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United States Department of Labor
Hearing on
MODEL NOTICES AND DISCLOSURES
FOR PENSION RISK TRANSFERS

I. Introduction

I am pleased to testify before the ERISA Advisory Council on the topic of model notices and disclosures for pension risk transfers. I last testified before the ERISA Advisory Council regarding private sector pension de-risking and participant protections in 2013 and am especially pleased for the opportunity to return to discuss this important issue.

Since the last time that I testified, employers that sponsor defined benefit plans have continued to confront volatility associated with their pension obligations. The same in-plan strategies and settlement de-risking strategies that I discussed in my prior testimony[1] remain the primary methods that plan sponsors use to reduce the effect of this volatility.

This hearing focuses on one of these de-risking settlement strategies, lump sum offers.[2] Although the ERISA Advisory Council is focused on lump sums offered in connection with limited election windows, from the perspective of participants, considerations about the content of disclosures typically would apply any time an individual is offered a lump sum distribution in lieu of an annuity benefit.

Presently, lump sum offer disclosures are highly regulated, and existing rules provide significant participant protections. In light of the existing regulatory structure, any future regulatory initiative should offer flexibility to employers and administrators who have a history of communicating with their workforce, minimize additional regulatory burdens imposed on defined benefit plans, be coordinated with existing rules, and provide participants with material that is concise and easy to understand.

My testimony will address the principles on which disclosure should be based, the existing rules governing disclosures connected to lump sum offers, and some areas that could be covered by voluntary model disclosures.

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[1] Available at https://www.dol.gov/ebsa/pdf/covingtonburling060513.pdf.

[2] Disclosures have received greater attention in recent years. Most notably, such disclosures were the subject of reports by the ERISA Advisory Council (available at http://www.dol.gov/ebsa/pdf/2013ACreport2.pdf) and the Government Accounting Office (available at http://www.gao.gov/assets/670/668106.pdf).

II. Principles on Which Any Additional Disclosure Guidance Should be Based

In light of the Council's desire to create model disclosures for pension risk transfers, particularly lump sum offers, I propose the following principles as a guide:

1. Model disclosures should be voluntary and customizable to meet the needs of a diverse workforce. Defined benefit retirement plan participants span industries, age groups, educational levels, geographical regions, and socioeconomic classes. By any measure, such participants form a diverse group. Given this diversity, any model disclosures should not be presented as a "one size fits all" requirement.

Employers and plan administrators best know their workforces and have long histories communicating with participants. I have worked with numerous employers and plan administrators to develop disclosures related to lump sum offers that are tailored to meet the needs of their particular workforce. Any model disclosure should be voluntary and customizable to serve as a tool to support these efforts and should not limit an employer's ability to tailor disclosures to the needs of its workforce and plan participants.

2. Model disclosures should minimize burdens on employers and plan administrators. Sponsors and administrators of defined benefit plans currently are subject to a tremendous amount of regulations and requirements—including regulation governing lump sum offer disclosures. As has been widely recognized, these burdens have contributed to the decline in defined benefit plans. Any new regulatory initiative should recognize that adding additional burdens related to lump sum offers could be counterproductive and, as discussed in more detail elsewhere in my testimony, unnecessary.

3. Guidance should be coordinated with existing rules. Existing rules, discussed in Part III, below, govern many aspects of required disclosures to participants who are offered lump sum distributions from defined benefit plans. Any new guidelines should neither conflict with these rules nor require duplicative or voluminous disclosures. Currently, disclosures to participants who are offered lump sum distributions span multiple pages and, as required by regulations, address complex concepts, such as relative values of different forms of distribution. Any model language should be coordinated with existing requirements and not merely add to the volume of materials already required because duplication and unnecessary volume of communications decrease participants' understanding.

4. Model disclosures should be concise. Lump sum offers may be made under many different circumstances, such as to participants when they retire, deferred vested participants whose employment terminated sometimes years or decades earlier, active employees (in the case of a plan termination), and, under certain limited circumstances, retirees in pay status. Furthermore, as I previously noted, defined benefit plan participants make up a diverse cross-section of America. In many cases, participants in some or all of these circumstances will not read, or not read carefully, tens of pages of materials explaining the consequences of a lump sum offer. More pages of disclosure does not necessarily result in greater understanding and can cause confusion regarding what points are most important. Model disclosures would be most useful if they address key points concisely.

III. Existing Rules Provide Many Protections

Offering a defined benefit plan participant a lump sum distribution of his or her pension benefits is, in brief, complicated. Several regulatory requirements govern. For example, ERISA[3] and the Code[4] impose requirements regarding the calculation of lump sums to ensure no forfeiture occurs. Accordingly, the amount of a lump sum distribution must be no less than the actuarial present value of the participant's accrued benefit determined using a specified mortality table and interest rate assumption. (See Code § 417(e); ERISA § 205(g)). Furthermore, in the case of a married participant, spousal consent must be obtained. (See Code § 401(a)(11) and 417; ERISA § 205(g)). And no "significant detriment" may be imposed on any participant who does not consent to a distribution. (Treas. Reg. § 1.411(a)-11(c)(2)(i)).

Required disclosures in the context of lump sum offers cover many areas, including the following:

- the material features of the optional forms of benefit available under the plan (Treas. Reg. § 1.411(a)-11(c)(2)(i))
- the right, if any, to defer receipt of the distribution (Treas. Reg. § 1.411(a)-11(c)(2)(i))
- the consequences of failing to defer (Notice 2007-7, Q&A-32, 33; Prop. Reg. § 1.411(a)-11(c)(2)(vi))
- a description of the optional forms available under the plan (Treas. Reg. § 1.417(a)(3)-1), including:
  - the amount payable in each form
  - the conditions for eligibility for each form
  - the relative value of the form compared to the qualified joint and survivor annuity
  - an explanation of relative value—
    - that communicates that "the relative value comparison is intended to allow the participant to compare the total value of distributions paid in different forms, that the relative value comparison is made by converting the value of the optional forms of benefit presently available to a common form (such as the QJSA[5] or a single-sum distribution), and that this conversion uses interest and life expectancy assumptions"
    - that includes "a general statement that all comparisons provided are based on average life expectancies, and that the relative value of payments ultimately made under an annuity optional form of benefit will depend on actual longevity," and
    - that provides either the assumptions used to calculate relative value or an offer to provide such information
- an explanation of the ability of the participant to roll over the lump sum distribution to another tax-qualified retirement plan or individual retirement arrangement, including the

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[3] "ERISA" refers to the Employee Retirement Income Security Act of 1974, as amended.

[4] The "Code" refers to the Internal Revenue Code of 1986, as amended.

[5] "QJSA" refers to the qualified joint and survivor annuity.

tax effects of doing so (Code § 402(f)); the IRS has provided safe harbor notices to comply with this requirement, and these notices were updated recently in Notice 2014-74.

IV. Areas that Could be Covered by Voluntary Model Disclosures

The myriad of disclosure requirements already in place regarding lump sum offers often results in voluminous—and thoughtful—disclosures to plan participants. Disclosures of more than 10 pages are not unusual with respect to lump sum windows offered by large defined benefit plans. Whether additional information could be helpful to plan participants is not entirely clear. However, should the Council wish to create model disclosures, I recommend that any such disclosures be voluntary and modular.

Disclosures currently being used typically cover many of the same topics the Council would seek to address, and given the efforts that have been made to develop existing disclosures in light of each particular employer's participant population, it would be important to make clear that (a) the models are not required, (b) the models have different parts, or modules, any of which may be used, and (c) the Council does not suggest that these new disclosures were previously required, in light of the fact that any such requirement has not been articulated previously in statute or regulation.

In this context, I suggest below some topics for possible model disclosures and some concise text that the Council might consider. Although similar to disclosures I have seen or written for clients, these samples are not verbatim excerpts of any of my client's disclosures. Furthermore, these suggestions are not intended to imply that these types of disclosures are typical or required under current law.

1. Lump Sum vs. Annuity

Participants presented with an offer to receive their retirement benefits in the form of a lump sum distribution might consider the following:

- <u>Management and Risk Tolerance</u>. Receiving a lump sum distribution will require the participant to manage the proceeds of this distribution. A model disclosure could explain that by accepting a lump sum distribution, a participant will take on the obligation of managing his or her retirement funds and that returns may vary. *E.g., "You will be responsible for the investment of your lump sum distribution. Your benefit's value will depend on the performance of the investments you choose. You should give careful consideration to how you will manage the lump sum payment, and you might wish to consult with a financial advisor."*

- <u>Investment Return Risk</u>. A model disclosure could address the fact that participants who elect lump sum distributions take on the risk that any expected return on investments may not be achieved. *E.g., "You should consider the risk that you may not achieve the return you expect on investments of your lump-sum payment. If, instead, you elect to receive your benefit as an annuity, the payment of your benefit does not depend on investment return because annuity payments are guaranteed for life."*

- Longevity Risk. Whereas annuities provide for a fixed income for life, participants that elect to accept lump sum distributions take on the risk of outliving their retirement funds. A model disclosure could address this uncertainty. *E.g.*, "*Choosing a lump sum provides less certainty. If you live longer than expected, you could exhaust the lump sum benefit before you die.*"

- Inflation Risk. Participants who elect to receive annuities that provide fixed monthly payments might consider the fact that the payments made earlier have greater value than payments made later, due to inflation. A model disclosure could address this point. *E.g.*, "*If you decide to take an annuity, the amount of your monthly annuity will be fixed for the rest of your life (and, depending on the form you elect, the life of your spouse). Your monthly amount is not adjusted by interest or to account for increases in the cost of living. Accordingly, payments made later may be worth less than payments made today.*"

2. Annuity Under Plan Terms vs. Commercial Market

Due to a number of factors, including the profit margin required by commercial annuity providers, annuities offered under plan terms generally provide more favorable terms than an annuity purchased in the commercial market from the proceeds of a lump sum distribution. A model disclosure could make clear that a lump sum payment likely cannot be used to purchase a commercial annuity that can replicate the plan's annuity payments. *E.g.*, "*While individual facts and circumstances may vary, generally, a commercial annuity purchased with the proceeds of a lump sum distribution would not replicate annuity payments from the plan. You might wish to consult with a financial advisor if you are considering taking a lump sum distribution in order to purchase an annuity from an insurance company.*"

3. Calculating a Lump Sum

For many participants, an explanation of how the lump sum amount was calculated is not easily understandable. Concepts related to interest rates and mortality tables are complex and not necessarily intuitive. A model disclosure could describe the lump sum calculation. *E.g.*, "*Your lump sum amount represents the total value today of your annuity benefit, determined based on certain assumptions. Each monthly payment that you would receive as an annuity benefit is valued based on the chances that you would live until the payment date (based on average life expectancy) and an interest rate assumption. Your lump sum amount is the sum of each of these values. The mortality table used for this purpose is _____. The interest rates used are ___% for payments during the first five years, ___% for payments during the following 15 years and ____% for payments made more than 20 years in the future.*"