



AMERICAN BENEFITS

COUNCIL

TESTIMONY OF

CRAIG ROSENTHAL

ON BEHALF OF THE

AMERICAN BENEFITS COUNCIL

FOR THE

ERISA ADVISORY COUNCIL:

PRIVATE-SECTOR DE-RISKING
AND PARTICIPANT PROTECTIONS

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My name is Craig Rosenthal and I am a Partner with Mercer, a worldwide employee benefits consulting firm. I am an actuary and senior retirement consultant who has been practicing in the private sector pension area for nearly 25 years. I am testifying today on behalf of the American Benefits Council (the "Council").

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

My testimony today focuses on the reasons behind plan sponsors' interest in reducing their pension liabilities through a number of de-risking approaches. I will also share some of Mercer's experience with regard to participant elections of annuities or lump sums and review some of the strict current-law requirements that govern participant communications and benefit security.

REASONS FOR PLAN SPONSOR INTEREST IN DE-RISKING

To better understand employers' motivations in considering de-risking strategies, it is important to understand how the legislative and regulatory environment for pension plans has made sponsorship increasingly difficult over the past few decades.

When many of today's plans were put into place, they were viewed as long term liabilities of the plan sponsor. As such, funding requirements were based on long-term expected investment returns. Similarly, the accounting rules governing plans also took a long-term view toward pension liabilities and required contributions.

In the late-1980s, however, two important developments increased the potential financial consequences of these liabilities. First, tax law changes introduced accelerated contribution requirements for plans that were less than 90% (or in some cases, 80%) funded, based on liabilities tied to generally conservative Treasury bond yields. At around the same time, the Financial Accounting Standards Board (FASB) mandated that companies reporting under US generally accepted accounting principles (GAAP) include pension costs in their income statements and include information related to the assets and liabilities of their plans in their financial statement footnotes. Those costs, particularly the liability measures, were based primarily on high quality corporate bond yields, which as we will see, becomes a key consideration in terms of pension plan risk management.

While there were fairly minor changes to both the funding requirements and accounting rules over the next 15 or so years, significant changes were made to both the minimum funding requirements and the US GAAP accounting rules during the 2000s

that increased pension costs and the volatility of funding obligations. In particular, enactment of the Pension Protection Act (PPA) in 2006 applied an accelerated and volatile funding regime to all plans under 100% funded by, for example, requiring that any funding shortfalls be funded over a seven-year period starting in 2008. On the accounting side, implementation of FAS 158 required most sponsors to reflect the mark-to-market values of pension plan assets and liabilities directly on their balance sheets starting at year-end 2006. Additionally, changes were made to PBGC premium calculations which resulted in pension plan sponsors generally paying higher premiums to the agency.

Since then, historically low interest rates (driven largely by Federal Reserve monetary policy), volatile equity values, the deepest economic recession since the Great Depression and an uneven recovery have lowered funding ratios and caused sharply higher contributions for many employers at a time when they can least afford it.

In addition to the risks associated with the assets and liabilities, plan administrative cost and complexity are also concerns. As an example, PPA heralded in a variety of restrictions based on pension plan funded status, including constraints on benefit accruals, lump sum payments and other accelerated distribution forms, and the funding of non-qualified deferred compensation, in addition to the higher funding requirements discussed above. At the same time, PBGC premiums are continuing to rise, and the recent Administration budget proposal would hike PBGC premiums far beyond those that recently took effect as part of the Moving Ahead for Progress in the 21st Century Act (MAP-21). While the bulk of the proposed increases are intended to fall on those plan sponsors that pose the most significant risks to the PBGC, it is widely believed that it will be impossible to accomplish anywhere near the proposed \$25 billion premium increase by raising premiums on those plan sponsors alone.

REASONS PLAN SPONSORS ARE CHOOSING TO DE-RISK

As a result of all of the above developments, a large number of sponsors have made changes to their pension plans aimed at reducing funding volatility, balance sheet volatility, and, to a lesser extent, PBGC premiums. This reflects an increasingly prevalent view by company CFOs that pension plans represent a financial risk to their organization due to the size and volatility of the liabilities.

While de-risking is a strategy being considered by many sponsors, there is no one-size-fits-all answer as to why some companies adopt de-risking approaches and others do not, nor is there a simple answer as to why companies that do de-risk do so in different ways. On the contrary, the decision as to whether and how to de-risk is made differently by different companies based on both economic factors and company risk tolerance. Among the most significant considerations for most plan sponsors are the following:

- The size of the pension plan liabilities relative to the overall size of the plan sponsor, which affects the impact that funding and balance sheet volatility can have on the company,
- The plan sponsor's views on the economic outlook and the plan sponsor's ability to withstand risk,
- The administrative costs associated with maintaining the plan, definitely including the growing PBGC premium burden, and the plan sponsor's views on future premiums,
- The plan sponsor's ability to raise capital, if necessary, to de-risk the plan,
- The existence of collective bargaining agreements, and
- The plan sponsor's ability to obtain accurate historical participant data.

At a high level, de-risking takes two forms. Sponsors can retain liability and associated assets, and attempt to coordinate assets with liabilities in such a way as to align movements so as to minimize volatility. This is often referred to as Liability Driven Investing, or "LDI", and often takes the form of investing a portion of plan assets in fixed income securities with similar characteristics as the liabilities. In many situations, this approach can work very well. But there are certain situations where an LDI approach does not address the core problem, since it does not do anything to address the size of the pension liability or PBGC premium issues.

Sponsors can also transfer liability to a third party, generally either to an insurer through an annuity purchase, or directly to the participant through a lump sum offer. These are not exclusive decisions either, as sponsors can employ multiple techniques to manage the overall plan risk. For purposes of today's discussion, we will focus on these risk transfer activities.

FULL VS. PARTIAL DE-RISKING

When a plan is fully terminated, all participants receive either a full lump sum equal to the actuarial value of their benefit (if offered), or their future benefits will be paid by the insurer from whom an annuity is purchased. When an annuity is purchased, the full amount of the benefit and all benefit options offered by the former plan are required to be replicated by the insurer (some small ancillary benefits not subject to IRC Section 411(d)(6) protection may sometimes be eliminated to simplify future plan administration).

When a plan is only partially de-risked, assets and liabilities are reduced by the amounts paid to participants / used to purchase annuities. While the funded

percentage of the plan would be reduced if the plan were less than 100% funded at the time, it is important to note that the Pension Protection Act has fail-safe measures that prevent certain actions from diminishing plan funded status below certain thresholds (e.g., full lump sum payments cannot be made when the plan is less than 80% funded).

Along the de-risking spectrum, lump sum payments to inactive participants (particularly terminated vested participants) can often generate the most administrative savings. However, it is important to note that electing a lump sum is strictly a voluntary choice for the employee (other than small cash-outs).

In the case of an annuity purchase, the annuity generally replicates all plan benefits and optional forms, so that plan participants will ultimately have all of the same alternatives and options that they would have had in the absence of the annuity purchase. Annuities come at a cost to the plan sponsor though, as the cost of purchasing an annuity is almost universally higher than the cost of offering lump sums. This increased cost is primarily the result of margins imposed by the insurer to cover potential adverse risks, profits, taxes and other expenses.

De-risking comes with both advantages and disadvantages from a corporate point of view. Generally speaking, there is a risk/reward tradeoff that plan sponsors must assess when they consider de-risking. For example, while transferring risk to the participant through a lump sum offering or to an insurer through an annuity purchase can relieve the plan sponsor of some or all of their pension liabilities, the interest rates used to calculate lump sum payments and/or are used by insurers to develop annuity purchase prices are usually lower than most plans are expecting to earn on their assets. Sponsors need to weigh the cost to de-risk, versus the potential risk exposure of keeping the assets and liabilities in the plan; as noted above, that risk exposure has grown substantially over the years. Most sponsors seriously considering the strategy often are implicitly willing to exchange an unpredictable liability for a fixed, determinable financial commitment.

Dramatic increases in PBGC premiums enacted last summer and the potential for major new hikes are likely to be a catalyst triggering increased consideration of de-risking by plan Proposals in Congress, and especially the administration's recent plan to increase premiums by \$25 billion over 10 years for "risky" sponsors and plans, send a powerful signal to plan sponsors that the legislative and regulatory climate may continue to impose additional burdens on plan sponsors.

It is difficult to predict what the future will bring. If funding and accounting obligations can be stabilized and the spiraling up of PBGC premium obligations can be reversed, there would be far less reason to de-risk. If, however, these critical issues are not addressed, it is possible that the volume of de-risking transactions will accelerate in the coming years, particularly when funding improves and/or interest rates rise. Even before the recent financial crisis, many sponsors acknowledged that if they were

developing a retirement program “with a clean sheet of paper”, they would not likely end up with their current plan designs, and the recent financial volatility has only further exacerbated that view, since the funding, accounting, and PBGC premium rules are now so sensitive to temporary market fluctuations. Also, in large part due to the increased cost of maintaining defined benefit pension plans, many defined benefit plans have been frozen or closed to new hires in recent years.

On a system-wide basis, the magnitude of pension liabilities far exceeds the supply of high quality corporate bonds typically used to back these obligations through annuity purchase. As a result, the ability to offer lump sums to participants is an essential component of any system-wide reduction in the risk that these obligations pose to plan sponsors and therefore indirectly to plan participants.

NO CUT-BACKS IN PARTICIPANT RIGHTS

ERISA rules govern certain aspects of the de-risking process, and provide significant protections for plan participants. For example, while a lump sum feature may be added to a plan at any time on a temporary or permanent basis (assuming PPA’s funding-based benefit restrictions are not in effect), most permanent plan features are protected by IRC Section 411(d)(6) which prevents a cut-back in accrued benefits (including the vast majority of accompanying rights and features). As such, a plan’s forms of payment options, including lump sums, are generally protected from being eliminated for benefits already accrued. Similarly, ERISA protections preclude a plan sponsor from requiring a lump sum benefit, other than for very small amounts not to exceed \$5,000.

A sponsor can generally terminate a defined benefit pension plan at any time, however, the sponsor must be willing to contribute the assets necessary to effect a standard termination (i.e., a termination where all benefit obligations are satisfied by the payment of lump sums or by the purchase of annuities).

PARTICIPANT DECISIONS REGARDING LUMP SUMS

Again, there is no one-size-fits-all with regard to participant elections of lump sums as each participant’s individual situation is different. With that said, we do know from past experience with plans that offer lump sums as an optional form of benefit and in situations where lump sums are voluntarily offered in connection with plan terminations, many participants opt for the lump sum. It is important to note that under the qualified joint and survivor benefit rules, all participants being offered a voluntary lump sum payment must also be provided with a default immediate annuity option (generally, a single-life annuity for unmarried participants and a legally required joint and survivor annuity for married participants). In practice, most plans offer a wide variety of annuity options in addition to the lump sum option, so the participant can

make an informed decision of how they wish to receive the pension benefit. Also, several years ago the IRS began requiring the relative value of each form of benefit to be disclosed so participants can make an assessment as to whether any particular form of benefit is more or less valuable than any of the others.

While experience varies by plan, when voluntary lump sums are offered by a plan on an ongoing basis (e.g., they are available upon separation of employment or retirement), typical election percentages range from 60% to 90%. However, in the case of one-time lump sum offers (including offers in connection with a plan termination), the election percentage for participants who have not yet commenced benefits tends to be lower, typically in the 40% to 60% range. It is important to note that in situations where there is a one-time offer of a lump sum, the lump sum election percentages are often correlated with the age of the participant.

Finally, as one would expect, a significantly lower percentage of participants who have already commenced an annuity form of payment (e.g., current retirees) typically choose to take a lump sum if offered it. While the reasons for this are subjective, many of these participants have built their financial plans around the existing annuity payment and/or may have been receiving this annuity benefit for a significant period of time, and thus would prefer to maintain the current monthly benefit. Of those that do elect the lump sum, evidence suggests that health considerations often play a important role in the decision to cash out. In this case, the lump sum offered may far exceed the potential value of a future income stream.

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Thank you again for providing the opportunity for me to present the American Benefits Council's testimony from the perspective of a plan sponsor. I welcome any questions you may have.