2015 Advisory Council on Employee Welfare and Pension Benefit Plans

Model Notices and Disclosures for Pension Risk Transfers

Written Testimony of Matt McDaniel

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My name is Matt McDaniel; I am a Partner at Mercer, and the firm's US DB Risk Leader. I am also a Fellow of the Society of Actuaries, Enrolled Actuary, and CFA charterholder.

I am testifying today as a representative of the actuarial profession. Pension actuaries are closely involved with helping pension plan sponsors evaluate and implement pension risk transfer activities. As such, actuaries are well-positioned to support adequate participant disclosure that helps effective decision making.

The statements contained in my testimony reflect my own opinions only, and may not reflect the opinion of any actuarial organization, or of my employer. This testimony exclusively focuses on pension plans with ERISA protection, and does not address other types of plans (for example, public sector or church plans[1]).

Background

Pension risk transfer activity has increased dramatically since 2012, as pension plan sponsors have looked to remove liabilities and uncertainty from their balance sheets. While comprehensive data does not exist on the number of plan sponsors executing on these types of transactions, some estimates indicate that as many as half of plan sponsors have either done some form of recent liability transfer or are seriously evaluating doing so. This trend has intensified each year since 2012, and shows no signs of abating soon. The reasons for this uptick in activity include: a desire for sponsors to reduce risk, an increase in the administrative costs of maintaining a pension plan (e.g. PBGC premiums), and more favorable economics of these transactions due to changes in pension law.

Broadly speaking, these transactions can be classified into two types of activity: lump sum payments to participants, and annuity transactions[2] with insurers. By law, a lump sum payment offer must be voluntary, and participants must retain the option to receive their benefits as otherwise provided by the plan. In contrast, the decision to make an annuity purchase is

[1] To date, risk transfer activities do not seem to be as prevalent in these types of plans.

[2] For the purposes of this discussion, I will focus on annuity "buyout" transactions, where benefit liabilities and assets are transferred out of the plan and to a 3rd-party insurer. An annuity "buyin", where the plan sponsor holds an annuity contract as a plan asset, essentially amount to an investment decision for the plan sponsor, as the covered participant remains in the plan. Annuity buyins are still relatively uncommon in the US.

generally made by the plan sponsor, and participants do not have a say in whether this transaction occurs, nor in the selection of the insurer.

This key distinction between risk transfer methods has significant implications when considering what types of participant disclosures and notices may be most appropriate. In a lump sum offer, the focus should be on the education of participants to arm them with the information necessary to make an informed decision, as they make what is generally an irrevocable benefit election. In an annuity purchase transaction, no decision is in play for the participant, so the focus should be on helping the participant understand the financial implications of the annuity purchase and any impact on benefit security.

Lump Sum Offers

Key considerations

The decision of whether to elect a lump sum or annuity is a difficult one for most participants. Factors that go in to the decision include: expected longevity, comfort with investing, desire to leave money to heirs, risk aversion, and more. But at its core, this decision primarily comes down to risk and return considerations for the participants.

Risk

One of the key advantages of a defined benefit plan is guaranteed[3] lifetime income. This greatly improves the chances that assets will last for a retiree's entire lifetime. The nature of longevity risk pooling in a defined benefit plan allows the plan to fund benefits for each participant's life expectancy in the aggregate. In contrast, an individual managing a lump sum cannot plan for just living to his or her life expectancy; there is about a 50% chance he or she will live longer than that – perhaps much longer.

The cost of purchasing an individual annuity from an insurer equal to the annuity provided by the plan will typically be larger than the calculated lump sum from the plan. Some have pointed to this as evidence that that the plan's lump sum offer is less than the value of the annuity. In my opinion, this is not the case: in addition to the insurer's overhead and cost of capital, an insurer selling an individual annuity must build in an expectation that individuals self-selecting a product for longevity protection will tend to have higher-than-average longevity. A pension plan offering a lump sum on a group basis is not subject to the same level of adverse selection. Therefore, participants who seek secure lifetime income are likely best served by declining the lump sum offer and electing an annuity.

[3] "Guaranteed" is used in this testimony to refer to the guarantee provided by the plan sponsor, as insured by the PBGC. Even with this "guarantee" there is still some risk of non-payment of benefits.

Feedback from participants has shown that many seem to over-estimate the risk of remaining in the pension plan. This may in part be due to media and entertainment venues sensationalizing the risk of retirees losing their pensions. In truth, for a participant to lose a benefit that has been accrued, a specific sequence of events must occur:

1. Plan assets must become insufficient to meet benefits due, and
2. The plan sponsor must become insolvent, and
3. The participant's benefit must be larger than the amount guaranteed by the PBGC[4]

Even in the case outlined above, most participants would end up receiving the majority of their benefits. So when participants cite benefit security as a rationale for taking a lump sum, it is logical to question how thoroughly they understand the mechanisms in place to protect them.

Return

Evaluating whether taking a lump sum provides a good financial return is driven by two factors: longevity and investment return. If participants knew how long they will live and what their future investment return would be, it would be relatively easy to definitively determine whether a lump sum or annuity provides a better return. Alas, none of us know how long we will live or what our future portfolio returns will look like!

The Internal Revenue Code provides a basis for determining interest rate and mortality assumptions for determination of lump sum amounts. But while these assumptions may be appropriate in aggregate for group populations, they are likely to be a poor proxy for any individual's experience. In other words, the decision of lump sum versus annuity is inherently a very personalized decision. The good news for participants is that they have some degree of asymmetric information. For mortality, they can evaluate their general health, longevity and health history of family members, and gender (females tend to live longer than males, meaning the annuity tends to be a better choice for females, all else being equal). For investment return, participants will need to assess how comfortable they are managing a large pot of money over a period of several decades.

One area of the lump sum evaluation that can be particularly opaque to participants is the inclusion of any subsidies in the lump sum calculation, for example, early retirement subsidies or optional form subsidies. Such subsidies are permitted – but not required – to be included in the determination of a lump sum. These rules allow for situations where a participant may unknowingly pass up a more valuable benefit by electing a lump sum.

[4] Technically, an alternative for #3 could be if the PBGC were to become insolvent, however, many observers believe that if this were to occur the federal government would intervene.

Example: say a plan provides unreduced retirement at age 60, but determines lump sum values based on the normal retirement benefit at age 65 (this practice is generally allowable under pension law). A participant already age 60 would be provided an (unreduced) immediate annuity option that reflects the subsidy, so he or she is able to make an informed comparison. But for a participant age 59, the election materials may not provide an indication that waiting one year could yield a larger benefit value. Relative value disclosures start to address this issue, but are not always clear to participants in practice.

A related concept to return is to ensure participants do not incur unnecessary taxation on their retirement benefits when paid a lump sum. The easiest way to achieve this is to roll the distribution over to an IRA or other tax-qualified vehicle. Some have questioned whether additional participant disclosure is needed in this area. I believe there is evidence that the tax notices included in election materials already do an adequate job of educating on this point. There is significant evidence that participants electing lump sums – especially those with large account balances, indicating that the lump sum represents a significant portion of their retirement wealth – generally tend to roll these distributions over[5].

Recommended approaches

The focus on participant notifications for lump sum elections should be to educate participants so they can make informed decisions. Specific requirements to achieve this would include:

- A description of the protections in place under ERISA, including the plan sponsor's obligations to preserve accrued benefits and the coverage provided by the PBGC.
- A statement that an annuity from a defined benefit plan is likely the most cost-effective method for participants to receive guaranteed lifetime income.
- A description of characteristics that would make participants tend to choose an annuity versus a lump sum, such as: health, family history of longevity, medical history, gender, and ability/comfort with investments.
- An online tool that would allow a participant to model the interaction between investment return and longevity, the purpose being to help them evaluate which option would be better in different scenarios. For example, a participant could enter an age at death of 85, and the tool would say that the equivalent investment return would be 7%. Alternately, the participant could enter an expected investment return, and the tool would provide the "breakeven" age at death. This would help participants understand the potential "returns" of the annuity under various scenarios. However, such a simplistic model could fail to help participants take into account risks associated with

[5] Data compiled by Mercer indicates that 80% of participants with a lump sum over $50,000 and 95% of participants with an account balance over $200,000 choose a rollover.

non-constant investment returns and uncertain longevity. Other, more sophisticated tools could be developed for this purpose, but the benefit of additional sophistication must be weighed against the likelihood that complex models are more difficult for participants to understand.

- Require that election materials: (1) clearly and in plain language describe the existence and nature of any subsidies (early retirement, optional form, or others), (2) disclose whether the value of these subsidies is reflected in the lump sum, and (3) describe the conditions under which a participant may or may not become eligible for these subsidies in the future.

Annuity Purchase Transactions

Key considerations

An annuity purchase differs fundamentally from a lump sum offer in that it does not change the form, timing, or amount of payments to be paid to the participant. In fact, the insurance contract is structured such that all benefit forms and options are the same as the terms currently provided by the plan. From the participant's perspective, the most visible change is that the monthly payment[6] now comes from an insurance company rather than the plan itself.

However, another factor that has changed for the participant is the level of benefit security – that is, what parties stand behind the benefit promise, and what their obligations are to keep participants whole. The table below summarizes this:

	Ongoing Plan	Annuity Buyout
Primary obligation	Plan sponsor	Insurance company
Secondary obligation	PBGC	State guarantee association

Evaluating which option provides higher benefit security is no simple task for even a pension professional, let alone the average participant:

- The plan sponsor is obligated to fund benefits in accordance with certain minimum funding requirements under ERISA. The ability of the sponsor to fund depends on the viability of the ongoing business. This will vary significantly from sponsor to sponsor, and is generally unknowable, leading to difficulty in ascertaining benefit security.

[6] Retirees (i.e. participants already receiving a monthly benefit) are the most common type of participant to have an annuity purchased on their behalf. However, annuities can also be purchased for participants (whether active or terminated) who have not yet retired. The benefit security implications outlined in this testimony are similar for each group.

- In the event the plan sponsor becomes insolvent, the Pension Benefit Guaranty Corporation (PBGC) steps in to take over the plan and make payments to participants up to certain limits. However, the limits of PBGC protection are poorly understood, and many participants believe the PBGC provides more or less security that it really does. In 2015, the PBGC guarantees a benefit[7] of about $5,000 per month for a 65-year-old, however, this amount is adjusted for age, early retirement, and form of payment (among many other factors). This makes it difficult for the average participant to even determine how much of their benefit is protected should the plan sponsor fail. Finally, the long-term financial health of the PBGC is somewhat uncertain. The PBGC's deficit hit a record $62 billion in Fiscal Year 2014. What would happen to participant benefits should the PBGC become insolvent[8] is unclear.
- In an annuity buyout, the selected insurance company takes over primary responsibility for ensuring payments are made. The security of the annuity will depend on the stability of the insurer selected, as well as the structure of the annuity contract[9]. The selection of insurer is a fiduciary decision by the plan sponsor, and follows stringent DOL guidelines to determine the safest available annuity provider. The insurance companies selected for these transactions are generally large and well capitalized. In many cases, it the insurer may be more financially sound and able to secure benefits than many plan sponsors.
- A key consideration of benefit security in an annuity buyout is the loss of PBGC coverage. However, benefits are backstopped by state guarantee associations in the event the insurer become insolvent. This is another area that is difficult for participants to evaluate – the coverage level and provisions vary by each state. Comprehensive data comparing the state guarantee associations is not widely available.

Recommended approaches

The focus on participant notices for annuity purchase transactions should be to inform and educate, rather than equip participants to make a decision. As such, the primary components of participant disclosure should include:

1. A description of what is occurring and what will remain unchanged through the annuity purchase process (e.g. benefit amount, optional forms, survivor benefits, etc).

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[7] Note that this discussion focuses on single employer plans only; the limits for multiemployer plans are quite different. However, annuity buyout activity has focused primarily on single employer plans to date.
[8] While the prospect of the PBGC becoming insolvent is frightening, it would not be entirely unexpected. The PBGC projects that their multiemployer program has a 90% chance of becoming insolvent by 2025. While the single employer program appears to be in better shape, similar projections are not available.
[9] For example, an annuity backed by segregated assets will be more secure in the event of insurer failure than a contract backed by the insurance company's general account.

2. A disclosure that this transaction ends the responsibility for the sponsor to fund benefits, and also eliminates PBGC coverage. This should include a description of what the PBGC coverage level is, in a format that can be easily understood by the average participant. Ideally, this could include information about what coverage level was applicable for each specific participant.
3. Information on the selected insurer, including an overview of financial health and the process used to determine this insurer was most appropriate. This could include information such as agency ratings and a discussion of the safeguards put in place to ensure benefit security.
4. Information that describes the coverage provided by the state guarantee association applicable to the participant. This information is currently not easy to find for participants. One option would be for a government body to create and maintain a webpage describing coverage levels by state and instructions for determining a specific coverage level.

Thank you for your time and consideration today. I am happy to answer any questions you may have.