2015 ERISA Advisory Council
Model Notices and Disclosures for Pension Risk Transfers
May 28, 2015

Good afternoon, members of the Council. My name is Roberta Rafaloff. I am a vice president in Corporate Benefit Funding at MetLife, our business area responsible for, among other things, group annuity based solutions for both funding and de-risking defined benefit (DB) plans in the Americas. 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. With $38 billion in transferred DB liabilities, MetLife is one of the leading providers of pension risk transfer solutions.

Our company's perspective, which I will be sharing today, is rooted in nearly a century of experience observing how actual benefit plan risks behave over a broad range of economic cycles, and then managing them effectively. Our core competencies in insurance, risk analysis and managing assets in the context of the liabilities they support enable us to protect against the unknown, and help us make the uncertain more predictable for plan sponsors and plan participants alike.

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. We welcome the opportunity to be part of this hearing today and appreciate being invited to testify. We believe that we have a unique perspective to share as a result of our long history as a pension benefit provider.

In our testimony, we'll explain how participant benefits are protected; the ways benefits can be distributed to plan participants, including the pros and cons of each approach; and, participant disclosures.

Guaranteeing Participant Benefits – Risk Transfer to an Insurance Company

Some have suggested that a "battery of procedural safeguards" be implemented "for annuitization transactions." We believe this is unnecessary and redundant. 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 rules governing the selection of an annuity provider recognize the paramount importance of benefit security for participants and are constructed to ensure that any insurer selected for this responsibility will be able to meet its obligations to their policyholders.

There has been considerable attention paid to comparing the strength of the insurance industry's State Guaranty Associations and the PBGC's pension benefit guarantee. 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.

When looked at in combination, an insured approach utilizing a highly-rated carrier with benefit protection from State Guaranty Associations offers at least as much protection, and for many participants, perhaps greater protection, than a traditional reliance on a plan sponsor and the PBGC.

Distribution of Participant Benefits – Risk Transfer to Participant

A defined benefit plan may pay benefits either as an annuity (monthly or at other regular intervals) or as a one-time payment (lump sum). In the case of a pension buy-out, there typically is no decision for the participant to make, unless the plan offers a lump sum alternative. If a participant accepts a lump sum distribution, then the individual will assume the investment, mortality and longevity risks otherwise assumed by the insurer. This can leave individuals at significant risk of outliving the income generated by their available retirement assets.

When being offered a lump sum in exchange for guaranteed lifetime income at retirement, the participant can waive his or her right to receive an income form of benefit. In fact, most plan participants will take a lump sum rather than an income stream under the mistaken belief that it has the greater value.

Lump sum offers are not generally communicated in a manner consistent with income-oriented framing or positioning. Unless the information about the consequences of the decision that the plan sponsor provides is framed in lifetime income terms, participants tend to underestimate future income needs and overestimate the wealth effect a lump sum offer conveys. This is unfortunate because leading academics have shown that "[i]ndividuals are much more likely to view annuities and other lifetime income products favorably if the information is presented in a frame that emphasizes consumption rather than in a frame that emphasizes wealth accumulation."[1,2]

When taking a lump sum, participants generally have two options (1) rollover their money into an individual retirement account (IRA) and then use a systematic withdrawal (SWiP) approach to spend down their assets; or (2) purchase a retail annuity.

In the case of a SWiP approach, the individual has complete control over investment management and the timing of distributions (subject to the minimum required distribution rules) but no protection against outliving their assets. While financial planning professionals have long suggested that individuals limit their annual withdrawals to no more than 4% of the first year's balance with such amount adjusted annually thereafter for inflation, recent research

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[1] Brown, Jeffrey R., Jeffrey Kling, Sendhil Mullainathan and Marian Wrobel, "Framing Lifetime Income." *Journal of Retirement*. Vol. 1(1): p. 27 – 37. Summer 2013.

[2] Brown, Jeffrey R., Jeffrey Kling, Sendhil Mullainathan and Marian Wrobel, "Why Don't People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle." *American Economic Review*, 98(2): 304-309. May 2008.

has called into question this 4% “rule of thumb” for drawing down retirement savings. For example, a whitepaper entitled "The 4 Percent Rule is Not Safe in a Low-Yield World"[3] concluded that "financial advisors relying on the classic '4% rule' for their clients' retirement income have a better than even chance of failure,"[4] particularly since the initial assumptions were based on returns seen in the 20th century and do not take into account today's historically – and sustained – low interest rate environment.[5]

It should be noted that rolling a lump sum distribution into an IRA may have several advantages. It allows the plan participant to choose from a wide variety of investments to provide for potential growth and/or preservation of capital, based on individual risk preference. It also allows for the flexibility to withdraw larger amounts of money in the case of medical or other financial emergency. However, large withdrawals can often jeopardize the chances of maintaining a steady income stream for the remainder of one’s life. In addition, as pointed out in the recent GAO report,[6] the flexibility provided by an IRA must be balanced against the risks of fluctuating investment returns, the effect of fees, the risks that the participant may face diminished capacity in future years, and the challenge of finding adequate financial advice.

A major drawback of a SWiP approach within an IRA is the inability to manage longevity risk. Individuals cannot self-insure the risk of outliving their money because they cannot accurately predict how long they will live – the only way that an individual can manage this risk is by converting his/her savings to an annuity.

Even if they opted for the lump sum rather than a group annuity, participants could purchase a retail annuity with all or a portion of a lump sum and/or other savings at the point of retirement. Purchasing a retail type of annuity can provide flexibility and individual choice. Individuals can select from a range of annuities, including single premium immediate annuities, variable annuities, longevity annuities, etc. While there is no shortage of retail annuities available in the marketplace, choice and flexibility can also add complexity and costs. It is also important for individuals to understand the costs of replicating the protection the group annuity provides using a retail annuity purchased with the lump sum proceeds. Retail annuity expenses can be higher than institutional annuities, because pricing is based on an individual’s life expectancy instead of a group’s, meaning that payments will likely be lower. There are also fees associated with various retail annuity features.

I’ve included an illustration which shows that if a male and female, both age 65, took a lump sum payment instead of the $1,000 per month they would have each received as a monthly pension benefit and then attempted to replicate that monthly income with a purchase of a retail annuity, they would lose over $100 in income each month. For example, the lump sum value of

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[3] Blanchett, David, Finke, Michael S., and Pfau, Wade, The 4 Percent Rule is Not Safe in a Low-Yield World (January 15, 2013). Available at http://ssrn.com/abstract=2201323.

[4] Weinreich, Gil. "Finke Study Warns: 4% Retirement Rule Is Dead, Long Live Annuities." ThinkAdvisor, January 17, 2013.

[5] We note further that the authors elaborated on this research in a Morningstar whitepaper entitled “Low Bond Yields and Safe Portfolio Withdrawal Rates.” Using a new model it developed, which "takes into account current bond yields when determining the success of different initial withdrawal rates," Morningstar has concluded that "safe initial withdrawal rates" (i.e., the initial percentage withdrawn from the portfolio) are actually lower than previous research has indicated, in which a 4% initial withdrawal rate was considered "safe." According to Morningstar, the 4% initial withdrawal rate may not be viable in a low interest rate environment.

[6] GAO-15-74, *Private Pensions - Participants Need Better Information When Offered Lump Sums That Replace Their Lifetime Benefits* (GAO 15-74, p. 31-2)

the $1,000 monthly pension benefit for a 65-year-old is $165,860 using PPA rates; if the participant was male and used 100% of the lump sum to purchase a retail single premium immediate annuity, the monthly payout he would receive would be $897 per month. For a 65-year-old female with the same lump sum benefit, the monthly benefit would be $861 per month.

Replicating a Monthly Pension Benefit

Age	**Gender**	**Monthly Pension Benefit**	**Lump Sum (LS) Value**	**Percentage of Lump Sum Used**	**Retail Annuity Monthly Payout*+**
65	Male	$1,000	$165,860	100%	$897
		$1,000	$165,860	50%	$449
65	Female	$1,000	$165,860	100%	$861
		$1,000	$165,860	50%	$430

<u>Assumptions</u>		
Mortality:	PPA 2015	
Rates:	1.27%	For the first 5 years
(April 2015)	3.52%	For the next 15 years
LS Conversion Rate	165.8602679	Unisex pricing

*Rounded to the nearest dollar amount
+Single premium immediate annuity

With the purchase of a retail annuity, it should be noted that there is an important role for financial advisors in helping the individual select the most appropriate retail annuity product, particularly because there are so many considerations, including the benefits and features of each. These include the type of annuity (e.g. variable or fixed) and the payout options (e.g. life only, life and period certain, etc.).

Participant Disclosures

Today, as companies contemplate whether or not to transfer the risk of paying DB pension benefits to either (a) the individual by offering lump sums or (2) to the insurer, which assumes responsibility for paying benefits until the last retiree and their beneficiaries die, it’s important for plan participants to understand the decisions that are presented to them by their employer.

Participants need information and disclosures that help them understand how annuities address longevity risk and the other risks they face. Before promulgating lump sum disclosures, the EAC may want to consider commissioning research to determine (a) how quickly lump sum payouts are depleted by the participant and (b) if the participant had the ability to take a partial lump sum and a partial annuity, how likely would they have been to take a combination of the two.

One of the greatest challenges of crafting disclosure requirements is that plan participants' financial knowledge and education will vary tremendously. However, disclosure requirements that lack specificity (i.e., are too "principles-based") may result in a lack of consistent application among plan sponsors and, in turn, relevance to plan participants. The disclosure regime that is crafted should:

- *Reflect the choices participants actually have* – Information on choices not available to a given participant is of no use. Disclosures should have meaning for the decisions the participant must make. If the participant has no stake in a given value or number, the disclosure can only cause confusion.
- *Provide meaningful information, but provide it clearly* – There are a tremendous variety of circumstances and choices that participants can face. Financial projections based upon those choices should help them make those decisions. However, they have to understand the information for it to be useful to them.

In the case of a lump sum, we agree with the GAO that "participants need better information when offered lump sums" that replace their lifetime benefits. As detailed in the 2015 GAO Report on lump sum windows,[7] the required disclosures to participants faced with a lump sum election lack completeness and consistency. The current disclosure regime relies heavily on *relative value statements* that compare the lump sum offered to the actuarial present value of the annuity being replaced. That disclosure, while required to be accurate with regard to the financial difference between the two options, has several important drawbacks:

- The relative value statement may be based on the same assumptions used to calculate the lump sum in the first place. The GAO also found that very few of the disclosures they examined provided additional information necessary for participants to tell if the lump sum amount being offered is fair compared to the monthly payment provided by the annuity;[8]
- The relative value statement does not even begin to evaluate the costs and risks assumed by the participant. In accepting the lump sum, the participant assumes the investment, mortality and longevity risks. The value of these risks, which the participant will pay if they attempt to turn the lump sum into lifetime income with a retail annuity, is not part of the relative value disclosure.

Disclosures to the participant required at the time they are presented with the option of receiving a lump sum or an annuity should more specifically and more clearly address the choices being presented to them – typically the choice between receiving a lump sum distribution from the plan, and receiving a monthly benefit.

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[7] GAO-15-74

[8] GAO-15-74, p. 40

The following key points should be presented to participants regarding each of these options:

- *Keeping the annuity*
    - Stress the importance of lifetime income and guarantees.
    - Meaningfully communicate the value of those guarantees and the cost to the participant to replicate them.
    - Combat the "wealth illusion": the idea that the lump sum offered – for many the largest single amount they will ever see – is so big, they can't possibly need it all for retirement.
    - Combat the "pittance illusion": the idea that what looks like a small monthly benefit has no value, when in reality the value promised would be expensive to replicate.
- *Accepting a lump sum distribution*
    - Provide a relative value notice to explain how the value of the lump sum compares to the value of the lifetime monthly benefit provided by the plan.
    - Stress that retirement income is critical. A lump sum distribution may be a rational choice in many circumstances, but the participant then needs their own plan for retirement income.
    - Stress the importance of qualified advice: distributions and reinvestment strategies can come with complicated risks and tax consequences that require professional analysis.
    - Illustrate the assumption of risk: investments that do not guarantee income pose significant risks to retirees. This was clearly demonstrated during the recent financial crisis.
        - It should be explained to participants that there are appropriate circumstances for accepting a lump sum payment; for example, if they have retirement income from another source, or have a need for the flexibility a retail annuity can provide.
    - The GAO report concluded that for some participants, their lack of knowledge of how the PBGC or state guaranty associations protect annuity guarantees contributed to their decision to accept the lump sum. The results of the study indicated that disclosures explaining the protections can help participants trust the lifetime income guarantee.[9]
        - Third party protections (i.e., PBGC vs. state insurance guaranty associations) *differ* between a plan annuity and an insurance annuity. The structural difference between the two should not lead to the conclusion that an insurance annuity is inherently less safe or, given the low probability of loss, changes the economic value of the annuity. For the state protection system, current guaranty association coverage disclosures should be adequate.
- *Transferring risk to an insurer*
    - As noted earlier in this testimony, a pension risk transfer to an insurer, where the same benefits earned are preserved in exactly the same form, the participant does not assume any risk with this transaction. Therefore, we do not believe additional disclosures should be required of the plan sponsor in the case of a risk transfer to an insurer. When the employer has opted to transfer

[9] GAO-15-74, p. 46-7.

the plan to an insurer, we believe certificates issued to the annuitants which describe the benefit that will provided to them, are adequate.

We think it is logical to conclude that a pension risk transfer to the insurer affords the participant the greatest chance of achieving a secure retirement. After all, group annuities have enjoyed a long and enduring history in the qualified plan arena, and today they directly fulfill the intent of the Employee Retirement and Income Security Act of 1974 (ERISA): they protect the promises made by plan sponsor; they pay the pension benefits earned by participants; and, they do so by providing guaranteed lifetime income. Joshua Gotbaum, former head of the PBGC, in his 2013 ERISA Advisory Council testimony on "Private Sector De-risking and Participant Protections" recognized the important role of insurer-provided annuities when he noted that "[b]efore ERISA, many companies created pensions by buying annuities from insurance companies....That's transferring risk from the companies to insurer, and by the way, it's what insurance companies are paid to do."