly payment provided by the plan and receive lump sum valuation results based on one or multiple interest rate benchmarks. These benchmarks would include the most current U.S. Treasury Rates, Corporate Bond Rates, or even the Pension Annuity Yield Curve used in the retail market.

Ultimately, it's up to the plan sponsor to provide a competitive "buy out" offer based on existing regulations and guidelines. Similar to the auto industry, providing a Kelly Blue Book or Edmunds website would allow the participant to better gauge the offer against a transparent benchmark.

2. Comparison of Risk

"What is the Implication of Choosing a Lump Sum vs. Lifetime Payment?"

There is a growing acceptance by our clients that a marriage between investment and insurance concepts is necessary to help guide the appropriate allocation of products to support income in retirement In simple terms, our research shows that converting a portion of your nest egg into a stream of lifetime income increases the amount you can spend at all ages, regardless of the exact cost of an annuity provided by the plan or a retail annuity.

The practical reality is that deciding to annuitize is not an "all or nothing" decision. In the retail market, financial advisors actively work with their clients to determine how to best allocate their retirement savings between locking in additional lifetime income guarantees versus keeping their savings invested in the market and drawing down on both interest and principal when needed. The mix between the two is both a behavioral and analytic decision specific to each and every participant.

The behavioral desire for control over one's money is a very strong force. Once the Lump Sum offer has been made the plan has already, in effect, given ownership of those assets over to the participant and having them give it back in exchange for a long term benefit is not easy. Typically, only those who seek out advice they can trust will yield to consultation that advocates for the purchase of a lifetime guarantee in return for loss of control of assets. There is a percentage of participants would be classified as "Do It Yourself" investors who will sacrifice pension-like guarantees in return for absolute control over their money. However, our clients have found that a majority of investors will look to a trusted source for guidance and advice.

One simple measurement that is used by our clients to evaluate the risk associated with retirement income options is the Retirement Sustainability Quotient (RSQ) which summaries the likelihood that your retirement portfolio will last as long as you do. The RSQ – which can be thought of as analogous to calculating the probability of precipitation on a given day – is estimated using an algorithm that takes into account many factors, including longevity tables and economic conditions, as well as personal factors like age, gender, health, and whether you have a defined benefit pension or just an investment account. There is no need to determine a planning horizon since the evaluation of investment spend-down and annuity payouts are tied to the same actuarial probabilities of survival.

A Sustainability score can range from 100 percent (very sustainable, and very good) to 0 percent (very unsustainable, and very bad). But unlike a bad weather forecast, you can actually do something about a bad RSQ. By "pensionizing" a fraction of your nest egg you can improve your RSQ. There are many ways or methods for computing a Sustainability score depending upon how it is applied. Within the context of making a Lump Sum decision, there are a couple of options to consider based on how some of our clients deploy this methodology:

a. **Comparing Risk – Plan Assets Only**

Framing the lump sum decision as an allocation decision and not an "either/or" decision may be less daunting and allow the participant to view a spectrum of choices related risk scores between Lump Sum and the plan annuity. This process is similar to considering the risk difference between multiple asset allocation models for a 401(k) plan. According to the GAO report addressing the risk transfer issue, there is between a 45% to 65% acceptance rate of the lump sum offer. You could argue that offering a series of partial election options would not change the overall amount of risk that the plan sponsor is looking to eliminate while more participants would choose a combination that would result in an aggregate decrease in the risk they take on.

In this example, pre-set allocations between Lump Sum and the plan annuity would be provided along with a corresponding RSQ Score within the disclosure/letter.

<u>Exhibit D: Sustainability Score Example with Full and Partial Election of Offer</u>

Name: Jane Doe (Age 55)
Lump Sum: $217,500

Allocation		Amount @ Age 65		
Lump Sum	Lifetime Pmt	Lump Sum	Lifetime Pmt	Est. Sustainability[1]
100%	0%	$217,500	$0	85%
75%	25%	$163,125	$342	89%
50%	50%	$108,750	$685	92%
25%	75%	$54,375	$1,027	96%
0%	100%	$0	$1,370	100%

1 - Guidance associated with the comparison methodology suggests that a participant would want to achieve a target score of 90% or higher to establish some lifetime certainty, assuming that they would need to rely on all of these assets to help fund their retirement.

In the example provided, the sustainability score is 100% for the option where the participant would solely choose the plan annuity. For the other options (including lump sum only), the score would assume that the participant would want to duplicate the same level of annuity income (e.g., $1,370 per month) from the plan.

For further clarification, the method of calculating the RSQ or Sustainability Score above can be expressed as follows:

RSQ = (Fraction of Income that is “Pensionized”) x 100%
+ (Fraction of Income that is Not “Pensionized”)
x (1 – Portfolio’s Probability of Ruin)%

In this case, the portfolio consists of only the lump sum amount available from the plan.

b. Comparing Risk – Include Participant Assets Outside of Plan

The evaluation of risk outside of the plan may be just as important as what is being offered within the plan. Every participant’s personal situation is different and they may or may not have to rely on the pension plan to fund their retirement. In this case the participant could be referred to a web site where they can enter some additional information about other sources of income (such as Social Security estimates) as well as other savings accounts and then evaluate their lump sum decision within the context of their broader financial situation. This level of analysis would also require them to specify an annual income goal amount necessary to support their anticipated lifestyle in retirement so that an RSQ could be calculated. In this case, the participant’s Longevity Risk Aversion can also be taken into consideration relative to the offer.

The participant could then enter both the lump sum and annuity payment information provided to them (or a series of allocations as suggested above) and observe how each scenario could impact their overall sustainability score.

It is important to note that evaluation tool is not meant to replace a financial planning process or be considered advice in any way, but rather a directional tool that can help demonstrate the downstream implications of a lump sum decision that is somewhat personalized to their own financial situation.

Our clients also leverage components of this methodology to evaluate estate planning trade-offs and decisions in retirement, however, this would present an unnecessary level of complexity to the participant and would be outside of the objectives of a pension risk transfer decision.