



AMERICAN ACADEMY *of* ACTUARIES

August 16, 2010

Ms. Stephanie L. Ward
Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC
202-693-8500
e-ORI@dol.gov

Re: Hearing on Certain Issues Relating to Lifetime Income Options for Participants and Beneficiaries in Retirement Plans

Dear Ms. Ward:

On behalf of the Pension Committee and Life Products Committee of the American Academy of Actuaries¹ we respectfully request the opportunity to testify at the September 14, 2010 public hearing on specific issues related to lifetime income options for participants and beneficiaries in retirement plans. The Committees previously submitted written comments in response to the joint Department of Labor and Department of the Treasury Request for Information (RFI) Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans on May 4, 2010.

We support efforts to facilitate access to and use of lifetime income options. In our previously submitted written comments, we emphasized the following themes, among others:

- The importance of addressing the longevity risks and other risks associated with an aging population that is increasingly dependent on individual account plans for retirement security.
- The risk management benefits of lifetime income options.
- The economic efficiency of lifetime income options.
- The importance of promoting education and financial literacy regarding retirement security issues.
- The benefits of incorporating the findings of behavioral finance into policy initiatives.
- The usefulness of encouraging multiple types of lifetime income options – including partial annuitization, refund guarantees, and deferrals to advanced ages – to fit the variety of individual circumstances.

We also supported, and continue to support, a requirement that some form of guaranteed lifetime income be one of the options offered in individual account plans, provided that such a requirement is accompanied by comprehensive, manageable regulations that permit plan sponsors, both large and small, to carry out such a requirement without exposure to excessive fiduciary risk.

¹ The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Our testimony would include more detail related to these themes, particularly as they relate to the specific issues outlined in your department's announcement of the hearings, and would not be limited to what was contained in our response to the RFI.

Attached to this letter as an Appendix is a brief outline of some of the concepts we would emphasize (with greater detail) in response to the specific issues listed in your announcement.

Should you have any questions about our request to testify, please contact Jessica Thomas, the Academy's Pension Policy Analyst, at 202-785-7868, or at Thomas@actuary.org.

Sincerely,

John H. Moore, FSA, MAAA
Chairperson, Pension Committee

Cande Olson, FSA, MAAA
Chairperson, Life Products Committee

Appendix – Outline of Some Ideas Organized Around Issues Raised in DOL Announcement

(Academy testimony would not be limited to these ideas. See attached RFI comments for a more detailed discussion.)

DOL Issue 1: Certain Specific Participant Concerns Affecting the Choice of Lifetime Income Relative to Other Options

(Specific concerns include: the long-term viability of the institution issuing the lifetime income product, inflation risk, the fees and complexity associated with some lifetime income products, and concerns about a lack of or limits on death benefits and withdrawal options.)

While addressing the participant concerns, it is also important for participants to understand the significant advantages of lifetime income relative to other options. These advantages include:

- Economic efficiency: It is significantly more cost effective for a person to insure longevity risk through risk pooling (whether through purchasing an annuity or other lifetime income guarantee or electing a lifetime income option in a pension plan) than to bear that risk alone (“self-insuring” it).
- Reduction of longevity risk: lifetime income security, since the participant will never run out of income.
- Avoidance of adopting an overly limited lifestyle from fear of outliving income.
- Reduction of investment management responsibilities when getting older.
- Less risk of unaffordable spending, since the amount of monthly income provides a budgeting signal that is absent with a lump sum

Concerns and questions about the long-term viability of the institution issuing the lifetime income product need to be addressed.

- Participants often lack knowledge about the extent of state insurance guarantees. Disclosure of such information would help.
- There is no federal equivalent of the FDIC for annuity products.

Regarding inflation risk, lifetime income products or options that offer protection against inflation are available, at a cost. Participants need to be aware of the options and their cost – as well as the cost or risks of not having lifetime income protection.

The fees and complexity associated with some lifetime income products are an impediment. Complex choices can impede decision making and lead to the seemingly simplest choice, the lump sum. Some standardization of products, if done carefully, could help. Also, especially in situations where an individual is making decisions outside of a sponsored plan, such as with a 401(k) rollover, individuals would benefit from some understanding of what is a fair price for an annuity, how to shop for one, and the degree of state or other government guarantee. It is, in fact, important for this discussion to reach beyond retirement plans, since individuals face the same longevity risks when they rely on rollover funds or personal savings.

Concerns about a lack of or limits on death benefits and withdrawal options can be addressed. Different types of lifetime income arrangements should be facilitated to provide such benefits or options, covered under Issue 5 below. Participants also need to understand the costs of including these benefits and options.

DOL Issue 2: Information to Help Participants Make Choices Regarding Management and Spend Down of Retirement Benefits

(The Agencies are interested in hearing testimony on whether participants in 401(k) and other defined contribution plans would be more likely to give due consideration to lifetime income stream options if they were furnished a benefit statement that, in addition to their account balance, sets forth their benefit in the form of a monthly lifetime benefit)

To help participants make choices regarding the management and spend down of retirement benefits, three things are critical:

- The provision of additional information to participants.
- Greater education in financial literacy, including longevity risk.
- The use of the findings of behavioral finance in designing programs and policies.

Standardized communication requirements and model disclosures and educational materials would provide uniform information, simplify administration, reduce fiduciary risk for plan sponsors, and enhance participant understanding.

Education should include general education upon enrollment, plus reinforcement at future dates (e.g., each plan year). Providing personalized quantified communication with each annual benefit statement is also important. (Further, financial literacy education should begin in secondary school.)

While education is critically important, it can only go so far, and policy changes also need to be formed with the lessons of behavioral finance in mind. Consumer decision-making is determined by both rational analysis and human psychology. Behavioral finance strategies must be considered in establishing policy in order to achieve greater use of lifetime income options. These strategies may include (a) reframing language and presentation and (b) restructuring choices and defaults.

Disclosing the account balance in the form of a monthly lifetime income can be very helpful, and is discussed further in the next section.

Related issues include:

- The question of how much guaranteed lifetime income is enough and what portion of savings to convert into lifetime income.
- The problem of inadequate savings.
- Specific approaches to reframing language and presentation and to restructuring choices and defaults.
- The specific information needed by participants to make informed decisions.

DOL Issue 3: Disclosure of Account Balances as Monthly Income Streams

(The Agencies are interested in hearing testimony on whether participants in 401(k) and other defined contribution plans would be more likely to give due consideration to lifetime income stream options if they were furnished a benefit statement that, in addition to their account balance, sets forth their benefit in the form of a monthly lifetime benefit.)

Translating account balances into income streams should be a dynamic part of the education process that is needed. Doing this as part of the individual benefit statement will refresh and reinforce the education annually. Giving the presentation of the lifetime benefit amount primacy over any presentation of lump

sum amounts would also be helpful. Individuals respond to perceived “signals” in making decisions, and presenting guaranteed lifetime income as the first option shown could be such a signal.

There are many more questions to answer regarding the methods, assumptions, and type of lifetime benefit equivalent to show. Whatever is provided should be enough to be informative and educational but not so much as to overload the participant with information, nor to overburden the plan sponsor with overly complex administrative requirements that could discourage plan sponsorship. Important concepts are currently funded (“accrued”) income at two or three target retirement ages (possibly the traditional age 65 or the Social Security eligibility age, as well as the value if retirement is delayed to a later age, such as the latest Social Security commencement age) and projected funded income if contributions continue at the current rate. If the plan includes an option for a partial annuity/lump sum combination, then the illustration should also address that, especially if the partial annuity can be deferred to an advanced age (such as 75 or 80). The income amounts (either monthly or annual) should include both single (perhaps with some guaranteed certain period) and joint-and-survivor annuities, since the status at retirement is unpredictable. Disclosures could include both the lifetime income equivalent of current account balances as well as the lifetime income equivalent of the current year’s contributions.

As for assumptions, there is no single right answer. It might be simplest and easiest for participants to understand if all plans’ statements were consistent with each other. This could include mandated mortality, interest, expense, and annuitization assumptions (either fixed by regulation and updated as necessary, or tied to certain market rates). Current plan-specified factors should be used if the annuity is to be paid from a companion defined benefit plan. Use of such mandated factors would narrow the plan sponsor’s responsibilities and lower its costs. The mandated factors could be readdressed periodically. Appropriate caveats should be stated. Assumptions could be in footnotes but should be disclosed.

One complicating factor is that the allocation of assets among different asset classes will vary from participant to participant. If the asset accumulation assumption were to vary from participant to participant based on an estimated return for each asset class, simplicity and comparability would be lost. Even more importantly, participants with more aggressive asset allocations would see amounts that failed to take into account the degree of risk assumed, and additional risk disclosure would be necessary. A better approach might be for the accumulation assumption to be the same for all participants and to mirror something like a high quality bond rate.

DOL Issue 4: Fiduciary Safe Harbor for Selection of Lifetime Income Issuer or Product
(Should different criteria apply to a fiduciary's decision depending on the size of the plan? Should different criteria apply depending on the type of lifetime income product? Are there standards that the Department of Labor could establish to provide comfort to plan fiduciaries regarding the solvency of the provider? Should the safe harbor be extended to other lifetime income options?)

Concerns about potential liability, counterparty risk, and complexity of products are all impediments to plan sponsors including lifetime income options in their plans. There is a wide range of options currently available and the products can have features that are difficult for lay people to understand. Selecting the best set of options, as well as the best provider, leaves the plan fiduciaries with significant liability for that choice.

Small plan sponsors may not have the expertise or funds to do a detailed analysis of products available. To the extent that their current investment provider has such an option available inside their investment product, there is not much impact. However, if they are expected to determine if this is the “best” product that can be offered and compare the costs of something inside an existing investment product to

other stand alone solutions, they may lack the ability to make that determination. They also may find it administratively burdensome to select and offer products that are outside the options available from a single investment platform being offered. Providing a vehicle through which small plans could access the group purchasing power that larger plans can obtain from annuity providers merely as a result of their relative size could encourage small employers to make such an option available to their participants. Additionally, small employers may not have dedicated HR or benefits personnel and will seek ease of administration in providing such a benefit within their plan.

DOL Issue 5: Alternative Designs of In-Plan and Distribution Lifetime Income Options

(The Agencies are interested in better understanding and further exploring those and other approaches to offering streams of lifetime income to plan participants, including approaches that are or will be available in the marketplace, and related financial, actuarial and legal issues.)

The American Academy of Actuaries supports a requirement that some form of guaranteed lifetime income be one of the investment or distribution options offered in individual account plans, provided that the requirement is accompanied by a clear set of regulations that will allow for their effective implementation at reasonable cost and without subjecting plan sponsors to undue fiduciary risk. Individual plan sponsors also should be permitted to make an annuity the default option, but at present, sponsors should not be required to make this the default option.

Having a variety of lifetime income options to suit varying circumstances is critical to achieving greater use. Participants need to understand the benefits and costs as well. Among the many variations are partial annuitization, refund guarantees, deferrals to advanced ages, incremental annuitization during the working years, “test-drive” annuities, and guaranteed lifetime withdrawal benefit structures for both annuities and mutual funds. To accommodate deferrals to advanced ages, modification of the required minimum distribution (RMD) rules would be helpful.

Another vehicle could be to provide lifetime income through a defined benefit plan, which can be more cost effective than doing so through defined contribution plans in the annuity market because of savings in administrative costs and the absence of profit margins, among other potential reasons. Employers could be encouraged to offer their retirees this feature of purchasing an annuity from the defined benefit plan at the point of retirement as a distribution option from the employer’s defined contribution plan. One potential stumbling block that would have to be addressed is the coverage by the PBGC of the annuities purchased from the defined benefit plan. It should also be recognized that any time a choice is allowed between a lump sum and an annuity, there is some amount of anti-selection cost.

Additional actuarial issues include longevity differences by gender, health status, and income.

- The longer expected lifetime of females vs. males means that the actuarial value of an immediate annuity for a 65-year-old female is roughly 7 percent greater than the corresponding value for a 65-year-old male. There is an incongruity in the fact that gender-neutral annuity rates are required within plans, while gender-distinct rates are used in the marketplace outside of plans. Within plans, the gender-neutral rates are relatively unfavorable to males. This creates an incentive for females to elect in-plan annuities at actuarially favorable rates and males to elect out-of-plan annuities at actuarially fair rates or to elect annuities less frequently because of the need to go outside the plan. The reason for being concerned about gender-neutral rates is that they could disproportionately lead males to fail to annuitize, jeopardizing their retirement security as well as that of their spouses.
- Standard annuities are poor investments for annuitants in poor health. Substandard annuities are offered by a few insurance companies. Although some allowance is made for significantly impaired

substandard annuities in statutory reserving, it may not be adequate to encourage the offering of a full range of substandard annuities.

- A group of white-collar employees will have longer life expectancies than blue-collar groups, and the cost of in-plan annuities may or may not vary accordingly. As above, the limited market in “substandard” annuities means that lump sum distributions provide only limited opportunities for the latter group to take advantage of what could be better annuity pricing for them.

Some of the different options and features discussed in this section, and their cost impact, are addressed further below:

- An inflation adjusted annuity has a higher cost for the same initial income (or provides less initial income for the same premium). The cost differential will vary with market expectations regarding inflation (which can be gauged by looking at the difference in yield rates between regular Treasury securities and inflation-adjusted Treasury securities, or TIPS). If markets expected future inflation to average about 3 percent annually, as has been the case during some recent market conditions, then inflation protection would result in about a 20 percent to 30 percent reduction in initial income to a 65-year-old male on a pure actuarial basis.
- An installment or cash refund feature guarantees that the total of all payouts will be no less than the premium. The cost varies by age, but it could reduce payouts by approximately 10 percent for single-life immediate income annuities and as little as 4 percent for 100 percent joint-and-survivor annuities.
- Guaranteed lifetime withdrawal benefit provisions in annuities provide guaranteed continuation of income after the account value has been depleted. This can sometimes reduce guaranteed income by as much as one-third when compared to an income annuity. This lower guaranteed income is due to (i) the cost of preserving access to account values (in contrast to the structured consumption of principal in an income annuity), (ii) the only partial pooling of longevity risk compared to the pooling that occurs in an income annuity, and (iii) providing a floor of protection in the form of an income stream when the account value is depleted by withdrawals and low returns.
- A mutual-fund-structured withdrawal program is not guaranteed, but it could provide an income for life depending on how the market performs, how much is withdrawn to cover income needs, and how long the retiree lives. The typical suggested withdrawal of 4 percent, annually-inflated, is only half of what might be available under an annuity (although it could be as much as three-quarters of initial income compared to a more expensive inflation-protected annuity) because the program is designed to primarily draw upon earnings rather than including a structured consumption of principal. This is the cost of retaining access to principal. Retaining this access to principal exposes the consumer to early significant drops in the market and a variable income throughout the retirement years.
- Deferred-start income annuities (DSIA) are one way to insure against living too long (e.g., by purchasing at age 65 a guaranteed income that will begin at age 85). In its purest form, this product provides no benefits other than the deferred income (i.e., if the annuitant dies before the income begins there are no benefits). The cost of a lifetime income that is purchased at age 65 and begins at age 85 is approximately 10 percent to 15 percent of the cost for an annuity with the same income amount beginning immediately. This purest form of “longevity insurance” is functionally the same as the life-contingent portion of a certain-and-life annuity. (This could be an ideal complement to a withdrawal-based income prior to the commencement of annuity income.) If a purchaser wishes to have a death benefit or some other withdrawal rights before the annuity income begins, these benefits make the DSIA more expensive because sharing of mortality gains is reduced or eliminated.
- In any situation where annuitization is by choice (as opposed to being the only option for all, as in many defined benefit plans), adverse selection will increase costs as the healthier people select annuities at a higher rate. We estimate that costs could increase on the order of 10 percent when

annuitization is by choice rather than mandatory. This is a consideration for any policy approach to achieving a higher prevalence of guaranteed lifetime income and to holding down costs.