

# Insider

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## Financial Reform Bill Will Affect Executive Compensation and Corporate Governance

On May 20, the Senate passed the Restoring American Financial Stability Act (S. 3217) by a 59–39 vote. Along with taking other measures aimed at ensuring economic stability, the landmark financial reform addresses executive compensation and corporate governance practices, including say on pay, compensation committee and advisor independence, clawback requirements, additional proxy disclosures and majority election of directors. The provisions generally affect U.S. publicly traded companies, but include more onerous restrictions for certain financial services organizations whose compensation programs might encourage risk taking that could harm the overall economy.

The executive compensation and corporate governance provisions are similar to those in the Wall Street Reform and Consumer Protection Act (H.R. 4173) approved by the House in December 2009. The bill is now headed for a House-Senate conference committee to negotiate a compromise between the House and Senate proposals.

### House and Senate agree on say-on-pay, compensation committee and advisor independence provisions

Both the Senate and House financial reform bills would require public companies to conduct annual, nonbinding shareholder votes on compensation paid to executives named in the proxy. The House proposal would also call for a nonbinding shareholder vote on golden parachute payments, require institutional investment managers to disclose their say-on-pay votes to shareholders and allow the Securities and Exchange Commission (SEC) to exempt certain

categories of issuers from the requirements. Under the Senate bill, brokers could not cast votes on behalf of a shareholder on say-on-pay, board member election, executive compensation or other significant issues unless that shareholder has specifically instructed them to do so.

Both the House and Senate bills would try to make compensation committees and advisors more independent, calling for the SEC to set new standards for compensation committee members, legal advisors, compensation consultants and similar professionals. Both bills seek to limit consulting, advisory and other compensatory fees to committee members. The House bill includes a blanket prohibition on using consultants who don't meet specific independence standards, while the Senate bill relies on the limits imposed by SEC regulation. The Senate bill omits the language in the House bill requiring SEC regulations that define independence for compensation consultants to be “competitively neutral among categories of consultants and preserve the ability of compensation committees to retain the services of members of any such category.” The Senate bill includes a nonexclusive list of factors to consider in assessing independence, such as policies and procedures the advisor has in place to prevent conflicts of interest.

### Senate bill would require clawbacks and additional proxy disclosures

The Senate bill includes requirements for clawbacks and proxy disclosures that do not appear in the House bill. Companies would have to establish policies to claw back incentive-based compensation (including stock options) paid to current or former named executive officers in the event of a restatement based on material noncompliance with financial reporting requirements. The clawback provision would apply to incentive-based compensation paid during the three-year period before the restatement date.

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## Insider

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Under the Senate bill, proxy disclosures would have to contain additional information:

- Companies would have to substantiate how executive compensation relates to the company's financial performance, taking into account changes in the value of stock, dividends and distributions.
- Disclosures would have to compare chief executive officer pay with median employee pay.
- Companies would have to disclose whether any employee or board member (or designee) can purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities owned or granted as compensation.

## Restrictions on financial institutions

Both bills include severe restrictions on pay at financial institutions, which lawmakers view as a root cause of the financial crisis. The bills would prohibit compensation practices that could have serious adverse effects on economic conditions or financial stability. The House bill would create a Financial Services Oversight Council to monitor the marketplace to identify systematically risky financial services companies and subject them to stricter standards, while the Senate bill would maintain regulatory authority within the Federal Reserve System.

## Outlook

Despite a few unresolved issues, such as a provision regulating derivatives, passage seems likely. Assuming the conference committee negotiations succeed, President Obama is expected to sign the act into law.

# Pension Funding Relief Moves Forward in Congress

Acknowledging the link between pension relief and jobs, both the House and the Senate have introduced relief bills over the last few months.<sup>1</sup> As the Memorial Day recess neared, the House and Senate were hoping to approve the American Jobs and Closing Tax Loopholes Act of 2010. The act was crafted by House Ways and Means Committee Chairman Sander Levin (D-Mich.) and Senate Finance Committee Chairman Max Baucus (D-Mont.). This iteration of the bill would grant plan sponsors extended amortization periods. It leaves out maintenance-of-effort requirements that appeared in some earlier proposals, but still requires higher pension contributions from plan sponsors that pay "excess" compensation.

In an April 13 letter to House pension legislators, the Obama administration suggested that any pension funding relief should be "targeted." Labor Secretary

<sup>1</sup> In a series of studies, Towers Watson has projected the regulatory funded status and minimum required contributions for single-employer defined benefit (DB) plans, in the aggregate. It has serially updated the analysis to reflect changing market conditions, new regulations, and enacted or proposed temporary legislative relief. See "DB Plan Funding Update: Extending the Analysis Period Shows the Need for Smoother Funding Relief," *Watson Wyatt Insider*, November 2009; "Funding for DB Pension Plans in 2010 and 2011 Under Relief Proposals," *Watson Wyatt Insider*, October 2009; "New Relief From IRS Reduces Required DB Plan Contributions for 2009, but Large Increase Looms for 2010," *Watson Wyatt Insider*, April 2009; and "The Future of DB Plan Funding Under PPA, the Recovery Act and Relief Proposals," *Watson Wyatt Insider*, January 2009.

# Towers Watson Responds to RFI From DOL and IRS About Income Options In Retirement Plans

Towers Watson has responded to a request for information (RFI) from the Departments of Labor and Treasury about lifetime income options for participants and beneficiaries in retirement plans. The RFI sought input into whether and how to promote the use of lifetime income distribution arrangements in employer retirement plans and individual retirement accounts. In its response to the RFI below, Towers Watson provides information and analysis, as well as suggestions for ways the government and pension plan sponsors can help retirees achieve a more financially secure retirement.

Dear Sir/Madam:

This letter is the response of Towers Watson to the request by the Department of Labor (DOL) and the Department of Treasury (Treasury) for information regarding lifetime income options for participants and beneficiaries in retirement plans.

Towers Watson is a global human capital and financial management consulting firm established on Jan. 1, 2010, as a combination of the former Watson Wyatt and Towers Perrin. With 14,000 associates around the world, we offer solutions in the areas of employee benefit plans, talent management, rewards, and risk and capital management.

In the retirement plan area, whether a client maintains a defined benefit (DB) plan, a defined contribution (DC) plan, or both, Towers Watson works with each client to determine the right approach to design, funding, investing, governance and employee engagement. We take into account the nature of each client's business, the composition of its workforce and its goals for benefit adequacy, competitiveness and cost management.

Towers Watson appreciates the opportunity to provide our views and information on this important topic of lifetime income options for participants and beneficiaries in retirement plans. In analyzing the issues raised in your request for information (RFI),

we found it helpful to think about your questions in seven broad areas. We have organized our response accordingly and hope that you find it helpful.

## I. What is our view about retirement plan participants getting their benefits as lifetime payments? [RFI questions 1, 12]

With declining mortality rates, the falloff in traditional DB plan coverage, and the potential for reduced benefits from Social Security, the exposure of retirees to longevity risk — or the risk of outliving one's savings — is significant and increasing in importance. Moreover, with the falloff in employer-provided retiree health insurance and rising health and long-term care costs, the exposure of retirees to costly morbidity and disability risks is also growing. As a result, a sound and efficient asset distribution strategy is needed for retirees to: a) maintain a reliable stream of income, b) preserve wealth for a variety of liquidity needs (family emergency, sudden expensive home repairs, disabled children, etc.), and c) insure against, or dedicate resources to, the possibly high costs of morbidity and disability.

Each retiree should ensure that the guaranteed lifetime payments available from any employment during retirement, DB plan distributions, Social Security, and insurance products will be sufficient to support basic consumption needs in retirement. Further, in assessing these lifetime payments, retirees should consider the impact of uncertain inflation. Discretionary spending is highest early in retirement, while expected spending on health care and long-term care needs increases as retirees age. The different natures of these types of spending, as well as whether insurance coverage is available should be factored into the financial strategies of the retired household. Also, due recognition should be given to the cognitive challenges that retirees often face in managing their investments and distributions as they age.

In the pure form instrument of an immediate straight life annuity, the policyholder pays a lump-sum premium to an insurer in exchange for the promise that the insurer will pay a series of periodic payments for the lifetime of the insured (or the joint lifetimes of the insureds), regardless of the longevity

The exposure of retirees to longevity risk is significant and increasing in importance.

Purchases of life annuities should be facilitated, particularly in a “DC-only” retirement plan setting, but not required.

outcomes of the individuals insured. Such an annuity transfers the uncertainty of the individual’s or couple’s lifespan with respect to consuming out of this lump sum to the insurer, which reduces its own uncertainty, in turn, by pooling the lump sums of many annuitant policyholders with similar longevity expectations (always, by age, where allowed by law, by gender, and, rarely, by health) together. Indeed, abstracting from any unique issuer costs of the life annuity, the return (ROI), contingent on survival, to an annuity should be higher than a bond portfolio of similar risk as of the insurer issuing the annuity. As the issuance age increases, the return, again contingent on survival, from the life annuity also increases, because the investments of the larger number of dying policyholders (because expected mortality increases with age) are, in essence, redistributed to those who remain alive. Owing to its nature, however, when a straight life annuity is used, the ability to bequeath assets is eliminated and advance access to future payments is not available or is strictly limited. Stated more bluntly, the return to an annuity at the death of the insured(s) is –100%.

A number of further trade-offs exist in practice, between maintaining an account balance versus receiving a series of guaranteed lifetime payments, that make this decision complex and unique to each individual. For example, research suggests that many Americans will not have adequate savings to generate sufficient lifetime payments at retirement to cover reasonable living expenses, thus perhaps leading them to accept an increased amount of risk in their investment portfolio in retirement to support their income needs. Others will have ample and secure income flows in retirement from Social Security and DB plans and generous coverage by employer-sponsored retiree health plans. For a significant number of plan participants at retirement, current poor health and its attendant costs makes formal annuitization a poor choice. More broadly, some products currently available in the marketplace are perceived to be (1) expensive (at least in part due to adverse selection of mortality risks, that is, the tendency of people with reasonable expectations of early death to avoid the voluntary purchase of life annuities, or because of high marketing or other issuer costs), (2) too complex, (3) subject to pricing risk at time of selection (owing to changing interest rates) and continuous risk of issuer failure, and (4) have limited flexibility. As a result, annuitization of benefits will potentially be perceived as a net loss by many individuals. In conclusion, purchases of life annuities should be facilitated, particularly in a “DC-only” retirement plan setting, but not required.

## II. What is the reality of the availability and nature of lifetime income options given by DC plan sponsors (internal or external to the retirement plan) or accessible in the commercial market for retirement plan participants and beneficiaries? [RFI questions 3–11, 30, 33, 34–37]

A plethora of insurance products are available in both the institutional and retail markets to provide lifetime payments in retirement including fixed immediate annuities, fixed deferred annuities, longevity insurance (fixed deferred annuity with income starting at an advanced age, e.g., age 85), inflation-indexed annuities, and variable annuities, which may include guaranteed minimum withdrawal benefits or other guaranteed benefits. The value proposition, however, is not obvious for the products currently available in the institutional marketplace because: 1) products are new and evolving, 2) products are perceived to be expensive, 3) flexibility in current solutions is limited, 4) there is a low take-up rate when offered, 5) plan sponsors have expressed limited appetite to adopt these products due to the relatively high fiduciary risk to which it exposes them, and 6) minimum required distribution rules may prevent the use of certain desirable strategies, such as deferring annuitization to the older age ranges of retirement.

While the retail market offers the ability to customize solutions to meet the needs of individuals overcoming the flexibility issues in the group market, the cost of distribution for these retail products is higher, resulting in a reduction in the amount of lifetime payments that can be generated from an account. The recent financial and economic environment has further caused producers to increase fees for guaranteed minimum withdrawal benefits on variable annuity products, which have become popular in the retail market over the past decade.

Some other out-of-plan rollover options include managed payout funds (which manage the distribution/decumulation phase of retirement such that the likelihood of success is enhanced but not guaranteed because they are not insured) as well as annuity purchase services where a third party negotiates group purchases with a variety of vendors from which the plan participant can choose.

## III. What is the reality of the demand for lifetime income options by retirement plan participants and what are explanations for this level of demand? [RFI questions 2, 16, 17, 29, 38, and 39]

Towers Watson has a variety of sources of information for both the prevalence of annuity

options in DC plans and the levels of annuity election in both DB and DC plans when both an annuity and a lump sum are available. We will provide detail on the various sources of information but they consistently exhibit a low level of election for lifetime options when a single sum option is available. This would seem to suggest a lack of demand, although it also could indicate dissatisfaction with the lifetime options offered in the particular situations. Alternatively, for DB plans, it could be attributable to a real or perceived additional value in the single sum offering. We do not have the data to draw definitively those distinctions or comment on why plan sponsors or participants made the choices that they did. We also note that the apparent lack of demand may not indicate a lack of need, but rather a lack of education and understanding of the attributes of lifetime options.

Towers Watson maintains a database of plan provisions for over 1,400 large employers, which indicates that between 20% and 25% of the

employers with DC plans offer some sort of lifetime options within those plans. Our work with plan sponsors indicates a stronger interest to offer lifetime options. Other sections of this response address the concerns and barriers that currently exist which we believe have prevented plan sponsors from doing more in this area.

Turning to participant choices, we have conducted an informal survey of our consultants working with DB plans that offer both lump sums and annuities, regarding the choices that participants have made historically. We received responses for over 20 plans covering well over 300,000 active participants. The responses indicated that, on average, over 80% of participants who terminated or retired elected a lump sum rather than an annuity. The lowest reported lump-sum election rate of the group was 55%. While this was not a rigorous study, the findings are very clear and are consistent with the anecdotal evidence that we have observed over the

Over 80% of participants who terminated or retired elected a lump sum rather than an annuity.

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## News in Brief

### IRS Provides Limited Relief for Document Failures Under Section 409A

In Notice 2010-06, the IRS announces a new correction program for nonqualified deferred compensation plans with document provisions that do not comply with Internal Revenue Code section 409A. The notice expands existing correction programs to companies that inadvertently failed to bring their plan documents into compliance with section 409A as of the Dec. 31, 2008 deadline.

Used together with Notice 2008-113, which outlines corrective actions available for operational failures, the relief may enable companies to help employees avoid the potentially severe penalties for inadvertently failing to comply with section 409A.

Under the notice:

- Employers can generally correct document failures without penalty if they do so before the offending provision causes an improper deferral or payment. This standard is generally applied separately for each participant. So even if the offending provision has already triggered an improper deferral or payment to one participant, the relief may still be available to other participants in the same arrangement.
- If a plan document is corrected before triggering a distribution, the participant would not be subject to additional taxes if the offending provision would not cause a different result for a distribution triggered within one year of the plan correction.

With corrections now available for both document and operational violations, companies should review plan documents and administration early and often to detect and correct any failures as soon as possible — the IRS rewards fast corrective responses. In particular, document failures otherwise correctable under Notice 2010-6 can be corrected by Dec. 31, 2010, effective as of Jan. 1, 2009, without any income inclusion (or the additional 20% tax), provided that any deferrals or distributions that may be operational failures under the corrected terms are also corrected under Notice 2008-113 by Dec. 31, 2010.

## Pension Funding Relief, from page 2

Hilda Solis said relief should free up resources for business investment and job creation but not enable employers to redirect those resources to shareholders or executives. She also said companies currently in bankruptcy or behind on pension contributions should not receive relief, and recipients of relief should notify their employees.

The rule defines “excess” [compensation] as aggregate includable annual compensation of more than \$1 million.

## Key relief provisions

Like earlier versions of the legislation, the American Jobs and Closing Tax Loopholes Act would give DB plan sponsors more time to amortize pension funding shortfalls. Sponsors could choose between two amortization schedules in lieu of the seven-year schedule for shortfall amortization bases under the Pension Protection Act:

- Under 2+7 amortization, plan sponsors would pay only interest for two years, followed by seven-year amortization. Interest payments for the first two years would be based on the plan’s effective rate of interest for the year.
- Under 15-year amortization, plans could amortize the funding shortfall base in level installments over a 15-year period using the segment rates or full yield curve.

Sponsors could elect the alternative amortization schedule for two years of relief between 2008 and 2011 for plan years whose final contribution deadline occurs on or after March 10, 2010. The relief years need not be consecutive.

Participating plan sponsors would have to notify plan participants and beneficiaries, labor unions and the Pension Benefit Guaranty Corporation of their election and provide information about the plan’s funded status.

Relief would not be available to companies in bankruptcy, plans in distress terminations or plans with unpaid minimum required contributions (including those for which a lien has arisen in favor of the plan due to unpaid contributions valued at \$1 million or more).

### Sponsors that paid “excess” compensation would have to contribute more to their plans

Under the American Jobs and Closing Tax Loopholes Act, plan sponsors that opted for funding relief would have to make higher pension contributions (called “installment acceleration amounts”) if they paid “excess” employee compensation, declared extraordinary dividends or redeemed 10% or more of company stock.

- **Excess employee compensation.** In general, the legislation would increase required contributions by the amount of any excess employee compensation. The rule defines “excess” as aggregate includable annual compensation of more than \$1 million (indexed after 2010 in multiples of \$20,000). Compensation includes the amount attributable to services rendered in 2010 and later, plus any amounts set aside or reserved (directly or indirectly) in a trust under a nonqualified deferred compensation (NQDC) plan.

Excess compensation would not include:

- Commissions
- NQDC, restricted stock, stock options or stock appreciation rights payable or granted under a written binding contract that was in effect on March 1, 2010, and was not modified in any material way before the remuneration was paid

- **Extraordinary dividends and redemptions.**

In general, pension contributions would be increased by the amount by which the sum of dividends declared by the plan sponsor for the year, plus the fair market value of stock redeemed by the plan sponsor during the year, exceeds the greater of (1) the plan sponsor’s average adjusted net income for the preceding year (determined without regard to any reduction for the preceding five years); or (2) the amount paid to redeem plan sponsor stock for the plan year, plus the excess of the aggregate amount of dividends paid during the plan year on preferred stock issued before May 21, 2010.

Certain dividends and redemptions would be disregarded:

- Dividends paid by one controlled group member to another
- Stock dividends
- In the case of securities that are not readily tradable on an established securities market, redemptions made pursuant to a qualified retirement plan or a shareholder approved program and redemptions due to the death, disability or termination of an employee or shareholder

These higher pension contributions would be capped annually. While relief was in effect, cumulative required contributions generally could not exceed the amount the sponsor would have been required to contribute without funding relief. Plan sponsors could use carryover or prefunding balances to satisfy the additional contributions. The additional contributions would be applied to reduce amortization payments

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**Lifetime Income Options**, from page 5

years working with such plans. It is possible that lump-sum election rates in DB plans will come down somewhat as the statutory interest rate changes, owing to the Pension Protection Act of 2006 (PPA), make them less attractive relative to annuity options (with the full impact in 2012 and beyond), but we have not seen movement in that direction and suspect that any change would be modest.

These recent changes in the law with regard to the minimum DB plan lump-sum basis and recent volatile market conditions could also impact future retiree elections in retirement plans. It is clearly too early to know the full impact of these factors on future annuity election rates, but these factors could arguably lead to a higher future demand for annuity options. Whether this occurs and, if so, to what degree, remains to be seen. Our experience suggests that the impact will be modest as we have observed high lump-sum election rates even in situations where annuities were made more financially attractive.

We have limited current data on DC plan participant elections. We note, however, that in a tabulation we did of Health and Retirement Study data from 1992 through 2004 regarding retiring workers' disposition of their DC account balances, about 4% of participants reported that they converted their balances to annuities in the two-year periods of each survey wave.<sup>1</sup> As additional evidence, a 2007 Towers Watson preference survey of 5,000 employees and retirees found that about 10% of those covered only by a DC plan reported that they expected or actually received some portion of their benefit as an annuity. The same survey showed that most participants had a preference for a combination of a lump sum and an annuity rather than only an annuity, although there was some sensitivity expressed toward the financial terms of that decision. Shorter life expectancies and poorer health moved participants noticeably toward the lump-sum preference on the spectrum.<sup>2</sup>

Reasons for the relatively low level of election for annuities among DC plan participants, whether available from the plan or purchased from a commercial insurer, could include the lack of understanding /lack of effective communication to participants, general mistrust of annuity products, participant desire for flexibility, bequest motives, pricing of options (including a long period of low interest rates), availability of Social Security or other retirement

income, home equity, expectations for higher returns elsewhere, etc. In addition, there may be a behavioral bias against annuitization, even with better communications, because some plan participants will avoid the reduction in gratification implicit in giving up immediate use of the lump-sum plan distribution.

**IV. Are there legal or regulatory impediments to the offering and use of lifetime income options that we recommend be fixed or modified?**

[RFI questions 11, 14, 16, 18–20, 25–29, 31–32, 34, and 35]

Whether or not to offer a lifetime income option in a DC profit sharing or 401(k) plan should be a plan sponsor design decision. For plan sponsors who are interested in offering a lifetime income option in their DC plans, the biggest perceived legal and regulatory risk is the potential fiduciary liability given the cost, complexity, counterparty risk, regulatory considerations and other issues related to these products. The DOL safe harbor rule for DC plan selection of annuity providers does not go far enough to ease plan sponsors' concerns. The DOL should provide specific and definitive ways in which the sponsor can fulfill its fiduciary obligations.

We believe that education is essential in helping participants to make the choice that is right for them regarding distribution options. That choice will always be an individual one as many factors — such as family status, health status, other sources of income, insurance coverage, pricing, risk profile, ability to manage investments, inflation expectations and many others — will influence the decision. Annuities are complex financial instruments that have embedded investment, credit and other risks, and participants are often not well equipped to understand and evaluate them. As with other investment options, participants can easily be overwhelmed if too many annuity options are given to them.

We believe that both the government and plan sponsors can play a role in the education process. The role of the government could be to establish model notices or communications which explain the general trade-offs between annuities and lump sums. It could discuss the risk/reward trade-offs on issues such as longevity, disability, investment, and inflation in a balanced manner so that participants can make well-informed choices. The role of the employer would then be to describe the particular options that are available under their plans. It is appropriate for plan participants close to retirement or already retired to have a range of distribution options and strategies to protect them against longevity, morbidity and disability risks.

The DOL should provide specific and definitive ways in which the sponsor can fulfill its fiduciary obligations.

Both the government and plan sponsors can play a role in the education process.

<sup>1</sup> Towers Watson, "Cashing Out: A Threat to Retirement Security?" *Watson Wyatt Insider* (September 2007), 17(9), pp. 35–41.

<sup>2</sup> Towers Watson, "Who Prefers Annuities? Observations about Retirement Decisions," *Watson Wyatt Insider* (April 2008), 18(4), pp. 12–21.

Plan sponsors are eager to provide information that will help their participants make informed choices but will not do so without knowing how this can be done safely.

As mentioned in other sections of this response relative to offering annuity options, one barrier that currently stands in the way of providing education regarding annuities is the liability plan sponsors are potentially exposing themselves to when they attempt to communicate on these issues. This is virtually identical to the issues surrounding investment education and advice that the government has been attempting to address for several years. Plan sponsors are eager to provide information that will help their participants make informed choices but will not do so without knowing how this can be done safely. The structure set forth above, in which the government is responsible for general education and model notices, is one suggestion to address this. If that approach is not taken then a clear set of guidelines which distinguish between education and advice, with protection given for education, is needed before plan sponsors will move forward in this direction.

#### **V. What do we think about combined annuity products?** [RFI question 15]

Seminal research has been conducted examining the implications of the positive correlation of mortality and disability for the combination of an immediate life annuity with long-term care disability insurance at retirement ages.<sup>3</sup> That research finds that combining the two insurance products could reduce the combined cost of both types of coverage and make coverage available immediately to more persons, by reducing adverse selection in the life annuity and minimizing the need for medical underwriting for disability insurance. It is estimated there that minimal underwriting in a combined product, excluding only those who would be available for disability benefits at purchase, would increase the potential market to 98% of 65-year-olds, compared to only 77% who can pass under current long-term care insurance underwriting practice. For the larger pool of potential insureds, simulated premiums for the combined product are lower by 3% to 5% than total simulated premiums for stand-alone life annuities and underwritten long-term care insurance purchased separately. This reduction in cost mainly arises from the inclusion of persons with somewhat impaired health and higher mortality probabilities, lowering the cost of the life annuity segment, but desiring and needing long-term care insurance coverage. The research finds the results are broadly fair to various groups and are robust to various ages and gender situations as well as

possible errors in the reporting of disability status and moral hazard in making claims.

One impediment to actually offering a combined product, also known as the life care annuity, has been its tax treatment. Recent research illustrates, however, that because of provisions in PPA, the life care annuity now (beginning in 2010) has an after-tax advantage over separate life annuity and long-term care insurance products for many middle- and upper-income retirees.<sup>4</sup> That same research explains that offering a life care annuity in a qualified retirement plan would likely be difficult or impossible, owing to the operation of minimum distribution rules, possible incidental benefit restrictions, and other considerations. Providing an above-the-line deduction to long-term care insurance premiums, as essentially was done in PPA for distributions from qualified retirement plans of public safety officers, would result in an even larger tax advantage than given to the life care annuity as an after-tax product sold to individuals.

Today there are only 10 to 15 insurance companies that offer combination deferred annuity/long-term care insurance, and to date, sales have been relatively low. With new federal tax advantages beginning in 2010 for combined products, however, more insurers are considering entrance into the market. The primary product design available today allows the policyholder to withdraw between two and three times the current annuity account value to pay for long-term care expenses. As with a typical deferred annuity, the premium deposited into the annuity is credited with interest and then charges are deducted for the long-term care insurance component. There is often a waiting period to make withdrawals for long-term care (typically two or three years) and an elimination period of 90–180 days once a claim is filed.

The most significant advantage of these annuity/long-term care products is that because they are offered in combination with an annuity plan and owing to the long waiting period for benefits, the long-term care insurance underwriting is limited in comparison with a stand-alone long-term care insurance policy. Therefore, an individual who does not qualify for coverage under a stand-alone policy may be able to obtain at least some coverage through the combination policy. Also the less intrusive underwriting could make the product more popular.

Another advantage to consumers is that they can maintain liquidity of their savings dollars. Unlike a

<sup>3</sup> Christopher M. Murtaugh, Brenda C. Spillman and Mark J. Warshawsky, "In Sickness and In Health: An Annuity Approach to Financing Long-Term Care and Retirement Income," 2001, *Journal of Risk and Insurance*, 68(2), pp. 225 – 254.

<sup>4</sup> David Brazell, Jason Brown and Mark Warshawsky, "Tax Issues and Life Care Annuities," Chapter 13 in John Ameriks and Olivia Mitchell, editors, *Recalibrating Retirement Spending and Saving*, 2008, Oxford University Press, pp. 295 – 317.



stand-alone long-term care insurance policy, if the policyholder should require additional financial resources in retirement, he/she still has access to the underlying deferred annuity funds. If the annuity funds are withdrawn to cover expenses other than for long-term care, however, the long-term care insurance component of the policy is forfeited.

Stand-alone long-term care insurers generally believe that a disadvantage of these marketed combination plans is that the consumer does not get the same level or immediacy of coverage available through a long-term care only policy. Combination plan sellers argue, however, that the consumer has at least obtained some level of protection.

**VI. Should some form of lifetime income option be required for DC plans; should it be the default distribution?** [RFI questions 13 and 38]

As stated above, whether or not to offer a lifetime income option in a DC profit sharing or 401(k) plan should be a plan sponsor design decision as it historically has been, especially given the cost, complexity of products, counterparty risk and other issues related to these products. If a plan sponsor decides to offer a lifetime income option, there should be no requirement that such option be the default distribution. The plan sponsor, however, should be free to make such an option the default distribution. We do believe that plan sponsors would be more likely to offer lifetime income options (as suitable) if fiduciary concerns were addressed. It is unclear to us what the impact on employee contribution rates or other plan dynamics would be if this was the default form of payment.

**VII. Should disclosing the income stream that can be provided from an account balance be mandated, and if so, how?** [RFI questions 21–24]

We do not believe that disclosing the income stream that can be provided from an account balance should be mandated. We support renewing efforts to enhance retirees' and pre-retirees' understanding of the annuity option, but do not believe an employer mandate is appropriate, unless it can be shown that such disclosures are helpful to employees in making retirement decisions.

One reason why employees do not utilize annuities is that they do not fully understand the various products available. Most employees do not understand the connection between the amount offered as a lump sum and the amount of monthly income offered as an annuity and do not have the ready ability to assess the adequacy of the total account balance or whether any monthly annuity

guarantee represents a fair deal. Regularly disclosing the lifetime income stream that might be expected from an account balance in the form of an annuity based on various market conditions might help with education. Plan participants would be able to evaluate the level of income their accounts may be able to provide, then plan and monitor that income level as appropriate in the years leading to retirement. This has the potential to serve as a tangible measuring stick for participants to evaluate their retirement preparedness and a meaningful incentive for participants who are not as prepared to redouble their efforts. In addition, this approach may ultimately increase participant demand for and utilization of the annuitization option.

There are risks, however, in the details of the calculations and the assumptions, as well as the form in which the information would best be presented. Plan sponsors will be reluctant to assume fiduciary risk by projecting income streams based on certain assumptions that are then not achieved. Government mandated annuity assumptions may seem desirable at first, but there are many details<sup>5</sup> of the calculations that would need to be specified in order to ensure uniformity among plan sponsors. And if the benefits statement becomes overly cumbersome or confusing, the goal of increasing participants' understanding of the annuity may not be achieved anyway. (One recent example of this is the new Annual Funding Notice for Defined Benefit Pension Plans, which provides an overwhelming amount of information to plan participants. While the goal is to better educate participants on the current funded status of the plans in which they participate, the resulting notice is so complex and confusing that we question whether it actually ends up achieving its intended goal.)

Rather than mandating that plan sponsors disclose the income stream that can be provided from an account balance, Towers Watson supports testing these disclosures in a proof-of-concept experiment. The DOL and Treasury could seek a number of plan sponsors to serve as volunteers. Volunteers would test different assumption sets and methods, as well as different forms of presenting the information (possibly including replacement ratios and various draw-down solutions in addition to life annuities), and would receive protection from liability for their participation.

<sup>5</sup> Should the illustration be based on accrued or projected benefits? How should future contribution rates be determined? How should future account growth be determined? What form of annuity should be illustrated? What mortality, mortality improvement and interest assumptions should be used? Should the income amounts be adjusted for inflation? Should a single or multiple scenarios be provided?

Towers Watson supports testing these disclosures in a proof-of-concept experiment.

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**Lifetime Income Options, from page 9**

The experiment would track participants' attitudes toward the annuity option before, during and after the study period, and would specifically monitor whether the enhanced disclosure caused more participants to consider an annuity option. By testing a variety of methods and assumption sets, this experiment would illustrate which are the most effective in improving plan participants' understanding of the annuity option.

At the conclusion of the experiment, the question of whether or not to recommend this type of disclosure and what form it should take should be reevaluated.

Thank you for the opportunity to share our views and information with you on this important matter. If you have any questions about our response, please contact Mark Warshawsky, Director of Retirement Research, at 703-258-7636 or Mark.Warshawsky@towerswatson.com.

Sincerely,  
William Gulliver  
North America Practice Leader, Retirement

**Pension Funding Relief, from page 6**

at the back end of the shortfall amortization base schedule.

Beginning with the year of the sponsor's election, these restrictions would apply for three years to sponsors that elected 2+7 amortization and for five years to those that elected 15-year amortization.

Having to make higher pension contributions could partially or fully nullify any relief. Plan sponsors will need to weigh the cost of determining these installment acceleration amounts against the likely net reductions in required contributions. In addition to higher costs, the requirements would have administrative and practical implications. For example, the actuary might need a considerable amount of information from the plan sponsor (and members of its controlled group) to determine the minimum required contribution, which could mean waiting until the end of the year or later.

**Look-back provisions**

The legislation would provide a lookback to help plan sponsors avoid restrictions on benefit accruals (imposed on plans that are less than 60% funded). For plan years beginning on or after Oct. 1, 2008, and before Dec. 31, 2011, most plan sponsors could use the adjusted funding target attainment percentage (AFTAP) for the last plan year ending before Sept. 30, 2009, as long as it exceeds the plan's current AFTAP. The bill also includes provisions addressing restrictions on Social Security leveling options (imposed on plans that are less than 80% funded).

Other than these provisions, the funding relief would have no effect on AFTAPs and benefit restrictions under Internal Revenue Code section 436, because the relief would not affect the calculation of assets and funding targets.

The bill would provide a lookback for determining whether plans could use carryover or prefunding balances.

**ERISA 4010 reporting**

The bill would establish a new trigger for 4010 reporting. Plans would be subject to 4010 reporting if the aggregate unfunded vested benefits for all plans within the controlled group (disregarding plans that are fully funded when taking into account only vested benefits) are valued at \$75 million or more.

**Other provisions and outlook**

The legislation also addresses defined contribution plan fee disclosure, funding relief for multiemployer plans and rollovers of amounts received in connection with an airline bankruptcy.

In the days leading up to the Memorial Day recess, House and Senate leaders were working to move the bill through both chambers before the recess. The House approved the legislation just before the Memorial Day recess, and the Senate is expected to debate the bill in June. The funding relief provisions seem to have been settled, but disagreement on other provisions could delay final passage.

Having to make higher pension contributions could partially or fully nullify any relief.

# COBRA Subsidy Slated to End May 31

Two recent laws make important changes to the COBRA<sup>1</sup> premium subsidy. The Temporary Extension Act of 2010 extended the premium subsidy from Feb. 28 to March 31, 2010. It also made the subsidy available to individuals who experienced a qualifying reduction in hours after Sept. 1, 2008, and were involuntarily terminated on or after March 2, 2010. The Continuing Extension Act extends the subsidy until May 31, 2010 (and retroactively covers the lapse from April 1 through April 15). Plan sponsors need to update their COBRA communications and reach out to COBRA vendors to ensure compliance.

## ARRA and 2009 amendment

The American Recovery and Reinvestment Act of 2009 (ARRA) established a 65% COBRA premium subsidy for up to nine months for people who lost their jobs and became eligible for COBRA continuation coverage between Sept. 1, 2008, and Dec. 31, 2009. The federal government provides the subsidy to employers in the form of a tax credit.

On Dec. 19, 2009, the Department of Defense Appropriations Act amended ARRA, extending the subsidy eligibility period to Feb. 28, 2010, and adding six months to the maximum subsidy period, which is now 15 months. Individuals whose subsidy period had ended before the extension took effect were given extra time to pay the reduced premiums afforded by the extension. To reinstate their coverage, they must pay 35% of premium costs within 60 days of the effective date or, if later, 30 days after receiving notice of the extension from their plan administrator.

## Temporary Extension Act of 2010

The second extension of the COBRA subsidy extended the premium subsidy to workers who were involuntarily terminated by March 31, 2010, and to those subjected to a qualifying reduction in hours

between Sept. 1, 2008, and March 31, 2010, followed by a termination on or after March 2, 2010. (The Continuing Extension Act, signed April 15 and discussed below, extends this provision until May 31, 2010.)

Where termination follows a reduction of hours, the continuation coverage period is calculated from the date of the reduction in hours — not the date employment was terminated. Employees who did not elect COBRA when their hours were reduced can elect COBRA following their termination. Under the Temporary Extension Act:

- If hours were reduced between Sept. 1, 2008, and March 31, 2010, and the termination was on or after March 2, 2010, the reduction of hours is the qualifying event.
- If an individual lost coverage due to a reduction in hours on or after Sept. 1, 2008, but did not elect (or elected and then discontinued) COBRA coverage, and he or she was involuntarily terminated on or after March 2, 2010, then the termination is the qualifying event. These individuals must be offered a new election period.
- While the individual's 18-month maximum COBRA coverage period is measured from the date of the reduction of hours, the 15-month subsidy period is measured from the termination of employment. If fewer than 15 months of COBRA coverage are available after employment termination, the subsidy period will be shorter than 15 months.

Under the Temporary Extension Act, the plan administrator must provide the ARRA general notice, including information about the new election period, to affected individuals within 60 days of the individual's involuntary termination. The U.S. Department of Labor (DOL) has updated its model COBRA subsidy notices to reflect the requirements of the Extension Act.

There are new penalties for plan sponsors and insurers for unwarranted COBRA denials. An individual, the DOL or, for non-ERISA plans, the Department of Health and Human Services (HHS) can sue to enforce the government's determination of entitlement to premium assistance. Moreover, the DOL and HHS can assess penalties against plan sponsors and health insurers that fail to comply with such a determination within 10 days of receipt.

The Temporary Extension Act protects employers from IRS challenges to subsidy entitlement determinations. An employer that reasonably assumes an employee has been involuntarily terminated, grants the subsidy and offsets its payroll

There are new penalties for plan sponsors and insurers for unwarranted COBRA denials.

<sup>1</sup> The Consolidated Omnibus Budget Reconciliation Act provides certain former employees, retirees, spouses, former spouses and dependent children the right to temporary continuation of health coverage at group rates when coverage is lost due to certain specific events.

tax liability need not worry about potential IRS challenges, as long as supporting documentation is maintained. This should minimize the employer's risk of liability for failing to pay required payroll taxes.

Employers might see another retroactive extension in June.

### Continuing Extension Act

In late March, Congress began a two-week recess without having extended eligibility for the COBRA premium subsidy, so availability lapsed. On April 15, Congress approved and President Obama signed the Continuing Extension Act. The act reinstates subsidy eligibility for employees involuntarily terminated between April 1 and April 15 and extends eligibility through May 31. In general, eligibility will be available to those involuntarily terminated between April 1 and April 15 who elect COBRA within 60 days after receiving their eligibility notice. The DOL is expected to update its model notices soon.

### Subsidy expires again

Congress failed to extend the subsidy before its Memorial Day recess, so eligibility expires for individuals who experience an involuntary termination of employment after May 31. Key lawmakers support extending the subsidy. On March 11, the Senate approved the American Workers, State and Business Relief Act, which would extend eligibility to Dec. 31, 2010. However, just before the Memorial Day recess, the House dropped a provision to extend the subsidy until Nov. 30 in an effort to trim revenue and attract votes to a tax extenders package. The Senate will consider the tax extenders package after the recess. The Senate could reinstate the COBRA subsidy extension or lawmakers could consider another short-term extension, so employers might see another retroactive extension in June.

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