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STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

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AND

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2018 ERISA ADVISORY COUNCIL

LIFETIME INCOME SOLUTIONS AS A

QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA)

The Investment Company Institute (ICI)[1] appreciates the opportunity to appear before the ERISA Advisory Council. The Council is considering whether to identify the need for lifetime income as an important public policy issue and whether it should advise the Department of Labor (DOL or the "Department") to support initiatives that could lead to broader use of lifetime income options in defined contribution (DC) plans. More specifically, the Council's stated objective "is to focus recommendations on promoting lifetime income within DC plans through providing further guidance on an annuity selection safe harbor and modifying the Qualified Default Investment Alternative (QDIA) rule to focus on asset accumulation and decumulation issues in the context of lifetime income needs and solutions." The presumption underlying these objectives is that Americans generally should annuitize more of their DC plan savings.

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Part I of this testimony focuses on research that can shed light on the Council's underlying premise that Americans are under-annuitized and that promoting annuities in DC plans is a necessary policy initiative. To address these issues, this testimony provides a review of the research on the question of annuitization and presents data drawn from a variety of sources including the Federal Reserve Board, Internal Revenue Service (IRS) Statistics of Income Division, DOL, US Census Bureau, Bureau of Labor Statistics, and surveys fielded by the ICI. Part II of this testimony examines two ideas that have been heavily promoted by proponents of increased annuitization in DC plans: a proposal to modify the QDIA safe harbor to permit limits on rights of transferability that currently require participants to be able to move out of the default investment at least once in any 90-day period, and a proposal to require benefit statements to include a lifetime income illustration based on an annuity calculation. Part II also considers whether implementing the ideas would serve the interests of plan participants and beneficiaries.

This written statement is submitted in conjunction with testimony of Sarah Holden, Senior Director, Retirement and Investor Research, and Shannon Salinas, Assistant General Counsel – Retirement Policy, before the Council on August 15, 2018.

Summary of Testimony

The underlying premise of the Council's focus on promoting lifetime income in DC plans, i.e., that most Americans are under-annuitized and that promoting annuitization of retirement account balances would benefit American retirees, is incorrect. The relevant research and data show that:

- Retirement resources, which allow workers to reallocate lifetime resources from their working years to their retired years, should be thought of comprehensively.
- The US retirement resource pyramid has a strong annuitized base, Social Security, which is progressive and provides high replacement rates for lower-income workers.
- When including all retirement resources, it is clear that US households are highly annuitized outside their DC plans.
- Individuals entering retirement who need more annuity income should first consider delaying claiming Social Security before purchasing an annuity in the market.
- In addition to regular income, most households want access to resources in times of unexpected need, and required minimum distributions (RMDs) are a responsible way to produce a lifetime income stream while still maintaining access to the account balance.
- Most retirement savers steward their accumulations to and through retirement.

- Households having difficulty in retirement typically had difficulty while working, and promoting annuitization will not solve the problem of limited lifetime resources.

Two ideas that have been heavily promoted by proponents of increased annuitization in DC plans—a proposal to modify the QDIA safe harbor to permit limits on rights of transferability that currently require participants to be able to move out of the default investment at least once in any 90-day period, and a proposal to require benefit statements to include a lifetime income illustration based on an annuity calculation—will not benefit DC plan participants and beneficiaries.

- The Pension Protection Act of 2006 (PPA) directed the Department to prescribe regulations implementing the QDIA safe harbor under section 404(c) of ERISA for the investment of assets in a "participant directed" individual account plan in the absence of an investment election by the participant or beneficiary. Consistent with the section 404(c) requirements applicable to "core" investment options, the QDIA safe harbor requires that a defaulted participant be able to move out of the QDIA to other investment options offered through the plan at least once in any 90-day period.

- The ability to move from the QDIA to other investment options available through the plan is a critical component of the QDIA safe harbor that protects participants who are invested by default, particularly because the safe harbor absolves the plan sponsor from liability for the "deemed" investment decisions of the participant.

- The QDIA rule applies the same protective conditions to all products that could be used as or within QDIAs, including annuities or other products with guarantee features. DOL already has made clear that such products could be incorporated into a QDIA as long as the plan and product meet all of the applicable safe harbor criteria.

- Eliminating or relaxing the requirement that participants and beneficiaries be able to move their assets out of the QDIA generally once in every 90-day period, specifically to promote annuities, could harm participants.

    - Although there is little specificity around what types of annuities or guaranteed products should qualify for the proposed special treatment, annuities are complex financial products that require consideration of many factors when determining whether a particular product, or an annuity in general, is right for any given individual.

    - The ongoing ability to move assets out of such a product (beyond the initial period of investment) is important because the individual may not fully appreciate the implications of the default investment until later; the individual's circumstances could change such that the product is no longer suitable; or the annuity provider itself could experience problems impacting its ability to make all future payments under the contract. For example, a participant might initially be comfortable with being defaulted into a deferred annuity only to determine a few years later that her calculus as to future needs and options has changed or the financial status of the annuity provider has changed. Locking the participant into the annuity under such circumstances would turn ERISA section 404(c) on its head and make a mockery of the "participant directed plan" concept.

- Although lifetime income illustrations generally help participants understand whether their savings habits are on track for a secure retirement and remind them to think about their accumulated savings in terms of income needs, proposals to require annuity-based lifetime income illustrations are ill-advised.
  - There is no single best method of illustration for all participants.
  - Annuity-based illustrations can fluctuate greatly from year to year based solely on prevailing interest rates and have no relevance to actual annuity rates in effect when a participant is nearing retirement.
  - Other illustration calculation methods (such as illustrations based on systematic withdrawals) may be more consistent with actual participant distribution strategies and easier for participants to understand.
- The Council should urge the Department to provide guidance to encourage voluntary lifetime income illustrations.
  - The Department should expand Interpretive Bulletin 96-1 to clarify that information on distribution options and retirement income, including income stream modeling or estimates, qualifies as participant education and would not be considered investment advice within the meaning of ERISA section 3(21)(A)(ii).
  - This approach would preserve the ability to use many of the carefully crafted lifetime income illustration methods already in use today and permit continued innovation of new and improved illustration methods and interactive tools.

I. <u>Research Does Not Support the Premise That American Workers Need More of Their Retirement Income in the Form of an Annuity</u>.

The underlying premise of the Council's focus on promoting lifetime income in DC plans is that most Americans are under-annuitized and that promoting annuitization of retirement account balances would benefit American retirees. This premise rests in part on research which uses simplified economic models to predict that individuals should annuitize all wealth at retirement. The supposed "annuity puzzle" arises because, contrary to these predictions, few households choose to purchase annuities.

This testimony will provide evidence that the Council's underlying premise is incorrect, that the so-called "annuity puzzle" is more a reflection of the limitations of the models used to predict behavior than it is a reflection of poor decision-making by households. A long line of research has pointed out that models predicting full annuitization at retirement oversimplify the choices that households face.

Additionally, analysis of data reflecting actual US experience finds that US households generally steward their retirement accumulations to and through retirement and appreciate the flexibility of having control over both income and assets, often citing concern about unexpected needs. US workers change jobs over their careers and the majority of workers across all age groups have low tenures at their current employers, which means the DC plan balance at any given employer is just one component of a household's retirement resources.

A. Research on the annuitization decision has evolved to incorporate a broader range of households' concerns.

The belief that there is an "annuity puzzle" in the United States dates back to the 1960s, when a seminal research paper showed that, absent a bequest motive, rational consumers should use all of their life savings to purchase an annuity at retirement.[2] The puzzle arose because the predictions of the economic model used in the paper were at odds with the actual behavior of US households—who rarely choose to purchase annuities, much less use their entire savings to do so.

Subsequent research has raised several issues with the models used to predict full annuitization. For example, rather than being actuarially fair, the price of annuities sold in the market includes sales charges and must be adjusted for adverse selection (that is, individuals who choose to buy an annuity tend to live longer than those who do not).[3] The models do not account for the fact that individuals have other annuitized resources, such as Social Security and defined benefit (DB) pensions.[4] Nor do they incorporate uncertainty about future consumption needs, which would cause individuals to keep a portion of wealth liquid in case of unexpected need.[5] Further, the models typically focus on single

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[2] See Menahem E. Yaari, "Uncertain Lifetime, Life Insurance, and the Theory of the Consumer," *Review of Economic Studies* 32, issue 2 (1965): pp. 137–150.

[3] For example, see Olivia S. Mitchell, James M. Poterba, Mark J. Warshawsky, and Jeffrey R. Brown, "New Evidence on the Money's Worth of Individual Annuities," *American Economic Review* 89, no. 5 (December 1999): pp. 1299–1318.

[4] For example, see B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," *Journal of Political Economy* 99, no.5, (October 1991): pp. 899–927.

[5] For example, see Sven H. Sinclair and Kent A. Smetters, "Health Shocks and the Demand for Annuities," *Congressional Budget Office Technical Paper* 2004-9 (July 2004); available at https://cbo.gov/sites/default/files/cbofiles/ftpdocs/56xx/doc5695/2004-09.pdf. Sinclair and Smetters (2004) concludes:

> A new explanation is offered for the thin private market for individual annuities in the United States. Individuals face a risk of health shocks which simultaneously cause large uninsured expenses and shorten the life expectancy. The value of a life annuity then decreases at the same time as the need for cash increases, undermining its effectiveness in providing financial security. When the risk of such health shocks is substantial, it is no longer

individuals, whereas married couples get much less insurance value from purchasing an annuity.[6] In addition, the prediction of full annuitization relies on the assumption that individuals place no value on resources passed on to their heirs, whereas evidence suggests that a large portion of the population desires to leave bequests.[7]

In fact, a recent study by Felix Reichling of the Congressional Budget Office (CBO) and Kent Smetters of the Wharton School finds no evidence of an annuity puzzle, concluding that most households should not annuitize any wealth.[8] Although previous research has found that the prediction of full annuitization was largely unaffected by the issues raised by critics,[9] Reichling and Smetters (2015) determines that the robustness of results is driven by assumptions embedded in the model. Specifically, the authors illustrate that the results of the original model are impervious to many considerations because of the assumption that individuals know what their survival probability will be in all future years. If, instead, it is assumed that individuals learn new information about their health and mortality risk over time, and that adverse health events both increase mortality risk and are costly (in the form of lower income or higher out-of-pocket expenses), then the result that retirees should fully annuitize disappears.

B. Retirees manage a range of resources in retirement and typically do not need additional annuitization.

This part of the testimony will look at what resources retirees have, how they access these resources in retirement, and review the reasons households do not demand additional annuitized resources. There are seven key takeaways from the research and data, which will be discussed in turn below:

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optimal for risk-averse individuals with uncertain life spans to hold all their wealth in life annuity form, even if annuity contracts are reversible, and bequest motives, transaction costs and adverse selection are absent.

[6] For example, see Laurence J. Kotlikoff and Avia Spivak, "The Family as an Incomplete Annuities Market," *Journal of Political Economy* 89, no. 2 (April 1981): pp. 372–391; Jeffrey R. Brown and James M. Poterba, "Joint Life Annuities and Annuity Demand by Married Couples," *The Journal of Risk and Insurance* 67, no. 4 (December 2000): pp. 527–553; Irena Dushi and Anthony Webb, "Household Annuitization Decisions: Simulations and Empirical Analyses," *Journal of Pension Economics and Finance* 3, issue 2 (July 2004): pp. 109–143; and Peter J. Brady, "Can 401(k) Plans Provide Adequate Retirement Resources?" *Public Finance Review* 40, issue 2 (March 2012): pp. 177–206.

[7] For example, see B. Douglas Bernheim (1991), note 4, supra; and John Ameriks, Andrew Caplin, Steven Laufer, and Stijn Van Nieuwerburgh, "The Joy of Giving or Assisted Living? Using Strategic Surveys to Separate Public Care Aversion from Bequest Motives," *The Journal of Finance* 66, no. 2 (April 2011): pp. 519–561.

[8] See Felix Reichling and Kent Smetters, "Optimal Annuitization with Stochastic Mortality and Correlated Medical Costs," *American Economic Review* 105, no. 11 (November 2015): pp. 3273–3320. Specifically, they conclude: "even under conservative assumptions, it is indeed not optimal for most households to annuitize any wealth; many younger households should actually *short* annuities" (page 3317).

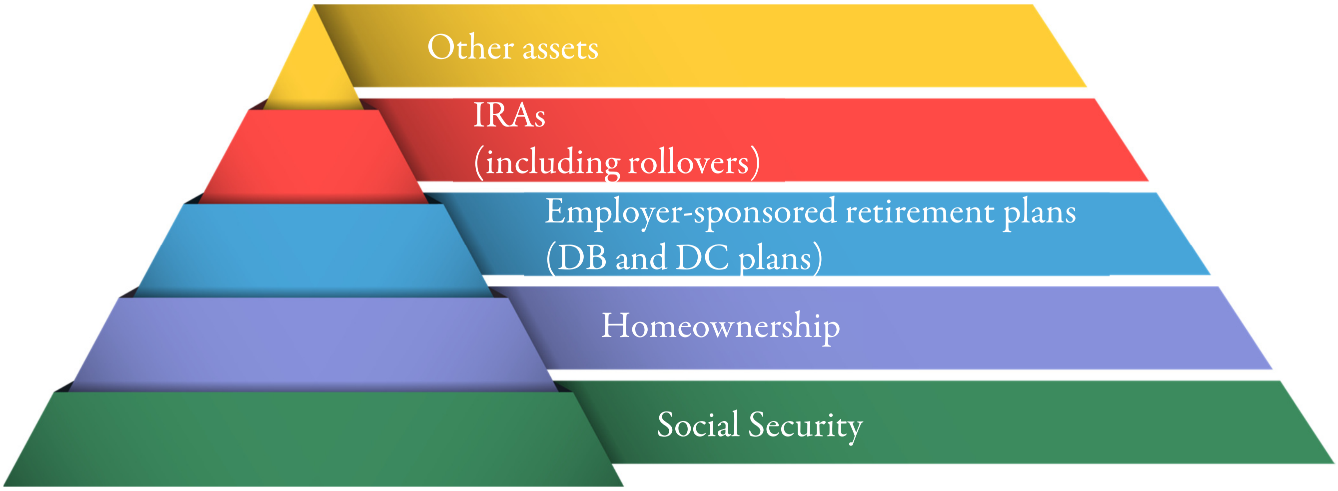
[9] See Thomas Davidoff, Jeffrey R. Brown, and Peter A. Diamond, "Annuities and Individual Welfare," *American Economic Review* 95, no. 5 (December 2005): pp. 1573–1590; available at https://economics.mit.edu/files/604.

1. Retirement resources, which allow workers to reallocate lifetime resources from their working years to their retired years, should be thought of comprehensively.
2. The US retirement resource pyramid has a strong annuitized base, Social Security, which is progressive and provides high replacement rates for lower-income workers.
3. When including all retirement resources, it is clear that US households are highly annuitized outside their DC plans.
4. Individuals entering retirement who need more annuity income should first consider delaying claiming Social Security before purchasing an annuity in the market.
5. In addition to regular income, most households want access to resources in times of unexpected need, and required minimum distributions (RMDs) are a responsible way to produce a lifetime income stream while still maintaining access to the account balance.
6. Most retirement savers steward their accumulations to and through retirement.
7. Households having difficulty in retirement typically had difficulty while working, and promoting annuitization will not solve the problem of limited lifetime resources.

1. <u>Retirement resources, which allow workers to reallocate lifetime resources from their working years to their retired years, should be thought of comprehensively</u>.

Before contemplating whether American workers should annuitize a portion of their DC plan accumulations, it is important to consider the full context of retirement resources. Saving for retirement consists of taking some of today's income and putting it aside to support consumption in retirement. Americans' retirement resources are best thought of as a five-layer pyramid, which draws from government programs, compensation deferred until retirement, and other savings (Figure 1). Specifically, the five layers are: Social Security, homeownership, employer-sponsored retirement plans (private-sector and government employer plans, including both DB and DC plans), individual retirement accounts (IRAs), including rollovers, and other assets.

Figure 1
The Retirement Resource Pyramid



Source: Investment Company Institute, *2018 Investment Company Fact Book* (www.icifactbook.org/)

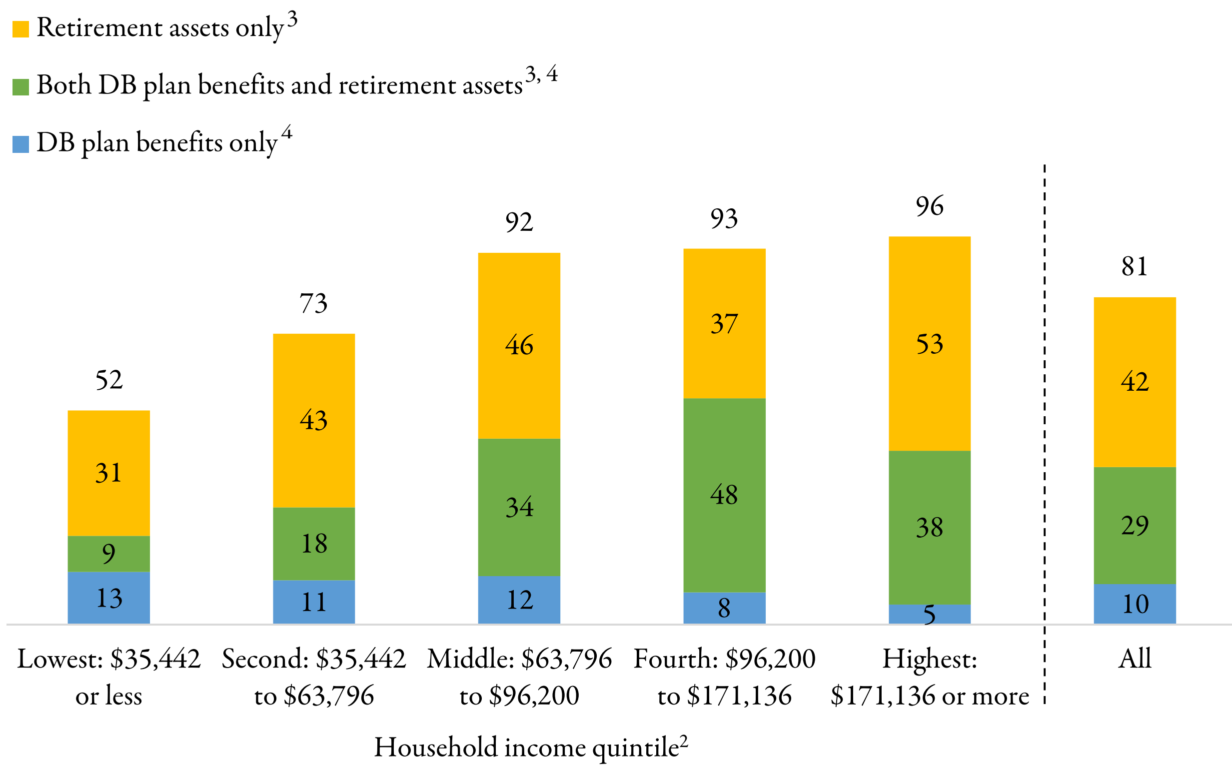
American households rely on a combination of resources in retirement, and the role each type of resource plays has changed over time and varies across households. Though the use of each layer differs by household, together they have broadly enabled recent generations of retirees to maintain their standard of living in retirement.[10] Nearly all workers have Social Security benefits,[11] and eight in 10 near-retiree households own their homes.[12] Complementing Social Security, eight in 10 near-retiree households have retirement accumulations, whether from DB plans, DC plans, or IRAs. In 2016, about four in 10 near-retiree households had DB plan benefits, about seven in 10 had DC plan assets or IRAs, and about three in 10 had both (Figure 2). Regardless of income quintile, a majority of near-retiree households have these retirement accumulations.

[10] See Peter Brady, Kimberly Burham, and Sarah Holden, *The Success of the US Retirement System* (December 2012), Washington, DC: Investment Company Institute; available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

[11] See Social Security Administration, "Fact Sheet on the Old-Age, Survivors, and Disability Insurance Program" (December 2017); available at https://www.ssa.gov/oact/FACTS/fs2017_12.pdf.

[12] ICI tabulations of the 2016 Federal Reserve Board Survey of Consumer Finances (SCF) finds that 80 percent of near-retiree households (households with a head of household aged 55 to 64 and a working head of household or working spouse) owned their homes: 56 percent owned the home with a mortgage and 24 percent owned their home mortgage-free.

Figure 2
Near-Retiree Households Across All Income Groups Have Retirement Assets, DB Plan Benefits, or Both
Percentage of near-retiree households[1] by income quintile,[2] 2016



[1] Near-retiree households are those with a head of household aged 55 to 64 and a working head of household or working spouse.
[2] Income is household income before taxes in 2015.
[3] Retirement assets include DC plan assets (401(k), 403(b), 457, thrift, and other DC plans), whether from private-sector or government employers, and IRAs (traditional, Roth, SEP, SAR-SEP, and SIMPLE).
[4] Households currently receiving DB plan benefits and households with the promise of future DB plan benefits, whether from private-sector or government employers, are counted in this category.
Note: Components may not add to the total because of rounding.
Source: Investment Company Institute tabulations of the 2016 Federal Reserve Board Survey of Consumer Finances

The concept of annuitization is broader than just annuity products, and the decision regarding annuitization requires consideration of all household resources. Social Security benefits and DB plan benefits that are not paid out as a lump sum provide monthly payments for life. Owner-occupied housing also represents an annuitized asset in that it provides a stream of housing services, reducing the amount of monthly income retirees need to generate.[13]

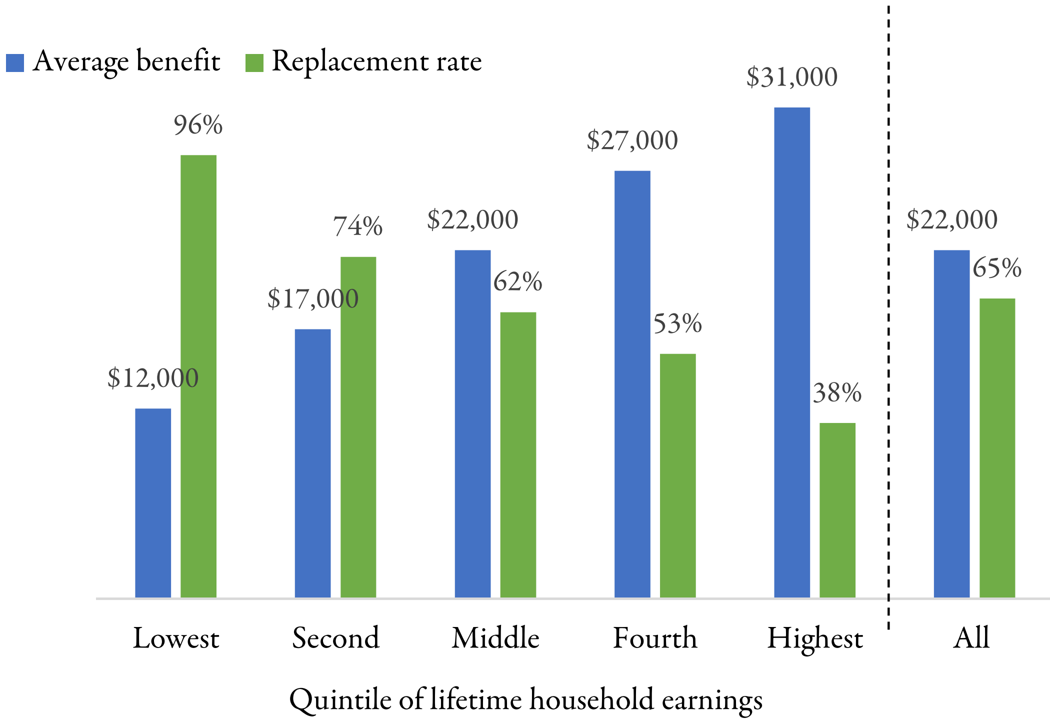
2. The US retirement resource pyramid has a strong annuitized base, Social Security, which is progressive and provides high replacement rates for lower-income workers.

A key source of annuitized income is Social Security. By design, Social Security is the primary means of support for retirees with low lifetime earnings and a substantial source of income for all retired workers. Based on CBO estimates, for those in the lowest quintile (20 percent) of workers ranked by lifetime household earnings, first-year Social Security benefits are scheduled to replace 96 percent of inflation-indexed lifetime earnings, on average, for workers born in the 1960s who claim benefits at age 67 (Figure 3).[14] That replacement rate declines to 74 percent for workers in the second quintile of lifetime household earnings, and then declines more slowly as lifetime household earnings increase. Even for workers in the top 20 percent of lifetime household earnings, Social Security benefits are scheduled to replace a considerable portion (38 percent) of earnings at full retirement age.

[13] If a household did not own its home, it would be required to pay rent to live in the home. Owner-occupied housing provides imputed rental income in excess of expenses, which reduces the need for a regular stream of income from other sources.

[14] See "Mean Initial Replacement Rates for Retired Workers, with Past Earnings Adjusted for Growth in Prices" and "Exhibit 7: Mean Initial Benefits for Retired Workers, with Scheduled and Payable Benefits" in Congressional Budget Office, *CBO's 2017 Long-Term Projections for Social Security: Additional Information* (October 2017); available at www.cbo.gov/publication/53245 and www.cbo.gov/system/files/115th-congress-2017-2018/reports/53245-supplementaldata.xlsx. The CBO calculation assumes claiming at age 65; ICI adjusts to claiming at age 67 (see discussion in Figure 6).

Figure 3
Social Security, A Real Annuity, Forms a Strong Base in the US Retirement System
Average benefits and replacement rates for workers born in the 1960s by lifetime household earnings quintile



Note: The average benefit is the scheduled benefit net of income tax and in constant 2017 dollars. The replacement rate is the scheduled Social Security benefit, net of income tax, as a percentage of a worker's average inflation-indexed lifetime earnings. CBO estimates are for workers who claim at age 65. ICI proportionately adjusts the CBO's estimates to represent workers claiming at age 67 (the full retirement age for workers born in the 1960s) according to the Social Security rules.
Sources: Investment Company Institute and Congressional Budget Office, *CBO's 2017 Long-Term Projections for Social Security: Additional Information*

3. <u>When including all retirement resources, it is clear that US households are highly annuitized outside their DC plans</u>.

Support for promoting annuitization within DC plans appears to rest at least partly on a perception that DC plan participants are under-annuitized and therefore that more participants in DC plans should annuitize their accounts. There is no evidence to support such a conclusion. All retirement income products and strategies involve tradeoffs and consideration of an individual's personal circumstances, such as other assets or income (including from Social Security), health status and life expectancy, the need for emergency reserves, specific goals in retirement, and the need to provide for other family members. Significantly, the majority of near-retiree US households already are highly annuitized.

a. Analysis of comprehensive household wealth finds high levels of annuitization.

A key explanation for why annuity demand is low is that most US retirees already hold most of their wealth in an annuity-equivalent form, including both future Social Security and DB plan benefits, and owner-occupied housing.[15] Households rationally may not want to annuitize more assets, preferring instead to preserve the liquidity and flexibility of their DC plan balances. Academic research that includes the present value of future Social Security benefits and DB plan benefits in a comprehensive measure of household wealth shows that the majority of near retirement–age households' wealth is effectively annuitized (Figure 4).[16] For example, 94 percent of comprehensive wealth of the lowest wealth quintile is annuitized assets, consisting of 80 percent in Social Security wealth, 12 percent in net housing wealth, and 2 percent in DB pension wealth. About three-quarters of the comprehensive wealth of the middle wealth quintile of near retirement–age households is annuitized assets: 44 percent in Social Security wealth, 15 percent in net housing wealth, and 16 percent in DB pension wealth. Even the highest wealth quintile is highly annuitized (half of their comprehensive wealth).

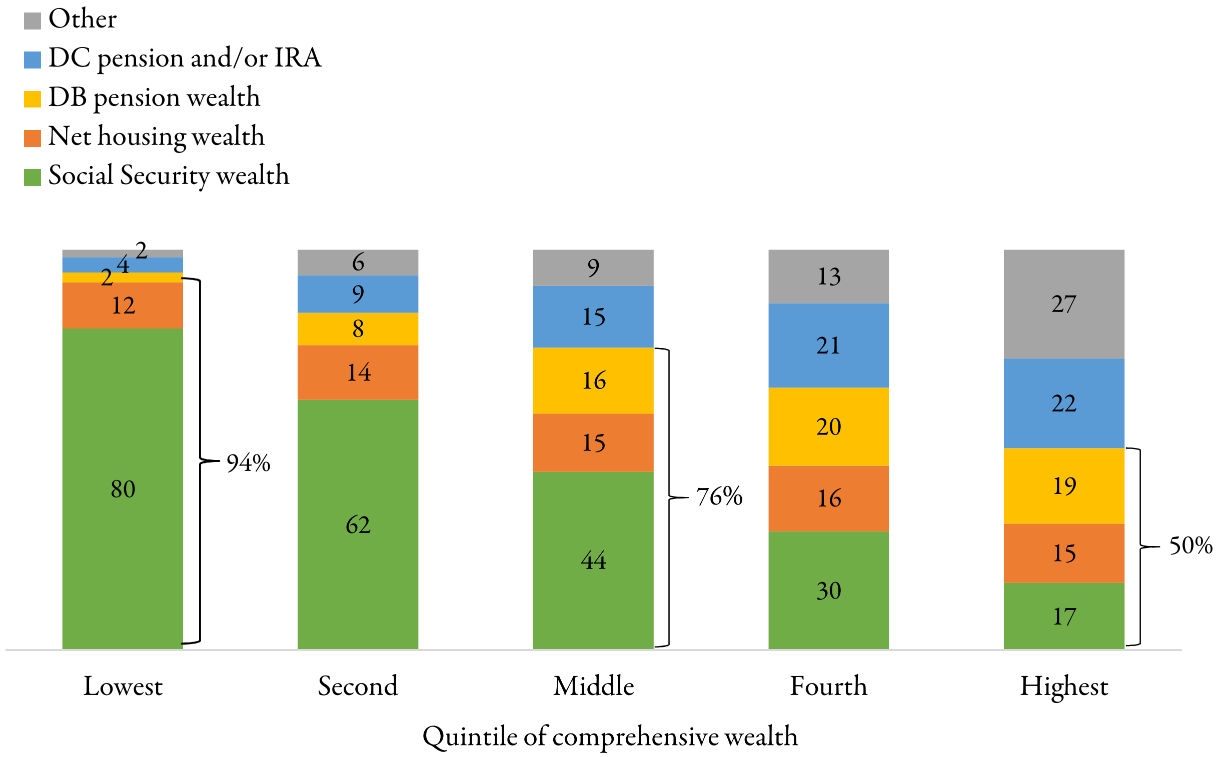
[15] See note 13, supra.

[16] See Alan L. Gustman, Thomas L. Steinmeier, and Nahid Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *University of Michigan Retirement Research Center Working Paper* 2009-206 (October 2009); available at www.mrrc.isr.umich.edu/publications/papers/pdf/wp206.pdf.

Figure 4

Many American Households Approaching Retirement Age Already Are Highly Annuitized

Percentage of comprehensive wealth by comprehensive wealth quintile, 2010



Note: Data represent households with at least one member aged 57 to 62 and exclude the highest and lowest 1 percent of households ranked by comprehensive wealth. Comprehensive wealth includes the present value of future Social Security benefits and the present value of future DB benefits, in addition to financial assets, net housing wealth, and other balance sheet items. Components may not add to the total because of rounding.
Source: ICI tabulation derived from an updated Table 3 of Gustman, Steinmeier, and Tabatabai (2009)

b. Data show that a high percentage of retiree income comes from annuity streams.

Analysis of IRS Statistics of Income tax data shows that most taxpayers' non-labor income is highly annuitized in the third year after claiming Social Security.[17] Reflecting the design of Social Security, 71 percent of non-labor income is Social Security benefit payments for the lowest income quintile (Figure 5). As one moves up the income distribution, this share falls to 57 percent for the second

[17] The research analyzed administrative tax data for individuals aged 55 to 61 in 1999 who were working and not receiving Social Security benefits. Data on these individuals were collected through 2010, with the analysis focusing on those workers who claimed Social Security retirement benefits between 2000 and 2007. The study found that most workers maintained or increased their spendable income in the three years after claiming. The study also found that, after claiming, most individuals received substantial income from both Social Security benefits and retirement income (from employer-sponsored retirement plans, annuities, or IRAs). See Peter Brady, Steven Bass, Jessica Holland, and Kevin Pierce, "Using Panel Tax Data to Examine the Transition to Retirement," *SOI Working Paper* (April 2017), Washington, DC: Internal Revenue Service and Investment Company Institute; available at www.irs.gov/pub/irs-soi/17rptransitionretirement.pdf and https://www.ici.org/pdf/ppr_17_brady_tax_panel_data.pdf.

income quintile, 46 percent for the middle quintile, and 38 percent for the fourth income quintile. In addition to Social Security, a portion of pension (from DB and DC plans) and annuity distributions, which tend to rise in share as one moves up the income distribution, is annuitized. Eighteen percent of non-labor income is DB, DC, and annuity payments for the lowest income quintile, rising to 37 percent for the fourth income quintile.

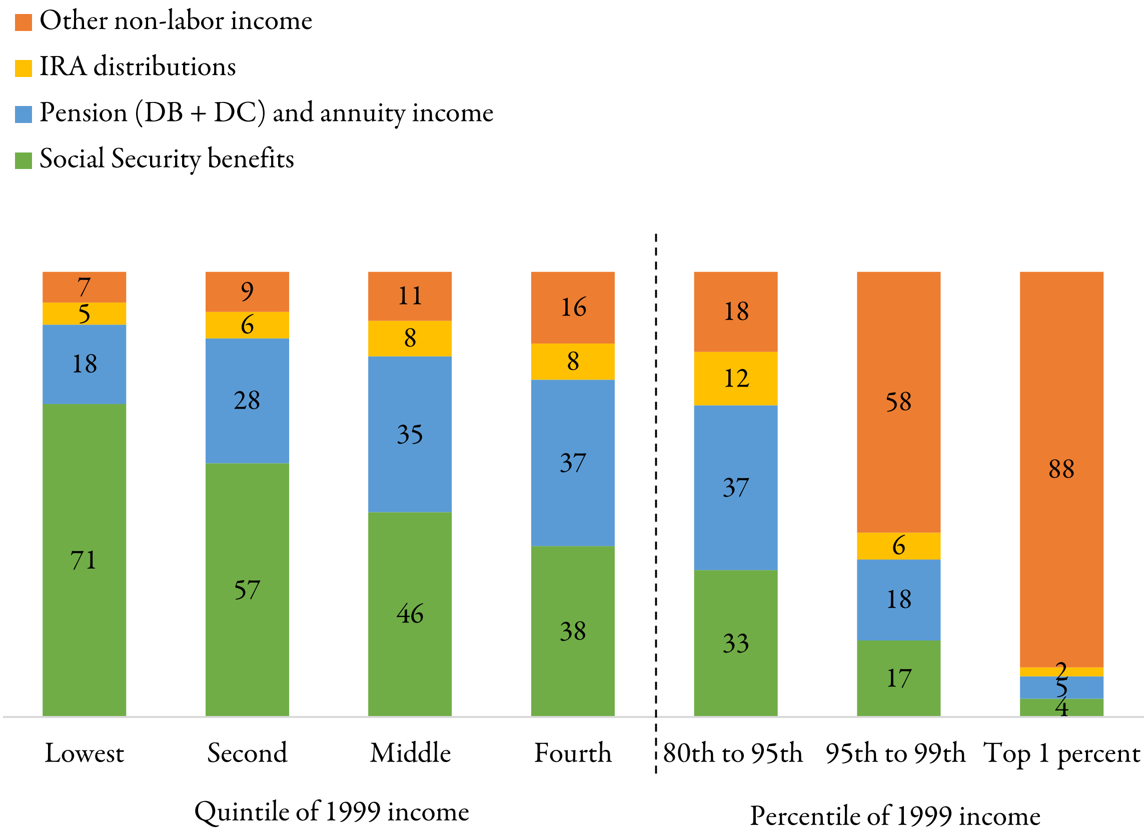
IRA distributions, which typically are used to provide a series of payments over time,[18] tend to edge up in share across the income distribution. Five percent of non-labor income in the third year after claiming Social Security is IRA distributions for the lowest income quintile, rising to 8 percent for the fourth income quintile (Figure 5).

Other non-labor income[19] represents a small share of non-labor income for most US retirees, with the exception of the top 5 percent of the income distribution.

[18] IRA distributions may be calculated based on life expectancy (whether using the required minimum distribution [RMD] rule or some other calculation), as a percentage of the account balance, as a fixed dollar amount, or as a lump sum. See Figure 10 later in this testimony for the actual distribution behavior of traditional IRA–owning households.

[19] Other non-labor income includes interest; dividends; gains or losses; business income (other than self-employment income); farm income (other than self-employment income); income from rental real estate, royalties, partnerships, S corporations, and trusts; alimony received; unemployment compensation; refunds, credits, or offsets of state and local income taxes; and other income.

Figure 5
Composition of Non-Labor Income Reflects Design of Social Security
Percentage of non-labor income in the third year after claiming Social Security



Note: Figure presents the composition of non-labor income in the third year after workers claimed Social Security. Components may not add to 100 percent because of rounding.
Source: Analysis of tax data; see Brady et al. 2017

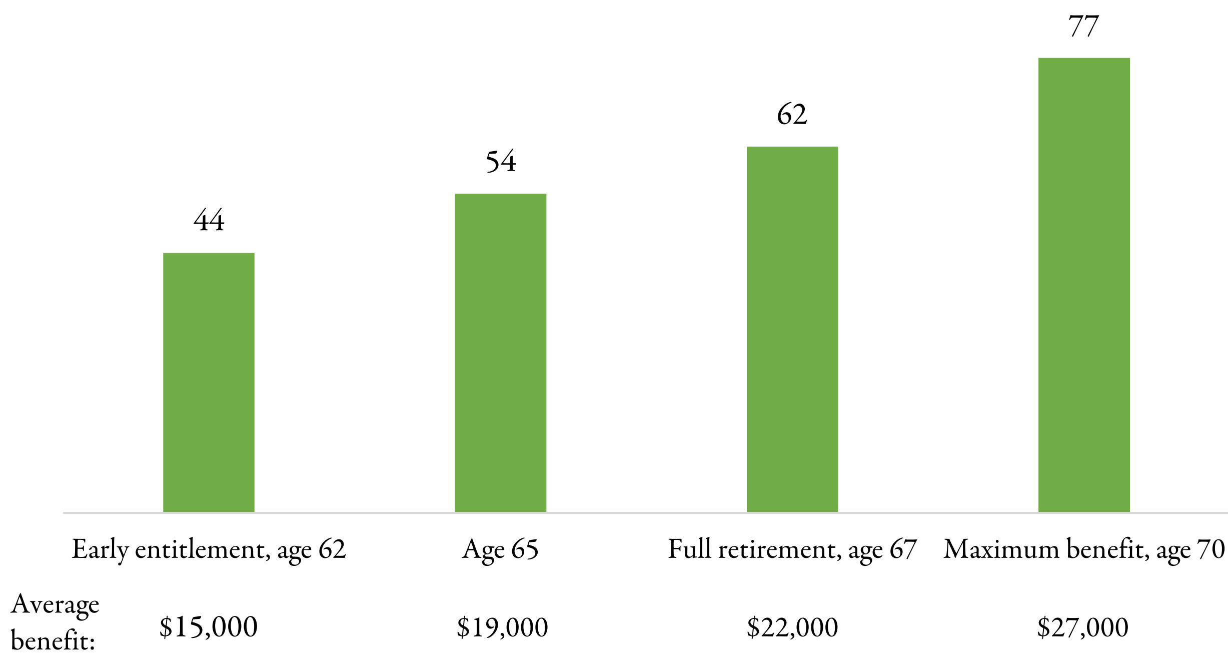
4. <u>Individuals entering retirement who need more annuity income should first consider delaying claiming Social Security before purchasing an annuity in the market</u>.

Individuals looking to increase annuity income in retirement have two options: they can purchase an annuity in the market or they can delay claiming Social Security benefits. Delayed claiming will provide more annuity income because, whereas the Social Security benefit increases for delayed claiming are designed to be actuarially fair for the average worker, market-priced annuities are not.

a. <u>Delaying claiming increases annual Social Security benefits</u>.

Although Social Security can be claimed as early as age 62, every month an individual delays claiming increases the monthly benefit (up to age 70). For example, for the middle quintile of lifetime household earnings for workers born in the 1960s, Social Security replacement rates are projected to be 44 percent, on average, for workers who claim at age 62 (Figure 6).[20] Every month claiming is delayed, up to age 70, benefits are increased. Claiming at the full benefit retirement age (age 67) increases the replacement rate to 62 percent and waiting until age 70 results in a 77 percent replacement rate. The average benefit amount nearly doubles from age 62 to age 70.

Figure 6
Delaying Social Security Dramatically Increases Benefits
Average scheduled Social Security replacement rates for workers born in the 1960s, middle lifetime household earnings quintile, percent



Note: CBO estimates replacement rates for workers who claim at age 65, calculated as scheduled Social Security benefits, net of income tax, as a percentage of a worker's average inflation-indexed lifetime earnings. ICI proportionately adjusts the CBO's average replacement rate at age 65 according to the Social Security rules to determine the replacement rates at the other ages.
Sources: Investment Company Institute and Congressional Budget Office, *CBO's 2017 Long-Term Projections for Social Security: Additional Information*

The adjustment in Social Security benefits by claiming age are designed to be actuarially fair. That is, the increase in monthly benefits is intended to compensate for the shorter number of months over which benefits are expected to be paid and keep the present value of lifetime benefit payments unchanged.

[20]See discussion in note 14, supra.

b. Market-priced annuities are not actuarially fair.

Annuities sold in the market are not actuarially fair—that is, typical estimates are that, for every dollar invested, expected lifetime payments are worth about 80 to 85 cents in present value.[21] Insurance company fees account for only a portion of the difference in value. Even if insurance companies charged no fees, market-priced annuities would not be actuarially fair because of asymmetric information and adverse selection. That is, individuals have a better estimate of their life expectancy than insurers and, as a result, individuals who voluntarily purchase an annuity typically live longer than average.

c. Delayed Social Security claiming maximizes annuity income.

As explained in Brady (2009), delayed Social Security claiming dominates the purchasing of a private-sector annuity:

> Because annuities bought in the private market are not actuarially fair for the average individual, the cheapest way to increase annuity income in retirement is to delay claiming Social Security benefits. Social Security benefits can be claimed as early as age 62, but, if initial receipt of benefits is delayed, benefits are increased using actuarially fair adjustments until the individual attains age 70. If a portion of retirement assets are earmarked for the purchase of an annuity in the private marketplace, it would be better to use those assets to fund retirement consumption and delay claiming Social Security benefits until the assets were exhausted or age 70, whichever comes first.[22]

In fact, Shoven and Slavov (2014) find that the returns to delaying Social Security claiming are better than actuarially fair because of changes to policy, mortality, and real interest rates since the claiming age adjustments were designed.[23]

Several recent studies have highlighted that delaying Social Security claiming dominates purchasing market-priced annuities:

- Bronshtein, Scott, Shoven, and Slavov (2016) finds that "most primary earners who either purchase a retail-priced annuity or opt for a defined benefit annuity when a lump sum is

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[21] For example, see Mitchell et al. (1999), note 3, supra.

[22] See pages 30 to 31 in Peter J. Brady, "Can 401(k) Plans Provide Adequate Retirement Resources?" *PRC Working Paper* WP2009-01 (January 2009); available at http://pensionresearchcouncil.wharton.upenn.edu/wp-content/uploads/2015/09/Brady-WP-Tweaked-01.12.09.pdf.

[23] See John Shoven and Sita Nataraj Slavov, "Recent Changes in the Gains from Delaying Social Security," *Journal of Financial Planning* 27, no. 3 (2014): pp. 32–41; available as a working paper at http://www.nber.org/papers/w19370.

offered, while forgoing the opportunity to delay Social Security" would have been better off using the resources to delay claiming.[24]

- Rundle (2018) concludes that: "results for the scenarios analyzed generally support delaying Social Security as a preferred method to annuitize assets over the direct purchase of a deferred annuity, particularly under the married scenario."[25]
- Vernon (2017) recommends that those who stop work before age 70 "use a portion of savings to enable delaying Social Security benefits as long as possible but no later than age 70."[26]

Policymakers considering rule changes to promote annuitization within DC plans must be mindful of the impact of such changes on the resources available to households to delay Social Security claiming. If the goal is to increase annuitized income, policymakers should be promoting delayed Social Security claiming, not the purchase of market-priced annuities.

5. <u>In addition to regular income, most households want access to resources in times of unexpected need, and required minimum distributions (RMDs) are a responsible way to produce a lifetime income stream while still maintaining access to the account balance</u>.

    a. <u>Households want access to resources in case of unexpected needs</u>.

Financial security in retirement requires not only regular monthly income, but also resources to tap in times of unexpected need. From time to time, households may need to replace an appliance, fix a car, or pay for an unexpected hospital bill. In those cases, it may be better to have liquid savings than to go into debt and pay it off monthly.

Retirees place value on having access to a "liquid" asset balance that is available for emergencies and other large expenditures that might arise. When traditional IRA–owning households were asked to consider how they expected to use future traditional IRA withdrawals in retirement, 65 percent indicated they planned to use some of their traditional IRA withdrawals for an emergency, 34 percent indicated healthcare expenses, and 25 percent indicated home purchase, remodeling, or repairs.[27]

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[24] See Gila Bronshtein, Jason Scott, John B. Shoven, and Sita N. Slavov, "Leaving Big Money on the Table: Arbitrage Opportunities in Delaying Social Security," *NBER Working Paper,* no. 22853 (November 2016); available at http://www.nber.org/papers/w22853.pdf.

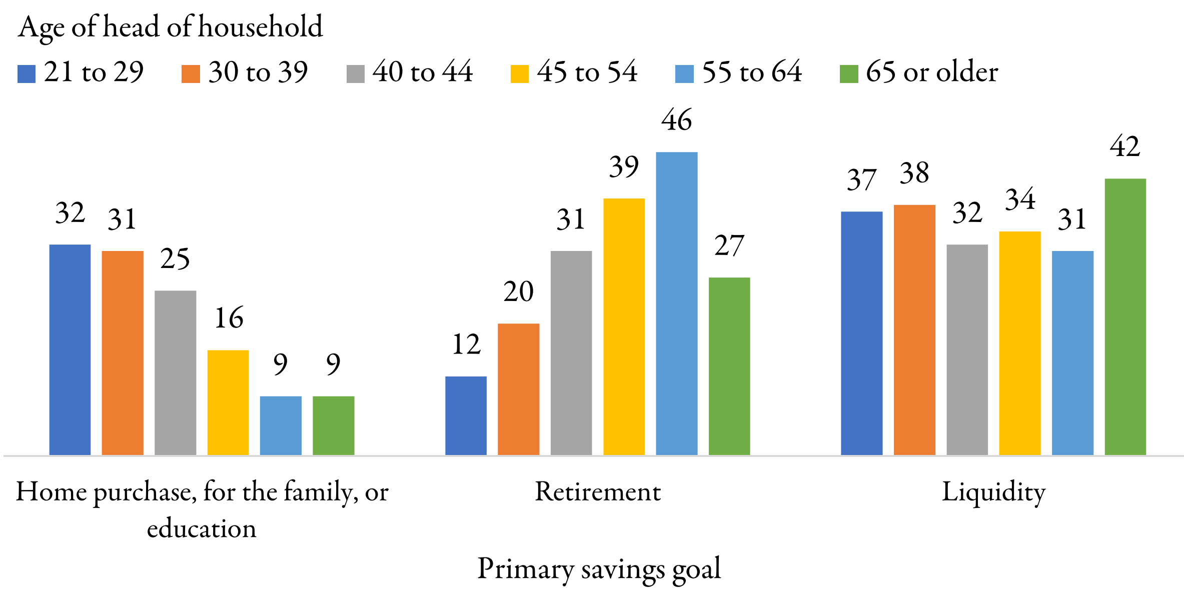
[25] See Jonathan Rundle, "A Social Security 'Annuity Purchase': Is Delaying Social Security More Effective than Purchasing a Deferred Income Annuity?" *The Journal of Retirement* 6, no. 1 (Summer 2018): pp. 8–21.

[26] See Steve Vernon, *How to "Pensionize" Any IRA or 401(k) Plan*, Stanford Center on Longevity (November 2017); available at http://longevity.stanford.edu/wp-content/uploads/2017/11/How-to-pensionize-any-IRA-401k-final.pdf.

[27] Multiple responses are included, and 62 percent indicated they would take future traditional IRA withdrawals in retirement to pay for living expenses. The base of respondents includes the 23 percent of traditional IRA–owning households in mid-2015 that were retired but did not take withdrawals (that were asked about their future plans), the 6 percent of nonretired traditional IRA–owning households in mid-2015 that took withdrawals, and the 55 percent of

Annuitization is difficult to reverse, and therefore reduces the liquidity available to the retiree. In fact, some of the observed "behavioral bias against annuitization" is simply prudent risk management on the part of real-world retirees, who have a greater awareness of the uncertainty of their own future spending needs. Household survey data indicate that more than four in 10 older households (aged 65 or older) indicate their primary savings goal is for liquidity (Figure 7). Households without such reserves to handle emergencies face the possibility of high-cost debt to cover a significant large expenditure that arises. Additionally, households may want the flexibility to spend more earlier in retirement while they still have the physical capability to enjoy the money.

Figure 7
Older Households Often Indicate Need for Precautionary Saving
Percentage of US households by age, 2016



Source: Investment Company Institute tabulations of the 2016 Federal Reserve Board Survey of Consumer Finances

b. <u>RMDs provide a reasonable distribution plan while preserving access to liquidity</u>.

DC plan participants have a range of income options, whether inside or outside of the plan, to manage income and assets in retirement. In addition to life annuities, these options include installment

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nonretired traditional IRA–owning households in mid-2015 that did not take withdrawals. See Figure 32 in Sarah Holden and Daniel Schrass, "The Role of IRAs in US Households' Saving for Retirement, 2015*," ICI Research Perspective* 22, no. 1 (February 2016); available at https://www.ici.org/pdf/per22-01.pdf.

payments and systematic withdrawal plans, life expectancy withdrawals, longevity insurance, and managed payout products.

Research finds that withdrawals based on remaining life expectancy work well. For example, Dus, Maurer, and Mitchell (2005), comparing life annuities versus phased withdrawal plans, conclude:

> As a standalone strategy, the 1/[expected life expectancy] phased withdrawal rule is appealing since it offers a relatively low expected shortfall risk, good expected payouts for the retiree during his life, and some bequest potential for his heirs.[28]

This is particularly true for married couples, who can pool mortality risk by making their spouse the beneficiary of their retirement account. This pooling provides benefits that compare favorably to market-priced annuities.[29]

After an extensive review, the US Government Accountability Office (GAO) concludes RMDs can work so well that they should perhaps be a default distribution option: "RMD-based default income can stretch out the account balances of these participants throughout retirement if sponsors and participants understand how they can be administered and used."[30]

In addition, Vernon (2017) does not recommend that retirees purchase annuities. Instead, workers are encouraged to delay claiming Social Security as long as possible (up to age 70), invest their remaining savings, and "use the RMD to calculate retirement income."[31]

6. <u>Most retirement savers steward their accumulations to and through retirement</u>.

Some proponents of annuities also appear to be concerned that annuities need to be promoted to prevent people from spending down their balances too quickly. Again, research finds that US retirees generally manage their income and assets responsibly in retirement.

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[28] See Ivica Dus, Raimond Maurer, and Olivia S. Mitchell, "Betting on Death and Capital Markets in Retirement: A Shortfall Risk Analysis of Life Annuities versus Phased Withdrawal Plans," *Financial Services Review* 14, no. 3 (Fall 2005): pp. 169–196; available as a working paper at http://www.nber.org/papers/w11271.

[29] See Kotlikoff and Spivak (1981); Brown and Poterba (2000); Dushi and Webb (2004); and Brady (2012), note 6, supra.

[30] See page 54 in US Government Accountability Office, "401(k) Plans: DOL Could Take Steps to Improve Retirement Income Options for Plan Participants," *Report to Congressional Requesters*, GAO-16-433 (August 2016); available at https://www.gao.gov/assets/680/678924.pdf.

[31] See page 8 in Vernon (2017), note 26, supra.

a. Majority of terminating DC plan participants preserve assets.

Research finds that, by and large, people act responsibly with their DC plan account balances over their careers and at retirement.[32] For example, Utkus and Young (2018), analyzing Vanguard recordkeeping data for plan year 2017, conclude that more than two-thirds of DC plan participants across all age groups with termination dates in 2017 preserved their retirement assets,[33] with about half leaving their account balances in the plan and about one-fifth rolling their account balances into IRAs (Figure 8).[34] Although 30 percent of terminating participants in 2017 took cash lump sums, these tended to be individuals with small accounts. As a result, 95 percent of assets of terminating participants were preserved for retirement.[35] If the analysis considers all terminated participants with access to plan savings (including participants who terminated before 2017), 84 percent of terminated participants preserve assets and 98 percent of assets are preserved.[36]

[32] For household survey data on DC plan distribution choices at retirement, see John Sabelhaus, Michael Bogdan, and Sarah Holden, *Defined Contribution Plan Distribution Choices at Retirement: A survey of Employees Retiring Between 2002 and 2007,* Washington, DC: Investment Company Institute (2008); available at https://www.ici.org/pdf/rpt_08_dcdd.pdf. The survey finds that few retirees cash out their balances, most select reinvesting a lump-sum distribution in a traditional IRA; installment payments; annuities; leaving the balance in their employer's plan; or a combination thereof.

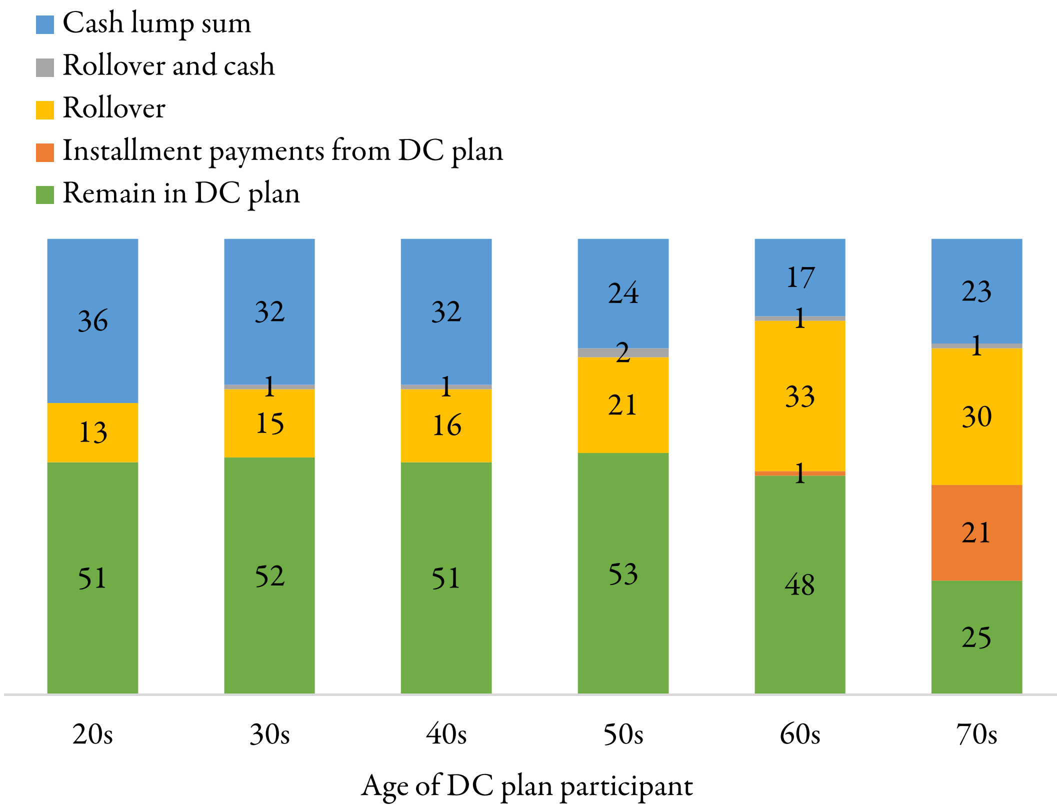
[33] Overall, 69 percent of DC plan participants terminating in 2017 preserved their assets. See Figure 113 in Stephen P. Utkus, and Jean A. Young, *How America Saves 2018: Vanguard 2017 defined contribution plan data*, Valley Forge, PA: The Vanguard Group (June 2018); available at https://pressroom.vanguard.com/nonindexed/HAS18_062018.pdf.

[34] Although just under half of terminating participants in their seventies remained in the plan, in contrast to younger terminating participants, 21 percent set up installment payments from their DC account balances, likely reflecting RMDs.

[35] See Figure 113 in Utkus and Young (2018), note 33, supra. Despite the fact that 9 percent of DC plans covering 14 percent of participants offer an annuity distribution option, and 12 percent of DC plans covering 1 percent of participants have a grandfathered annuity option in Vanguard's recordkeeping system (see Figure 110 in Vanguard's report), the number of participants (and share of assets) engaging that option is negligible and is therefore, not included in Figure 113 in Vanguard's report (or Figure 116 in Vanguard's report, note 36, infra).

[36] See Figure 116 in Utkus and Young (2018), note 33, supra.

Figure 8
Majority of DC Plan Participants Preserve the Assets When They Leave Employment
Percentage of participants with termination dates in 2017 by participant age

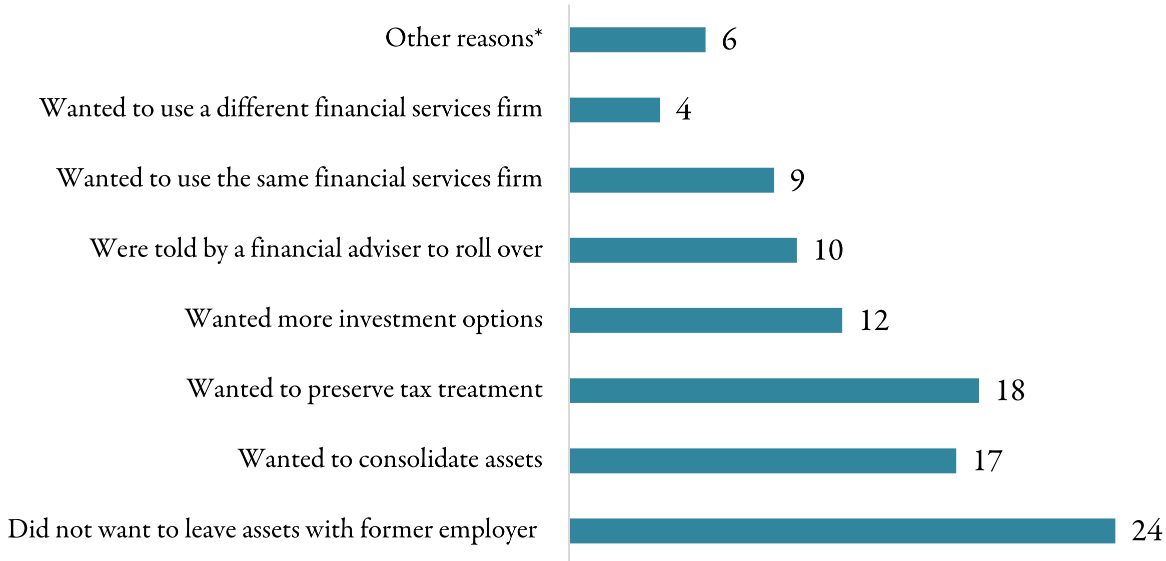


Note: Participants' use of the annuity option is negligible and is not plotted.
Source: Vanguard, *How America Saves, 2018: Vanguard 2017 Defined Contribution Plan Data*; see Utkus and Young (2018)

Research shows that participants who choose to roll over account balances into IRAs have researched the decision and have reasons for doing so.[37] In mid-2017, 41 percent of traditional IRA–owning households with rollovers indicated their primary reason for rolling over was essentially to keep track of and consolidate the money (Figure 9). Others primarily were seeking more investment options (12 percent), to use the same financial services firm (9 percent), to use a different financial services firm (4 percent), or to follow the advice of a financial adviser (10 percent).

[37] See Sarah Holden and Daniel Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2017," *ICI Research Perspective* 23, no. 10 (December 2017); available at https://www.ici.org/pdf/per23-10.pdf. Figure 13 in the report presents the sources of information participants consulted when making the rollover decision.

Figure 9
Traditional IRA Rollovers Often Are Used to Consolidate Assets
Primary reason for most recent rollover; percentage of traditional IRA–owning households with rollovers, mid-2017



* Other reasons include thinking it was easier to roll over to an IRA than to a new employer's plan (4 percent) and wanting the same investments as in the former employer's plan (2 percent).
Source: Investment Company Institute IRA Owners Survey; see Holden and Schrass (2017)

b. IRA investors spend down their balances responsibly.

Research finds that traditional IRA investors are responsible stewards of those assets to and through retirement.[38] Few IRA-owning households withdraw money from their IRAs in any given year, and most withdrawals are retirement related. Twenty-six percent of households owning traditional IRAs in mid-2017 reported taking withdrawals from these IRAs in tax year 2016.[39] Among households taking

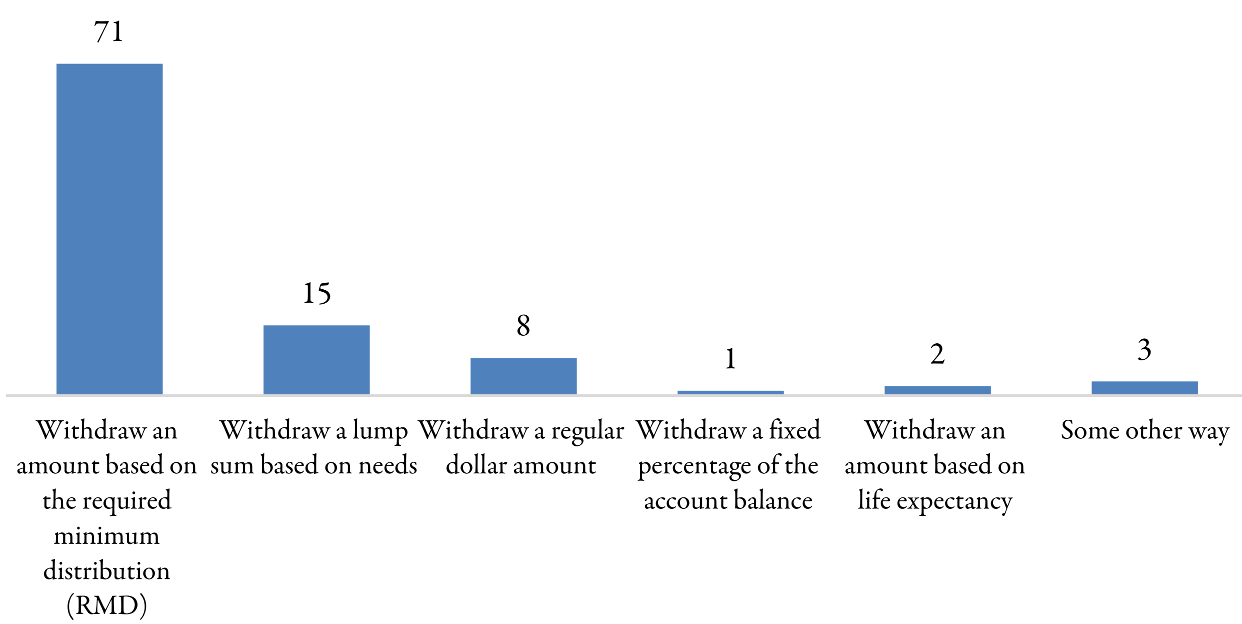
[38] As households roll over and otherwise open IRAs, they do so at a range of financial services providers. In mid-2017, 77 percent of traditional IRA–owning households held their traditional IRAs through investment professionals and 30 percent went directly to mutual fund companies or discount brokerages. Multiple responses are included. Investment professionals include full-service brokerages (31 percent of traditional IRA–owning households in mid-2017), independent financial planning firms (24 percent), bank or savings institutions (27 percent), and insurance companies (8 percent). Direct sources include mutual fund companies (20 percent of traditional IRA–owning households in mid-2017) and discount brokerages (13 percent). See Figure 19 in Holden and Schrass (2017), note 37, supra.

[39] See Figure 21 in Holden and Schrass (2017), note 37, supra.

traditional IRA withdrawals in tax year 2016, 81 percent reported that someone in the household was retired from their lifetime occupation.[40]

A common strategy to tap retirement assets is through withdrawals based on remaining life expectancy, specifically often required minimum distributions (RMDs). Among traditional IRA–owning households in mid-2017 who took withdrawals from their traditional IRAs in 2016, 71 percent calculated the withdrawal amount to meet the RMD (Figure 10). Another 11 percent had systematic withdrawals in place, with either a regular dollar amount (8 percent), an amount based on life expectancy (2 percent), or a fixed percentage of the account balance (1 percent) determining the amount. Another 15 percent of withdrawing traditional IRA–owning households had taken a lump sum based on needs, which highlights the flexibility of maintaining an IRA balance.

Figure 10
RMDs Are the Dominant Withdrawal Amount
Percentage of traditional IRA–owning households in mid-2017 with withdrawals in tax year 2016



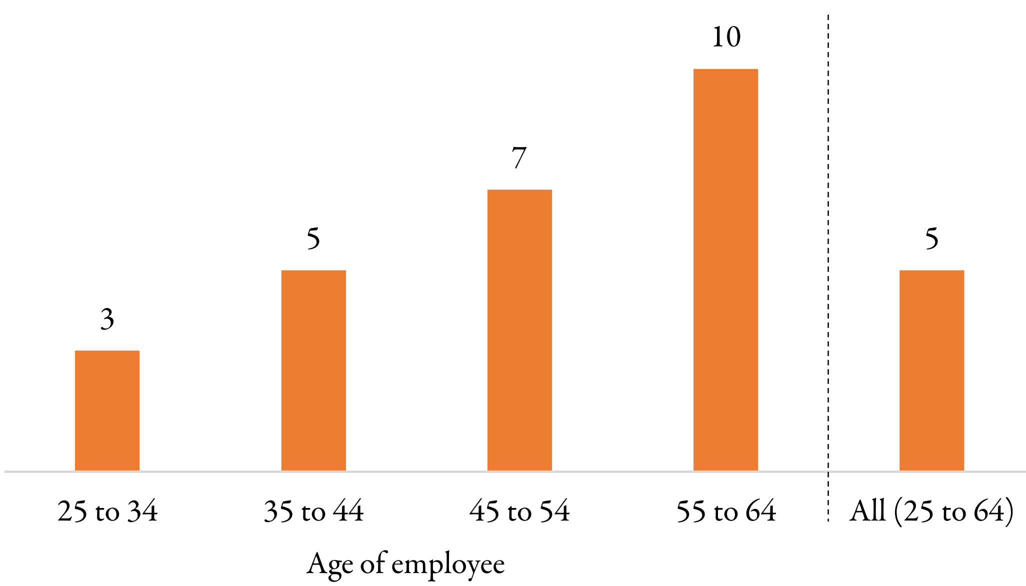
Source: Investment Company Institute IRA Owners Survey; see Holden and Schrass (2017)

[40] Id. In addition, IRS Statistics of Income Division data on IRA investors find that the majority of distributions are taken by older IRA-owning taxpayers (see IRS Statistics of Income, "SOI Tax Stats - Accumulation and Distribution of Individual Retirement Arrangements (IRA);" available at https://www.irs.gov/statistics/soi-tax-stats-accumulation-and-distribution-of-individual-retirement-arrangements). And, ICI analysis of recordkept data on IRAs in The IRA Investor Database™ finds that distributions are concentrated among older IRA investors, and in the case of traditional IRAs, often calculated to fulfill RMDs (see the *ICI Research Report* series available at https://www.ici.org/research/investors/database).

c. Worker mobility makes annuitization within DC plans problematic.

Promoting deferred annuity purchase early in a worker's career is problematic because American workers are a mobile workforce, which means that over the course of a career one individual could have several retirement plan accounts or accumulations. It also means that during their careers, they likely will be changing jobs at some time. The median tenure among private-sector workers aged 25 to 34 is 3 years (Figure 11). Median tenure only rises a bit among private-sector workers aged 35 to 44, to 5 years, and to 7 years among private-sector workers aged 45 to 54. As a result of this workforce tenure pattern, in-plan products that do not provide liquidity and flexibility may pose challenges for workers as they move through their careers.[41]

Figure 11
The American Workforce Is Mobile
Median length of employment at current employer among private-sector wage and salary workers, in years, by age group, 2016



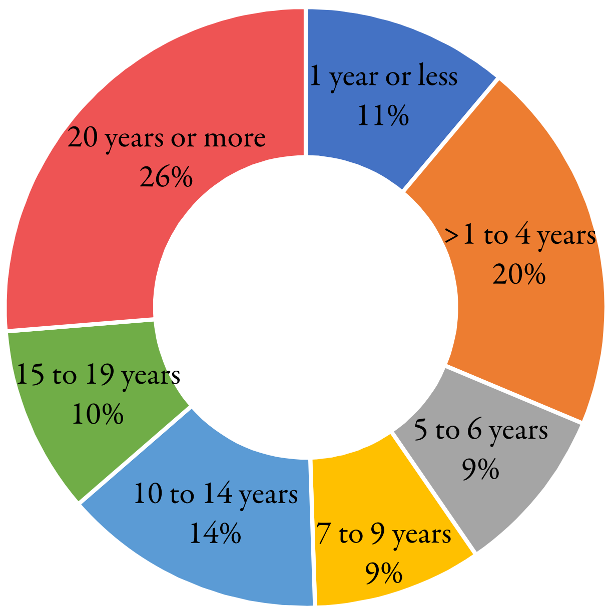
Source: ICI tabulations of Current Population Survey

In fact, it is unclear that any given DC plan in a person's career is where an annuitization decision should be made, particularly given that the reason many roll over assets into IRAs is to track and consolidate the assets. Current Population Survey data indicate that even among private-sector workers

[41] See Craig M. Gross and Jonathan R. Kahler, "Perspective on annuities for accumulation in defined contribution plans," *Vanguard Commentary* (May 2017); available at https://institutional.vanguard.com/iam/pdf/ISGAMA.pdf?cbdForceDomain=true.

aged 55 to 64, there is a wide range of tenures. Nearly one-third of private-sector workers aged 55 to 64 have been at their current employers for 4 years or less, and nearly three-quarters have less than 20 years of tenure (Figure 12).

Figure 12
Few Near-Retiree Workers Have Been at Their Employers for Full Careers
Percentage of private-sector workers aged 55 to 64 by length of employment at current employer, 2016



Median tenure: 10 years

Note: Components do not add to 100 percent because of rounding.
Source: ICI tabulations of Current Population Survey

d. Americans value flexibility and choice with regard to annuitization at retirement.

With regard to the specific idea of annuitizing a portion of DC plan balances, ICI included questions in our fall 2017 household survey to gauge US households' views on annuitization in DC plans. Surveying consumer preferences regarding annuitization is difficult because the subject matter is complicated[42] and may not be salient at the current time for many households. In addition, academic research has

[42] See Suzanne B. Shu, Robert Zeithammer, and John W. Payne, "Consumer Preferences for Annuity Attributes: Beyond Net Present Value," *Journal of Marketing Research* 53 (April 2016): pp. 240–262; available at www.anderson.ucla.edu/faculty/robert.zeithammer/ConsumerPreferencesforAnnuityAttributes.pdf.

shown that word choice in surveys on annuities has a dramatic impact on the perceived desirability of the annuity option.[43]

With these difficulties in mind, ICI asked three questions regarding the control of retirement account balances in a survey of US households. In the first question, respondents were asked to react to a simple statement: "Retirees should be able to make their own decisions about how to manage their own retirement assets and income." Ninety-two percent of respondents either "strongly agreed" or "somewhat agreed" with that statement.[44] Agreement was slightly higher for households with retirement accounts (93 percent) than for households without retirement accounts (89 percent). In addition, agreement with the statement was generally higher for older households.[45]

The second and third questions about control of retirement accounts were focused on sentiment regarding more-specific annuitization policy options. The second statement read: "The government should require retirees to trade a portion of their retirement plan accounts for a fair contract that promises to pay them income for life from an insurance company." The third statement replaced "from an insurance company" with "from the government." The distinction between insurance company and government as annuity provider had only a small effect on household sentiment, so the results for the second and third retirement account disposition questions were very similar.

Overall, more than 80 percent of respondents either "somewhat disagreed" or "strongly disagreed" with the proposed change in control of account disposition (Figure 13). The overall disapproval rate occurred even though the question was worded to eliminate bias toward disagreement; the proposal indicated that the retiree trade only "a portion" of their assets under a "fair" contract giving them "income for life." At 85 percent, the disapproval rates for the proposed annuitization requirements are slightly higher for those owning DC accounts or IRAs. Disapproval also tends to increase with both age and household income.[46]

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[43] See Jeffrey R. Brown, Jeffrey R. Kling, Sendhil Mullainathan, and Marian V. Wrobel, "Why Don't People Insure Late-Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle," *American Economic Review* 98, no. 2 (2008): pp. 304–309; and John Beshears, James J. Choi, David Laibson, Brigitte C. Madrian, and Stephen P. Zeldes, "What Makes Annuitization More Appealing?" *NBER Working Paper*, no. 18575 (November 2012); available at www.nber.org/papers/w18575.

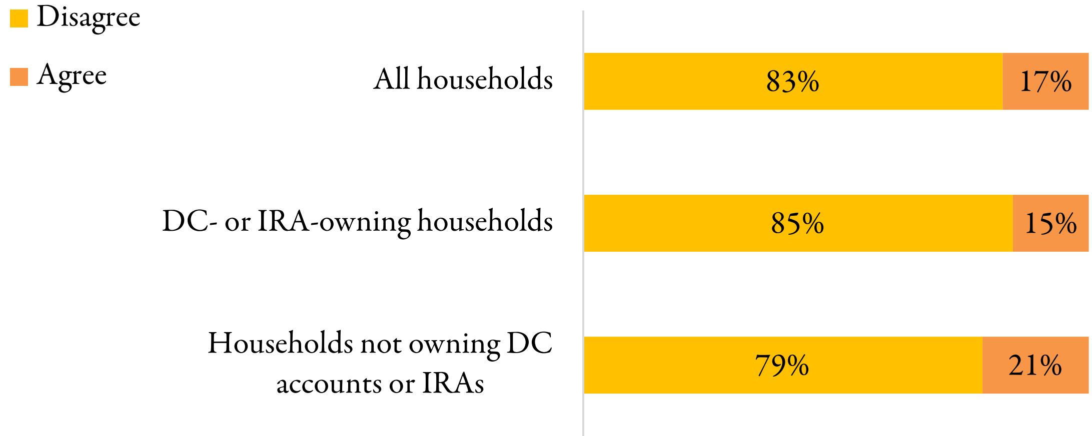
[44] See Figure 5 in Sarah Holden, Daniel Schrass, Jason Seligman, and Michael Bogdan, "American Views on Defined Contribution Plan Saving, 2017," *ICI Research Report* (February 2018); available at www.ici.org/pdf/ppr_18_dc_plan_saving.pdf.

[45] Id.

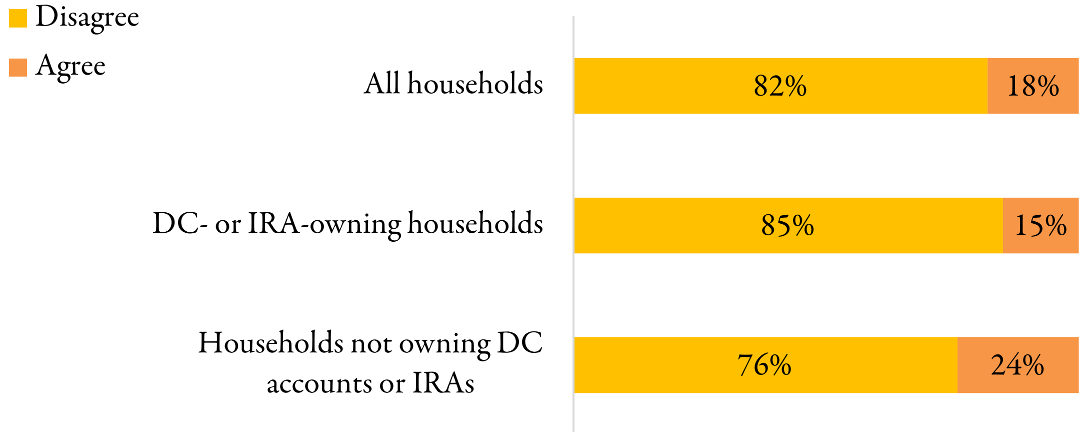
[46] Id. See Figures 6 and 7 in the report.

Figure 13
Large Majorities of Americans Want to Keep Retirement Income Flexibility
Percentage of US households disagreeing or agreeing by ownership status, fall 2017

The government should require retirees to trade a portion of their retirement plan accounts for a fair contract that promises to pay income for life from an insurance company.



The government should require retirees to trade a portion of their retirement plan accounts for a fair contract that promises to pay income for life from the government.



Source: ICI tabulation of GfK KnowledgePanel® OmniWeb survey data (fall 2017); see "American Views on Defined Contribution Plan Saving, 2017," *ICI Research Report* (February 2018)

7. Households having difficulty in retirement typically had difficulty while working, and promoting annuitization will not solve the problem of limited lifetime resources.

Part of the goal of promoting annuities in DC plans appears to be motivated by a concern that retirees will spend down balances too quickly or irresponsibly. Several researchers have found that retiree households tend to maintain their wealth in retirement.[47] Recent research finds that retired households who have low end-of-life wealth typically entered retirement with low wealth. Annuitization will not solve the problem of low lifetime resources. Poterba, Venti, and Wise (2018) studies the evolution of household wealth through retirement to the end of life and concludes:

> Low levels of wealth accumulation before age 65, rather than gaps in the safety net after 65 or rapid spend-down of accumulated assets, appear to be the primary determinant of low levels of wealth just before death.[48]

*   *   *

Because the factors affecting the decisions on how to manage income and assets in retirement vary across households, there is not one best method for managing the decumulation phase for all participants. Given this heterogeneity in solutions and the already important role that Social Security plays in providing a real annuity for life, the Council should not recommend tilting the playing field to promote annuitization inside DC plans. Beyond the concern that market-priced annuities are not actuarially fair—that is, typical estimates are that, for every dollar invested, expected lifetime payments are worth about 80 to 85 cents in present value—the compounding impact of fees for the option of annuitization over the course of a career when annuitization may not be demanded in the final analysis does not serve DC plan participants well. Decisions on managing assets in retirement are highly individualized and may involve a combination of several different products or strategies and possibly multiple accounts. Such decisions usually are better saved for when the participant is closer to retirement, and able to consider all of the household's resources.

II. Proposals Intended to Promote More Annuitization in Defined Contribution Plans Would Not Serve the Interests of Participants and Beneficiaries.

The testimony above makes clear that the underlying premise on which the Council is working—that American workers should receive more of their retirement income in the form of an annuity—is not

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[47] For example, see David Love, Michael Palumbo, and Paul Smith, "The Trajectory of Wealth in Retirement," *Journal of Public Economics* 93, issue 1–2 (February 2009): pp. 191–208.

[48] See James M. Poterba, Steven F. Venti, and David A. Wise, "Longitudinal Determinants of End-of-Life Wealth Inequality," *NBER Working Paper,* no. 23839 (September 2017, Revised May 2018); available at http://www.nber.org/papers/w23839.

only incorrect, but should not be used to justify preferences designed to encourage more annuitization in defined contribution (DC) plans. In this part of the testimony, we examine two ideas that have been heavily promoted by proponents of increased annuitization in DC plans and explain why implementing the ideas would not serve the interests of plan participants and beneficiaries. These ideas are—

- A proposal to modify the QDIA safe harbor to permit limits on rights of transferability that currently require participants to be able to move out of the default investment at least once in any 90-day period, and
- A proposal to require benefit statements to include a lifetime income illustration based on an annuity calculation.

A. <u>The Council should not recommend changes to the QDIA safe harbor to permit restrictions on a participant's ability to move out of a QDIA beyond what is currently allowed</u>.

As the Council is aware, in 2006, the Pension Protection Act (PPA) directed the Department to prescribe regulations implementing a new fiduciary safe harbor under section 404(c) of ERISA for the investment of assets in an individual account plan in the absence of an investment election by the participant or beneficiary. Previously, there was no express fiduciary relief for the investment of participant accounts absent specific direction from the participant. This rather dramatic law change was in response to concerns that employers typically used investment products such as fixed-income funds, which invest in illiquid assets and tend to underperform the market, as default vehicles in their plans to avoid liability for losses in these accounts. For employees defaulted into such a product early or mid-way in their careers, who tend to stay invested in the default investment, this often had a significant negative impact on their ability to accumulate adequate retirement savings. Inherent in this new safe harbor was a view that plan sponsors and fiduciaries should have comfort in selecting a default investment strategy that would be a comprehensive, diversified vehicle appropriate for long term savings, while preserving the ability of defaulted participants and beneficiaries to make their own affirmative investment elections.[49] In adopting what became known as the "Qualified Default Investment Alternative" or "QDIA" rule, the Department estimated that by facilitating the adoption of automatic enrollment plans and encouraging investments appropriate for long-term retirement savings,

[49] 72 Fed. Reg. 60452, 60463 (October 24, 2007) ("It is the view of the Department that investments made on behalf of defaulted participants ought to and often will be long-term investments and that investment of defaulted participants' contributions and earnings in money market and stable value funds will not over the long-term produce rates of return as favorable as those generated by products, portfolios and services included as qualified default investment alternatives, thereby decreasing the likelihood that participants invested in capital preservation products will have adequate retirement savings.")

the QDIA rule will increase aggregate account balances by between $70 billion and $134 billion by 2034.[50]

The QDIA rule includes several conditions designed to protect participants and beneficiaries whose assets are invested by default, in the absence of an affirmative direction. These include an initial (and subsequent annual) notice requirement with instructions on how to direct investment out of the plan's default investment; a requirement that participants and beneficiaries have the opportunity to direct investments out of a QDIA as frequently as a participant or beneficiary who affirmatively elects to invest in the QDIA, *but not less frequently than once in any three month period*; and a strict limitation on transfer restrictions, fees, and expenses during the 90-day period after the participant's first investment in the QDIA.

It has been suggested that the Council recommend changes to the QDIA regulation to loosen the condition relating to the ability of participants to direct investments out of the QDIA at least quarterly, but only with respect to certain products (i.e., annuity products). Specifically, the suggestion is to permit "reasonable liquidity and transferability conditions consistent with income guarantees."[51]

Promoting guidance that serves to lock a participant into an annuity to which he or she was defaulted (a) is unnecessary in light of existing DOL guidance clarifying that annuities can be used as investments within a QDIA, (b) is inconsistent with the policy goals behind the QDIA safe harbor and the general ERISA section 404(c) safe harbor relieving fiduciaries from liability for the investment decisions made by individual participants and beneficiaries, and (c) could be harmful to those who are locked into such products.

1. <u>The QDIA rules are not product-specific and DOL already has clarified that annuities and other products with guarantee features may be used within the QDIA framework</u>.

The QDIA rules were written in a product-neutral manner to accommodate a broad range of diversified investment products and strategies. For example, while target date mutual funds generally fit within one of the specified categories of QDIAs, the safe harbor would also accommodate non-mutual fund products,[52] asset allocation portfolios composed of investment options available through the plan,

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[50] 72 Fed. Reg. 60466.

[51] See written statement of Michael Hadley for the June 19, 2018 hearing of the ERISA Advisory Council, available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2018-lifetime-income-solutions-as-a-qdia-hadley-written-statement-06-19.pdf; see also written statement of Mark Foley for the June 19, 2018 hearing of the ERISA Advisory Council, available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2018-lifetime-income-solutions-as-a-qdia-foley-written-statement-06-19.pdf.

[52] Section 404c-5(e)(3) makes clear that other products, in addition to "[a]n investment company registered under the Investment Company Act of 1940," will qualify for QDIA treatment (e.g., an investment managed by an investment manager, a trustee, or a plan sponsor who is a named fiduciary).

or managed account products. The conditions of the safe harbor apply equally regardless of which type of product or investment strategy is selected as a plan's QDIA. The proponents of modifications to these requirements, however, want special treatment for a particular product type (i.e., annuities), despite the potential for significant adverse consequences to affected participants as described below.

There is no restriction in the QDIA regulation specifically intended to exclude annuity or other insurance products.[53] The Department has already provided guidance clarifying that annuity products and other investment products with guarantee features may be incorporated into QDIAs,[54] and guidance explaining that annuities and other guaranteed products can be used within a target date fund QDIA as a component of the fund's fixed income investment,[55] as long as the vehicle meets all of the applicable safe harbor conditions.

Most recently, a 2016 Information Letter issued by the Department[56] provides helpful clarity for product sponsors seeking to include annuity products in default investments. The Information Letter states that target date funds that include annuity contracts can be QDIAs, so long as the plan meets all QDIA requirements (such as providing proper notice to the participant or beneficiary, participants having the right to direct investments out of the QDIA, and the fund meeting certain investment risk and return characteristics and fee restrictions). The letter also clarifies that it is possible to prudently select a default investment that does not qualify for the fiduciary safe harbor, for example because the investment incorporates annuity features with transferability restrictions.[57] As such, the guidance provides a good deal of comfort for the use of annuities in target date funds.

It is important, however, that the fiduciary safe harbor for QDIAs remains limited to investments with sufficient rights of transferability so that participants can move out of the default investment if they so

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[53] In fact, section 404c-5(e)(4)(vi) provides that "[a]n investment fund product or model portfolio that otherwise meets the requirements of this section shall not fail to constitute a product or portfolio for purposes of paragraph (e)(4)(i) or (ii) of this section solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment fund product or model portfolio."

[54] See Information Letter to J. Mark Iwry, Senior Advisor to the Secretary and Deputy Assistant Secretary for Retirement and Health Policy, Treasury Department, dated October 23, 2014, available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/information-letters/10-23-2014.

[55] See Information Letter to Christopher Spence, Senior Director, Federal Government Relations, TIAA, dated December 22, 2016, available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/information-letters/12-22-2016.

[56] Id.

[57] Id. The target date fund under consideration in the 2016 Information Letter allowed participants to transfer or withdraw from the annuity portion of the fund (i.e., the "Annuity Sleeve") without restriction for 12 months after the initial investment and, thereafter, any funds invested in the Annuity Sleeve would be available for transfer to another investment option only in installments over an 84-month (or seven year) period.

desire. In the 2016 Information Letter, the Department struck a careful balance between making annuities available within QDIAs, while at the same time ensuring that plan participants who are defaulted into a QDIA will not be locked into that investment with no or limited opportunity to transfer to another plan investment option and no recourse against the plan for its default investment designation. Simply put, the idea that participants defaulted into an investment would be unable to move out of that investment for years[58] after making an affirmative decision to do so turns ERISA section 404(c) on its head and makes a mockery of the "participant directed plan" concept.

2. Further relaxing the QDIA safe harbor's requirement that participants be able to move out of a QDIA is particularly problematic for defaults into annuities.

Consideration of whether to modify the QDIA safe harbor should not be done in the abstract. Rather, such consideration should be made with a full understanding of the underlying products to which participants will be defaulted. Other than a suggestion to permit "reasonable liquidity and transferability conditions consistent with income guarantees," however, there is little detail on the types of products that would qualify or what limits on transferability would be employed.[59] While presumably a deferred annuity, not an immediate annuity,[60] would be used for this purpose, witnesses have not suggested any limit on the requested preferential treatment of annuities to those only of a specific type.[61] A reference to all products with "income guarantees" leaves a wide variety of annuity products that may be contemplated. The vast disparity in annuity types and available features, their inherent complexity, and their opaque pricing make it particularly difficult for participants to make apples-to-apples comparisons of such products and to determine reasonableness of fees. Even the insurance industry acknowledges the difficulty of determining financial soundness of annuity providers. These factors make the QDIA safe harbor's liquidity and transferability requirements critical if such products are to be available as safe harbor default investments.

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[58] Id.

[59] The target date fund under consideration in the 2016 Information Letter described above would have—after an initial 12-month period—allowed transfers out of the annuity pool to other investment options available through the plan only in installments over an 84-month (or seven year) period. See note 64, infra, describing the target date fund for which guidance was sought.

[60] See text accompanying notes 64 and 65, infra, describing the annuity arrangements that have been considered by the Department for inclusion in a default investment product.

[61] A deferred annuity is an annuity contract with a delayed annuity commencement date, in which the insurer's payments to the owner are delayed to the future. Under an immediate annuity, payments commence soon after purchase. An immediate annuity is usually purchased with a lump-sum and guaranteed income starts almost immediately and generally is irrevocable once payments begin.

a. The QDIA safe harbor's liquidity/transferability requirements are necessary safeguards if annuity products are to be available as QDIAs.

While we are aware of no limitations on annuity type having been discussed in connection with the request for relief from the QDIA safe harbor liquidity requirements, various annuity products appear to be contemplated. One witness at the Council's June 19, 2018 hearing, for example, referred to the use of guaranteed lifetime withdrawal benefits (GLWB) and guaranteed minimum withdrawal benefits (GMWB) and similar features as part of a target date fund or balanced fund.[62] Another witness referred to its solution that incorporates a guaranteed fixed annuity into a target date fund framework.[63] This target date fund product was also the subject of the Department's 2016 Information Letter mentioned above.[64] In a prior 2014 Information Letter, the Department opined on a QDIA designed to begin including unallocated deferred annuity contracts[65] in a participant's investment when the participant in the fund attains age 55.

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[62] See written statement of Marc Pester for the June 19, 2018 hearing of the ERISA Advisory Council, available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2018-lifetime-income-solutions-as-a-qdia-pester-written-statement-06-19.pdf.

[63] See written statement of Mark Foley for the June 19, 2018 hearing of the ERISA Advisory Council, available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2018-lifetime-income-solutions-as-a-qdia-foley-written-statement-06-19.pdf.

[64] The product is described as a custom target-date investment model that would allocate a portion of a participant's investment (up to 50 percent) to a fixed guaranteed annuity. "[U]nlike traditional TDFs, the ILCP [Income for Life Custom Portfolio] allocates investment funds to a fixed guaranteed annuity (Annuity Sleeve). The Annuity Sleeve provides a guaranteed return element to the portfolio and the option of guaranteed lifetime income as a benefit distribution alternative. The ILCP glide path increases the allocation to fixed-income funds as a participant ages, along with gradual increases to the Annuity Sleeve over time (e.g., 7% at age 45 and 40% at age 65). The percentage allocation to the Annuity Sleeve is capped at 50 percent." "The Annuity Sleeve in the [Income for Life Custom Portfolio] is subject to certain liquidity restrictions. Specifically, the ILCP will allow participants to transfer or withdraw from the Annuity Sleeve without restriction for 12 months after the initial investment. After this 12-month period, any funds invested in the Annuity Sleeve of the ILCP would be available for transfer to another investment option only in installments over an 84-month period. All other funds in the ILCP would be liquid and transferable."

[65] The guidance includes the following description: "An 'unallocated deferred annuity contract' is a contract with a licensed insurance company that promises to pay income to covered plan participants at some date in the future (possibly far into the future) on a regular basis for a period of time or for life. The annuity is written on behalf of a group of participants and not issued to and owned by a specific individual. As such, unallocated deferred annuity contracts do not ordinarily require the insurance company to have or maintain any personal information on individuals in the group. Rather, units of the unallocated annuity generally are largely interchangeable among members of the covered group, which facilitates transferability and allocation within the group, for example at the dissolution date of each Fund." "At its target date, each Fund dissolves, and participants with an interest in the Fund will receive an annuity certificate providing for immediate or deferred commencement of annuity payments. The certificate represents the participant's interest in the unallocated deferred annuity contracts held by the Fund. For instance, if a Fund's asset mix contains a fifty percent investment in unallocated deferred annuity contracts, then half of each participant's individual account balance will be reflected in the certificate. The remaining portion of each such participant's interest in the Fund will be reinvested by the participant or plan fiduciary in other Plan investment alternatives in accordance with title I of [ERISA]." DOL Information Letter issued to J. Mark Iwry on October 23, 2014. IRS Notice 2014-66 addresses tax treatment of the same product. While the Notice clearly

Deferred annuities come in a broad variety of product types. At the most basic level, they can be fixed (amounts accumulate at a fixed rate of interest), fixed-indexed (returns on contributions based on a specified equity-based index, such as the S&P 500),[66] or variable (returns are based on the performance of selected investment options).[67] Within these categories, products can have an endless variety of benefits and features,[68] carrying varying restrictions, charges, and potential penalties. While on one level flexibility and choice are desirable, as insurers have added more options to products, the products have increased in complexity. It is widely acknowledged that challenges exist in understanding how the products work.[69]

Given the wide array and varying complexity of annuities, such investments are not appropriate for the special treatment sought that would, in effect, lock participants into an investment for years, when those participants have not made any affirmative selection. Rather, the nature of these products requires a greater analysis by the participant.[70] But beyond the intricacies of the particular annuity product, there are other critical questions that must be evaluated as part of a decision to annuitize. These include, among other things:

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responds to a specific product, Treasury did not disclose the name of the product or which insurance company planned to offer it.

[66] FINRA issued an investor alert to caution investors regarding the significant complexity of fixed-indexed annuities in http://www.finra.org/investors/alerts/equity-indexed-annuities_a-complex-choice. See also "Understanding the Complexities of Fixed Indexed Annuities," available at https://www.annuityfyi.com/blog/2014/10/understanding-the-complexities-of-fixed-indexed-annuities/ (accessed August 7, 2018).

[67] Noting the fact that variable annuities are complex products, SEC's Office of Investor Education and Advocacy issued an Investor Bulletin with information about variable annuities. https://www.sec.gov/files/ib_var_annuities.pdf (See also FINRA's Investor Alert, Investor Annuities, Beyond the Hard Sell. https://www.finra.org/sites/default/files/InvestorDocument/p125846.pdf)

[68] Such features can include stepped-up death benefits, guaranteed minimum income benefits, long-term health insurance, principal protection, inflation protection.

[69] "Even Math Teachers are at a Loss to Understand Annuities," New York Times, October 28, 2016, available at https://www.nytimes.com/2016/10/29/your-money/403b-teachers-annuities.html.

[70] Experts point to a number of questions that must be addressed in connection with the consideration of an annuity purchase, including, among other things, the amount of monthly income likely to be provided based on the sum invested, what the annuity guarantees, the fees and expenses charged, the death benefits provided to a spouse or other beneficiary, the applicable penalties for canceling the annuity or withdrawing savings, and the meaning of highly opaque contractual terms (such as "spread," "margin," and "participation rate") that impact the investor's return under the annuity contract. See e.g., "How to Select and Shop for an Annuity," *Wall Street Journal*, available at http://guides.wsj.com/personal-finance/retirement/how-to-select-and-shop-for-an-annuity/; Jacobs, Deborah L., "the ABCs Of Annuities: 8 Questions To Ask Before You Buy," *Forbes* (February 15, 2012); and "Tips for Consumers: Six Important Questions to Ask When Purchasing an Annuity," Insured Retirement Institute, available at http://irionline.org/docs/default-source/Research/finra-annuity-questions-2016.pdf?sfvrsn=0.

- Whether participants need annuitized income beyond that provided by Social Security or other forms of annuitized benefit streams, versus their future needs for liquidity.[71]
- The potential return of the annuity investment in its accumulation phase—net of fees, administrative and other sales charges—compared to the potential return of other investments available through the plan.
- The likelihood that the potential annuity payment (which may remain static throughout retirement) will be sufficient to meet expected retirement needs of a retirement that could last more than 30 years.
- The ability of the annuity provider to honor its annuity payment obligation at and after retirement, which could be decades into the future.

The answers to these questions are not only resistant to easy analysis, but their supposition can change over time and throughout a participant's work history. A participant might initially be comfortable with being defaulted into a deferred annuity only to determine a few years later that her calculus as to future needs and options has changed, or that the financial status of the annuity provider has changed. It is critical then that the Council protect the rights of a participant defaulted into the plan's QDIA to elect to transfer out of the QDIA into another investment offered through the employer's plan. Eliminating this right solely for certain investment products with inherent liquidity constraints, in order to promote use of those products, would be a perilous change of course. In our view, the decision to invest in a product with liquidity constraints should only be made with a full understanding of the limitations on transferability and any financial penalties that would apply.[72]

b. <u>The difficulty in determining the ability of a provider to pay future payments makes the QDIA safe harbor's liquidity/transferability requirements critical when annuities are used as default investments</u>.

Perhaps the most difficult determination that must be made when deciding to invest or remain invested in an annuity is the ability of an annuity provider to fulfill its obligation to pay future payments upon the conversion of the accumulated account balance and conversion of the deferred annuity contract to an immediate fixed annuity. This determination must be made not only at the beginning of the investment, but on an ongoing basis throughout the accumulation period of the contract—a period that can last decades. When considering whether an exception should be made to the QDIA regulation's liquidity requirements then, it is instructive to examine the stated rationale for encouraging

[71] See text accompanying notes 15 through 27, supra, describing the high level of annuitization and perceived liquidity needs of near-retiree US households.

[72] Participants who are placed in such an investment by default may have the ability to make penalty-free withdrawals within the first 90 days, but the serious consequences of an irreversible (or partially irreversible) investment decision are not diminished after that initial 90-day period. It is likely that a participant invested by default in a non-liquid QDIA may not come to fully comprehend the implications of that investment selection within the initial 90-day withdrawal period or even within the one-year mark.

the Department of Labor to make changes to other regulations that are intended to encourage greater annuitization. One such proposal, also the subject of the Council's consideration, is a proposal to modify the annuity selection safe harbor under 29 CFR 2550.404a-4.[73]

It should come as no surprise that proponents of modifications to the QDIA regulation also tend to support changes to the annuity selection safe harbor. Those supporting changes to the annuity selection safe harbor focus their criticism of the current regulation on the requirement that fiduciaries determine whether "an annuity provider is financially able to make all future payments under an annuity contract." One such proponent has explained that "[t]his standard is difficult to meet in part because it is hard to draw this conclusion."[74] Moreover, among the impediments cited by those encouraging more annuitization in defined contribution plans, is a lack of knowledge of annuities and difficulty in evaluating the costs and burdens associated with such products.[75]

The obvious irony here is that once participants are defaulted into an annuity product, the burdens associated with evaluating the investment fall squarely on them and not the plan fiduciary. It is hard to fathom how a participant is better able to evaluate the costs and burdens of the annuity investment than the plan fiduciary for whom the added relief under the annuity selection safe harbor is focused. And, the participants arguably have much more at stake than relief from fiduciary responsibility. After all, they will be the ones who suffer in retirement if the annuity provider is not able to make future payments under the annuity contract.

B. The Department should not prescribe a single method for providing lifetime income estimates.

Another potential idea for promoting greater annuitization in DC plans includes proposals, both legislative and regulatory,[76] to require plans to provide lifetime income illustrations based on the annuitized value of the participant's account balance, using certain assumptions to be determined by the Department. These proposals have encountered significant opposition due to their mandatory nature and narrowly-prescribed calculation method, which fails to reflect other well-received income stream calculation methods already in use today (and which may align more closely with real-world

[73] See note 51, supra, and 2018 ERISA Advisory Council Issue Statement, available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2018-lifetime-income-solutions-as-a-qdia.pdf.

[74] See page 26 of letter from Walter Welsh to Office of Regulations and Interpretations, Employee Benefits Security Administration, US Department of Labor (May 3, 2010), available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB33/00637.pdf.

[75] Id. at page 16 ("Employers tend to weigh the retirement security advantages of a particular design feature against the potential costs and burden considerations—pure and simple. Plan features that tend to be selected are those that present obvious advantages relative to cost. In the case of guaranteed lifetime income, many believe they do not have enough knowledge or experience to understand the costs or benefits.").

[76] See Lifetime Income Disclosure Act, S. 868 and H.R. 2055; Pension Benefit Statements, Advance Notice of Proposed Rulemaking, 78 Fed. Reg. 26727 (May 8, 2013).

distribution strategies employed by participants) and which would effectively inhibit the development of additional innovative illustration methods in the future. We describe further below the various disadvantages associated with mandated, annuity-based calculations and the advantages associated with other calculation methods voluntarily in use today.

For participants in DC plans, providing an illustration or estimate of the monthly income that could be expected from a participant's current or projected account balance would help participants understand whether their savings habits are on track for a secure retirement and remind them to think about their accumulated savings in terms of income needs. Many retirement plan providers already provide this type of illustration on participant benefit statements or provide access to calculators or other modeling tools that participants can actively engage with. The Department should not cut off these efforts and further innovation through a mandatory, inflexible rule for lifetime income illustrations. Instead, participants would be better served by the Department encouraging plans to voluntarily provide such illustrations through guidance making clear that, under certain parameters, illustrations are not fiduciary advice and the plan sponsor or other fiduciary cannot be held liable for actual outcomes that differ from the income estimates or projections.

1. <u>The Department should not mandate annuity-based lifetime income illustrations</u>.

In 2013 the Department previously proposed (in an Advance Notice of Proposed Rulemaking or "ANPRM") to require lifetime income illustrations based on the annuitized value of the participant's account balance.[77] No further formal action was taken on the ANPRM after the close of the extended public comment period. Under the draft proposal, a participant's account balance (and projected account balance) would be converted to an estimated income stream using a calculation intended to approximate an annuity payable from an insurance company, based on a single life and, for married participants, the joint lives of the participant and a spouse. The income stream conversion would include interest and mortality assumptions, subject to a general standard taking into account generally accepted actuarial principles. The Department indicated in the ANPRM that it was also considering providing a safe harbor set of assumptions that would be deemed reasonable: a rate of interest equal to the 10-year constant maturity Treasury securities rate and mortality as reflected in the mortality table under Internal Revenue Code section 417(e)(3)(B). For plans with an annuity distribution option offered by a licensed insurance company, the safe harbor interest and mortality assumptions would be replaced by those of the plan's annuity product.

While annuity-based illustrations may be a reasonable choice for some, this type of illustration should not be singled out and elevated to preferred status by any regulator. It is not clear that this single method is the best illustration to help people envision the monthly retirement income that can be generated from an account balance. We have several concerns with mandating an annuity calculation as

[77] 78 Fed. Reg. 26727 (May 8, 2013).

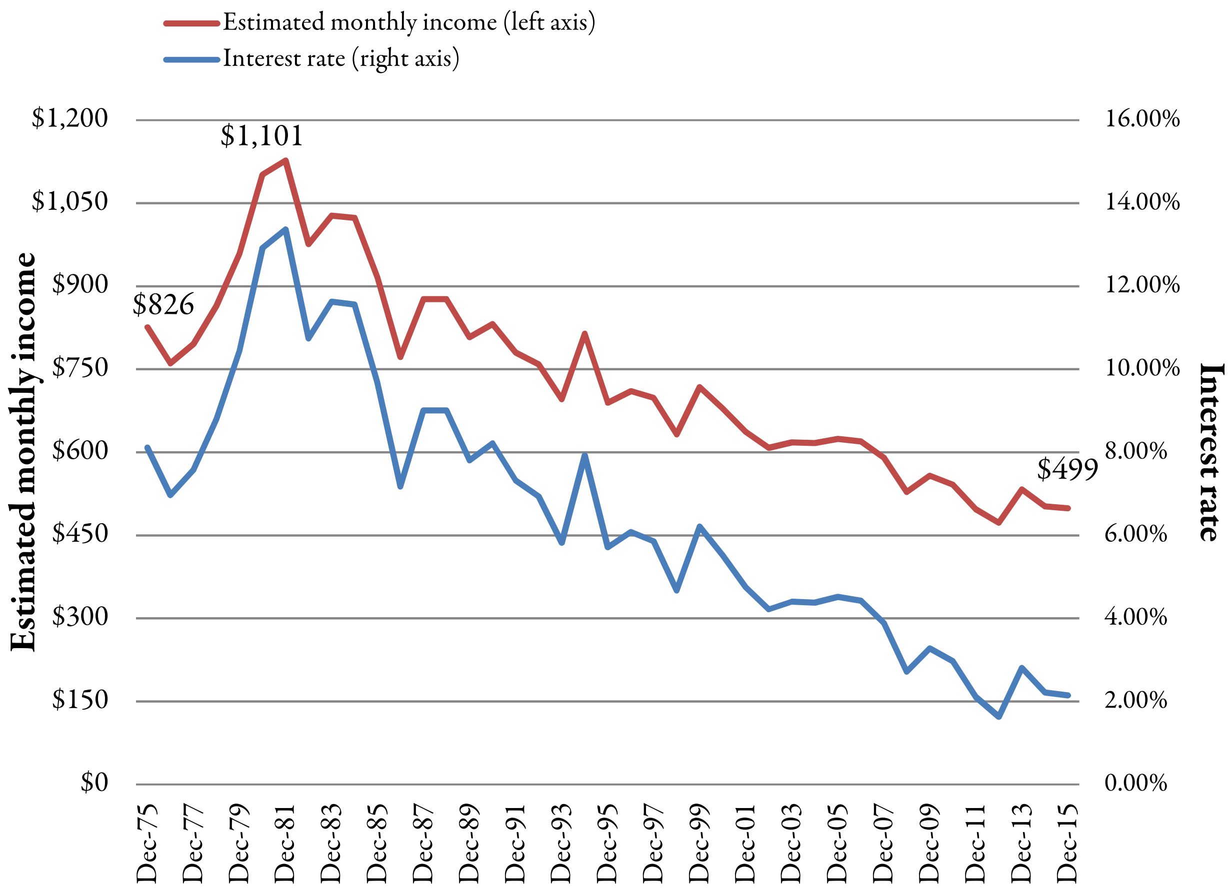
the sole method of conversion, as well as with certain of the safe harbor assumptions outlined in the prior DOL proposal. To the extent that the Department revisits its 2013 proposal, we urge the Department to allow flexibility to use alternative conversion methods, whether the illustration is voluntary (as we recommend) or mandatory. As explained below, estimations of lifetime income streams based on annuity calculations can fluctuate substantially over a participant's working life due to the necessary reliance of such calculations on prevailing interest rates. The Institute is also concerned that illustrating future retirement income based on annuity calculations is not consistent with currently prevalent distribution behavior by participants and will not convey information in the most useful or relevant way.

a. <u>Variability of annuity-based estimates could cause confusion</u>.

We question the usefulness of a lifetime income conversion methodology based on an annuity calculation, particularly for participants who are a significant number of years away from retirement. In this respect, because such calculations would be based on prevailing interest rates and not interest rates in effect when the participant actually retires, the income stream generated by the Department's previously proposed calculation methodology may have very little relationship to the actual lifetime income that a participant can expect to receive on or near to a projected retirement date. Furthermore, fluctuation in the 10-year constant maturity Treasury securities rate will result in fluctuating estimates regardless of changes in the account value, which could lead to confusion for participants. In Figure 14 below, we illustrate the effect of this interest rate fluctuation on payment stream illustrations for a hypothetical participant using historical 10-year Treasury rates.

Figure 14
Projected Balance Remains the Same but the Income Generated by the Proposed Annuity Changes

Single-life annuity starting at age 65 purchased with $100,000; calculation uses 2018 unisex mortality tables and 10-year US Treasury yields, year-end 1975–2015



Note: Interest rates are equal to the 10-year constant maturity Treasury securities rate for the first business day of the last month of the quarter.
Sources: Investment Company Institute tabulations, Federal Reserve Bank of St. Louis, and Internal Revenue Service

Figure 14 illustrates the monthly payment estimates for a hypothetical worker who entered the workforce at age 25 in 1975, with an account balance that grows according to the Department's projection assumptions[78] so that the projected balance at retirement ($100,000) remains constant over the time period covered.[79] The projected balance is converted to a single-life annuity with no survivor benefit using 10-year Treasury rates[80] and the applicable mortality table for 2018 under section 417(e)(3)(B) of the Internal Revenue Code.[81] A worker who reaches age 65 in 2015 and who entered the workforce at age 25 in 1975 would have experienced all the interest rates illustrated in the figure over the course of his or her career. With a projected balance of $100,000, the participant's 1975 year-end benefit statement would have shown expected monthly annuity payments of $826 at age 65. Only 5 years later at age 30, the participant's year-end statement from 1980 would have shown expected monthly annuity payments of $1,101 at age 65 with the same $100,000 projected account balance. As this participant retired in 2015 at age 65, however, his year-end statement would show expected monthly annuity payments of about $500 with the same projected balance of $100,000. As this example shows, the income stream derived from the Department's previously proposed annuity calculation methodology is highly variable and can produce wide swings in potential income from year to year. The preferred status that a safe harbor designation would provide this method may signal to plan sponsors and participants that this calculation is superior, but, at best this calculation can only give a general indication of income in the future and at worst can be misleading to participants.[82]

[78] The investment returns are 7 percent per year (nominal) with an inflation rate of 3 percent per year. Contributions continue to retirement at age 65 and the current annual contribution amount increases by 3 percent per year (at the rate of inflation).

[79] This ensures that the variability shown stems solely from the impact of prevailing interest rates and not from the assumptions used in projecting the hypothetical account balance.

[80] FRED, Federal Reserve Economic Data, Federal Reserve Bank of St. Louis: *10-Year Treasury Constant Maturity Rate (DGS10), Percent, Daily, Not Seasonally Adjusted*; Board of Governors of the Federal Reserve System; http://research.stlouisfed.org/fred2/graph/?id=DGS10; accessed July 30, 2018. Interest rates are for the first business day of the last month of the period to which a quarterly statement would relate.

[81] IRS Notice 2017-60.

[82] The payment stream amounts generated under the Department's ANPRM approach would also fail to realistically depict an annuity purchased at the time of the statement. In this respect, although intended to illustrate annuity payments that could be generated by purchasing an annuity at the time of the statement, the payments expressed would not accurately depict actual payments from an annuity product because the estimates lack an insurance load, and from the perspective of most annuity products purchased outside the plan, inaccuracy also results from the use of a unisex mortality table. The components of an insurance load, including profits and operating costs of the insurer, are important aspects in determining the monthly payments under an annuity product. Not including an insurance load will result in overstated payments. The use of a unisex mortality table is inconsistent with how most retail annuities are priced, and thus could result in either overstatement or understatement of the payments depending on whether the participant is female or male.

b. Flexibility to use other illustration methods is crucial.

Lifetime income estimates based on an annuity calculation have drawbacks compared to other calculation methods (such as systematic withdrawals,[83] life expectancy withdrawals,[84] or other forecasting methods yet to be developed) that may be more reflective of actual participant behavior and less likely to lead to confusion. In reality, DC plan participants have a range of income options, whether in or outside of the plan. In addition to life annuities, these options include installment payments and systematic withdrawal plans, life expectancy withdrawals, longevity insurance, and managed payout products.

Because the factors affecting the decisions on how to manage income and assets in retirement vary across households,[85] there is not one best method of illustration for all participants. Given this unknown variable, it is important to be guided by the goals of such an illustration—to help participants determine whether their retirement savings in the particular plan are on track for their own particular circumstances and to ensure that they appreciate that the savings must last a number of years. Moreover, the illustration should not attempt to provide guidance on how to draw down assets in retirement. Decisions on managing assets in retirement are highly individualized and may involve a combination of several different products or strategies and possibly multiple accounts. Such decisions usually are better saved for when the participant is closer to retirement.

In this respect, presenting estimated lifetime income on benefit statements is necessarily limited to what can be provided through a participant's current retirement plan. While such an illustration can be helpful to encourage the participant to focus on paycheck replacement and in recognizing that his or her retirement savings will need to last over a long period, employer-provided statements should not be thought of as a substitute for a comprehensive plan that would consider all sources of potential income (including other employer retirement plans, IRAs, and Social Security), taxes, costs and other issues beyond the scope of any given employer-provided benefit statement.

For these reasons, some providers and plan sponsors have concluded that providing participants with on-line tools and calculators is more beneficial than including on benefit statements income stream estimates based on a pre-determined set of assumptions. Such tools can permit participants to factor in assets outside of the employer-provided plan and other individualized circumstances to make the estimate more meaningful. They are available when the participant is ready to engage in retirement

[83] A systematic withdrawal approach, which some financial planners use when advising clients at retirement, would take a certain percentage, such as 3 percent or 4 percent, of the projected final account balance at retirement age. To determine monthly income in the first year of retirement, the amount would be divided by 12.

[84] A life expectancy approach would divide the projected account balance by the life expectancy stated on appropriate tables at a certain age, such as age 65 or 67, and then divide by 12.

[85] See text accompanying notes 10 through 19, supra, describing the variation in income and assets of US households in retirement.

planning information-gathering and may be more cost-effective than a mandatory one-size-fits-all approach.

That said, in any attempt to require lifetime income illustrations or to provide a safe harbor for such illustrations, it is crucial to allow flexibility to determine what type of conversion method would be appropriate for each plan. In many cases, illustrations of income based on systematic withdrawals could better serve DC plan participants than the Department's previously proposed annuity approach. Systematic withdrawal approaches for calculating lifetime income, based on modeling designed to achieve high probabilities of income replacement throughout retirement, can be used to illustrate future income streams that more realistically project potential income in a way that reflects likely participant behavior in retirement. This approach also has the advantage of being straightforward and easy to understand from a participant's perspective and, therefore, is likely to elicit favorable behaviors (*e.g.* better savings rates) as a result.[86] We do not suggest that this approach should be mandated in place of the annuity method, but given its merits, it should be included in any safe harbor established by the Department. As discussed earlier, any safe harbor should be both wide enough to encompass other methods of illustration and flexible enough to cover future innovation.

2. <u>The Department should use the existing framework of IB 96-1 to encourage lifetime income illustrations</u>.

Our testimony is not intended to downplay the importance of lifetime income for retirement savers in DC plans and IRAs. Rather, because there is more than one way to generate lifetime income and the optimal strategy will differ depending on individual circumstances, we believe that default or opt-out approaches are unsuitable for the distribution phase and could be harmful to retirement savers. Educating participants about distribution strategies and their trade-offs would more effectively promote consideration of lifetime income. For participants in DC plans, providing an illustration or estimate of the monthly income that could be expected from a participant's current or projected account balance would help participants understand whether their savings habits are on track for a secure retirement and remind them to think about their accumulated savings in terms of income needs. Many retirement plan providers already provide this type of illustration on participant benefit statements or provide access to calculators or other modeling tools that participants can actively engage with.

Instead of introducing a new mandate for plans, we recommend that the Department provide guidance to encourage greater use of income stream illustrations; and we are confident that more and more plans will begin to offer them. A significant step the Department could take in this regard would be to expand

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[86] See Jack VanDerhei and Nevin Adams, "A Little Help: The Impact of On-line Calculators and Financial Advisors on Setting Adequate Retirement-Savings Targets: Evidence from the 2013 Retirement Confidence Survey," *EBRI Notes* 34, no. 3 (March 2013), pp. 2–15, available at www.ebri.org/pdf/notespdf/EBRI_Notes_03_Mar-13_RCS-PlFrm1.pdf.

the guidance provided in Interpretive Bulletin (IB) 96-1 to clarify that this type of information qualifies as participant education and would not be considered investment advice within the meaning of ERISA section 3(21)(A)(ii). IB 96-1 has been highly successful in establishing clarity on how plans and their service providers can provide education and information to participants without crossing the line into investment advice. Since its publication, IB 96-1 has helped significantly increase the availability and use of participant education materials and tools.

The Institute previously wrote to the Department suggesting language for revising IB 96-1 to explicitly cover information on distribution options and retirement income, including income stream modeling or estimates.[87] This relatively easily implemented change would ensure the continued development and innovation of illustrations of lifetime income in a way that is protective of participants. Complementary to clarifying participant education guidance, the Department also could require any illustrations to be accompanied by a clear statement that the illustration is an estimate and that actual payments in retirement will differ, as well as require disclosure of the assumptions used in projecting the account balance and converting the account balance to an income stream. A simple, broadly-applicable set of guidelines like this would likely generate greater interest and comfort among plan sponsors in providing illustrations.[88]

For those participants whose plans do not provide income stream estimates, it is important to remember that there are a number of widely-available interactive calculators, including the Department's own calculator.[89] If the Department is intent on mandating that benefit statements include some information pertaining to income stream illustrations, a better approach would be to require a reference to the calculator posted on the Department's website, with a link or other instruction on how to access the calculator. This reference should include a link to the Department's other materials regarding retirement planning, so that participants focus not just on the account to which the statement relates, but also other retirement plans and resources.

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In conclusion, we strongly urge the Council not to support the suggested modification of the QDIA rules to permit liquidity and transferability conditions for guaranteed income products. Such a change

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[87] See Letter from Mary S. Podesta, Senior Counsel – Pension Regulation, Investment Company Institute to Robert Doyle, Director, Office of Regulations and Interpretations, EBSA, dated February 18, 2011, available at https://www.ici.org/pdf/24982.pdf.

[88] In addition to the approach we suggest, which centers around expanding Interpretive Bulletin 96-1, the Department may determine to propose a regulatory safe harbor to address liability concerns raised by some plan sponsors and other groups. If a regulatory safe harbor is adopted, we strongly urge the Department to ensure that it is broad enough to encompass a variety of illustration methods in addition to annuity-based illustrations, including future innovation in this area.

[89] See the Department's lifetime income calculator, available at https://www.askebsa.dol.gov/lia/home.

would be a disservice to DC plan participants and beneficiaries. Instead of promoting specific distribution products, the Council should consider recommending that the Department issue guidance to encourage plans to voluntarily provide lifetime income illustrations in a way that preserves flexibility for plans to determine the method of illustration and allows continued innovation of lifetime income illustration tools.

We thank the Council for allowing us to share our research and views on this important topic.