PENSION & LONGEVITY RISK TRANSFER for INSTITUTIONAL INVESTORS

Strengthening Retirement Outcomes for DB Plan Participants

WAYNE DANIEL AND CYNTHIA MALLETT
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Retirement security for today’s defined-benefit (DB) pension plan participants can be significantly affected by plan sponsors’ plan design choices and the decisions participants make with regard to how to take their accrued benefits. The choice between receiving an income for life or electing these benefits as a lump sum can be presented to plan participants either at the point of retirement or when they terminate their employment with the company, or the choice can arise if the company transfers the risk of paying DB pension benefits. For the latter, pension risk can be transferred to either the individual by offering lump sums or to an insurer with the purchase of a group annuity contract. Lump sum windows—where an employer offers a temporary, one-time cash-out opportunity for DB plan participants in lieu of guaranteed lifetime income—have become increasingly popular in recent years. In fact, a recent survey of plan sponsors who intend to de-risk their DB plan with some type of risk transfer found that more than three-quarters (77%) of sponsors say they would likely use a lump sum, either on its own or in combination with an annuity buyout to achieve their de-risking goals.1

EVOLUTION OF DB PLAN BENEFITS

Corporate DB pension plans came into existence in 1875 when the American Express Company, then a railroad freight company, established the first private pension plan in the United States.2 In the public sector, the first law creating retirement benefits for public employees was passed in New York State in 1857. It provided a lump sum payment to New York City police officers injured in the line of duty and was revised in 1878 to provide a lifetime pension for police officers at age 55 after completing 21 years of service.3

For many years, DB pensions were the predominant workplace retirement program. At their height, DB pensions provided benefits to 38 million American workers.4 These benefits were first traditionally, then legally, paid as an annuity—a guarantee that the individual would receive income that he or she could not outlive—as the standard form of benefit.

In 1956, two important DB pension-related public policy developments provided the regulatory infrastructure for income benefits. First, the Internal Revenue Service (IRS) issued Treasury Regulation Section 1.401-1(b)(1)(i), which stated that a pension plan is “a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement.” Second, the IRS issued Revenue Ruling 56-693, which stated that funds in a pension plan may not be made available

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until “any severance of employment (e.g., retirement, disability, or death),” because allowing a distribution before such time “is inconsistent with the accepted concept of a pension plan.”

Through the 1960s, DB plans paid out benefits solely as life annuities. DB plans provide employees with benefits calculated using a formula, traditionally based on the participant’s compensation and years of service at retirement. IRS rules require that DB plans offer a benefit in the form of a life annuity (except for total accrued benefit amounts under $5,000), which means that the participant will receive equal, periodic payments, often as a monthly benefit, that continue for the rest of the participant’s life. A married participant must be offered a Qualified Joint and Survivor Annuity that extends benefit payments over the life expectancy of the spouse as well as that of the employee.

Beginning in the 1970s, some DB plans began to offer the option of full or partial lump sum distributions, and in the 1980s and 1990s, this form of distribution was often added as a means of encouraging early retirement initiatives. Furthermore, as “hybrid” cash balance pension plans expanded in the 1980s with benefits expressed as account balances, so did distribution options. While hybrid cash balance plans are required to offer an income form of benefit payout, most also included the option for a lump sum form of benefit similar to defined-contribution (DC) plans. The addition of lump sums proved both easy to communicate to, and popular with, employees.

For both traditional and hybrid pension plans, once lump sums had been added, qualified plan anti-cutback rules served to keep these lump sum benefit payment options in place, meaning that the guaranteed income benefit that was synonymous with the earliest pension plans appeared to be losing out to the lure of a one-time payout.

A separate development that paralleled, and overlapped to some degree, with the emergence of lump sum benefit payment options was the decline in DB pension plans. Increasing financial, accounting, and regulatory pressures have caused the number of companies providing DB plans to their workers to decline steadily and significantly over the last few decades. Today, although many public sector workers are still covered by DB pensions, only 20% of Fortune 500 companies provide a DB plan to salaried new hires, down from 59% among the same employers in 1998. 

LUMP SUMS MAY NO LONGER ALIGN WITH PLAN OBJECTIVES

From an employer perspective, lump sums—offered either at retirement or through a special “window”—can reduce the pension liability on the balance sheet to the extent they are accepted by plan participants. However, the practice fails to accomplish the pension’s original and primary objectives—an orderly way for employers to enable their older workers to transition into retirement and secure retirement outcomes for all participants. This is because lump sums irrevocably transfer future risks—namely, investment, market, and longevity risks—to the participant.

Prior to January 1, 2008, the effective date for the Pension Protection Act (PPA) of 2006, the value of a lump sum distribution was based on the average rate of return for 30-year Treasury securities. This rate was lower than the corporate bond rates used to value plan liabilities for funding purposes. This resulted in benefits valued as lump sums being larger and more expensive for the plan than the amount carried for funding purposes. If paid, the funded ratio would be adversely affected. In order to offer a lump sum payment option, it is required to be actuarially equivalent to the present value of the standard income payment stream. The PPA changed both its overall funding requirements and phased in the basis for lump sums under IRC §417(e) from the 30-year Treasury rate to an average corporate bond yield curve from 2008 through 2011. These combined changes generally increased plan liabilities to be more in line with termination annuity costs as well as reducing lump sum valuations, making them more in line with plan funding. By replacing 30-year Treasuries with new corporate bond rates at the same time as the Great Recession, the PPA unintentionally enhanced the appeal of lump sum activity because Federal tax rules unrelated to the PPA permitted use of a look-back rule when setting lump sum valuation rates. Because rates fell as the recession advanced, in 2012, plans could look back to higher rates in the summer of 2011 and pay out smaller lump sums than if they had been required to use current rates. The unusual duration of the recession extended the utility of this strategy.

This discount rate change under the PPA was fully effective for plan years beginning in 2012. In April 2012, Ford Motor Co. was the first large corporation in the United States to offer a voluntary lump sum DB plan payment to about 90,000 U.S. salaried retirees and...
former employees. Prior to 2012, risk transfers were most likely to take the form of an annuity purchase from an insurance company, simply because it had cost less to purchase a group annuity contract for plan participants than it did to offer lump sums. Since 2012, there has been a significant increase in the number of lump sums being offered to terminated employees who are vested in their benefits. According to the Bureau of Labor Statistics, lump sum payments were available to 34% of private industry workers in traditional DB plans in 2014. This is up from 24% in 2010.

**DB PLAN PARTICIPANT CONSIDERATIONS: LUMP SUM OR PAYCHECK FOR LIFE?**

Today, a lump sum—whether at the point of retirement or one offered through a special window—is often the option chosen by most DB plan participants, if it is available, rather than a guaranteed annuity. In fact, a study from the Employee Benefit Research Institute found that the rate of annuitization varies directly with the degree to which plan rules restrict the ability to choose a partial or lump sum distribution. Those with DB plan design features that restrict lump sum distributions had a significant positive effect on actual annuitization rates for plan participants.

In selecting a lump sum over guaranteed income, participants often don’t fully understand the choices being presented to them, or the implications of their decision. Many participants mistakenly believe the lump sum has a greater value than an annuity, even though they typically understand neither how the values are calculated nor what the cost would be to replicate the guaranteed income an annuity would provide. Lump sums are calculated using a participant’s monthly pension amount, age, and actuarial factors based on mortality tables and interest rates specified in the plan, according the Society of Actuaries.

When deciding how to take their pension benefits, participants are frequently influenced by the “wealth illusion” (also known as the “lottery effect”). Even though most people are accustomed to gearing their spending toward the income they earn during their working years, behavioral economics has shown that the idea of suddenly being offered what is perceived as a large sum of money can be tempting. This wealth illusion can cloud decision making and stand in the way of carefully considering the guaranteed lifetime income they would forgo in retirement by taking a lump sum.

Unfortunately, what many pensioners don’t realize—often until it is too late—is that when they accept a lump sum distribution, they run a significant risk of prematurely depleting their assets. One of the first studies of lump sum distributions was in 1986 by Lawrence Atkins, who presented information from the 1983 Current Population Survey Employee Benefits Supplement. Atkins concluded that most distributions were spent, not saved, and that the groups with substantial saving probabilities were older, were better educated, and received larger distributions. At the time Atkins conducted his research, plan sponsors may not have been aware of the impact that lump sums would have on a participant’s retirement security.

Fast forward to a recent “MetLife Paycheck or Pot of Gold Study,” released in April of this year, in which Harris Poll surveyed more than 700 workplace retirement plan participants who were given a choice between a lump sum or an annuity as a retirement distribution option from either a DB or DC plan. Atkins’ conclusions were reaffirmed with the findings from the MetLife study: one in five plan participants who selected a lump sum from a workplace retirement plan (21%) had completely depleted it. Those who fully depleted their lump sums did so, on average, in five and a half years. Others with money remaining are concerned about the money running out.

It is important for an individual to understand the market, investment, and longevity risks they are taking on by choosing a lump sum. Market and investment risks subject the assets to market fluctuations, which can increase or reduce the value of assets—they become much more than theoretical risks once individuals are living on these funds. Furthermore, half of all individuals will live longer than the only mortality information most might be familiar with—the required minimum distribution (RMD) table used for all 401(k) contributions. This longevity risk increases the likelihood that they could run out of money in retirement. There are also tax consequences of taking a lump sum, and they will forgo protection against creditors in the case of a personal bankruptcy in the future. They should also consider their investment skills and how these may change as they get older and experience potential declines in cognition. Last but certainly not least, pensioners run a dual risk of squandering their money at one end of the spectrum and, at the other end of the spectrum, under-spending due to fears of running out of money.
CLEAR AND COMPLETE LUMP SUM EDUCATION AND COMMUNICATION NEEDED

Whenever a lump sum benefit payment is present within a DB plan, whether as a one-time window with a pension risk transfer (PRT) transaction or one available to all participants at retirement, it has become clear that the way in which they are both designed and communicated will have a significant impact on the effect of the feature. One way to encourage more careful consideration of annuities as an alternative to a lump sum is for the plan sponsor to offer clear and complete education and communication with income-oriented framing or positioning.

In January 2015, the U.S. Government Accountability Office (GAO) released a report entitled, “Private Pensions: Participants Need Better Information When Offered Lump Sums That Replace Their Lifetime Benefits.” This report focused on 1) the prevalence of lump sum offers and sponsors’ incentives to use them; 2) the implications for participants; and 3) the extent to which selected lump sum materials provided to participants included key information. The GAO concluded that “for participants being asked to choose between a lifetime benefit option and a lump sum, it is important that they understand how the two compare.” Better information is needed when offering lump sums, as participants do not have “a full appreciation of the range of risks involved.” The U.S. Department of Labor’s (DOL’s) ERISA Advisory Council heard testimony in June and August 2015 concerning model notices and disclosures for lump sums and pension risk transfers and shared its recommendations and draft model notices with the Labor Secretary on November 4, 2015. Meanwhile, on July 9, 2015, the IRS issued Notice 2015-49, which effectively halted the stream of private letter rulings similar to the one obtained by Ford for its 2012 transaction referenced earlier, which had permitted sponsors to offer to accelerate or “commute” benefits for retirees already receiving pension income benefits in a temporary “window” period. Sponsors can only continue such window offerings for participants not yet in pay status.

In the United Kingdom, major pension reforms that ended required annuitization to allow for flexibility have resulted in a startling percentage of individuals under age 65 taking lump sums. A recently-released Financial Conduct Authority report looked at how pension savers had responded to 2015 reforms, and found that the 72% of DC pension pots have been accessed by consumers under 65, most of whom have taken lump sums. The reforms also enabled those with DB pensions to swap them for DC schemes, if their employer allowed it. Since the reforms went into effect, more than £12 billion has been withdrawn from DC schemes in the United Kingdom, which is concerning to U.K. regulators, the Trades Union Congress (TUC), and retirement industry professionals. Commenting on the report by the U.K. Financial Conduct Authority, TUC General Secretary Frances O’Grady said, “This is a damning verdict on so-called ‘pensions freedom’. Workers who are facing insecurity in their working lives now risk being plunged into insecurity in old age.”

Among DB plan participants in the MetLife study who were given a choice between a lump sum or an annuity, fewer than half (45%) said that at the time they made their decision, they recall being presented with information comparing the total amount of the lump sum versus the total value of the annuity payments (see Exhibit 1). This indicates a potential opportunity to improve upon the information provided to DB plan participants because, as the American Academy of Actuaries has noted, “[w]hen lump sum distributions are offered, it is critical that participants receive information that is sufficiently clear and complete to enable them to make informed decisions regarding whether to accept the lump sum offer.”

Additionally, only 31% of DB plan participants who were given a choice between a lump sum or an annuity recalled receiving information about the risk of outliving their money, and only 12% remembered receiving information about the risk of spending a large sum more quickly than expected. One-quarter of DB plan participants (26%) recall being shown

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**EXHIBIT 1**
Deciding Between a Lump Sum and an Annuity
Key Comparison Information Lacking

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<th>Percentage of DB Plan Participants Who Recall Receiving:</th>
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<td>Information comparing the total amount of the lump sum vs. the total value of the annuity payments</td>
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45%
information about coordinating their pension benefits or DC plan savings with other sources of retirement income (e.g., Social Security, pension income, or other retirement savings).

These findings suggest that this area is well positioned to benefit from best practices, under which PRT can coexist effectively with optimized outcomes for plan participants. Practical suggestions drawn from our experience could include the following:

- **Frame from an income starting point.** Plan sponsors should be actively working to change participants’ mindsets about the primary purpose of their workplace retirement savings: to create lifetime income to sustain them throughout retirement.
- **Match the education to the plan’s facts.** Participant education may need to be situational, as in a lump sum window offer, where it will need to supplement required notices, or conceptual, where it can introduce retirement income education more broadly.
- **Simplicity is crucial for effectiveness.** Plan sponsors express a strong preference for simplicity over flexibility in their plan designs.
- **Utilize a mix of delivery methods.** Participants learn in a variety of ways; some by reading, some by watching or listening, and others by interaction.

### Annuity Buyouts Protect Participant Benefits

With annuity buyouts, insurance companies take on the plan’s risk and the company is able to remove the liability from its books. Participants’ benefits are preserved in exactly the same amount and form; the only thing that changes is the entity from which an individual receives their annuity payments. The insurance company assumes the financial and administrative responsibilities of paying the benefits, thus relieving the plan sponsor of its contractual obligation to participants. Once the insurer has assumed the obligation to make the payments to participants, those participants become annuitants and are no longer plan participants. 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 or partial annuitization.

### Risk Transfer That Provides for Retirement Risk Security

In addition to clear and complete education, the manner in which a plan sponsor decides to manage their plan’s risk can significantly impact participants’ retirement security. With a pension risk transfer to an insurance company, plan sponsors can reduce their risk while still ensuring successful retirement outcomes for their plan participants. Through the purchase of group annuity contract from an insurance company, the pension plan’s obligations and related risks are transferred to the insurer.

**Adding Partial Annuitzation**

With partial annuitization, DB plan sponsors enable their participants to avoid the “all-or-nothing” choice they are usually asked to make. In September 2016, the IRS issued final rules that make it easier for DB plan sponsors to permit their participants to take their DB pension benefits as a partial annuity/partial lump sum. This could prove beneficial and attractive to DB participants in any plan that has added a lump sum feature in the past or is designing a new PRT window offer. According to our research, if presented with a new opportunity to choose a lump sum, annuity, or some combination of the two, regardless of the choice they made previously, 30% of workplace retirement plan participants would choose partial annuitization.

**Can DB QLACs Provide a Better Window Offer?**

Plan sponsors and policymakers should also consider the merits of qualifying longevity insurance contracts (QLACs) for DB plans. Although QLACs are only currently permitted to be offered to DC plan participants, allowing DB plans with lump sum features to offer QLACs could encourage greater rates of annuitization. With a QLAC, a portion of the DB participant’s earned benefit could be used to provide a deferred benefit, which would provide guaranteed monthly income at some point in the future, such as age 80 or 85. QLACs provide two significant benefits: the ability to exempt the value of the QLAC from RMD rules and guaranteed income that is less expensive than an immediate annuity where payments commence immediately after...
election. Additionally, because benefit payments from a QLAC commence later in life, this timing may coincide with when cognitive declines have begun to set in and an individual may no longer want to, or be able to, manage his money on his own. The individual is instead provided with the security of guaranteed income in his or her later years.

**Should Optional Payment Forms Be Classified as Protected Benefits?**

Finally, policymakers should consider revising DB plan anti-cutback rules to allow plan sponsors to eliminate lump sum distribution options from their DB plans if they believe it’s in the best interest of their plan participants, as emerging experience suggests that lump sums can undermine participants’ retirement security. One might view as precedent the rules under the PPA under which this optional form of benefit is suspended when plan funding drops below a defined level.

**CONCLUSION/SUMMARY**

Whether or not plan sponsors will be able, or willing, to curtail the use of lump sum distributions for workplace retirement plans in the coming years is still an open question. It is a question that should be given careful consideration as long as the ultimate goal of these plans is to help ensure successful retirement outcomes for plan participants. After all, as a fiduciary, plan sponsors are responsible for making decisions that are in the best interests of members of the plan. Emerging information that millions of American workers are potentially at risk of depleting their retirement assets prematurely in the future illustrates the outsized effect that plan design decisions made by the plan sponsor can have on outcomes for participants.

Adding partial annuitization may be a plan design change both for plans that already have lump sums as well as for those that are considering changes to traditional income benefits, and plans with traditional income benefits may find that adding optional forms of benefits, such as lump sums, may not be in the best interests of the participants, even with additional education. Overall, given new knowledge and insights, plan sponsors are in an excellent position to mitigate these effects before they occur for future retirees through both plan design and more comprehensive education, whether the plan is in an ongoing status or involved in a PRT process.

**ENDNOTES**

8While the majority of lump sum windows have been offered to terminated-vested participants, the U.S. IRS had issued several private letter rulings beginning in 2012 allowing certain plan sponsors to offer lump sum windows to retirees already receiving annuity payments from their DB plans. In July 2015, however, the agency released Notice 2015-49 indicating it would be discontinuing this practice. The notice stated that the agency intended to amend the minimum distribution regulations to prohibit lump sum payments to participants or beneficiaries currently receiving annuity payments. Specifically, the amendment to IRC Section 401(a)(9) prohibits lump sum payments or any other accelerated form of distribution to replace any joint and survivor, single life, or other annuity currently being paid under a defined-benefit pension plan.


“Paycheck or Pot of Gold Study,” MetLife, April 2017.


The 2015 ERISA Advisory Council, Executive Summary to The Secretary of Labor, November 4, 2015.


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