Statement of Norman Stein

Before the ERISA Advisory Council

Working Group on

"Considerations for Recognizing and Addressing Participants with Diminished Capacity"

September 18, 2020

Good morning. I am Norman Stein. I am a professor at the Drexel University School of Law, where I teach and write principally in the areas of employee benefits and tax law. I am also Senior Policy Advisor for the Pension Rights Center in Washington, on whose behalf I am testifying today.

The Pension Rights Center is the country's oldest consumer organization dedicated solely to protecting and promoting the retirement security of American workers, retirees, and their families. So on behalf of the Center, thank you for inviting me here today to present our views on how to address the effects of participant diminished cognitive functioning on the administration of employer-provided benefits in the private sector.

Today's topic is an important one. Americans, including participants in employer-sponsored retirement programs are living longer than they were in 1974, when ERISA was enacted. While increases in life expectancy is a demographic trend to be celebrated, it also means that we are seeing and will continue to see increases in the numbers of Americans suffering from age-related cognitive impairment. Indeed, it is estimated that 3% of adults between age 65 and 74 and suffer from Alzheimer's disease, 17% between the ages of 75 and 84, and between 32% over age 85.[1] And dementia can occur with respect to a variety of mental functions, from memory, to reasoning and judgment, to social intelligence, to communication skills. Being inflicted in one area may not necessarily mean being impaired or impaired to the same extent in other areas. Many older individuals who suffer cognitive impairment are unaware of it. And some estimates suggest that as many as 10% of people over age 65 suffer some degree of cognitive impairment from Alzheimer's or otherwise and 17% of individuals over age 70 suffer dementia.

There is also some research suggesting that moderate cognitive impairment can impact older but not yet elderly adults and this can affect an individual's ability to manage their financial matters. And other research suggests that older individuals, even if not suffering from detectable dementia, may be more susceptible to the influence of others than younger individuals, making them potentially vulnerable to pressure from financial advisers who seek to manage their money, to creditors, and to relatives.

Employer-provided retirement plans raise issues with respect to cognitively impaired individuals. Such people are sometimes asked to make difficult decisions, often implicating large amounts of money. For example, defined benefit retirees, already in pay status, may be offered a one-time election to convert their remaining annuity into a lump sum. Or a participant in an individual account plan can face a continuing decisions on whether to take a lump sum distribution of their account balance or how to shape her investment portfolio. Sometimes a spouse of a participant will be required to consent to a plan distribution. And a perhaps surprising statistic is that almost 1% of married couples over age 65 will get a divorce

[1] See 2020 Alzheimer's Disease, Facts and Figures (Alzheimer's Association 2020).

and may have to negotiate over how to divide a pension. There are also decisions and elections that participants must make in ERISA covered employee and retiree health care plans.

Such decisions are difficult for many if not most plan participants, but the difficulties can be geometrically compounded for those that are experiencing escalating degrees of cognitive impairment. People who administer and advise retirement plans are correct to be concerned about ensuring that that those who suffer from cognitive impairment, whether severe or moderate, are protected against the product of their own impaired judgment and also from those who might prey on them, which can include not only out-and-out con artists but also financial advisors, relatives, and in some cases, even the plan sponsor. They are right to be concerned about these issues on both moral and professionalism grounds and in some situations because of a legitimate fear of potential legal liability.

The Council has set parameters for the study: the Council seems to be especially interested in identifying and evaluating strategies, practices and procedures that plans, services providers, and sponsors are currently using to better serve participants suffering from impairments—essentially compiling a compendium of best practices. The Council also has indicated matters outside the scope of its project: state law regarding mental capacity, legal recourse for injured parties, and cyber-security issues. My testimony will probably linger at the outer edges of those borders, in part because I do not think there is much that plans and service providers, on their own, have been and can be doing to address the problems of diminished capacity and because any effective solutions will probably involve thinking about new mandatory legal standards, expanding federal legal remedies and/or reining in ERISA preemption of state law. In addition, I suggest that regulatory and legislative sensitivity to specific problems that can affect cognitively impaired plan participants may have more potential to ameliorate abuse and judgment issues faced by such participants than cataloging and then publicizing current best practices.

I will divide my discussion this morning into three parts. First, I want to identify some of the situations in which plan participants with diminished capacity can be harmed with respect to their benefits and rights in an ERISA plan, whether because of unethical and/or illegal behavior by third parties or because of their own impaired judgment in financial matters. Second, I will explain why I am skeptical about the overall utility of looking at current plan practices to identify a sort of gold standard that other plans can adopt, although I agree that there are steps plans should take and some probably are taking to prevent abuse in certain situation. And finally, I want to describe some potential regulatory and legislative safeguards that might address some of the specific problems that I identified in the first part of this testimony.

A. Substantive Areas of Concern

I want to expand on some of the situations that I mentioned a few minutes ago in which elderly ERISA-plan participants who suffer from some cognitive impairment may be at risk.

1. <u>Situations in which participants have the ability to take a lump sum distribution or otherwise accelerate plan distributions.</u> A participant in a defined benefit plan may have an option to take a lump sum. The option is typically at the time of initial benefit commencement or earlier separation from service but there has been a recent trend of offering a lump sum option after benefits have commenced, in which the case the participant will be making the election at an older age. In defined contribution plans, participants are usually

free to take a lump sum at any time after separation from employment or to accelerate distribution once a periodic schedule of distribution has begun. Moreover, depending on the type of plan—profit-sharing or pension—a married participant must also consent to a lump sum distribution.

Whether a lump sum distribution will enhance the well being of a participant depends on a number of complex and interlocking variables and requires a reasonable degree of mental acuity or a competent and non-conflicted advisor to make an appropriate decision. People who have experienced a decline in cognitive functioning thus may find evaluating a lump sum benefit option difficult and be challenged to make a good decision. In addition, outside actors—financial advisers looking to manage the participant's assets, children looking for support from their parents—may have an incentive to push the participant to a bad decision. And in the case of lump sum windows offered on a one-time basis to retirees, there is added pressure and in such cases, the employer often has often concluded that most lump sum decisions will improve plan finances and inure to the ultimate benefit of the plan sponsor rather than the participant.

2. Decisions on how to allocate investments within a self-directed defined contribution plan, both while an active employee and after retirement.

3. Decisions whether to annuitize benefits in a defined contribution plan that offers an annuitization option and sometimes to select among different annuity products.

4. Applying for benefits. Applying for benefits can be a challenging process. The Pension Rights Center is the technical advisor to five pension counseling clinics across the country and one of the more commonly requested services is just negotiating the application process. Failure to successfully complete an application can cost an individual their benefits

and sometimes result in an effective forfeiture of full benefits. And choosing among different benefit options, already partly discussed in 1., can also be challenging.

5. Accessing, interpreting and retaining plan communications and information. This is especially an issue for older participants who receive electronic disclosure.

6. Dividing a pension or retirement savings account on divorce. Perhaps surprising is the fact that approximately one percent of married couples over 65 get divorced. Dividing a pension and dealing with retaining rights in other employee benefits can be particularly challenging for cognitively impaired individuals.

7. Elections about retiree health care plans and giving informed consent to medical procedures.

8. Keeping beneficiary designations current.

B. Skepticism about the Utility of Identifying Current Best Plan Practices in Addressing Issues of ERISA and Cognitive Decline.

I should begin here by acknowledging that I am not in a good position to identify what plans, their sponsors and their service providers are currently doing to address the problems faced by participants suffering from cognitive decline. My background is not in human resources and I have never been and I think it is safe to say never will be asked to administer a benefits plan, although I have served on university employee benefit committees both at the University of Alabama and Drexel University. And while I have taught elder law to law students, I am not expert in either the areas of mental functioning, legal competence, or the tools used to protect the elderly from abuse. The Pension Rights Center, which is the technical advisor to five pension counseling projects, sees problems that can are compounded by insensitive plan administration but typically is not privy to the practices and professionalism that good plans use to address and prevent or mitigate the problems. This is simply to say that I am not a good witness to let you know what good stuff is currently taking place on the ground, which is not to claim that some plans do not have good practices in place. But in general, I think expecting plans to meaningfully address problems of participant cognitive decline on their own is at best one glob of pigment on a palette of possible remedies and at worst might make things worse. And at the conclusion of this part of my testimony, I will suggest some reasons that my skepticism may be mistaken.

But here are the reasons I am skeptical that there is much that can usefully be done at the plan administrative level, at least on a voluntary basis to effectively address these issues.

1. Identifying people experiencing cognitive decline is a difficult task, even for the people whose specialties are medicine and gerontology. In a 1997 study of the efficacy of diagnostic classifications to identify patients afflicted with dementia, the researchers found that six commonly used classifications seldom agreed on whether a patient suffered from dementia.[2] The range of percentages of people classified with dementia, depending on the classification scheme used, ranged from 3.1% to 29% and only a very few participants in the study were diagnosed for dementia under all six classification schemes. The reality that medical specialists have difficulty diagnosing dementia, especially when they are trying to identify mild impairment, suggests that benefit plan administrators may not be especially adept at it, no matter how strong the plan's efforts and good will may be. Moreover, displays

[2] Erkinjuntti, Ostbye, Steenhuis, Hachninski, The Effect of Different Diagnostic Criteria on the Prevalence of Dementia, 337 New England Journal of Medicine 1667 (1997).

of dementia with respect to different areas of cognitive capacity may mean that a person who will make a poor judgment in one area may not make one in another area.

2. Plans that identify possible impaired cognitive functioning in some participants may find it difficult to develop processes that adequately address the impairment in all or even most cases. For example, a plan employee or service provider may identify a possibly impaired participant. Plan procedures might require that the participant be required to consult with a close family member. But how will that family member be identified, especially where family dynamics among the participant's children are more like Jacob and Esau than Jane and Lizzie Bennet? And should plans automatically accede to the wishes of a state-appointed guardian? Is there authority in ERISA for a plan to develop special procedures for those suspected to be impaired? What happens when well-meaning plan procedures result in poor outcomes—does the plan bear potential legal liability?

3. Assessing participants for dementia will, as I suggested, be both over- and under-inclusive, producing false negatives and false positives. How will participants who are incorrectly tagged for protection react? Could their benefit rights have been adversely affected by the plan's extra solicitude and precautions? Would such people suffer dignitary costs? And the use of the most obvious proxy—age—would be especially over-inclusive and raise questions of age discriminatory practices, no matter how well intentioned.

4. There are times when the plan sponsor and a plan participant may have conflicting interests. An example I have already touched on is when a plan offers a limited one-time lump-sum buyout window to people in pay status.

5. Financial advisors who give advice to participants to take a lump sum distribution will have a conflict of interest if they will be managing the distributed assets for a fee. It can

be difficult for a plan that suspects a financial advisor of predatory practices to confirm its suspicion and then act on it. It risks liability if it is incorrect and probably does not have the resources to determine whether a financial advisor has crossed an ethical or legal line.

6. Even if a successful program can be designed, it may require substantial resources that plans may not be legally obligated to incur and, as I already suggested, if they do devote resources to policing third parties for elder abuse and arguably facilitate a bad outcome, they may risk ERISA liability for doing so.

As I indicated earlier, my skepticism may be misplaced. I look forward to reading your report and hope that you are able to identify effective plan practices and procedures that can address efficiently address problems faced by those with impaired capacities. I am skeptical but eager to be proved wrong.

And there is one particular strategy through which plans may, in fact, be able to stop predatory practices: where the plan suspects that the participant is a victim of a scam or fraud. Training plan personnel to identify potential situations of fraud and notifying authorities of their suspicions, and perhaps also slowing down the processing of an application to take a lump sum or make a large withdrawal from a defined contribution account balance where fraud or elder abuse is suspected, is both plausible and has the potential to protect participants from being victims of financial crimes.

C. Regulatory and Legislative Responses.

In addition to plans putting in place procedures to address cognitive impairment in plan participants, Congress and the federal agencies with jurisdiction over ERISA, can take regulatory and legislative steps to mitigate the impacts of such impairment. At least some of the areas that I earlier identified as creating problems for people suffering cognitive impairment offer possibilities for creative and effective rules to limit the effects of diminished judgment and financial acumen on the participant and to prevent or redress various forms of predatory behavior. I offer some examples of where I think legal rules could have an impact, but I do not intend or suggest that the list is complete. It is intended to be illustrative but not comprehensive.

1. Lump Sum Buyouts Offers to those in Pay Status. The relevant law under section 417 relating to elections to take a lump sum distribution present ambiguity about whether plans are permitted to offer a post-benefit commencement lump sum buyout offer, at least in situations other than plan termination. The Department of Treasury initially interpreted the law (in a series of private letter rulings) to permit such lump sum buyout offers. As I will illustrate below, a retiree who accepted the offer generally did so against his or her best interest, sometimes encouraged by financial advisors hoping to manage the lump sum and/or family members who wanted access to the cash payout. In most situations, this negatively impacted those who selected the lump sum, as described below.

One clear situation where the decision increases the participants welfare is where the participant knows they have a terminal illness, which permits them to engage in adverse selection by choosing the lump sum option, which is certainly more valuable than a life annuity whose payment period will be cut short by the certainty of an early death. This is the primary group—perhaps the only group, in the view of pension economist Alicia Munnell, among others—that will be financially better off swapping their annuity for a lump sum.[3]

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[3] Karen Friedman, Why GM Retirees Should Say "no" to Lump sum Payoff Option, Detroit Free Press (July 19, 2012), http://archive.freep.com/article/20120719/OPINION05/207190412/Guest-commentary-Why-GM-retirees-

Everyone else, or almost everyone else, who selects a lump sum will be forfeiting a substantial portion of their retirement savings and ERISA protections.[4]

It is reasonable to assume that the plan sponsor that permits retirees an election to convert their remaining annuity into a single-sum payment is not doing so because it wants to provide a large financial windfall for former employees with terminal illnesses. It is because the gains from participants who select the lump sum against their interests will more than compensate the plan/plan sponsor for those who reap a windfall through adverse selection.[5]

Why is the participant's election generally less than optimal. There are two principal reasons: (1) the lower economic value of a lump sum compared to an annuity (for most participants) and (2) the retirement-management problems created by lump sums

a. Lower Economic Value of Lump Sum

The value of a lump sum (leaving aside the case of the retiree who is aware that he will have a shorter than average life expectancy and will adversely select against the annuity) will generally be less than the value of an annuity. There are several reasons for this. First, when an employer purchases an annuity, it is purchasing both administrative and investment management services, features for which the participant is not compensated when it selects a

[4] Relatively young deferred vested participants in some cases may also benefit by taking a lump sum, since they may have less risk aversion than older individuals and may thus be in a better position to take on more risk in return for a higher expected rate of return than is reflected in the lump sum calculation. As discussed below, most older employees cannot bear the risk of an investment portfolio with a higher risk/reward ratio. There may also be some affluent individuals who can bear risk and may prefer a lump sum to shape a more aggressive portfolio. Finally, individuals with high levels of high-interest debt may benefit from a lump sum where bankruptcy is not a realistic alternative, although one can argue that a non-attachable stream of income can be particularly attractive to such individuals.

[5] The insurer can presumably make estimates of the number of participants with the ability to adversely select and adjusts the premium upward assuming these individuals will adversely select, but presumably its premium will not make reflect an "adverse selection" charge for the possibility that participants in excess of this estimate will select lump sums.

lump sum. Second, the discount rate the plan uses to value the annuity generally exceeds the rate of return a participant can realize on relatively safe investments (and is higher than the discount rate a commercial insurance company will using in setting premiums for an equivalent annuity).

While the participant could invest the lump sum in riskier asset classes, this would involve a level of risk that an older person, who generally cannot afford large investment loss, should not take. In addition, the discount rate is pegged to a basket of investment grade bonds. The participant is unlikely to realize this rate of return, however, because the participant will be unlikely to replicate the hypothetical bond portfolio from which the discount rate is generated, in part because the return will be reduced by fees. Moreover, some companies with investment grade credit ratings will nevertheless default, and the lump sum discount rate does not reflect this risk. Finally, if the participant decides to invest the lump sum in an immediate annuity, he or she will find that the annuity they are able to purchase on the individual annuity market will be approximately 28 to 32% lower than the benefit under the plan for a person between 65 and 75 (the reduction will be steeper for women than for men because insurance companies will use gender-biased life expectancy tables).[6]

In addition, in cases in which the plan subsidizes the joint and survivor annuity, the lump sum does not have to reflect the value of the subsidy, which will, in addition to the other

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[6] The estimates were prepared by comparing lump sum values under ERISA as of January of this year for a 65 year old, a 70 year old, and a 75 year old, and then using an annuity calculator for fidelity, assuming that the individual took a straight life annuity and resided in the state of New York. The author's personal experience with Fidelity is that it serves as broker for a number of insurance companies, all of which are highly rated for claims paying ability but are not necessarily the highest rated. For a 65-year old man, an annuity purchased from Fidelity would be approximately 28% lower than the plan annuity and for a similarly aged woman the annuity purchased from Fidelity would be approximately 31% lower than the plan annuity.

factors mentioned, mean the lump sum will have lower economic value for plans whose lump sum calculation does not include the value of the reflect the value of the subsidy.

b. Retirement Management, Spousal Protection, and Taxation Problems

An annuity provides a regular stream of income for the life of the participant. This provides the employee with valuable insurance advantages that are hard to replicate without purchasing an annuity contract. It also spares the participant from the time, risk, and expense of managing investments, a particularly difficult responsibility when the participant is also drawing down those assets in retirement. During the draw-down period, because of the constantly declining principal caused by withdrawal of assets, it is difficult to make up for even relatively small market losses without reducing the amount withdrawn from the plan.

Moreover, an older retiree with several hundred thousand dollars will be seen by some unscrupulous financial advisers and out-and-out scam artists as bearing an irresistible gift. And that retiree, especially if burdened by diminished mental capacity, may begin to consume beyond sustainable levels. And in some cases, financially stressed relatives will borrow (or worse) from the retiree. It should also be said that the negative management impact of a lump sum will generally be most severe for a female beneficiary, who has a longer life expectancy than her husband and is THUS more likely to be alive when the assets are exhausted.

In addition, a participant who does not roll over all of his or her distribution will be subject to income taxation, and because of the bunching in a single year, could be taxed at a higher marginal tax rate than the participant would ordinarily bear. If not rolled over, the assets would be subject to the claims of creditors, and even if rolled over, the assets would be easily accessible to the participant and in certain circumstances can be subject to creditor collection. In addition, the participant's spouse loses important spousal protections, because the participant is permitted in an IRA to withdraw much or all of the account without spousal consent. Also, in some states payments from a retirement plan are exempted from state income taxation but withdrawals from individual retirement accounts are not.[7]

Generally speaking then, selection of a lump sum is not a good decision for a retired participant unless the participant has an affirmative reasons to select the lump sum, a short remaining life expectancy for example. Yet experience with these lump sum offers suggests that many retirees selected the lump sum despite it having a lower value than the annuity, against their best interest. Why did they do so?

For a variety of reasons, the problems of poor decision-making, can be more profound for retirees already in pay status than for other participants. First, of course, is that some percentage of retirees suffer some diminished cognitive capacity.[8] Moreover, the lump sum option in a derisking transaction is a window benefit, available only for a short period of time, which puts additional pressure on the participant, especially one suffering early symptoms of dementia. Older people, particularly those with diminished capacity, may also be subject to pressure from children (who may see a possibility of access to additional money if a lump sum is selected, or a larger inheritance) and from investment advisers who stand to profit if the participant takes a lump sum and then pays them, directly or indirectly, to manage the lump sum. An older spouse may not be in as strong a position to object to the lump sum option. In addition, in some plans retirees and their spouses have already considered and rejected a lump sum option and now will have to revisit that decision, which can be

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[7] See Georgette Jasen, IRA Payouts May Avoid State Income Tax (July 7, 2013) ("Many states that tax IRA distributions don't tax Social Security and other pension income.") http://www.wsj.com/articles/SB10001424127887324188604578541751270494278. The rules of different states differ.

[8] 2014 Alzheimer's Disease, Facts and Figures, http://www.alz.org/downloads/Facts_Figures_2014.pdf

particularly unfair if mental capacity has diminished between the time of initial benefit commencement and the offer of a new lump sum benefit window.

So why do employers expect so many retirees to make decisions against their own economic interest and in favor of the employer's economic interest? Here again the answer is multi-factorial.[9] Behavioral economists have shown that individuals have difficulty accurately discounting future payments and thus will overvalue lump sums. Moreover, some retirees will be concerned that if they unexpectedly die early, they will have "forfeited" their benefit. Retirees may be pressured by creditors to take a lump sum. And as already noted, financial advisers who work on commission have a financial interest in recommending that a participant forgo the annuity in favor of a lump sum, children and other relatives may pressure the retiree to take a lump sum, and some retirees will be experiencing diminished mental capacity and simply not be able to make good decisions. It is no wonder so many retirees, especially those with reduced cognitive functioning, make bad choices, and no wonder that employers anticipate that they will make bad choices. Offering a lump sum option to retirees can be a form of corporate elder abuse.

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[9] Some have argued that choice is always good and that the lump sum option permits people to maximize their welfare by selecting the choice that makes most sense to them. But as explained in the text, this argument is inconsistent with the way many people make choices. In fact, the only situation in which it is clear that a participant in pay status will maximize his or her welfare by selecting a lump sum is if they know they are near death and thus will receive little benefit to a continuing annuity. But if this were the only case in employers and insurance companies assumed participants would elect a lump sum, the insurance company would increase the premium substantially because of the loss of short-lived participants in the insured pool. It is improbable that employers would be willing to pay those higher premium charges, so it is reasonable to assume that the employer and the insurer predict that a sufficient number of people will select the lump sum against their interest. It is also worth noting that few employers would presumably be willing to bear an extra cost to give participants who know they are about to die a financial windfall.

The Department of Treasury, in apparent recognition of this, reversed course and the IRS announced it would not issue future rulings endorsing post-retirement lump sum offers. Refusing to issue such rulings discouraged such lump sum offers. Since the law is itself ambiguous on whether such lump sum offers are permissible once the plan's normal retirement benefit has commenced, and the IRS is not required to issue rulings, this regulatory action protected older participants and likely improved policy outcomes. I would point to this decision on the Department of the Treasury as a thoughtful and even courageous change of regulatory direction. Unfortunately, after a change in administration, Treasury reverted to its original position, giving plans and plan sponsors the imprimatur of government approval for these potentially abusive plan practices.

2. Investment Advice. The Department of Labor, in its 2016 so-called conflict of interest regulations, reversed earlier guidance in which it held advice to choose a lump sum distribution did not, in itself, make the person giving the advice an investment advisor, in part because the advice was not "continuing advice." These regulations were subsequently vacated by a 2-1 panel decision of the Fifth Circuit Court of Appeals, with the Department choosing not to ask for reconsideration or seeking review by the Supreme Court. But to the Department's credit, in the preamble to the restoration of earlier regulations and a new prohibited transaction exemption, the Department opined that rollover advice could, in fact, render a party a fiduciary under ERISA. This position will help protect vulnerable older employees from falling prey to pressure from unscrupulous investment advisors recommending a lump sum because of the compensation they will earn from a lump sum distribution.

3. Electronic Disclosure. The Department of Labor recently issued regulations that provided that a plan could satisfy its statutory disclosure obligations through electronic notice. A participant can affirmatively default out of this regime and continue to get hard copies of required disclosure, but people with diminished cognitive impairment are both less likely to opt out of the default electronic disclosure regime and are more likely to be harmed by electronic disclosure (because they will not be able to navigate it and because there is no requirement that the plan indefinitely retain disclosed materials for the participant or his representatives if they later need it). A regulatory requirement that had the opposite default rule for people over age 65, an age at which perhaps as many as 10% suffer from at least mild cognitive impairment, would have provided better protection for participants with cognitive impairment than applying the same default rule in favor of electronic disclosure that applies to younger participants.

4. Acceleration of Withdrawals in Defined Contribution Plans. A regulatory requirement, actually suggested by one of my students as we discussed this topic, would be a special procedure, similar to the hardship withdrawal rules applicable to 401(k) plan pre-retirement withdrawals, that would apply when a retired participant thought to increase his annual withdrawals over previous years by a designated percentage.

Thank you and I am happy to answer questions.