



AMERICAN BENEFITS COUNCIL

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Testimony of Craig Rosenthal
on behalf of the American Benefits Council
Before the ERISA Advisory Council
on Model Notices and Disclosures for Pension Risk Transfers

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 over 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 types of information that plan participants often receive when they are offered an opportunity to take a lump sum distribution in lieu of receiving a monthly plan benefit, and makes some suggestions related to the recent GAO Report (GAO-15-74 Lump Sum Windows).

At the outset, I would like to make three overriding points. First and most importantly, the Council strongly supports disclosures that help participants make informed and prudent choices. So if additional guidance is needed to enhance disclosure and help participants, we support that effort. Second, it is critical that any new guidance be clearly prospective only. Many transactions have occurred in reliance on the law in effect at the time of the transaction. It would not be appropriate to establish new rules unless those new rules are prospective by their terms. To do otherwise would undermine a fundamental premise of our voluntary system: the ability to rely on the law in effect at the time a transaction occurs. Third, any new guidance needs to provide flexibility for plan sponsors to fulfill their disclosure obligations in a way that fits their circumstances and their workforce.

PARTICIPANT COMMUNICATIONS MATERIALS

Most consulting firms have developed robust and customizable communication materials that can be tailored to the specific features of each pension plan. These materials often include the following items, and are designed to comply with all existing required benefit disclosures:

- An overview of the program, including any time constraints, and a discussion of the voluntary nature of the program

- Key things to consider when deciding whether to elect the lump sum offer, including the key attributes of both annuities vs. lump sums
- Payment options for the lump sum benefit (rollover vs. taxable distribution), including information about the potential to rollover into another employer plan, and the penalty taxes that may apply for taxable distributions to participants under age 59-1/2
- Annuity payment options, including an explanation of the available options
- How to accept the offer, and a disclosure that the participant's benefits are not affected if the offer is not accepted
- Information about who to contact for additional assistance, which is often a toll-free number to a benefits call center.
- A personalized statement listing all benefit options available at the current time, and information about the relative value of each form, either in percentage terms, or where the relative values for specific optional forms of payment are approximately equal, a statement to that effect.

In addition to the core communications materials, participants are also typically provided with the following standard disclosures:

- Qualified Joint & Survivor explanation
- Relative values explanation
- Notice of failure to defer payments (i.e., financial consequences of electing early payment)
- Special Tax Notice, outlining tax implications of rollover vs. taxable distribution

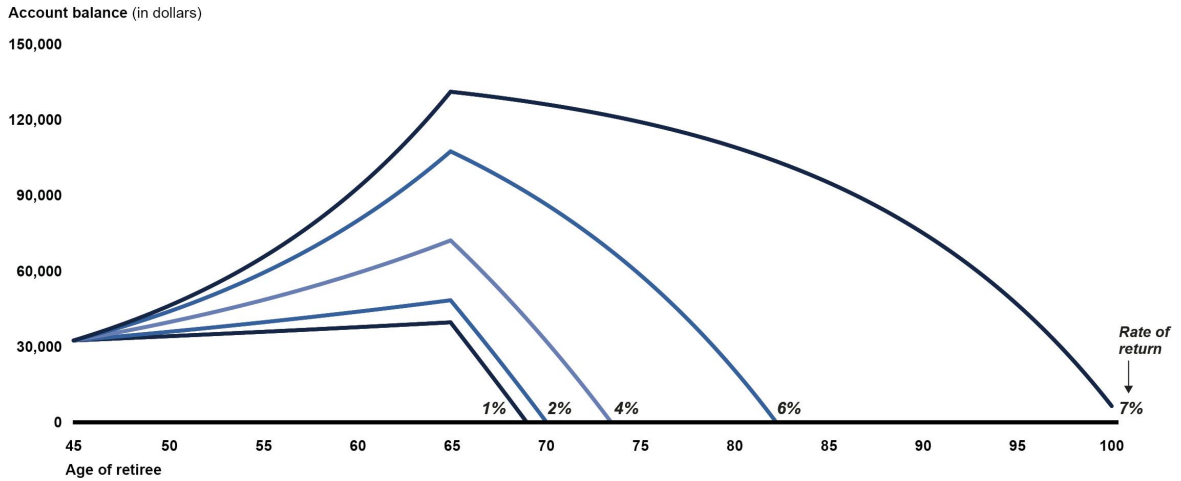
SOME COMMENTS ON KEY CONCERNS RAISED IN THE GAO REPORT

Before focusing on participant disclosures, the GAO Report raised three key issues that we would like to address as they inform the discussions related to participant disclosures.

1. GAO REPORT – REPLICATING RETIREMENT INCOME

The GAO report included the graph below which shows the rates of return needed for a participant age 45 to replicate their \$10,000/year benefit at age 65 with the \$32,453 lump sum that was paid in 2012. This participant's lump sum was effectively based on an interest rate of about 6% (the PPA third segment rate applies to payments made 20 years or more into the future; lump sum calculations for participants with pension payments within the first 20 years would have used lower PPA first and/or second segment interest rates for those payments, which would have resulted in a lower effective interest rate). Not surprisingly, at a 6% rate of return this lump sum will provide for the \$10,000 annual payment until about ages 82-83, which is about the life expectancy reflected in the underlying mortality table

used to determine this lump sum¹.



This graph illustrates the risks associated with taking the lump sum payment, both in terms of investment earnings and longevity. If this participant earns less than the underlying interest rate and/or outlives their life expectancy, their accumulated assets will not be sufficient. Conversely, if the participant out-earns the underlying interest rate and/or does not live as long as anticipated by the underlying mortality table, their accumulated assets will exceed the amount necessary to replicate the retirement benefit for their lifetime.

It is important to note that if a similar graph were prepared for an older participant, these illustrative rates of return would likely result in sufficient assets for longer post-retirement periods as the lump sums would be based, at least in part, on lower first and second segment PPA interest rates. In other words, the required investment return for an older participant to replicate the retirement until a specific age would be lower, which makes sense given the shorter time horizon until payments are made.

As indicated in the GAO report, nearly half of the respondents (7 of 15) who elected lump sums cited their belief that they could “achieve a better rate of return on the money” themselves as one of the top three reasons they chose the lump sum. As shown in the graph below, if this 45-year old participant is reasonably confident she can achieve a 7% compounded rate of return, her retirement assets would be sufficient to provide an annual payment of \$10,000 until age 100 (and should she die before the assets were exhausted, the remaining assets would pass to her heirs as part of her estate).

¹ It is important to note that an actuarial present value, such as a lump sum, is not the same as the present value of an annuity for one’s life expectancy.

2. GAO REPORT – LOOK BACK PERIODS

The GAO Report also discusses look-back periods used to determine interest rates for lump sums. In particular, due to significant interest rate declines in the marketplace during 2012, the GAO report indicates that the lump sum payment would have been 31% larger had it been determined based on September 2012, rather than August 2011 interest rates. This is due to the very significant decline of the PPA third segment interest rate from 6.02% to 4.67% between these dates. While interest rates have been volatile in recent years, this amount of change is an anomaly that presumably resulted from external geopolitical and macroeconomic forces. Looking forward one additional year to 2013 lump sums, the commonly used August-December 2012 rates were significantly lower than the 2013 rates for most months (which would have led to lower lump sums had more current interest rates been used).

It is important to note that pension plans must have pre-existing provisions that define which set of interest rates are used for lump sums paid at a particular time. Perhaps the most common way that pension plans set their interest rates is on an annual basis, using rates from the last few months of the prior year. This is not done with any bias in mind, rather it is designed to provide knowable rates for participants so that they can evaluate their retirement options without having the figures change dramatically over the course of the months leading up to their retirement. It is also important to note that under existing law, any changes to the interest rate timing results in a 12-month period where the participant will receive the greater of the lump sum determined on the old basis and the new basis. Due to the lead time to prepare a lump sum cash out (typically at least 4-6 months elapse between (1) the date a plan sponsor makes a final decision to adopt a lump sum window and (2) the payment date), it is impossible for a plan sponsor to handicap where market interest rates will be at any future payment date.

3. GAO REPORT – EARLY RETIREMENT SUBSIDIES

The GAO Report also makes note of how the inclusion /exclusion of early retirement subsidies that are included in the annuity benefit impacts the value of the lump sum. As an example, using the same \$10,000 example discussed above, the GAO report indicates that if this benefit were available on an unreduced basis at age 60 (5 years earlier than the Plan's Normal Retirement Date of age 65), the lump sum calculated on this basis would be 40% higher (\$54,301 vs. \$32,453). While perhaps true of one of the plans they examined, unreduced benefits at age 60 is fairly uncommon in plans today, especially for employees who terminate prior to attaining a plan's earliest retirement date (i.e., terminated vested former employees). Furthermore, even when significant early retirement subsidies are available, many

participants do not commence their benefits at the first available age.

Looking at more common early retirement provisions, there are a large number of plans that apply the same initial early retirement reductions as are used for Social Security benefits (e.g., a 6-2/3% reduction for the first few years of early commencement). Despite these being generally viewed as including a modest early retirement subsidy, there have been a number of articles written in recent years suggesting that individuals should not commence their Social Security Benefits at the earliest possible age as the larger benefit would be more beneficial in later years.

While early retirement subsidies are not required to be reflected in lump sums (the longstanding IRC 417(e) rules require the lump sum to be at least the present value of the accrued benefit payable at the Plan's Normal Retirement Date), the relative value regulations require a comparison of the lump sum to the value of the immediate annuity, and when early retirement subsidies are not included in the lump sum calculations, but are included in the annuity, the relative values will clearly show that the lump sum has a lower value than the underlying annuity.

GAO's EIGHT QUESTIONS THAT ADDRESS KEY FACTORS PARTICIPANTS NEED TO KNOW IN ORDER TO MAKE AN INFORMED BENEFIT CHOICE

The GAO report identified the following eight questions and suggested some additional related sub-questions based on their examination of 11 benefit packages used for lump sum offers during 2012. We provide some high-level comments pertaining to each of GAO's questions.

1. What Benefit Options are Available?

GAO acknowledged that all packages provided both a lump sum and at least one immediate annuity option, and that 9 of the 11 packages also provided a deferred annuity option (typically at the date that full benefits are payable), however only one of the packages also provided the deferred annuity at the plan's earliest retirement date.

While it is important for the participant to understand their available payment dates, we do have some concerns about showing a future benefit amount that depend on future external factors. In particular, some plans use variable interest rates to provide actuarially equivalent early retirement benefits, which means that the early retirement benefits at any particular future age can change as a result of changes in underlying interest rates. As such, we would urge the EAC to consider these types of issues when considering disclosure of early retirement benefit amounts, as the description of the these external factors and their sensitivities can be complex. We believe that it is in everyone's best interests to ensure that all information provided to plan participants is written in a simple and direct manner, and tested to ensure that it will be understood and add value to the average plan participant. As such, the

EAC could consider whether the more common practice of telling participants what their earliest payment age would otherwise be, and directing them to the Plan's summary plan description for additional information related to early retirement benefits and the various payment options might be more beneficial.

2. How Was the Lump Sum Calculated?

GAO indicated that only 2 of the 11 packets they examined fully explained how the lump sum was calculated. They went on to say that 9 of the 11 packets lacked some of the key information used in calculating the lump sum amount, such as the interest rates or mortality assumptions. GAO acknowledged that not all participants would necessarily use this information to arrive at a decision, but their discussions with participants indicated that at least some would.

Speaking from my experience as an actuary, these are particularly difficult concepts for the vast majority of plan participants to understand, and very detailed explanations in this area are far more likely to lead to confusion instead of clarity. For example, unless there are pages of very detailed and technical explanations (which are unlikely to be read or understood by most participants), the terms "RP-2000 Mortality Table projected to 2022 on a unisex basis" and "IRS spot segment interest rates for <Month> <Year> of x% for payments during the first 5 years, y% for payments during the next 15 years and z% for payments made beginning in 20 years" are likely to confuse the average participant.

In order to better help plan participants better understand how their lump sums are calculated, some high level, yet informative information could be provided. This could start with a statement saying that the lump sum was calculated based on a benefit of \$x assumed to commence on a specific date, and then go on to describe the underlying assumptions at a high level. For example, a general description that the mortality assumption represents average life expectancies based on mortality tables chosen by the IRS and participants electing a lump sum payment may be better or worse off, depending on how long they live and their rate of return. Similarly, information about the effective interest rate (the single interest rate that would derive the same lump sums as the 3-tier IRS spot-segment rates) could be informative, along with a statement that participants electing a lump sum might be better off if they can earn more than this rate, and worse off if they earn less than this rate, again depending on how long they live.

3. What is the Relative Value of the Lump Sum vs. the Monthly Annuity?

The GAO report acknowledged that the relative value notice required under current law was provided, however, little additional explanation was provided to help participants understand what the numbers meant and there were some differences in how the relative values were presented. In addition, the GAO noted that none of the relative value statements included information about how much it would cost on the open market to replicate the plan's lifetime annuity option.

Current retirement packages include a description of the relative values so that participants can understand their options. This information is often contained in the Explanation of the Qualified Joint and Survivor Annuity (QJSA), as the relative values are often compared to the QJSA as it is the default form of payment under federal pension law. In general, these descriptions say that the comparison is made by converting the value of each optional form of benefit to a lifetime annuity and showing the ratio of each optional form to the lifetime annuity (alternatively, some plans do this comparison by converting each into a lump sum and comparing the relative values of lump sum equivalent values of each benefit – either option is permitted under current law). Many explanations also say that these relative values are based on average life expectancies and the relative values will vary based on how long the participant and beneficiary live. We are very open to improvements in the relative value presentations, but it is not clear what the GAO is looking for beyond the very helpful information currently required and provided.

One area that we feel particularly strongly about is the comparison of the lump sum value to the purchase price of a retail annuity – we do not think this is an appropriate benchmark to measure the value of the lump sum offering for several reasons. Retail annuities are priced higher than the value of the pension lump sum because they include sales charges and expenses (e.g., profit margins, taxes, costs of actuarial reserves, etc.) and they typically use more conservative life expectancy assumptions to reflect potential adverse selection (i.e., they often assume that individuals seeking to purchase an annuity are willing to do so because they expect to live a longer than average lifetime). In addition, many retail annuities include embedded options such as minimum aggregate payment guarantees that result in increased costs for their products, which make them difficult to compare to annuities offered from pension plans. For these reasons, we believe that the comparison to the price of a retail annuity would be very misleading to participants, and would suggest limiting any such discussion to a simple statement explaining that the lump sum will typically not be sufficient to purchase the annuity benefit in the retail annuity marketplace, due to some of the reasons outlined above.

4. What are the Potential Positive and Negative Ramifications of Accepting the Lump Sum?

The GAO Report states that in order to make an informed decision about accepting a lump sum, plan participants need to understand potential positive and negative ramifications of their decisions. In Table 2 of the GAO Report, a number of pros/cons of accepting a lump sum are outlined.

GAO Report – Table 2: Examples of Positive and Negative Ramifications of Accepting a Lump Sum	
Potential positive ramifications of accepting a lump sum	<ul style="list-style-type: none"> Potential inflation protection (depending on investment choices and actual returns) Potential to leave a bequest to a beneficiary other than a spouse Ability to consolidate retirement assets Control over investment decisions Possibility of earning investment returns
Potential negative ramifications of accepting a lump sum	<ul style="list-style-type: none"> Participant bears investment risk Participant bears responsibility for managing the money Participant bears the risk of outliving the lump sum funds (longevity risk) Participant bears the risk of overspending (in the absence of the budgeting signal provided by a monthly pension)
Source: GAO 15-74	

We believe those items shown in Table 2 are a good start, and many lump sum offerings include several of these items. That said, if the EAC is considering incorporating these items into future guidance, we would suggest that some of the wording be adjusted to be clearer to the average plan participant. For example, the first item refers to potential inflation protection (based on investment choices and actual returns), which presumably is meant to convey that if a higher rate of return is earned, the withdrawals in later years can be increased – it is not presumably intended to imply that an inflation indexed annuity is necessarily available if a lump sum is elected. To facilitate more informed choices, participants may be better served by comparisons between the annuity and lump sum options (e.g., “if you elect an annuity...” and “if you elect a lump sum...”, instead of focusing solely on the pros and cons of a lump sum.

In addition, we think some high level information about how the lump sum could potentially replicate the participant’s accrued benefit would be useful to show. For example, three possible investment returns could be shown, with the central rate assumed equal to the weighted average interest rate used to calculate the lump sum benefit. In addition, alternate investment returns of 1% lower and 1% higher could be shown, and the expected age when the assets would be exhausted could be shown. A sample table might look like the following:

If You Invest Your Lump Sum and Your Annual Investment Return is:	Your Assets Will Be Sufficient to Withdraw \$1,000 per Month From Age 65 Until Approximately Age:
5.0%	74
6.0% (the weighted average interest rate that was used to calculate your lump sum amount)	82
7.0%	100

Note: If you start drawing down your investments earlier, your assets will run out at an earlier age. If you defer the drawdown of your assets until a later age, your assets will replicate your monthly benefit for a longer period of time. Please note that the investment returns shown above are for illustrative purposes only, and your actual investment returns will likely vary from the rates shown above. While the lump sum option provides you with flexibility, you will also be responsible for the financial management of your lump sum payment. The XYZ Retirement Plan is unable to provide you with investment advice, and we are not representing that any such rate of return would be achievable. As such, please consult with your financial advisor to discuss the appropriateness of particular investment return assumptions and the risks associated with investing.

Despite the inclusion of potential disclaimers, we would recommend that any such disclaimers be carefully constructed to ensure that they convey the appropriate information, in a simple and direct manner so that they will be understood and add value for the average plan participant.

5. What are the Tax Implications of Accepting a Lump Sum?

The GAO report noted that all 11 packets that they reviewed outlined the tax implications of electing a lump sum, and that each package provided information about the rollover options and the potential for an excise tax for participants under age 59-1/2 who do not roll over their distributions.

We believe that the information already provided in this area is sufficient, and the high level of rollovers observed by the GAO is supportive of our views.

6. What is the Role of the PBGC and What Level of Protection is Provided on Each Benefit Option

The GAO report noted that 10 of the 15 participants that they interviewed who elected lump sums said that one of the main reasons they elected the lump sum said they were worried that the plan sponsor would default on its pension promise. Furthermore, GAO suggests that participants would benefit from a greater understanding of the PBGC guarantees.

Information about PBGC's protections is provided in the summary plan descriptions

already provided to every plan participant regularly, and additional summary information about PBGC's protections is also included in the Annual Funding Notice that is provided to each plan participant on a yearly basis. This notice summarizes the plan's funded position, and describes the PBGC protections that would apply in the event that the plan sponsor is unable to fulfill its obligations. Therefore, we are not sure how to interpret these participants' comments. Perhaps the point is that the communications need to be shorter and simpler, to make them more reader-friendly. In this regard, we would recommend to the EAC that any recommended disclosures, PBGC or otherwise, be written in a simple and direct manner and tested to ensure that they will be understood and add value to the average plan participant.

7. What are the Instructions for Accepting or Rejecting a Lump Sum, and
8. Who can be Contacted for More Information or Assistance

The GAO report acknowledged that all 11 of the election packets reviewed provided clear administrative instructions on how to elect a lump sum, immediate annuity or deferred annuity. Also, all packets provided a contact, such as a call center, so participants could ask general questions about the lump sum offer. Furthermore, most participants interviewed felt that the data included in the election materials was accurate and they found the process of completing the paperwork to be fairly straightforward.

We believe that the information already provided in this area is sufficient as evidenced by the feedback received by the GAO.

HELPING PARTICIPANTS, PROSPECTIVITY, AND FLEXIBILITY

We want to return to our three key points. First, we support efforts that make disclosures more helpful to participants, as we want participants to make the right choices for their own circumstances.

Second, as the EAC considers possible solutions to the items identified above, it is imperative that any future guidance be applied prospectively. Many plan sponsors have offered lump sums to participants in recent years in an effort to continue to maintain their plans, while at the same time offering participants additional choices. It is our understanding that all such offerings were done based on an understanding of the existing ERISA requirements.

Third, we firmly believe that due to the wide variety of plan provisions that exist in the defined benefit universe, there is no "one size fits all" approach that will accommodate or contemplate every possible option. As such, it is very important for any future guidance to be flexible enough to allow plan sponsors to customize the language to accommodate different plan features, some of which may be somewhat uncommon.

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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.