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Submitted for the Record

U.S. Senate Special Committee on Aging Hearing on March 12, 2015
"Bridging the Gap: How Prepared are Americans for Retirement?"

Chairman Collins, Ranking Member McCaskill, and distinguished Members of the Committee:

I appreciate the opportunity to provide written testimony for your committee's hearing titled "Bridging the Gap: How Prepared are Americans for Retirement?" on behalf of the Pension Practice Council of the American Academy of Actuaries.[1]

While most people understand the need to save for retirement, many either are not able to accumulate sufficient funds during their working years or are not sure how to use their savings to generate monthly income through their retirement years of an unknown length. Each retiree's life span is unique and uncertain, which makes planning for lifetime income difficult, especially as Americans on average continue to live longer. In addition, the shift by employers over the past 30 years away from offering defined benefit (DB) retirement plans toward defined contribution (DC) plans such as 401(k)s has amplified the financial risks taken on by employees and retirees. The American worker must consider many more factors today in planning for secure, predictable income throughout his or her retirement.

Preparation for retirement and the subsequent managing of finances in retirement involve many steps: setting aside sufficient funds; prudently managing investments before retirement; thoughtfully selecting a retirement date; establishing and following a retirement budget; managing investments in retirement, including homeownership; and securing retirement income for a lifetime of an unknown duration. Policymakers and financial experts have generally focused attention on these issues, but the last one – assuring a lifetime income – needs additional examination.

[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and 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.

Lifetime-income risk, or the threat of running out of income due to living longer than initially planned, is not just a personal financial issue but a societal one as well. Public safety-net programs can be strained if expected to cover large numbers of individuals who have not addressed their lifetime-income risk. Without careful planning, retirees risk running out of income to cover the basic necessities and face becoming reliant on Social Security as their only source of retirement income and, in dire situations, having to rely on family or social safety-net programs. Public options may not be available or sustainable to support all those who find themselves coming up short. The goal of financial stability in retirement is paramount.

Social Security from its inception was intended to protect retirees against poverty in old age[2] and, to that end, has been successful. It was not meant to provide full-income replacement in retirement. By design, Social Security replaces a greater proportion of pre-retirement income for lower-wage earners who might have had less opportunity or ability to save on their own. This is illustrated below.

Annual Social Security Income at Age 66					
Final Income (wages)	**SS Average Income* (wages)**	**Primary Benefit**	**Spouse Benefit**	**Total Benefit**	**Percent of Final Income**
$25,000	$22,002	$12,874	$6,437	$19,311	77%
50,000	44,004	20,292	10,146	30,438	61%
100,000	88,008	29,000	14,500	43,500	44%
250,000	96,896	30,405	15,203	45,608	18%
500,000	96,896	30,405	15,203	45,608	9%

SSA Publication No. 05-10070-09

* *Recognized income for Social Security. Assumes the ratio of actual income to Social Security limit in all years is the same as in the final year.*

Lifetime-income risk is affected by one's personal choices and luck as well as broader considerations, such as the strength of the nation's economy and influence of financial structures (e.g., savings vehicles, market investments). Lifetime-income risk therefore reflects a confluence

[2] "We can never insure 100 percent of the population against 100 percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age." – President Franklin Roosevelt upon signing the Social Security Act in 1935.

of economic and financial events, and circumstances. Real estate values and stock market prices have gained significance as factors of lifetime-income risk during the recent financial crisis due to their volatility.

Lifetime-income risk can vary according to individual circumstances, and thus affects various segments of the population differently. Retirees able to accumulate sufficient assets to meet their lifetime-income needs under most circumstances can still face lifetime-income risk but have mitigated it. Retirees unable to accumulate significant assets are probably not in a position to implement any lifetime-income solution beyond a reliance on Social Security. The large segment of the population between these two extremes may need to take direct action to assure their lifetime income is sufficient to meet their basic financial needs in retirement.

The Long and Short of Longevity Risk

A significant concept underpinning lifetime income is "longevity risk," which has many dimensions and includes the increasing life expectancies of retirees and their spouses, and conceptions and misconceptions of life expectancy and its implications. Longevity risk also includes the risks of declining health, loss of ability to manage finances, and loss of independent living. A very important longevity risk is lifetime-income risk. Individuals who underestimate their likelihood of living into the older ages could deplete their assets well before the end of life.

Americans are living longer, and consequentially spending more time in retirement. When the Social Security Act was enacted in 1935, the life expectancy for someone who reached age 65 was 13 years for males and 15 years for females.[3] In time, people began to consider age 65, the time at which full Social Security benefits were available, to be the "normal" retirement age. Social Security's retirement age of 65 also became the typical, and sometimes mandated, retirement age in employer-sponsored pension plans.[4] As of 2014, the life expectancy based on Social Security tables at age 65 is 19.3 years for males and 21.6 years for females. People are living longer due to improvements in health care, nutrition, and lifestyle choices. This increase in longevity over time can add significant costs for retiree benefits.

The probability of living a long life, which might even be longer than one's life expectancy, is significant. As a result, the financial risk of not having lifetime income beyond Social Security is substantial. The following chart show the probability of living from age 65 to various advanced ages, both for the general population and for someone with 25 percent lower mortality. This latter group represents many retirees who have good health, have lived healthy lifestyles, and have worked in jobs that didn't take a physical toll. The survivor columns show the probability of at least one member of a couple living to the various ages.

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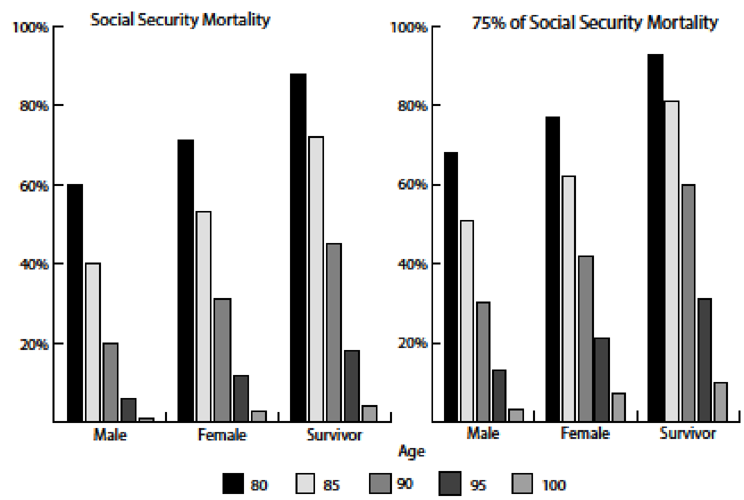
[3] Life expectancy is the average future remaining lifetime for a group of people at a specific given age – in this case, age 65 going forward. Approximately half of those entering retirement are expected to live longer than this, and many misunderstand this retirement planning benchmark.

[4] For more on normal retirement age, see the Academy issue brief, *Rethinking Normal Retirement Age for Pension Plans*: http://www.actuary.org/files/Normal-Retirement-Age_Issue-Brief_March_2013.pdf.

Probability of Living from Age 65 to Various Ages



An important issue underlying many causes of inadequate lifetime income is the unpredictability of an individual's life span and an understanding that life expectancy is not how long an individual will live. Many people who carefully plan for their income needs in retirement do so based upon a fixed retirement horizon of average life expectancy and thus might give short shrift to the significant probability of living longer. Most people simply do not have the tools readily available to determine how much money they need to accumulate to finance a retirement that could last 30 years or more.

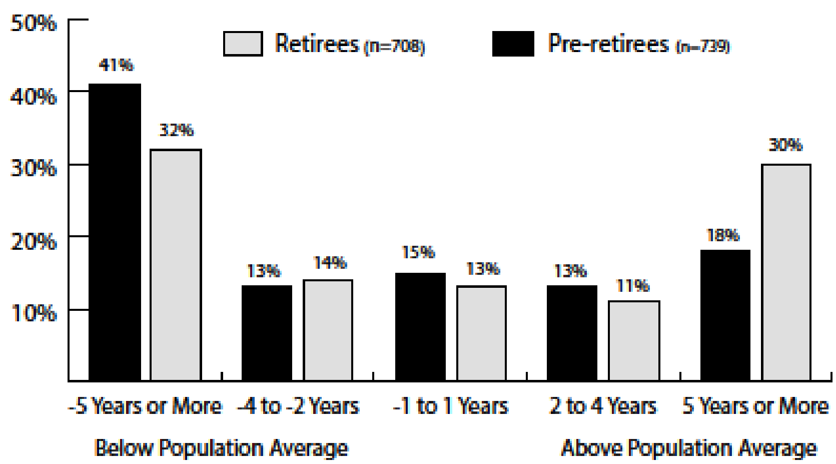
Even those who plan well financially for their retirement often misestimate income needed from retirement savings because of:

- Uncertainties of estimating how long they or their spouse could live.
- Difficulties of earning a long-term secondary income after retirement.
- Poor understanding of how inflation, especially in medical costs, can cause income needs to grow.
- Risks of poor asset performance.
- Loss of their ability to manage finances and their investments as cognitive capabilities diminish.
- Difficulty in living realistically within their retirement budget.

Finally, while the concept of longevity risk is something that actuaries are very familiar with in their work with pension plans and annuities, it is not well understood by the general public. About 46 percent of pre-retirees (51 percent for males and 42 percent for females) think they will not live as long as the average person their age and gender, according to the Society of Actuaries' Retirement Risk Survey that compared respondents' estimates of personal life expectancy to those of the population as a whole.[5] Life expectancy is calculated as a measure of broad population averages, not a predictor of a specific individual's life span. Approximately half the population will live longer than their average life expectancy. If all retirees are successful in planning perfectly to have their money last to exactly their life expectancies, about half of them will run out of money.

Therefore, life expectancy is only a starting point for discussion. Individuals need to think about a much longer financial planning horizon. Understanding life expectancy involves analyzing several issues: how long people may live, the considerable variability around the average value, and the financial consequences for individuals who live a shorter or especially a longer time. In addition, retirees and pre-retirees generally have financial planning horizons that are shorter than their life expectancies. Retirees say they typically look five years (median) into the future, while pre-retirees typically look 10 years ahead when making important financial decisions.[6]

Difference between respondent estimate of personal life expectancy and actual population life expectency between retirees and pre-retirees providing an estimate.



Source: Society of Actuaries, 2011 Risks and Process of Retirement Survey: SOA UP94 Values Projected to 2011.

5 http://www.soa.org/files/research/projects/research-2011-risks-process-report.pdf.
6 http://www.soa.org/files/research/projects/research-key-finding-under-managing.pdf.

Longevity Uncertainty + Compounding Economic & Behavioral Factors = Lifetime Income Risk

With longevity uncertainty amplifying their effects, other factors increase an individual's risk of not having adequate lifetime income, including:

- The trend away from traditional DB employer pension plans, designed to provide lifetime income, toward DC plans, which generally are based on optional contribution levels. In 1980, 84 percent of workers in medium and large organizations were covered by DB plans. In 2010, only 30 percent were.[7] Comparable figures including small employers were 35.0 percent in 1980 and 14.2 percent in 2010.[8] The reasons cited by some plan sponsors as the leading cause of this trend were the introduction of stricter accounting rules, and other regulatory actions since the passage of Employee Retirement Income Security Act (ERISA)[9] in 1974.
- The trend toward opting more often to take lump-sum distributions from DB plans, which potentially makes managing one's assets and budgeting expenses challenging in light of financial risks. Distributions from DC plans generally have been taken as lump-sum payments,[10] although it is difficult to determine the incidence of participants taking their lump sums and investing in particular types of savings or structured distribution plans in retirement. Full lump-sum distribution options also have been added to DB plans in recent years, with fully half of DB plans now offering such distributions. Participation in DC plans and IRA rollovers places the onus of asset management on the retirees for lifetime income needs above what is received from their Social Security benefits.[11] This trend also affects retirees' spouses, who face lifetime-income risks if the retirees either took lump-sum distributions or chose lifetime incomes without spousal continuation benefits.

Lump-sum distributions can appear to workers nearing retirement as not only adequate but generous for their retirement needs. Decisions to take a lump-sum distribution or to annuitize can be affected by many variables, including one's tenure in the plan or size of the available lump sum.[12] However, it is important for new retirees to examine their retirement-plan accumulations in terms of generating sufficient enough retirement income to sustain their pre-retirement standard of living.

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[7] http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2004.pdf.

[8] 2011 PBGC Data Book Table S-33: http://www.pbgc.gov/documents/pension-insurance-data-tables-2011.pdf.

[9] ERISA is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans.

[10] Among DC plans, 97 percent offer a lump sum payout and 81 percent of participants utilize it. Retirement Income Practices Study, MetLife Inc., June 2012.

[11] Social Security benefits are the foundation on which to build a secure retirement. Savings and pensions also are key components of retirement plans. Most financial advisers say about 70 percent of pre-retirement earnings is needed to comfortably maintain a pre-retirement standard of living. They recommend that retirement preparation utilize a combination of Social Security, private pensions, and personal savings. http://ssa.gov/planners/benefitcalculators.htm.

[12] See Employee Benefit Research Institute issue brief: *Annuity and Lump-Sum Decisions in Defined Benefit Plans*: *The Role of Plan Rules*, http://www.ebri.org/pdf/briefspdf/EBRI_IB_01-13.No381.LSDs2.pdf.

- Additional factors that influence financial literacy (addressed in Section IV) include:
    - Incomplete understanding of lifetime-income risks by pre-retirees and retirees, coupled with difficulties obtaining sufficient retirement-planning advice.
    - Failure to fully plan for the effects of inflation over a long period, especially as health care costs have trended above general inflation levels.
    - Inadequate appreciation of the value of delayed retirement.

Construction Zone: Building a Retirement Portfolio to Last a Lifetime

Many different strategic approaches exist to securing a lifetime income, starting with Social Security as a foundation and then factoring in employer-sponsored retirement or other benefit plans, annuities, and various avenues for freeing up income from held assets. Medicare coverage and long-term care insurance policies can mitigate the need for an emergency fund to pay for medical and extended care costs, and can be factored into income planning. Managed portfolios and even reverse mortgages are used by some to provide partial solutions to their retirement income needs. In addition, either because of need or the ability and desire to stay active, some opt to extend their active employment beyond normal retirement age, an option that is available only as long as their health remains good and jobs are available. The challenge in any of these strategies, either in isolation or combination, is getting workers and retirees to take optimal advantage of the resources available that best suit their circumstances.

The income provided by various approaches can differ greatly. For instance, some approaches, such as annuitization, rely on sharing risk with others (through an insurance company or a pension plan) and guarantee an income for life, however long that might be. Others involve prudence in drawing down individual savings. If risk sharing is used, the amount of assets needed to maintain a given retirement income is lower than for a self-managed drawdown. Stated differently, a given amount of assets will provide a greater stream of annuity income than the amount that can be safely withdrawn in a self-managed drawdown, with the annuity providing assured lifetime payments that cannot be guaranteed with the drawdown option. This is due to the pooled assets in an annuity that utilizes the remaining funds from those who die early to provide income to those who live longer – whereas in a self-managed program these funds remain solely with the retiree. It should be noted that even though the use of risk-pooling approaches effectively eliminates the possibility of running out of funds, there are tradeoffs associated with longevity-pooling approaches, including the loss of use of those funds for other purposes such as unexpected large expenses and legacy goals. Thus, the decision as to the appropriate approach to use should be based on the individual situation.

Many of today's approaches have varying degrees of merit that make them generally appropriate for retirees or, specifically, to the circumstances of a particular retiree. For most individuals, no single option provides a complete solution. A personal retirement plan could include several approaches discussed here in addition to other options, and could be customized to meet the individual needs of each retiree.

Social Security. Social Security provides an inflation-adjusted income that supplies a higher percentage wage replacement for low-wage earners than for high-wage earners. Generally, except for low-wage earners, Social Security is only the starting point to addressing lifetime-income needs. The effectiveness of addressing lifetime-income needs is influenced by the choice of a date to commence taking benefits. Postponing commencement can significantly increase future benefits.

Employer-provided Retirement Plans. Generally, there are two types of U.S. employer-based retirement plans: DB and DC plans. These also may be complemented by post-retirement medical plans. DB plans provide a lifetime income, generally without inflation protection. However, a majority of retirees who have the option forgo the income for a lump sum,[13] usually a rollover to an IRA. Mandated unisex conversion rates make lump sums disproportionately attractive for males and unattractive for females. DB plans are continuing to become less common, thus leaving the responsibility for lifetime income to the retiree.

DC plans provide an accumulation and leave it to the retiree to convert to lifetime income, if desired. The most common type of DC plans, 401(k)s, primarily depend upon voluntary contributions, but these are often insufficient to fund an adequate lifetime income. A few plans provide access to annuity purchases while funds are accumulating or at the time of a distribution.

Insured Annuities. Annuities are the basic method of converting an accumulation to lifetime income. Lifetime-income annuities vary by the time of purchase, timing of income commencement, method and flexibility in providing a lifetime income, and amount of income depending on health. Attractiveness of annuities also will vary with the investment yield that can be earned on the investments that support the annuity. Various types of annuities are available to individuals in different financial situations, including:

- Single Premium Immediate Annuities (SPIA), which provide a lifetime income but commonly offer a guarantee when the annuitant dies. Guarantees could be payments: during the lifetime of a surviving spouse; for a period certain such as 10, 15, or 20 years; continuation until the sum of all payments equals the premiums; or a lump sum equal to premiums less all prior income payments.

[13] Full lump-sum distributions are allowed in 54 percent of DB plans and 65 percent of participants in those plans take the lump sum. Partial lump-sum distributions are allowed in 25 percent of DB plans and 13 percent take a partial lump sum. Retirement Income Practices Study, MetLife, June 2012.

- Deferred Income Annuities (DIA), also known as longevity insurance. DIAs provide an income that begins at a specified date, such as age 70 or 85, and are purchased either with a single payment or multiple payments, usually at or before retirement.

- Guaranteed Lifetime Benefit Riders on Deferred Annuities, which combine two financial products: an annuity that accumulates contributions and earnings, and a rider that converts the accumulation into a lifetime income of a specified amount. The income begins with level withdrawals of a specified amount from the annuity and continues with lifetime-income payments from the rider after the annuity value has been exhausted. This annuity is structured to guarantee the income even in the event that the underlying investments have poor investment results or the individual lives longer than expected.

- Stand-Alone Living Benefits (SALB), also known as contingent deferred annuities (CDA). These guarantee a lifetime income in conjunction with investments managed outside of the insurance company, such as mutual funds. The income begins with level withdrawals of a specified amount from the investments and continues with lifetime-income payments from the SALB/CDA after the accumulated funds have been exhausted. The income guarantee is structured to guarantee the income even in the event that the underlying investments have poor investment results or the individual lives longer than expected.

Reverse Mortgages. Some designs can provide an income for many years or a lump sum that can be used to purchase a lifetime-income annuity. The principal value is in freeing up equity in a home. The percentage of home value available varies by age and becomes higher with advancing age.

Non-guaranteed Approaches. Various approaches can provide an income that lasts for many years. However, they lack the assurance that the income will last for a lifetime. In the event of low investment returns or a very lengthy life, the income either could fail to last a lifetime or could need to be reduced to continue it for a lifetime.

- Supplemental earned income in retirement not only reduces the need for an income guarantee but also extends the value of accumulated retirement assets. The ability to work during retirement of course depends on the overall health of individual retirees, the opportunity to continue to apply job skills as they get older, and the job market's demand for their skills. In some cases, health insurance may be provided, which can reduce some retirement expenses.

- Managed portfolios generate income through the structured drawdown of accumulated assets as needed to supplement other sources of income. There are various investment approaches, strategies, and methodologies employed, as noted below. While these strategies provide income at specified times, they might fail to provide the desired level of income or fail to provide it over an unpredictably long lifetime due to poor investment results or reinvestment requirements.

- *Structured withdrawal programs* involve an "x percent withdrawal program" in which a retiree initially withdraws x percent of savings per year and then increases the dollar amount annually at the rate of inflation. These programs are often referred to as 4 percent withdrawal programs, but the x percent rate differs by situation, such as age, anticipated market returns, and investment volatility. Poor investment returns or high longevity can cause the invested assets to be depleted during the retiree's lifetime.

- *Time-segmented distribution strategies* divide retirement assets into segments that are "tagged" to provide income over a specific period of time in retirement. The investments will range from lower-risk assets for short-term needs and higher-risk assets for long-term needs. The adequacy of income can depend upon the level of investment yield. Although a program can be designed to cover a long period, it cannot be guaranteed to last a lifetime.

- *Laddering of bonds* involves building a portfolio of bonds that mature on different dates, providing income through interest payments and the return of principal upon maturity. This helps the retiree manage both cash flow and interest-rate risk, although it cannot be guaranteed to last a lifetime.

- *Structured distribution target date funds* provide an investment glide path for retirees through a mix of investments adjusted according to the fund's investment policy in an attempt to reduce investment risk as an individual ages. An additional dimension in some funds is to plan annual distributions that meet the income needs of retirees. The goal of the funds is to provide income during retirement while automatically adjusting investment allocations to reflect the retiree's shorter duration for investments and declining tolerance for risk.

- Period certain annuities provide income for a specified period of time and thus do not protect against lifetime-income risk.

New Approaches to Planning for Lifetime Income

The 4 "R"s – Retirement Reading, (w)Riting, (a)Rithmetic: Financial Education

Many aspects of planning for a secure lifetime income, such as longevity risk, are not fully understood by many people. Pre-retirees should consider a full, objective assessment of retirement plan distribution options that address longevity risk and the impact of inflation on retirement income. A significant focus on the importance of consistent and lasting income in retirement is also needed, especially in situations where an individual is making decisions outside of a sponsored plan, such as with a 401(k) rollover. Individuals also could benefit from some understanding of a fair price for an annuity, how to shop for one, and the degree of state or other government guarantee.

Prospects for Employer-based Retirement Plan Education

Because of the concentration of retirement savings, exclusive of Social Security benefits, in employer-sponsored retirement plans, the workplace can offer a significant forum to make retirement-planning education available to employees, not just at retirement but throughout their careers. This is particularly useful for those employees who cannot afford or might not independently seek out a financial adviser. Employers have the opportunity to communicate on a regular basis with participants when fund statements and other required notices are distributed. Where no retirement plan exists, perhaps an employer could provide additional information through Department of Labor (DOL) pre-approved materials. Many employers that currently sponsor retirement plans already provide some guidance to employees through third-party-sponsored seminars on the topic of investment decisions, but typically do not provide a full range of choices with respect to achieving lifetime income.

Although employers are often optimally situated to make retirement planning information and advice available to their employees, not all are willing or able to do so. One possible reason for this is a concern that it could lead to the employer's liability should advice received by an employee through such an effort later be claimed to have harmed an individual's financial position. Thus, employer-based education will require some action to appropriately protect employers from liability under ERISA fiduciary requirements.[14] Small employers in particular would probably benefit from cost-saving, standardized approaches, perhaps supported and coordinated by the DOL.

Employers could be encouraged to offer this information through the availability of easy, safe, and low-cost approaches to provide education about lifetime-income products (how they work, key features, pros and cons) and the options available to employees. Employers should

[14] See Academy Comments to DOL for more background: http://www.dol.gov/ebsa/pdf/1210-AB33-RTT042.pdf and http://bit.ly/ZOC5lo.

recognize that helping workers plan for retirement can also be in their own interest, as this can facilitate an orderly exit of their workforce rather than having employees "retire in place."

The form and timing of such educational processes are critical issues that should be addressed. Workers clearly need to receive information years before actual retirement, and advance understanding of the importance of lifetime income and corresponding early action can be beneficial to them. Establishing a comprehensive understanding of the relationship among accumulated retirement funds, the retirement-age goal, and the ability to provide a lifetime income following retirement should form the foundation of the education and should guide an employee's actions well in advance of retirement – preferably over the course of an entire career. Information can be provided on an annual basis at minimum throughout employment, perhaps with greater depth and intensity during the 10-year period prior to the normal retirement date. A combination of educational booklets, videos, and annual benefit statement communications should be the medium for educating all employees. Additionally, pre-retirement seminars could be offered for employees approaching retirement within 10 years.

Currently, plan sponsors commonly provide generic articles on retirement preparedness issues but offer little individualized information beyond a statement of current benefits provided by the retirement plan. Some employers provide pre-retirement seminars 10 years before retirement age. However, these may focus more on important, broad retirement issues rather than an individualized discussion of financial issues and options.

It is common for participants in a DB plan to opt to take their benefits in a lump sum at retirement in lieu of the guaranteed income.[15] Increased education at the time of distribution about the value of lifetime income could lead to a better-informed decision and a general change in behavior by employees at the time of retirement in favor of securing lifetime income. Creation of safe harbors for ERISA fiduciaries could facilitate actions that are advantageous to plan participants.

Setting a New Standard for Financial Literacy

Standardized communication requirements, 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 information upon enrollment in a plan plus reinforcement on a yearly basis.

[15] Full lump-sum distributions are allowed in 54 percent of DB plans, and 65 percent of participants in those plans take the lump sum. Partial lump sum distributions are allowed in 25 percent of DB plans, and 13 percent take a partial lump sum. Retirement Income Practices Study, MetLife, June 2012.

While customized material often provided by the vendor about specific options within the plan should be encouraged, the DOL could provide a notice that would provide generic information on the importance of income guarantees extending for life – similar to the tax notice currently provided by the IRS on distributions. This information should include illustrations of the probability of survival of the individual and of one member of a married couple to various ages beyond average life expectancy at retirement, using one of a set of standard mortality tables. Plan sponsors could also provide this information on their company intranet site or during company human resources meetings.

In designing standardized communications and model documents, input from retirement security practitioners is critical to making these tools effective and understandable. To make informed decisions, participants should understand the following:

- The need and value of longevity protection.
- How to interpret mortality and longevity expectations.
- Various approaches to address lifetime income, including both annuities and self-managed programs such as systematic mutual fund withdrawal programs.
- Death benefits and income guarantees for surviving family members after the death of the participant.
- Costs and available income amounts of the various approaches.
- Limitations within the approaches, such as the varying levels of illiquidity in different annuity products and the uncertainty of the sufficiency of a systematic withdrawal program.
- Risks of the various approaches. These risks could include purchasing an annuity when interest rates are low, trade-offs between income amount and guarantees of minimum returns, the impact of a market fall in the early part of a mutual fund withdrawal program, and the impact of inflation if the income stream does not protect against it.
- The risk of the temptation to spend down segments of a lump sum or to take undue investment risk with it. Workers and retirees could benefit from education about the differences between "expected" returns and the possible range of returns.

Unscrambling the Potential of an Accumulated Nest Egg

The Department of Labor[16] and members of Congress have made proposals to require that the standard retirement-benefit statement that individuals receive show the monthly amount of retirement income that could be generated by the accumulated balance. Such a requirement would focus the statements on income potential as well as total account balances, and several different lifetime-income strategies could be illustrated.

ERISA section 105 requires DC plans to furnish each participant with an individual benefit statement, at least annually (quarterly where plan participants control investment choices), that includes the participant's "accrued benefits" or account balance. Translating account balances into income streams should be a dynamic part of the needed education process. Doing this as part of the individual benefit statement will refresh and reinforce the education periodically. With this goal in mind, the DOL has launched an initiative to require that the standard retirement-benefit statement received by individuals show the amount of retirement income that could be generated by the account balance. Appropriately presenting this income stream requires actuarial considerations such as mortality, assumed retirement age, level of contributions to be made in the future, and interest rates.

To aid participants' understanding of their statements, the simplest and easiest method would be to make all plans' statements consistent with one another. A standardized statement 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 DB plan. Use of such mandated factors would narrow the plan sponsor's responsibilities and lower costs. The mandated factors could be re-addressed periodically. Appropriate caveats should be stated, and assumptions 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. 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. All possible approaches should be explored with plan sponsors or record-keepers that could provide the service.

The DOL's proposal would apply to all DC plans and is intended to achieve the goal of translating account balances into income streams. The DOL proposal would allow either a "best-

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[16] Advance Notice of Proposed Rulemaking regarding the pension benefit statement requirements under section 105 of ERISA, 78 FR 26727 – 39 (May 8, 2013).

practices" approach based on a "reasonableness" standard or a safe-harbor approach where all applicable assumptions and methods would be standardized. Assumptions would need to be disclosed. The DOL proposal would require that income streams be provided based on current account balances as well as account balances projected to retirement age.

Resetting Today's Retirement Rules for Tomorrow's Retirees

Changes to enhance lifetime income, especially in the public policy arena, are not easily developed due in part to the varied needs of disparate segments of the population and differing needs within any segment. Appreciation for these differences helps focus a national debate around lifetime-income policy. Virtually all retirees face lifetime-income risk in varying degrees, but individual solutions can diverge widely.

Accessing qualified and affordable planning advice often is difficult for those needing the advice to plan for lifetime incomes. It is important to make planning advice more broadly available to those not currently served.

A further difficulty in addressing lifetime income is that varying health status among retirees and their spouses can influence the choice of optimal solutions. Lifetime-income guarantees can be a positive option for an individual in excellent health but less beneficial for someone in poor health. Health status also changes the needs that must be met in the form of both greater incurred expenses and the need for long-term care financing or insuring.

Substandard annuities are annuities that offer increased payments to people with impaired life expectancies but are offered by just 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.

There is an incongruity in that gender-neutral annuity rates are required within plans, while gender-distinct rates are used in the marketplace outside of plans. Within DB plans, the gender-neutral rates are relatively favorable to males taking lump sums. This disparity 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 concern about gender-neutral rates is that they could disproportionately lead males to not annuitize, which could jeopardize their retirement security as well as that of their spouses. However, the use of a 100 percent joint and survivor option can eliminate this disincentive to annuitize.

Availability of In-plan and Plan-distribution Lifetime Income Options

Having both in-plan and outside-of-plan solutions is essential so that participants in all situations can have access to lifetime-income arrangements. Many options already exist outside of plans, but it would be helpful to have more lifetime-income options available within plans as well. A requirement that some form of guaranteed-lifetime income be one of the investment or distribution options offered in individual account plans would be helpful, provided that the requirement is accompanied by a clear set of regulations that allow for effective implementation at reasonable cost and without subjecting plan sponsors to undue fiduciary risk.

It would also be helpful if individual plan sponsors were encouraged or required to make a form of lifetime income a default option. Such a change would require some level of fiduciary protection, such as clarification of a safe harbor. 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.

Lifetime income is a long-term commitment, and some retirees may be concerned that the insurer or the pension plan will not be able to deliver the guaranteed benefits. These concerns could be alleviated by providing retirees with a better understanding of the value of state life and health guaranty associations and the Pension Benefit Guaranty Corporation, as well as possibly strengthening both guarantees. Similarly, the continued viability of Social Security must be ensured so that the foundation of lifetime guarantee remains strong.

It should be recognized that the Treasury and Labor departments have studied various regulatory relief options to address some aspects of lifetime-income options that could be made available to retirees,[17] including simplification of partial annuity distribution options under DB pension plans[18] and recognition of longevity annuity contracts[19] as a way to satisfy part of required minimum distribution rules.

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[17] Academy Life and Pension practice councils' comments to departments of Labor and Treasury Request for Information *Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans* http://actuary.org/files/public/pdf/pension/aaa_rfi_050410.pdf and testimony of Academy Pension Committee and Life Products Committee: http://www.actuary.org/files/DOL_Hearing_Lifetime_Income_Options_8-16-10.pdf.

[18] Academy Pension Committee comments to Internal Revenue Service: http://actuary.org/files/publications/AAALetter_PartialAnnuity_120503.pdf.

[19] Academy Pension Committee comments to Internal Revenue Service: http://actuary.org/files/publications/AAA_Letter_Longevity_Annuity_120503.pdf.

Encouraging and Simplifying Use of Lifetime Income

Lifetime-income guarantees could be encouraged by providing additional tax-favored treatment. For example, interest earned after lifetime income has been purchased irrevocably could be afforded tax-free treatment. There are different ways to design this incentive: It could apply to pension payments from DB plans, single premium immediate annuities, deferred income annuities, guaranteed minimum income benefits, and guaranteed lifetime withdrawal benefits on variable annuities and mutual funds (in the last case dependent upon some type of irrevocable utilization guarantee). Incentives could apply both to tax-qualified and individual retirement savings.

The federal government offers tax-deferral of qualified retirement savings as a means of encouraging workers to set aside funds for their retirement. Required minimum distribution (RMD) rules exist to help ensure those savings do not create excessive tax deferral. An RMD also has a secondary function of creating a structured withdrawal program, but this withdrawal pattern might not have a close relationship to actual needs. The previous rules recognized immediate annuitization as a method of satisfying RMD requirements but did not accommodate other guaranteed-income approaches, such as deferred income annuities (DIAs) that provide a specified lifetime income beginning at a specified advanced age. Those requirements included the value of a DIA in tax-qualified assets and distribution beginning at age 70½. The rules were was contrary to the purpose of a DIA, which might ideally be designed to begin providing income at a much later age, such as age 85. In July 2014, the IRS issued final rules facilitating the use of DIAs at more advanced ages. The new regulations also included a death benefit that allows the principal in the annuity to be returned to the retirement account if a beneficiary dies before the annuity-income commences.

Aging Out – Rethinking "Normal" and Delayed Retirement Age

Social Security recognizes delayed retirement by increasing available benefits 8 percentage points[20] annually from the attainment of normal, or full, retirement age through the actual retirement age or age 70, when the benefit amount stops increasing. For someone born after 1960, their normal retirement age for Social Security is 67. Should they continue to work to or past age 70, their monthly benefit would be 124 percent of the full benefit amount.[21] This structure provides some flexibility for retirees and offers equivalent value for deferring income commencement. Longevity risk, by its definition, occurs at high ages and it can be addressed by increasing income guarantees available at those ages. If the delayed retirement age were increased beyond age 70, it would present the possibility of increasing the amount of Social Security income available to a retiree during the later years of life. On the other hand, delayed

[20] For those born in 1943 and after.
[21] http://www.socialsecurity.gov/retire2/1960.htm.

commencement of Social Security always carries the increased risk that a retiree might forgo receiving benefits and die before the deferred retirement date. In addition, if rules setting the full retirement age for private-sector DB plans were changed to permit employers to raise them to match the full retirement age of Social Security, it would better align these important behavioral signals with the current increases in the Social Security normal retirement age[22] and possibly encourage workers to remain in the workforce and retire later. Delaying retirement would mean more benefit accruals in a worker's pension plan, allow individuals more time to accumulate retirement savings, and lead to higher standards of living in retirement.[23]

In addition, some have advocated raising the RMD age on tax-qualified accumulations from 70½ to a higher age in order to recognize increases in life expectancy. The current RMD age was set 50 years ago. Such a change could apply not only to DC plans but to all retirement plans. The objective of this approach is to create a practical solution for individuals who are still working and wish to defer retirement income until true retirement. Raising the RMD age would also increase the aggregate amount available to individuals over the duration of their retirement.

Conclusion

Securing assured lifetime income is necessary for all retirees, but obtaining it remains a challenging goal for many. Some steps have been taken to improve retirement security, but workers, retirees, and society could benefit from further actions that aid people in creating assured, adequate income throughout their retirement years. This goal could be achieved through additional education at the individual level and adopting initiatives at the public-policy level.

The American Academy of Actuaries is committed to examining the challenges of Americans securing income throughout their entire lifetimes, addressing the actuarial and public-policy aspects of lifetime income, and raising the level of understanding and awareness of the actuarial profession, public policymakers, and the general public of the need to address lifetime-income issues. I thank you for the opportunity to submit testimony on a topic that is vital to millions of Americans and would welcome the chance to discuss this issue further with the committee.

[22] For those born after 1960, age 67 will be their full retirement age.

[23] http://www.actuary.org/files/Normal-Retirement-Age_Issue-Brief_March_2013.pdf.