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Pension Freezes Continue Among Fortune 1000 Companies in 2010

By Brendan McFarland and Erika Kummernuss

From 2009 to 2010, the number of *Fortune* 1000 companies sponsoring a frozen pension plan increased by 4%. After peaking in 2006, the overall freeze rate has remained relatively constant over the last three years, as the economic climate has remained uncertain. Meanwhile, the number of sponsors of defined benefit (DB) plans (both active and frozen) in the *Fortune* 1000 has continued to decline modestly, as new entrants to the list are more likely to sponsor only defined contribution (DC) plans.

This shift from DB to DC plans has been ongoing for more than 10 years now, driven by a variety of plan sponsor motives, including addressing financial difficulties, aligning retirement packages to better compete in a global market and reducing risk. Notably, regulatory uncertainty around hybrid DB plans, such as cash balance designs, has significantly contributed to the trend. The shift to DC plans typically transfers retirement responsibility from employers to employees, most of whom will manage their own contributions, accumulations and eventual withdrawals under those DC arrangements.

Towers Watson has been collecting data on DB sponsors in the *Fortune* 1000 for many years, with a particular focus on firms that have frozen their plans. In a DB plan freeze, the company typically retains the plan but stops future accruals for all or some workers. Freezes can take various forms. Traditional pensions, which use a pay-and-service-related formula, can halt the years-of-service component of the formula, freeze the pay portion to disregard future salary increases or both. In a hybrid

or other account-based pension plan, companies typically stop making pay credits to the accounts, but balances continue to accrue interest.

Many large companies sponsor more than one pension plan. Some maintain different plans for unionized and salaried workforces, and others have multiple plans due to mergers and acquisitions. So a sponsor of a frozen plan might also maintain an active DB plan, which is indeed the case for some firms in this analysis. We identify the total number of DB plan sponsors, the number that have frozen at least one pension plan and the number that have never frozen a DB plan.

DB sponsorship and freezes among the Fortune 1000

In this analysis, firms are classified as DB sponsors if they maintain DB plans, even if the plans are frozen. Between 2004 and 2010, DB sponsorship among the *Fortune* 1000 declined from 63% to 59%. Turnover in the *Fortune* 1000 list plays a large role in the decline. Historically, companies edged off the list have tended to sponsor DB plans, while their replacements have not. Of the 74 companies new to the *Fortune* 1000 in 2010, 51 sponsor only a DC plan and 23 maintain a DB plan (11 of which are frozen). Of the 74 companies that dropped off the 2009 list, 38 sponsor only a DC plan, while 36 maintain a DB plan (14 of which are frozen).

Plan terminations also contribute to the decline in DB sponsorship, as some companies have offloaded plan assets and liabilities to third parties over the last several years (see “Terminated plans” below).

The percentage of *Fortune* 1000 companies that sponsor DB plans and have not frozen any of them has fallen significantly over the last seven years. In 2004, 59% of *Fortune* 1000 companies maintained DB plans and had no frozen plans, compared with

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only 38% in 2010. Over the seven-year period, the number of *Fortune* 1000 sponsors of at least one frozen plan has more than quadrupled — from 45 in 2004 to 208 in 2010 (as shown in *Figure 1*). Between 2004 and 2010, the percentage of DB plan sponsors with one or more frozen pension plans rose from 7% to roughly 36%.

Timing of freezes and composition effect of 2010 *Fortune* 1000

Pension freezes among *Fortune* 1000 companies began accelerating in 2003. *Figure 2* shows the incidence of pension freezes from 1989 to 2019 (including planned freezes) for the 2010 *Fortune* 1000. Thirty-one companies froze a pension plan in 2007, 23 in 2008 and 28 in 2009. There have been 18 freezes so far in 2010.¹

We next examine companies that have remained on the *Fortune* 1000 list since we began our study seven years ago (see *Figure 3*). This analysis is one way to highlight the effects of turnover in the *Fortune* 1000 on our results.

Plan sponsorship for the seven-year *Fortune* 1000 group looks slightly different from sponsorship for the 2010 group (see *Figures 1* and *3*). The percentage of companies sponsoring DB plans is higher among the seven-year group than among today's *Fortune* 1000 (65% versus 59%), and the percentage of DB sponsors that maintain one or more frozen plans is somewhat lower (34% for our seven-year group compared with 36% for the 2010 *Fortune* 1000 DB sponsors).

We next look at three retirement-expense accounting measures (where full financial data were available for comparison) for the seven-year *Fortune* 1000 group.

Figure 4 shows service cost, which is the actuarial present value of pension benefits accrued during the year, net pension expense and DC expense for fiscal years 2003 and 2009.² These values are calculated on an average basis for three categories of DB plan sponsors: those with no frozen plans, those that first froze one or more of their plans between 2004 and 2010, and those that froze at least one plan before 2004.

From fiscal year 2003 to 2009, service cost for pensions increased by roughly 5% for all companies in this analysis, while DC expense shot up 59%. The growth in service cost overall is primarily attributable to companies that have not frozen DB plans. Service costs rise due to salary increases, declines in the interest rates used to calculate the service cost component and other factors.³ Over this period, service cost increased by roughly 28% for sponsors of actively accruing pensions, but decreased by 53% for sponsors that froze at least one plan.⁴

While DC plan expense rose for all companies, the increase was 102% for DB plan sponsors that first froze a pension plan in the last seven years, compared with 42% for DB plan sponsors that have not frozen a DB plan. This is not surprising. After freezing a DB plan, most companies enhance their matching or nonmatching DC contribution and/or adopt plan features to boost participation in their DC plan.

Pension expense is the total measure of expense for a DB plan. In addition to being influenced by the same factors as service cost, pension expense is greatly affected by the plan's funded status. At year-end 2009, average pension expense had declined by 10% in companies that had first frozen a pension in the last seven

¹ If a plan is frozen as of December 31, we consider the freeze to occur the following year (e.g., if a sponsor freezes a plan on December 31, 2009, participants have already accrued their 2009 benefits, so we consider 2010 the year of the freeze).

² Net pension expense consists of service cost and all other components, including net interest on unfunded liability and amortization of past gains/losses and plan amendments. DC expense includes matching and nonmatching employer contributions for the year, which in some cases are offset by forfeitures for terminating participants who are not fully vested.

³ Decreases in discount rates increase service cost. Discount rates at year-end 2002 averaged 6.7% compared with 6.3% at year-end 2008.

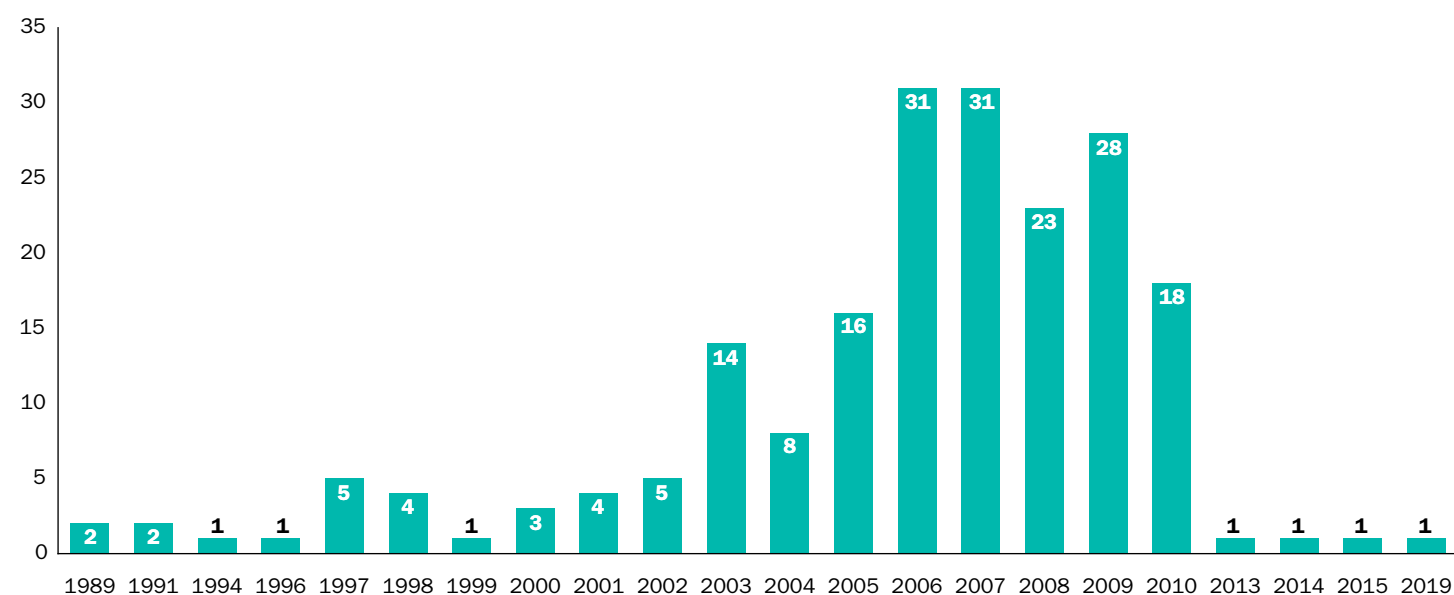
⁴ The service cost is non-zero for these companies as well as the group that froze a plan before 2004 because some companies freeze a DB plan for one group of workers (typically salaried) but keep the plan actively accruing benefits for other workers (typically union or hourly employees) or subsidiaries.

Figure 1. DB sponsorship among Fortune 1000, 2004-2010

Fortune 1000 list year	Number of DB plan sponsors	Sponsors of actively accruing DB plans with no frozen plans	Sponsors of one or more frozen DB plans
2010	586	378	208
2009	607	417	190
2008	624	455	169
2007	638	500	138
2006	627	514	113
2005	627	556	71
2004	633	588	45

Source: Towers Watson.

“The number of *Fortune* 1000 sponsors of at least one frozen plan has more than quadrupled — from 45 in 2004 to 208 in 2010.”

Figure 2. Incidence of pension freezes in Fortune 1000, 1989–2019*


*Announced and planned after 2010.

Source: Towers Watson.

Figure 3. Current DB sponsorship for Fortune 1000 companies since 2004

Companies in Fortune 1000 since 2004	Number of DB plan sponsors	Sponsors of actively accruing DB plans with no frozen plans	Sponsors with one or more frozen DB plans
723	472	311	161

Source: Towers Watson.

Figure 4. Service cost, net pension expense and DC expense for seven-year Fortune 1000 group (\$ thousands)

	Count	2003			2009		
		Average service cost	Average net pension expense	Average DC plan expense	Average service cost	Average net pension expense	Average DC plan expense
All companies	335	\$54,414	\$56,888	\$35,723	\$57,395	\$86,070	\$56,888
No frozen DB plans	227	\$57,948	\$56,078	\$34,799	\$74,171	\$101,633	\$49,337
First froze DB plan in 2004–2010	82	\$60,763	\$75,012	\$41,856	\$28,704	\$67,772	\$84,356
First froze DB plan before 2004	26	\$ 3,532	\$ 6,801	\$24,441	\$ 1,412	\$ 7,902	\$27,947

Source: Towers Watson.

years, likely due to the reduction of service cost offset by increased expense due to declines in funded status. At the other end of the spectrum, DB plan sponsors that had not frozen a DB plan reported an 81% increase in pension expense by the end of fiscal 2009, with much of this increase likely attributable to declines in funded status.

From 2003 to 2009, average retirement expense (net pension expense plus average DC plan expense) increased by 54% for all companies, 30% for companies that froze a DB plan and 66% for DB plan sponsors with no frozen plans. Note that although the changes over the period are very different, average costs in 2009 are virtually the same for those that have never frozen a DB plan and those that froze a plan after 2003.

Industry analysis

In the past, most companies that froze their DB plans were in financial distress. More recently, pension freezes have spread across all sectors, although some industries experience higher freeze rates than others (see *Figure 5*).

Industries with higher DB sponsorship rates are less likely to freeze a plan than those with lower sponsorship rates. The utilities industry is a good example. It has high rates of DB sponsorship and very few plan freezes. Plan sponsorship rates are generally linked to companies' financial success and stability, as well as to the rewards strategy commonly employed within the industry.

Over the last year, the percentage of companies with one or more frozen plans has increased in most sectors, with the communications and retail sectors having realized the largest changes.

In 2010, 55% of DB sponsors in the communications sector maintain at least one frozen DB plan, compared with 43% last year and 30% in 2008. Between the 2008 and 2010 analyses, the percentage of sponsors in the retail sector with one or more frozen DB plans jumped from 36% to 54% — an 18-percentage-point increase. The retail sector has one of the lowest DB sponsorship rates of any sector.

Closing plans to new hires

Over the last several years, Towers Watson has also tracked *Fortune* 1000 firms that close a DB plan to new

“From 2003 to 2009, average retirement expense increased by 30% for companies that froze a DB plan and 66% for DB plan sponsors with no frozen plans.”

Figure 5. DB sponsorship in the 2010 *Fortune* 1000 by industry

Industry (sorted by % of DB sponsors)	Firms in <i>Fortune</i> 1000	Number of DB plan sponsors	Firms with no pension freezes	Firms that have frozen one or more DB plans	% of firms that are DB plan sponsors	% of firms with no pension freezes	% of firms with one or more frozen DB plans
Aerospace and defense	7	7	6	1	100.0%	85.7%	14.3%
Utilities	63	59	53	6	93.7%	89.8%	10.2%
Food and beverage	32	29	23	6	90.6%	79.3%	18.8%
Manufacturing	155	128	88	40	82.6%	68.8%	31.3%
Automobiles and transportation equipment	21	17	10	7	81.0%	58.8%	41.2%
Natural resources	64	48	35	13	75.0%	72.9%	27.1%
Energy	34	22	16	6	64.7%	72.7%	27.3%
Wholesale	39	25	12	13	64.1%	48.0%	52.0%
Insurance	64	40	32	8	62.5%	80.0%	20.0%
Financial services	66	40	19	21	60.6%	47.5%	52.5%
Transportation	32	19	11	8	59.4%	57.9%	42.1%
Communications	53	29	13	16	54.7%	44.8%	55.2%
Pharmaceuticals	22	9	6	3	40.9%	66.7%	33.3%
Professional and business services	65	26	13	13	40.0%	50.0%	50.0%
High technology	78	29	12	17	37.2%	41.4%	58.6%
Retail	113	37	17	20	32.7%	45.9%	54.1%
Health care	50	14	10	4	28.0%	71.4%	28.6%
Property and construction	22	5	2	3	22.7%	40.0%	60.0%
Tourism and leisure	17	3	0	3	11.8%	n/a	100.0%
Education	3	0	0	0	0.0%	n/a	n/a

Source: Towers Watson.

hires. When a DB plan is closed, current employees continue to earn pension benefits, but employees hired after the close date cannot participate in the plan. If a company closed a DB plan but also froze another plan or closed the plan before freezing it, it is considered to have frozen a pension plan for this analysis. Between 2005 and 2010, the number of companies that closed at least one DB plan to new hires rose from 25 to 85. Only 29% of *Fortune* 1000 companies maintain a DB plan and have neither frozen nor closed one of the plans to new hires. Of DB plan sponsors, 50% now have at least one plan that is either frozen or closed to new hires — up from 44% last year.

Terminated plans

In addition to freezing and closing DB plans, some firms in the *Fortune* 1000 have chosen to terminate their DB plans, which also contributed to the decrease in companies that maintained a DB plan over the past year. In a terminated pension plan, all benefits are settled by transferring assets and liabilities to a third party (typically an insurance company), paying all benefit obligations directly to participants or some combination of the two approaches.

Therefore, a termination implies a plan freeze has already occurred. Eleven *Fortune* 1000 companies have terminated one or more pension plans or are in the process of doing so. Eight of the 11 companies either started or completed this process within the last two years. In one termination, the company had to unload its pension liabilities to the Pension Benefit Guaranty Corporation⁵ due to financial distress. The other companies voluntarily terminated their plans.

⁵ The Pension Benefit Guaranty Corporation is a federal insurance program funded by DB plan sponsors that protects the benefits of participants in private DB plans if a company's pension plan defaults.

Conclusion

The march of pension freezes continues at a steady pace. Only 38% of *Fortune* 1000 companies currently maintain a DB plan and have no frozen plans — a stark decline from 2004, when 59% of *Fortune* 1000 companies had not frozen a DB plan. Many companies today are opting to provide DC plans as the sole vehicle for accumulating retirement income.

The shift from traditional DB plans to DC plans has redirected a share of employer funding away from older workers, thereby enabling younger workers to make more significant contributions toward a financially secure retirement. Nonetheless, events such as the 2008 stock market crash highlight some potentially problematic effects on workforce patterns created by DC-only platforms. Many DC plan accounts suffered major losses during the recent financial crisis, forcing some older workers to postpone retirement to recover from market losses and rebuild their retirement nest eggs.

Despite ongoing pension freezes, companies in industries with high DB plan sponsorship rates have been more likely to keep their plans alive than other companies (except for the troubled auto and finance industries), and this pattern could continue into the future. Some of these plan sponsors may have taken steps to minimize the risks associated with DB plan sponsorship so they can continue enjoying the advantages of DB plans over DC plans. DB plans provide greater reliability and security for workers, and offer sponsors unique opportunities for long-term financial efficiency and workforce management.

“Of DB plan sponsors, 50% now have at least one plan that is either frozen or closed to new hires — up from 44% last year.”

Recession Continues to Undercut Social Security and Medicare in the Short Run

Long-Term Impact of Health Care Reform on Programs Is Uncertain and Controversial

By Mark J. Warshawsky

The recently released and long-delayed annual reports from the trustees¹ on the financial state of Social Security and Medicare show the recession continues to take a toll on both programs. The toll is particularly costly in the short run — as outlays rise and, especially, revenues from payroll taxes fall even more steeply than under prior projections.

Social Security is running large cash flow shortfalls in 2010 and 2011 — years sooner than expected. For the second year in a row, neither a cost-of-living adjustment (COLA) to Social Security benefits nor an increase in the payroll tax base is likely, owing to tame inflation. The gap between Medicare's expenditures and income grew in 2009 and 2010, resulting in the program's largest-ever deficit as a percentage of taxable payroll. Also for the second year in a row, Part B premiums will be held constant for most beneficiaries, but new and high-income

¹ The government trustees are the secretaries of the Treasury, Labor, and Health and Human Services, and the Social Security commissioner; the two public trustees' positions are vacant again this year.

enrollees will pay particularly large increases. Part D premiums, however, are not expected to increase much.

To reflect the impact of the health care reform legislation passed in March on both programs, the trustees delayed issuing the 2010 reports. The estimated long-term Social Security shortfall is slightly lower than last year's because a small portion of compensation is expected to be shifted from tax-exempt employer-sponsored health benefits to taxable wages. Health care reform is scored as delivering a large boost to Medicare's overall finances.

These long-run projections are unusually tentative, because there is little precedent for — and thus knowledge about the impact of — many of the health care reform provisions. Even more significantly, the political will required to implement some key provisions might not exist — past outcomes of delayed cost-reducing provisions have been disappointing for fiscal discipline. In fact, the Medicare actuary submitted a separate report featuring an alternative, more pessimistic — and in his view more realistic — outlook.

The very concept of government trust funds has become more controversial and nebulous at the same time. The provisions counted as improving Medicare's finances were also used to fund health insurance entitlement programs for the low- and moderate-income non-elderly populations. Given this “breaching of the walls,” it is doubtful whether a projected boost to the Medicare trust fund is economically or even politically significant for the program.

It is also increasingly acknowledged that, despite its massive size, the Social Security trust fund is not an independent source of support, like a pension fund holding stocks and bonds. Rather, it is simply a call for higher taxes, less spending or more deficits elsewhere in the federal budget — an increasingly doubtful proposition when the government's annual deficit is nearly \$1.5 trillion and future fiscal prospects are discouraging.

Social Security

The economic recession was deeper than projected by the trustees last year. The large surpluses of tax income over expenditures of the past have turned into large deficits this year and next, according to the trustees' intermediate projections. Higher unemployment and stagnant wages have cut deeply into payroll tax collections, while disability and early retirement program claims (and expected future payouts) are rising or occurring earlier than expected. The trustees expect to see weak and brief cash flow surpluses in 2012, 2013 and 2014, with deficits

re-emerging in 2015 (one year earlier than in last year's trustees' report). The deficits will then balloon as the remainder of the baby boom generation retires.

The reason for the improvement projected for Social Security's long-run finances is health care reform. In particular, a combination of federal subsidies for individual insurance through the health benefit exchanges, penalties for being uninsured or not offering coverage, an excise tax on so-called Cadillac plans and anticipated competitive premiums from health benefit exchanges are expected, on net, to increase the share of employee compensation provided in taxable wages versus exempt health benefits.

The higher share of taxable compensation boosts the program's projected finances moderately overall, but more appreciably over the long run. The projected gains are highly speculative, however, because the health benefit exchanges are not yet operational. While the crowd-out of employer-sponsored health plans by the health benefit exchanges is likely, the timing and extent are unknown. And the excise tax was so controversial that the final legislation delayed it for several years, calling into doubt whether it will ever be implemented.

Figure 1 shows this year's cash flow projections for Social Security over the 75-year horizon, compared with last year's projections.

In the longer run, as trust fund bonds are redeemed to make up program deficits, the fund is expected to be exhausted in 2037 (the same as last year's projection). At that point, tax revenue could fund slightly more than three-fourths of scheduled benefits. Immediately increasing the payroll tax rate by 1.98 percentage points or cutting benefits by 12.8% would balance the system for the next 75 years. But, because the annual balance is projected to be -4.12% of payroll in 2084, these changes would only lend a temporary veneer of well-being and generational equity to the program.² Every year that passes adds to the deficit, demonstrating the need for an even longer projection horizon.

Under a more comprehensive “infinite horizon” measure, the payroll tax rate would have to be increased by 3.5 percentage points, benefits cut by 20.7% or some (presumably gradual) combination of the two to achieve sustainable solvency and share the burden of reform between current and future generations.

Medicare

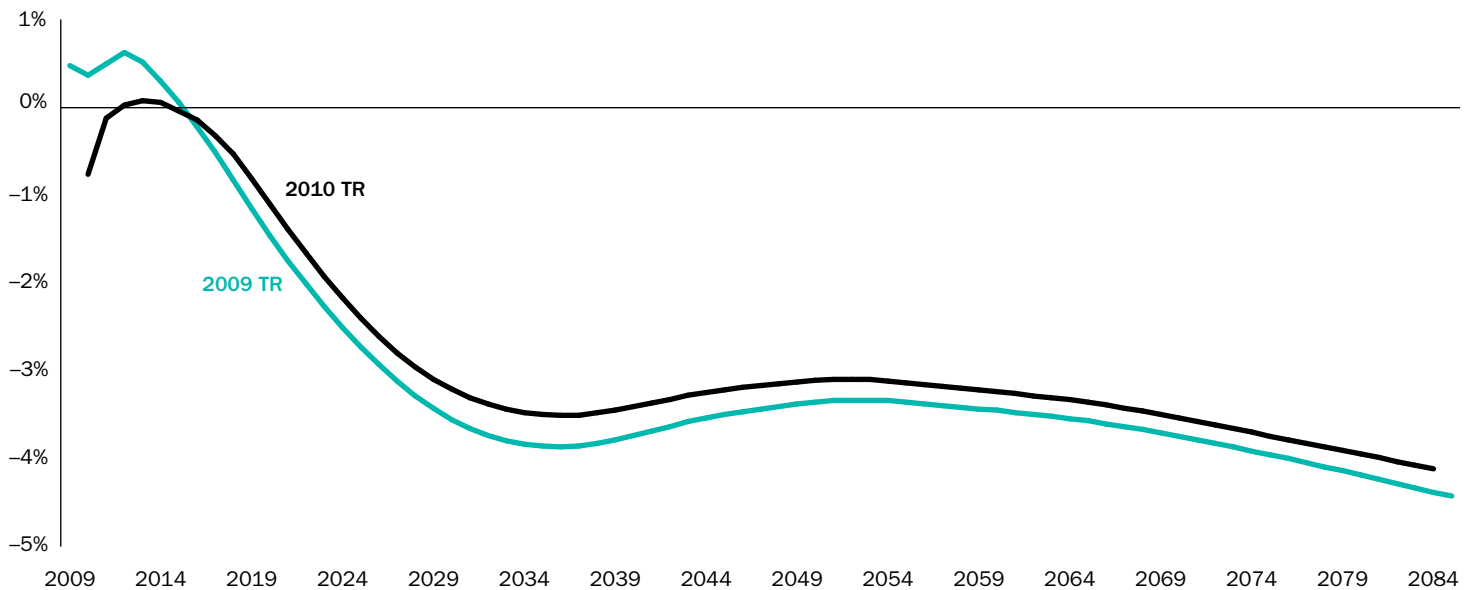
As mentioned above, health care reform legislation is projected to have a major positive impact on

“The provisions counted as improving Medicare's finances were also used to fund health insurance entitlement programs for the low- and moderate-income non-elderly populations.”

² Even if in one year the problem were solved out for a 75-year horizon, the following year's trustees report would show a negative actuarial balance.

Figure 1. Social Security annual balances: 2009 and 2010 Trustees Reports

As a percentage of taxable payroll, based on intermediate assumptions



Source: OASDI Trustees Report, Social Security Administration.

Medicare's financial picture, with three changes being particularly important:

1. Slower growth in provider payments due to productivity adjustments — which affect all Hospital Insurance (HI) (Part A) and about half of Supplementary Medical Insurance (SMI) (Part B) providers. Health care reform links payment rates for certain Medicare services to overall economic productivity, so the annual price updates for these providers will be adjusted downward by growth in economy-wide productivity improvements. The trustees assume the prices Medicare pays for these health services will rise about 1.1% per year more slowly than assumed in the past, owing to this new provision of law.
2. Reduced payments to Medicare Advantage plans
3. Increased HI payroll taxes on high-income workers (because the income thresholds are not indexed, over time an increasing proportion of workers will become subject to the additional HI tax rate)

In addition, current law reduces the Medicare payment rates for physician services by 30% over the next three years. The trustees assume these cuts will be made despite the virtual certainty that Congress will continue to override them as it has in previous years.

In both 2008 and 2009, the HI trust fund paid out more in hospital benefits and other expenditures than it received in taxes, and the imbalance is projected to continue through 2013. To make up the difference, the federal government will redeem trust

fund bonds. Thereafter, provisions under health care reform are projected to turn the deficits into surpluses, until the HI trust fund runs dry in 2029 (12 years later than projected in last year's report).

The projected 75-year actuarial deficit for Part A is 0.66% of taxable payroll under current law, down from 3.88% in last year's report. However, the Medicare actuary believes that Congress is unlikely to allow the productivity adjustments to be made fully beyond 2020 or at all beyond 2036 because the labor-intensive health care sector cannot reduce its costs to the same extent as the overall business sector. Under this alternative scenario, the HI actuarial deficit is 1.91% of taxable payroll.

The SMI part of Medicare includes physician and other services (Part B) and prescription drugs (Part D). Both parts are financed by enrollee premiums and, primarily, general revenue transfers from the federal budget. Part B benefit costs increased by 7.3% in 2009, but Part D benefit costs were lower than expected because of a higher penetration of lower-cost generic drugs and fewer new drugs reaching the market.

Part B outlays were 1.5% of gross domestic product (GDP) in 2009 and are projected to grow to about 2.5% of GDP by 2084. According to the actuary, these projections are seriously understated because of the substantial reductions in physician payments required under current law (which have always been overridden by Congress), and are further understated if the slated reductions in future price updates for most other Part B providers are not feasible. Under

“The excise tax was so controversial that the final legislation delayed it for several years, calling into doubt whether it will ever be implemented.”

the actuary's alternative projection, Part B costs would be 5.2% of GDP by 2084 and would exceed current-law projections by 22% in 2019, by 40% for 2030 and by 112% in 2084.

Part D outlays are estimated to increase from 0.4% of GDP in 2009 to about 1.8% by 2084. These outlay projections are slightly lower than those in last year's report, principally because of lower-than-expected spending in 2008 and 2009, as well as lower growth in prescription drug spending projected for the next 10 years. These lower Part D expenditures, however, are mostly offset by the cost of closing the coverage gap (or "donut hole"), as called for under health care reform.

Near-Term issues

The trustees do not expect a COLA in Social Security benefits in December 2010 (nor was there a COLA last year). Since 1975, automatic annual COLAs have been tied to annual increases in the Consumer Price Index (CPI).

A hold-harmless provision under current law prevents recipients' net Social Security benefits from decreasing when the increase to their Medicare Part B premium is bigger than the increase to their cash benefits.³ As there will be no COLA, the Part B premium increase for 2011 will exceed the increase to cash benefits in all cases, thereby exempting those protected by the hold-harmless provision from paying the higher premium. So these beneficiaries will pay the same Part B monthly premium in 2011 they paid in 2009/10 — \$96.40.

The hold-harmless provision does not protect new enrollees during the year, high-income enrollees subject to the income-related premium adjustment,⁴ and those dually eligible for Medicare and Medicaid (state Medicaid programs pay their full premiums). To keep the Part B trust fund solvent under both current law and prudent agency practice, these enrollees — who account for roughly 25% of all beneficiaries — will have to pay substantially higher premiums. In 2010, the monthly premium for these beneficiaries rose to \$110.50. In 2011, monthly premiums will rise to \$120.20 for newly eligible enrollees with annual incomes between about \$15,000 and \$85,000. Single enrollees with incomes above \$85,000 (or married enrollees filing jointly with incomes above \$170,000) will pay from \$168.10 to \$384.20 per month. Also, note that the health care reform law froze the income thresholds used to calculate Part B income-related premiums at

2010 levels for years 2011 through 2019, so more retirees will be paying the higher premiums over time.

Absent a Social Security COLA, the law does not allow increases to the Social Security taxable wage maximum, currently \$106,800. Nor can the government increase the retirement-earnings-test exempt amount, currently set at \$14,160 for those younger than normal retirement age. Many of these non-adjustments may have near-term implications for employer retirement plans using permitted disparity with Social Security.⁵

Last year, political discussions about the COLA issue were intense. One senior citizen advocacy group recommended an ad hoc 2% increase in Social Security benefits for 2010, but finally supported an ad hoc \$250 payment. The Obama administration agreed with this proposal but did not put forward a "pay-for," such as raising the taxable wage maximum or having the permanent COLA use a version of the CPI that reflects smaller increases in the prices paid for consumer goods. Thus, the ad hoc payment would have increased the deficit.

To the surprise of many political observers, concern about the deficit trumped the senior lobby and the Senate rejected the administration's proposal. Similarly, the House passed legislation to freeze the 2010 Part B premium at its 2009 level for all beneficiaries and to make up the shortfall through general revenues, but the Senate did not vote on it. Given that worries about the deficit have only intensified, neither COLA increases for Social Security nor adjustments to Part B premiums are likely to emerge from the political process for next year.

Finally, the average wage index used in determining annually various bend points in the Social Security benefit formula and earnings required for a quarter of coverage declined in 2009. Therefore the dollar values for the bend points will decline slightly in 2011, and the earnings required for a quarter of coverage will remain unchanged. And the government estimates that average monthly Part D premiums will increase by \$1 to \$30 in 2011. Moreover, under health care reform, Part D enrollees whose incomes exceed certain thresholds (unindexed through 2019) pay higher premiums, as under Part B.

Reform of both Social Security and Medicare is sure to come under inquiry and discussion by President Obama's bipartisan fiscal reform commission, which will submit its recommendations just after the November congressional elections — if it can agree on a way forward.

"Given that worries about the deficit have only intensified, neither COLA increases for Social Security nor adjustments to Part B premiums are likely for next year."

³ The net benefit equals the increase in the Social Security benefit minus the increase in the Part B premium.

⁴ Beneficiaries whose incomes exceed \$85,000 in 2009 (\$170,000 for joint filers) must pay an income-related monthly adjustment amount and thus a larger share of the total Part B premium.

⁵ According to the 2009 Towers Watson Comparison database, about 44% of pension plans are integrated with Social Security.

DOL FAQ Provides Enforcement Safe Harbor for Outpatient Benefits Under MHPAEA

By Kathleen Rosenow and Sharon Cohen

The Department of Labor (DOL) recently released a new and very welcome Frequently Asked Questions (FAQ) document about the Mental Health Parity and Addiction Equity Act (MHPAEA). The MHPAEA requires parity between mental health/substance use disorder (MH/SUD) benefits and medical/surgical (M/S) benefits. The FAQ establishes a safe harbor for complying with the parity requirement.

Group health plans commonly require copayments for office visits and coinsurance for other outpatient services. These requirements often cause health plans to fail the parity test, which requires financial requirements and treatment limits for MH/SUD benefits to be no more restrictive than the “predominant” requirements and limits for M/S benefits (those applied to at least two-thirds of M/S benefits). Under the safe harbor, plans may divide outpatient services into two subclassifications: office visits and all other outpatient items and services.¹

Parity requirements under MHPAEA

Parity refers to financial requirements, such as deductibles, copayments, coinsurance and out-of-pocket maximums, and quantitative treatment limits, such as number of visits, days of coverage and days in a waiting period. Group health plans also must provide parity for nonquantitative treatment limitations, for example, prior authorizations and utilization reviews.

The interim final regulations issued earlier this year created six classifications of benefits that must be analyzed separately:

1. Inpatient, in-network
2. Inpatient, out-of-network
3. Outpatient, in-network
4. Outpatient, out-of-network
5. Emergency care
6. Prescription drugs

If a group health plan does not use a network of providers, then all benefits are treated as out-of-network. And if a plan provides out-of-network care for M/S benefits, it must also provide out-of-network care for MH/SUD benefits.

The first step in applying the parity requirement is to determine whether a financial requirement or quantitative treatment limitation applies to at least two-thirds of all M/S benefits in its classification. Without the safe harbor, this test could have some unfavorable (and possibly unintended) results. For example, suppose 50% of outpatient, in-network M/S benefits are subject to copayments, and the other 50% are subject to coinsurance. In that scenario, the group health plan could not impose copayments or coinsurance on MH/SUD benefits because neither financial requirement applies to two-thirds of the outpatient, in-network M/S benefits. So the plan would have to pay 100% of MH/SUD benefits.

Safe harbor

The agencies had received comments from plans and issuers about the common practice of requiring copayments for outpatient office visits and coinsurance for other outpatient services, such as surgery and laboratory charges.

Until final regulations are released, plans that meet the safe-harbor conditions will not run afoul of the rules. To comply, plans must categorize outpatient benefits into office visits and all other items and services. Within each subclassification, any financial requirements and treatment limitations on MH/SUD benefits may not be more restrictive than the predominant financial requirement or treatment limitation for substantially all M/S benefits.

Other than multitier drug formularies, no other subclassifications are allowed. So plans may not maintain separate subclassifications for generalists and specialists.

MHPAEA compliance for grandfathered plans under health care reform

All health plans must comply with the MHPAEA. The agencies note that changes to health plans made to comply with federal or state requirements under the MHPAEA will not affect a plan’s grandfathered status under health care reform as long as the changes to cost-sharing percentages, fixed-amount copayments, employer contribution rates and annual limits do not violate the grandfathering regulations.

“To comply, plans must categorize outpatient benefits into office visits and all other items and services.”

¹ Note a similar special rule provided in the interim final regulations also applies for multitier prescription drugs.

Towers Watson Testifies on Products and Strategies for Lifelong Retirement Distributions

Testimony of Mark Warshawsky, Director of Retirement Research, Towers Watson, presented to the Departments of Treasury and Labor at the joint hearing “On Certain Issues Relating to Lifetime Income Options for Participants and Beneficiaries in Retirement Plans,” September 15, 2010, Washington, D.C., Department of Labor Auditorium

“Insurance against outliving retirement assets make encouragement, but not the mandate, of annuitization a worthy public policy goal.”

As is well-documented, private-sector employers have been moving away from traditional defined benefit pension plans for more than a decade. These plans generally pay benefits to a participant as a life annuity, thereby providing a fixed stream of lifetime income at retirement. Employers have moved toward defined contribution and hybrid plans, that is, individual account plans, which are almost always designed to pay benefits as a lump sum. There are many reasons for this trend, but the focus of the Departments in your request for information and in this hearing is on the consequences for plan participants in terms of lifelong security during retirement and whether government policy can play a positive role in this particular area. Stated more directly, the operative questions are whether something important is being lost by the steady decline in mandatory annuitization, and if yes, whether there are products or strategies that can replace, in whole or in part, what has been lost. Finally, if such products and strategies are reasonably available, a further question is how the government can encourage their adoption by individual account plan sponsors and participants.

As Towers Watson stated in its April 2010 response to the original RFI, we believe that the desire of all plan participants for flexibility, liquidity and control, as well as the particular desire of those with impaired longevity for more immediate access to funds, are legitimate considerations for choosing a lump sum. Indeed, when given the choice, most retirement plan participants take a lump-sum distribution. At the same time, insurance against outliving retirement assets, the simplicity of investment and distribution management for many households, and the peace-of-mind and prudence obtained from a steady income flow, make encouragement, but not the mandate, of annuitization a worthy public policy goal.

In this testimony, I will first describe the features of the insurance product most like the traditional defined benefit pension in its distribution phase — the immediate fixed life annuity — and list some of its advantages and disadvantages. Then I review several other products and strategies — the inflation-indexed immediate annuity, immediate variable annuity, variable annuity with a guaranteed minimum withdrawal benefit, systematic withdrawals from a portfolio of mutual funds, and combinations of immediate fixed life annuity(ies) with systematic withdrawals — and compare their advantages and disadvantages. I also pay attention to the consequences of risks arising from uninsured health and long-term care expenditures for the household.

For the most part, I rely in my statement on past research that co-authors and I have conducted — empirical investigations and stochastic simulation studies modeling the probability distribution of payment streams from these products and strategies given the background risks of uncertain asset returns and interest rates, individual mortality and inflation.¹ We have been careful to get the essential details of product features, including average fee levels, incorporated correctly in this research. The studies generally describe what is available in the retail market, although with the exception of fee levels, many of the features and characteristics carry over to the institutional market. The other members of this panel will focus more on the institutional market, as well as on some other products that are currently available to retirement plan participants.

Advantages and disadvantages of full use of immediate fixed life annuities at retirement

Research shows that the uncertainty about the remaining length of life during retirement is large and reduces welfare because the household faces a distressing choice — either it should reduce consumption in order to maintain assets to finance a possibly long retirement, or maintain its standard of living and risk having to reduce spending suddenly and significantly if it outlives the average and runs out of money. [1] Things are somewhat better for a couple than an individual because there is some pooling of mortality risk with two members rather than just one, but even here risks remain and hard choices must be made. Research shows that full use of an

¹ [References] will be made throughout the text to the published articles listed at the end of the statement.

immediate straight life annuity, either for an individual or as a joint-and-survivor payment, at the point of retirement resolves this uncertainty and gives a substantial lift to the welfare of the household. [1]

The full use of fixed annuities also has the virtue of simplicity for investment strategy, where that responsibility and risk falls entirely on the insurer who guarantees the payment flows (which include investment and mortality returns). Simplicity also applies to distribution strategy, where a fixed income flow from an annuity frees the household from having to manage the size of withdrawals from its pool of savings and blocks the opportunity to entertain rash temptations for large, imprudent, expenditures. It is also likely that simplicity is more highly desired and becomes more appropriate as the retired household ages and its cognitive abilities decline.

But this product and simple strategy has several disadvantages as well. A steady fixed flow of income can easily turn into an impediment if a large legitimate need for a significant amount of assets arises suddenly, such as a family emergency, a big uninsured medical or long-term care bill, an uninsured home or auto repair, and so on. A fixed annuity also does not hedge other extant economic risks, in particular inflation and insurer insolvency. If there is inflation, a fixed annuity will produce less and less income in real terms with time, and, more significantly, if inflation picks up suddenly what was originally adequate will unexpectedly shrink in terms of purchasing power. In our research, this inflation risk is found to be significant and can produce real income shortfalls, even though a fixed life annuity gives the highest income flow of all the products and strategies at the point of retirement. [3] In addition, insurer insolvency, although a rare event, could be catastrophic if the relevant state guarantee funds do not cover the losses. An immediate annuity has a shorter horizon (20 or 30 years) than a deferred annuity (which might need to exist for 50 or 60 years through the last payment) and so reduces insolvency risk, but not to zero, even for highly rated issuers.

Two other disadvantages arise from the nature of fixed annuity pricing, which depends mainly on three factors — marketing and administrative expenses, interest rates at the time of issuance and mortality expectations. Because interest rates are volatile, the prices charged for fixed annuities are also volatile. This can be called timing risk. Two otherwise identical people retiring with the same account balance could receive significantly higher or lower incomes simply because one retired just one year (or even quarter) earlier. For example, my research found that retiring in March 1986 instead of March 1985 would have caused a loss of 27.4% of income if the full annuitization strategy were pursued. [2]

With regard to mortality, insurers must price their life annuities based on the expected mortality rates of those who purchase the product. In a voluntary market (as opposed to, say, Social Security and some traditional defined benefit plans, where annuitization is mandatory), those with impaired health and shorter expected longevity are likely to avoid the purchase of annuities. The insurer must therefore consider the resulting downward bias to mortality rates in pricing the annuity. Also annuity purchasers are likely to come from higher socioeconomic groups than non-purchasers, and the wealthy generally have lower mortality. Our research found that the impact of these “adverse selections” adds about 10% of the annuity price, compared to what would have been charged if the mortality of the general population were to apply. [1] This may be the cause of the complaint sometimes heard that annuities are “expensive.”

Some alternative product and strategy solutions

An inflation-indexed immediate annuity reduces the exposure to inflation risk. This product is the same as the fixed annuity except that payments increase with consumer price inflation (although insurers do impose annual caps of 5% or 10%, somewhat limiting the extent of protection). It has the same advantages of hedging longevity risk and simplicity, but suffers from the same disadvantages of illiquidity, the risk of insurer insolvency, timing risk and adverse selection. My research, admittedly based on a small sample, found that the expense load, which includes the cost of adverse selection, on an inflation-indexed annuity was about 5 percentage points higher than on the fixed annuity, perhaps owing to a more limited investment portfolio available to insurers to back inflation-indexed products. [2] To pay for the cost of indexing, the initial and some subsequent payments from an inflation-indexed annuity will pay less than the nominal fixed annuity; if the rate of inflation is lower than expected, a nominal annuity will, after the fact, be a better deal.

An immediate variable annuity delivers variable income for life, with no residual at death. At the time of purchase, the investor selects an assumed interest rate (AIR). This AIR together with the insurer’s mortality guarantee determines how many annuity units the investor gets for his premium. The annual payment to the insured, conditional on surviving, is equal to the number of annuity units multiplied by the value of each unit. The unit value evolves with the net investment performance of underlying funds chosen by the insured, relative to the AIR. The net performance is the gross investment returns net of fund management and insurance fees — these average more than 200 basis points. The payment

“Inflation risk is found to be significant and can produce real income shortfalls, even though a fixed life annuity gives the highest income flow of all the products and strategies.”

stream will rise if the net investment return is higher than the AIR. The investor can choose a higher AIR to receive larger payments in the early years of retirement, but then she risks more income volatility later in life and smaller payments if investment performance is poor.

The main advantage of an immediate variable annuity is that it eliminates timing risk — for the same AIR, every investor starts out with the same initial payment. Because it is a life annuity, it also covers mortality risk — payments will continue for life. Depending on the funds chosen, their investment performance and the AIR used, payments might increase, even substantially, over the life of the insured. The disadvantages include lack of liquidity, insurer insolvency risk and adverse selection; fees can also be significant. There is also some added complexity in the product, which arises from the need to make investment and AIR selections. Finally, by definition, the income flow is uncertain and makes financial planning during retirement more difficult. Our research shows that the volatility of inflation-adjusted income for a variable annuity invested 50/50 in stocks and bonds is among the highest of the products and combinations that we have modeled and the risk of real income shortfalls is higher than for a fixed annuity. [3]

A relatively new product has been developed which adds a guaranteed minimum withdrawal benefit rider to a conventional deferred variable annuity. The deferred variable annuity acts as an investment account while the rider guarantees that, regardless of investment performance and length of life, (nominal) income will not fall below a certain percentage (generally 5%) of the “income base” and could increase if investment performance is good. The income base does not decrease and could increase with the account value. The account value is the actual market value of the invested portfolio that fluctuates with investment performance and may be reduced to zero after subtraction of income payments and fees. With the addition of the fee for the rider to the usual variable annuity fees, total fees come to about 300 basis points, on average.

We have modeled several portfolio choices for this product in our research and here report on the results with a 70/30 stock/bond mix, which may be a sensible choice to maximize the value of the rider without adding too much risk. The advantage of this product is that the account provides liquidity, at least until it (is likely to) runs out if the retiree lives too long. There is no timing risk, and lifelong payments can increase (but will not decrease in nominal terms) with investment performance. The disadvantages include complexity, insurer insolvency risk and fees.

Our research shows that the variable annuity with guaranteed minimum withdrawal benefit has a reasonable expectation of a significant account balance, and low volatility around the income flows, but the initial income is relatively modest and is highly likely to fall short of minimum real income targets over the lifetime of the retired person. [3]

A completely non-insured strategy is to take systematic withdrawals from a portfolio of mutual funds. There are many ways in which this can be done; we model in our research the withdrawal of a constant percentage of the mutual fund balance in each period and use the same percentage as is guaranteed by the variable annuity with a guaranteed minimum withdrawal benefit — 5%. We assume a 50/50 equity/bond asset allocation — a common balanced fund or target-date fund allocation around retirement — and that investment fees are 120 basis points.

This distribution strategy produces the highest account balances throughout retirement, with a good possibility of a significant residual upon death, according to our research. [3] Hence, liquidity is excellent and there is also no insurer insolvency risk and little timing risk. Although there is some complexity here, some products in the marketplace “automate” the investment and withdrawal functions. The disadvantage of this strategy comes on the income side — it produces the highest probability of not meeting minimum real income targets, and averages the lowest real income flow. [3]

Finally, we have considered some combination strategies using a fixed annuity and systematic withdrawals. The motivation is that the sharp edges of the trade-offs presented above might be smoothed and something more desirable will result. We modeled two combinations — (a) a one-time partial fixed annuity purchase using 30% of the value of the retirement accounts while the remainder of the account is distributed through systematic withdrawals from a mix of mutual funds, and (b) a gradual annuitization until age 75 combined with systematic withdrawals from mutual funds, and at age 76 and beyond — full annuitization. For both combinations, we increase the equity share in the mutual fund portfolio because the annuity basically has bond-like investment properties.

The research results do show some nice characteristics for these combinations. The first combination produces quite a bit of liquidity, with account balances nearly as high as those produced by the variable annuity with guaranteed minimum withdrawal benefit, and less volatility. It also gives a higher average real income flow, with some upside potential, than some of the other products and strategies. [3] The second combination, by definition,

“Systematic withdrawals from a portfolio of mutual funds produce the highest account balances throughout retirement, with a good possibility of a significant residual upon death.”

only provides liquidity for the first 10 years of retirement. Its income characteristics, however, are the best of all the products and strategies that we have modeled. In particular, mean real income flows are the highest, and the risk of shortfalls is the lowest. There is substantial upside potential and the downside is protected. [3] The timing risk of annuitization is hedged by the gradual “laddering” of annuities. Postponing annuitization increases income flows because of the positive impact of the “mortality premium,” that is, the extra return gathered from the pooling of mortality risk becomes greater at older ages. Both combinations have some insurer insolvency risk and higher fees (and the cost of adverse selection), but, by definition, less than the pure annuitization solutions. Because, to my knowledge, these combination strategies have not yet been “automated” in the marketplace, they unfortunately appear to be complex for a household to pursue.

Particular consideration of uninsured health and long-term care spending risks

Thus far, I have not paid particular attention to uninsured health and long-term care spending risks beyond a generalized desire for liquidity. In one research article, we did so, explicitly modeling those risks in an analysis of the optimal annuitization and investment strategy for a retiree. We incorporated the results of other empirical research that the mean and variance of uninsured health and long-term care spending increase with age, especially for households with higher wealth and income. The results of our

research are that annuitization should begin around the mid 70s for an individual and continue until about the mid 80s for significant annuitization, but still keeping aside about a fifth to a quarter of the original account balance for other liquidity needs. [4] At the initial point of retirement, the investment portfolio should be quite conservative, with only about a third invested in equities; as annuitization starts, however, the optimal equity share rapidly increases, to around 70% in the late 70s, whereupon it starts to gradually decline throughout the rest of retirement. [4] The central insight here is that the life annuity, purchased in stages later in life, can serve as a hedge against investment risks and against health and long-term care spending risks, which increase in probability and size with age, in the absence of specific or complete insurance coverage.²

Conclusion

I hope my testimony has depicted part of the rich menu of products and strategies which can be used to provide lifelong income to retirees. They all have advantages and disadvantages, which plan sponsors and retiring participants have to consider and weigh. Some use of life annuities is likely to play a role if income production is a central concern, but it will not be the complete solution. Indeed, much more technical research and market experimentation is needed, and I hope that any guidance coming from the government in this area will be encouraging rather than constraining.

“The life annuity, purchased in stages later in life, can serve as a hedge against investment risks and against health and long-term care spending risks.”

² As we described in our response to the original RFI, a combination of an immediate life annuity and comprehensive long-term care insurance seems like a promising potential development. See [5].

Research references

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