Transcript of Testimony as Presented at Public Hearing Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans

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Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW.
Washington, DC 20210
Attention: Lifetime Income Public Hearing

Re: RIN 1210–AB33: Transcript of Testimony Presented at Public Hearing on Lifetime Income Options for Participants and Beneficiaries in Retirement Plans

<Tamara Burden> Good afternoon. I'm Tamara Burden and I'm a principal and consulting actuary with Milliman. Milliman is a leading actuarial and consulting firm and we do a lot of work with insurance companies and plan sponsors on retirement savings products. I'm also the managing director of the Retirement Guarantee Network which is devoted to bringing guaranteed lifetime income to defined contribution plans. I really appreciate this opportunity to speak with you today.

The Department of Labor (DOL) is at a key juncture. You are looking now at ways to provide American workers access to and encouragement to buy cost-effective lifetime retirement income. You are aware that many of us here today believe that a key reason current products aren't being widely adopted inside of employer-sponsored plans is because of uncertainty involving the fiduciary safe harbor for retirement income products. A number of speakers have discussed this issue in detail and asked the Department of Labor to consider modifying or extending that safe harbor. Today I would like to talk about extending that safe harbor to stand-alone living benefit products (which are also known as guaranteed lifetime withdrawal benefits in the variable annuity space). I have three points to make:

- These products are good for American workers
- These products require insurance companies to manage risk prudently
- In order to protect the interests of plan sponsors and the American worker, the safe harbor should only be extended in the presence of certain safeguards

The beneficiaries of sound public policy in this instance are Americans who are either saving for retirement or planning their transitions from their working to their retirement years. With the welfare of those beneficiaries firmly in your minds, I ask you to carefully consider my remarks today.

So what makes stand-alone living benefits good products? In today's world, Americans are facing retirement with too little savings, with recent large losses in retirement accounts, and with interest rates at record lows. We don't have the luxury of conservative investment portfolios focused on protecting principal. For many, the best hope they have for a secure retirement is to tap in to the upside potential of equity investments. But on the other hand, we can't withstand another collapse of the global financial system that wipes out a big chunk of our retirement savings. Americans need investment strategies and products that allow them to prudently invest in equities while, at a reasonable cost, protecting their retirement incomes against market declines.

When people don't have a lot saved for retirement, it becomes difficult to partition assets into a recurring income stream to pay regular bills and expenses, and money for unexpected events (say, a sudden medical emergency). So even while people are trying to maximize their income stream they need to maintain control of and access to the underlying assets.

Americans also need longevity protection. They need to be able to draw retirement income without having to worry about what might happen if they live longer-than-average life spans.

Products that offer all of these benefits in one package exist in the marketplace today. These are "stand-alone living benefits." These products enable participants to take advantage of a guaranteed lifetime retirement income, with equity participation before and throughout retirement, while maintaining full control of and access to their underlying assets.

How do stand-alone living benefits work? Say it's the beginning of 2008, you're 65 years old, and you are planning to retire at the end of the year. You've got $400,000 in your retirement account, and that will support a pre-tax income of about $2,000 a month. At the end of the year, your 401(k) balance has fallen to $250,000 a year. This will only support an income of $1,200. If you had a stand-alone living benefit guarantee, you would be able to take the $2,000 a month that you'd been counting on, and when you ran out of money, the insurance company would pick up the $2,000 monthly payments as long as either you or your spouse were still alive.

That sounds pretty great. You might be wondering—what's the catch? How does that work? Retirement income guarantees are terrific, but every dollar that a participant doesn't lose has to come from somewhere. In practice, these dollars come from the insurance company that provides the guarantee, but the insurance companies themselves get the money from the marketplace. They do this by using derivatives—not the complex, illiquid kind that helped cause the global financial crisis, but rather the simplest, most liquid and transparent hedge assets available. I want to stop here for just a moment and emphasize that these are not new risk management strategies I'm talking about. I'm describing for you how the insurance companies who sell these products today—many of those companies represented at this hearing, in fact—manage this risk right now. So insurance companies use derivatives, and derivatives have a pretty ugly connotation these days. I'm going to take just a minute to address that. Derivatives can be used in two ways. One is to leverage risk in the hope of a higher return (that would be similar to AIG and their credit default swaps) and the other is to lay off risk that already exists in a portfolio, winding up with a smaller net risk position. That's the use of derivatives that applies here. In general, in managing this kind of business, life insurers have avoided complex financial instruments and have emphasized transparency and reliability in their operational processes. This emphasis on simplicity has helped the life insurance industry to avoid the pitfalls encountered by the banking industry.

In fact, in 2009, Milliman completed a study of insurance companies offering guaranteed retirement income products and determined that the hedging programs had been about 94% effective in achieving their designed goals during the period from September 2008 through March 2009.[1] Just in September and October of 2008 alone, these hedging programs saved the life insurance industry an estimated $40 billion.[2] Imagine where we'd be today without those hedging programs.

To look at the value of these products in another way, I took half a dozen publicly traded insurance companies that sell this business today and looked in their annual filings with the Securities and Exchange Commission where they have to report the value of their living benefit guarantees. At the beginning of the year, these companies had an average liability of $275 million. By the end of the year, this number had ballooned to $3 billion! That's an increase of almost 11 times. You can look at this number in two ways—one is to think, "Whoa, these are risky products!" and the other is to think, "Wow, look how much money that guarantee saved the American worker!"

So now that you have a better picture of not just how stand-alone living benefits work but also how insurance companies manage the risk exposure, I want to talk about the concerns of plan sponsors. It isn't that they doubt hedging programs work—they do! they have!—but these guarantees are just backed by the general account of the life insurance company.

Even though the insurance companies have significant regulation governing the reserves and capital that must be held to support each of their lines of business, including these products, the failure of an insurance company means that in some area of its business these reserves and capital proved to be insufficient. Once an insurance company is in receivership, the participants in such a plan just end up in a line of creditors. To make matters worse, the circumstances that would lead to a failure of a large, highly-rated insurance company would be just the circumstances that create huge guarantee liabilities. And these are the same times when participants need most to be able to rely on those guarantees. We saw exactly this perfect storm of events in the recent financial crisis.

One approach that has been proposed is to extend the existing safe harbor to cover other lifetime income products, a recommendation with which Milliman agrees. However, it is important to realize that the safe harbor is a protection of last resort for plan sponsors. Sure, they don't want to be held liable themselves if the insurance company fails to make good on their promises, but what plan sponsors really want is assurance that the guarantees will be paid even if the insurance company gets into financial trouble.

So what is the solution? I want to draw your focus to something fundamental about these products and their risk management. These liabilities develop and are funded over time as the market moves. They are not funded by insurance company capital and surplus—they are funded by gains in the assets being held to defease the liabilities. So the solution is straightforward. Take the assets backing these guarantees (the hedge instruments and any payoffs they've generated) and segregate them in a collateral trust account that accrues to the benefit of the plan participants in the event of an insurer failure.

Segregating the assets is no hardship to insurers, who all manage hedging programs to fund their guarantee liabilities anyway. Companies are already holding those reserves. They are already holding those hedge assets. This simply draws the line in the sand clarifying that these assets are specifically earmarked for this guarantee and thereby clarifies the place in the creditor chain where the participants sit in the event of a default by the insurance company. Now plan sponsors have a viable option for replacing defaulting insurers, or simply continuing to manage the risk on their own. Such a collateral account removes the vast majority of the risk associated with the potential failure of an insurer and puts the power to secure the guarantee back into the hands of the retirees and the plan sponsor.

In summary, I've focused today on stand-alone living benefit products because they have some fundamental features that are very attractive. They allow Americans, those working and those retired, to maintain significant exposure to equity markets while maintaining control of and access to underlying assets. They provide downside protection against adverse financial markets and protection against outliving assets. These products are immensely valuable for many American workers, but the flip side of that is they can create enormous risk exposure for the insurance companies who provide them. Although companies can and do manage this risk exposure appropriately, the sheer size of the market and the huge value these guarantees can have mean the Department of Labor needs to look carefully at how the guarantees are supported. Specifically, we encourage the Department of Labor to consider extending the fiduciary safe harbor only in the presence of certain safeguards: the presence of a basic, transparent, industry-standard hedge program and the existence of a collateralized separate account that holds the hedge assets and cumulative payoffs from those assets.

Thank you for your time and attention.

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