AMERICAN ACADEMY *of* ACTUARIES

June 11, 2010

The Honorable Herb Kohl
United States Senate
Special Committee on Aging
G31 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Bob Corker
United States Senate
Special Committee on Aging
628 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Kohl and Ranking Member Corker:

On behalf of the American Academy of Actuaries,[1] I enclose written testimony that we wish to submit in conjunction with your committee's June 16 hearing on Turning Retirement Savings into Lifetime Income. We commend your committee for holding this hearing on the critical issue of retirement security.

Our testimony consists of our May 3 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*. That submission consists of a four-page executive summary letter and twenty-one pages of answers to many of the questions posed in the RFI. We strongly support efforts to facilitate access to and use of lifetime income options, and we emphasize 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 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 professional association with over 17,000 members, whose mission is to assist public policymakers 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.

We thank you for the opportunity to submit this testimony and would be happy to discuss further with you or your staff. Should you have any questions or concerns, please contact either Jessica Thomas, the American Academy of Actuaries' pension policy analyst, at 202-785-7868 or thomas@actuary.org, or me at 202-223-8196 or todisco@actuary.org.

Sincerely,

Frank Todisco

Frank Todisco
Senior Pension Fellow
American Academy of Actuaries

AMERICAN ACADEMY *of* ACTUARIES

May 3, 2010

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
Submitted via email to e-ORI@dol.gov

Attention: Lifetime Income RFI

The American Academy of Actuaries'[1] Pension and Life Practice Councils respectfully request your consideration of comments regarding the joint Department of Labor (DOL) and Department of the Treasury Request for Information (RFI) *Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans*. We believe that encouraging and supporting methods to address longevity risk is important to pursue, and we commend the DOL and Treasury for undertaking this project.

The attachment to this document includes our responses to certain questions posed by the DOL and Treasury in the RFI's Q-and-A section. Please note that we have not responded to all questions in the RFI. Rather, we have limited our responses to those where we believe that the actuarial profession provides a unique perspective or has particular knowledge related to a specific topic addressed in the RFI.

In addition to our responses to the RFI questions, we have summarized below what we believe are some of the most significant issues that relate to addressing longevity risk, grouped into several themes.

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). Longevity risk is a true and significant risk. It is far more economically efficient to address longevity risk through the methods of risk pooling rather than through individuals saving additional amounts to cover the possibility of living beyond life expectancy (which roughly half the population is anticipated to do). Annuity income (that is, insured longevity risk) achieves its cost efficiency through both longevity pooling and making full use of both principal and investment earnings. In contrast, depending on the

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method used to “self-insure,” 50 percent to 75 percent more money would need to be set aside than if an individual participated in a risk-pooling arrangement, a comparatively inefficient use of scarce retirement resources. Of course, many people choose not to provide for longevity risk at all. This can also be considered as socially inefficient, since the resources for those who will outlive their assets must be provided in some manner from other private or public sources.

From the standpoint of utility theory, guaranteed lifetime income has high value for participants, employers, and society—up to a point. For taking care of basic physical needs and reasonable social needs, the value of a guarantee is high. At some point beyond that, the value of guaranteed income drops significantly and the value of a bequest to heirs increases correspondingly. An overriding policy question is "How much guaranteed income should policy be designed to facilitate/encourage/incent?" To the extent that guaranteed income is of high value, the cost efficiency of risk pooling validates the effort to try to facilitate such arrangements.

Education and behavior:

Education about the financial impact of longevity risk is one of the foundations on which progress must be built. Consumers first need to understand the many dimensions of longevity risk and then need guidance on how to address it. Among these dimensions are the income level required to meet essential needs and the impacts of inflation and longevity. Social Security provides only a basic floor of retirement income; consumers need to understand their total income needs and any gaps between need and available sources of income. The impact of substandard health also must be recognized. As they learn to take all of these factors into account, consumers will be in a position to address their individual needs using annuities or other products.

The approach to financial education is also important. Education, together with the provision of relevant and accessible information, should be encouraged and facilitated. 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). We believe providing personalized quantified communication with each annual benefit statement is also important. In designing standardized communications and model documents, input from retirement security practitioners is critical to making these tools effective and understandable. We offer help in that regard.

We believe further that financial literacy education should begin in secondary school. Establishing a sound lifetime financial literacy curriculum may require multiple agency efforts.

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.

Forms of lifetime income that could facilitate more widespread use:

Partial annuitization is an important strategy that should be facilitated. Any policy encouraging annuitization should include partial annuitization options. Partial annuitization options more readily allow taking into account each individual's unique situation and retirement income needs.

Modification of the required minimum distribution (RMD) rules to accommodate additional longevity insurance would be helpful. Some annuities purchased by individuals who are near retirement guarantee an income that begins many years later, commonly at age 80 or 85. These deferred income annuities are sometimes referred to as "longevity insurance." Although all income annuities provide some degree of longevity protection, these deferred income annuities should be distinguished from the more common type of deferred annuities that provide cash values at all points in the deferral period. Single-premium immediate annuities, which also protect against longevity risk, are exempt from RMD requirements while deferred income annuities are not.

One strategy for providing retirement security would be to meet shorter term needs through savings and other exhaustible resources and meet the risk of longer-than-expected lifetimes through deferred annuities. For many retirees, this strategy would be an attractive alternative to immediate annuities. Modification of the RMD requirements to put deferred income annuities on an equal footing with immediate income annuities would broaden options for retirees.

Refund-type annuity options within plans could lead to significantly higher annuity election rates. These could take the form of cash refund annuities or life annuities with a guaranteed "certain" period. Although these annuities are slightly more expensive and thus provide somewhat less longevity protection, the refund feature addresses the common concern of dying early and "losing" the money paid for the annuity.

In-plan options simplify the process. In-plan options would facilitate annuitization for plan participants. These options might include incremental annuitization, a potentially helpful way to facilitate annuity offerings within a defined contribution plan. By purchasing annuities over the individual's career, the concept of dollar cost averaging mitigates the interest rate risk of making a single purchase at retirement. However, gender neutral requirements with regard to in-plan conversion of accounts raise the issue of annuitization rates that could be significantly less attractive for males.

Requirements and accommodations:

We support a policy, accompanied by a set of reasonable and practical regulations, requiring that some form of guaranteed lifetime income be one of the investment or distribution *options* offered in individual account plans. Tax-qualified programs that are intended to help encourage retirement security should offer the most reliable form of retirement security, a guaranteed lifetime income. However, it is essential that a set of comprehensive, manageable regulations be in place concurrently with the start of any such requirement so that plan sponsors (both large and small) can carry out this requirement without exposure to excessive fiduciary risk. Absent workable regulations and fiduciary support, employers would be discouraged from sponsoring these plans and as a result participants would fail to benefit from their potential.

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. Many complexities are involved in determining the appropriate level of annuitization for individual participants, including their Social Security income, other annuity income sources, out-of-plan retirement savings, other assets (e.g., real estate, including reverse mortgage arrangements) and participants' overall health. The complexities involved in evaluating each individual's situation mean that any default requirement would need to be considered carefully.

Accommodations may be needed for small plans. For example, mandatory participant education requirements could prove overly burdensome for small plan sponsors, leading them to choose not to sponsor retirement plans. A standardized set of minimum educational material could address this. Providing a means to make group pricing rates available to small plan sponsors who are unable to obtain more favorable rates due to their smaller covered population also would encourage annuitization.

More details on these and other issues can be found in our responses to the individual questions contained in the accompanying document. We again thank you for the opportunity to comment on these very important retirement security issues—issues that we think will become even more important as our population continues to age.

We would be happy to discuss any of these items with you at your convenience. Please contact Jessica M. Thomas, the Academy's pension policy analyst (202-785-7868, thomas@actuary.org), if you have any questions or would like to discuss these items further.

Sincerely,

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Vice President – Pension
Chairperson, Pension Practice Council

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Lifetime Income RFI

ANSWERS TO SPECIFIC QUESTIONS

General

1. From the standpoint of plan participants, what are the advantages and disadvantages for participants of receiving some or all of their benefits in the form of lifetime payments?

Our comments on this question are focused specifically on annuity arrangements, not other forms of lifetime payments such as guaranteed lifetime withdrawal benefits (GLWB).

The advantages of annuity arrangements are:

a) lifetime income security, since the purchaser will never run out of income,
b) reduction of investment management responsibilities when getting older,
c) payment structure flexibility that can cover dependent as well as participant needs (e.g., survivorship annuities),
d) avoidance of adopting an overly limited lifestyle from fear of outliving income, and
e) economic efficiency of risk pooling.

The disadvantages of annuity arrangements are:

a) lack of access to ready money, if needed,
b) inflation indexing and/or increasing payments that require lower starting income and may be inflexible,
c) consumer fears of being on the "losing" side of the insurance function (dying early and "losing" most of the principal) ,
d) annuity purchases in a low-interest environment that lock in low returns, and
e) loss of financial planning flexibility if all benefits are in the form of lifetime payments.

Additional commentary on the advantages and limitations of participants receiving their benefits in the form of lifetime payments is provided below.

It is much less expensive to pool longevity risk via an annuity than to self-insure. Annuity income offers the additional advantage of being able to make full use of principal and investment earnings. Depending on the method used to self-insure, 50 percent to 75 percent more money would be needed to guarantee lifetime income on one's own than via a pooled approach. This is because self-insurance of the longevity risk requires having enough assets to provide an income to a very advanced age and to have a cushion for poor investment results. In contrast, an annuity will be priced roughly to life expectancy. The difference in assets required is substantial and has a great impact on the lifestyle that retirees can afford.

In general, guaranteed lifetime income has high value for participants, employers, and society—up to a point. For basic individual needs and reasonable social needs, the value of a guarantee is high. At some point beyond that, the value of guaranteed income drops significantly and the value of a bequest to heirs increases correspondingly. An overriding policy question is "How much guaranteed income do we want to facilitate/encourage/incent?" Once that question is answered, then the specific questions about how to provide guaranteed income can be addressed more fully.

2. Currently the vast majorities of individuals who have the option of receiving a lump sum distribution or ad hoc periodic payments from their retirement plan or IRA choose to do so and do not select a lifetime income option. What explains the low usage rate of lifetime income arrangements? Is it the result of a market failure or other factors (e.g., cost, complexity of products, adverse selection, poor decision-making by consumers, desire for flexibility to respond to unexpected financial needs, counterparty risk of seller insolvency, etc.)? Are there steps that the agencies could or should take to overcome at least some of the concerns that keep plan participants from requesting or electing lifetime income?

Many participants place value on having their money in hand. The desire for control and flexibility from retirement through death overwhelm potential feelings of security that might be generated by purchasing an annuity, which won't prove its worth until another 25 years or more. Other factors driving the low usage of lifetime income options include:

a) inadequate education on the value of lifetime income,
b) as mentioned in Question 1, fear of being on the "losing" side of the insurance function,
c) attraction to what appear to be substantial windfalls (lump sum amounts) without properly considering economic equivalencies,
d) fear of inflexibility after the annuity is purchased,
e) low usage by others, which creates word of mouth advice to not annuitize,
f) belief that Social Security provides sufficient guaranteed income,
g) discouragement or lack of encouragement from some financial planners—and even from some insurance agents—concerning the use of immediate annuities,
h) availability of other methods of creating income streams, e.g., 4 percent withdrawal programs with mutual funds,
i) low interest rates, resulting in low payments, when the option is exercisable,
j) perception by some that the interest yields paid by insurance companies are low,
k) some concern about the risk of insurer solvency, lack of knowledge about the extent of state insurance guarantees, and the absence of a federal equivalent of the FDIC,
l) plan sponsor neutrality or unwillingness to appear to offer advice,
m) unattractiveness of an annuity if the person is in poor health and a substandard annuity is not available or believed not to be available,
n) complex choices that impede decision making and lead to the seemingly simplest choice, the lump sum, and
o) in defined contribution plans, the unequal value provided to males and females with any in-plan gender neutral annuitization, making an annuity option relatively less appealing to males (and in defined benefit plans, making the lump sum relatively more appealing to males).

One initiative in particular that would help address the problem of low usage of lifetime income options would be more thorough financial education, delivered in the work environment and other venues. This education should emphasize the nature of basic needs, coverage from Social Security, and residual needs. Quantitative guidance would be helpful. (We believe further that financial literacy education should even begin in secondary school. A sound lifetime financial literacy curriculum may require a multiple agency effort.)

3. What types of lifetime income are currently available to participants directly from plans (in-plan options), such as payments from trust assets held under a defined benefit plan and annuity payments from insurance contracts held under a defined contribution or defined benefit plan?

Lifetime income options are always available to participants in defined benefit plans. But some defined benefit plans are hybrid types, such as cash balance and pension equity plans, which present benefit accruals primarily as lump sums and lead to an extremely high prevalence of lump sum elections. Some defined contribution plans offer a lifetime income option, but most do not.

4. To what extent are the lifetime income options referenced in Question 3 provided at retirement or other termination of employment as opposed to being offered incrementally during the accumulation phase, as contributions are made? How are such incremental or accumulating annuity arrangements structured?

In both defined benefit and defined contribution plans, the benefit election, applicable to all prior accruals or accumulations, is generally made at the point of retirement, not incrementally during the working years. Incremental elections could have two potentially significant advantages. First, for both defined benefit and defined contribution plans, the comparison would be against much smaller lump sums (just one year's accrual or contribution), blunting the allure of large single sum amounts. Second, for defined contribution plans, incremental annuity purchases greatly reduce the interest rate risk of making a single annuity purchase at retirement—when interest rates might be at a low point and annuities relatively expensive.

The downside of the incremental approach is (a) locking in a decision about future needs many years in advance, and (b) making incremental purchases at interest rates that might end up being less than what would have been available at retirement.

6. What types of lifetime income or other arrangements designed to provide a stream of income after retirement are available to individuals who have already received distributions from their plans (out-of-plan options), such as IRA products, and how are such arrangements being structured (fixed, inflation adjusted, or other variable, immediate or deferred, etc.)? Are there annuity products under which plan accumulations can be rolled over to an individual retirement annuity of the same issuer to retain the annuity purchase rights that were available under the plan?

Income options available to individuals who have already received distributions from a plan include:

a) single premium immediate annuities,
b) deferred annuities that can be annuitized at a later date at the then-prevailing rates,
c) deferred-start income annuities that determine the payout amounts at the time of purchase but for which the income does not begin for many years, (e.g., 20 years),
d) mutual-fund-structured withdrawal programs (e.g., 4 percent annually-inflated withdrawals), which are guidelines that are intended to have a high probability of providing withdrawal amounts for the entirety of life if the withdrawal amount is sufficiently conservative. However, they do not guarantee that the funds will be sufficient (and the amount withdrawn each year will be significantly less than the amount that could be provided through an income annuity—see answer to Question 7).
e) guaranteed lifetime withdrawal benefits (GLWB). A GLWB guarantees that a specified amount may be withdrawn each year, even if the account value has fallen to zero (although this specified amount will be significantly smaller than that available through an income annuity—see answer to Question 7), and
f) IRS required minimum distributions determined under the annual recalculation option, which technically would last a lifetime, but doesn't guarantee level or increasing income.

There are annuity products that include inflation protection, either in the form of a fixed annual increase or true inflation, but possibly with an annual cap. Their popularity is limited by the fact that the initial income amount is reduced (as discussed in the Question 7) in return for the increasing benefit.

7. What product features have a significant impact on the cost of providing lifetime income or other arrangements designed to provide a stream of income after retirement, such as features that provide

participants with the option of lifetime payments, while retaining the flexibility to accelerate distributions if needed?

Various features can affect the cost of a guaranteed income stream.

a) 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.
b) 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.
c) 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.
d) 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.
e) 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.
f) 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.

8. What are the advantages and disadvantages for participants of selecting lifetime income payments through a plan (in-plan option) as opposed to outside a plan (e.g., after a distribution or rollover)?

The advantages to participants of in-plan annuitization are:

a) ease of implementation by the participant,
b) possible availability of periodic purchases rather than at a single point in time, which can mitigate the risk of making all purchases at a time of low interest rates,
c) more favorable (low expense) rates may be negotiated by a defined contribution plan (or provided through a defined benefit plan),
d) potential for lower rates by avoiding the costs of adverse selection, and
e) higher level of due diligence resulting from plan sponsors' fiduciary responsibilities, as well as the plan sponsor's superior ability to evaluate the financial stability of potential annuity providers and to restrict available providers to those best able to meet their lifetime commitment to the participants.

The disadvantages to participants of in-plan annuitization are:

a) required use of gender neutral rates that are relatively unfavorable for males, such that the incongruity of having such rates within plans and sex-distinct rates outside of plans could lead to females primarily electing in-plan annuities at actuarially favorable rates and males electing out-of-plan annuities at actuarially fair rates or electing annuities less frequently,
b) lack of flexibility and/or alternatives,
c) possible unavailability of attractive rates for individuals in poor health,
d) inability to comparison shop,
e) possible limitations on how much or little one can annuitize, and
f) tax laws that favor lump sums by immediately taxing annuity benefits but allowing for deferral of taxes on lump sums that are rolled over to an IRA until the participant begins withdrawals, thus allowing the participant to maintain some measure of control over the timing of taxation when a lump sum is elected.

9. What are the advantages and disadvantages from the standpoint of the plan sponsor of providing an in-plan option for lifetime income as opposed to leaving to participants the task of securing a lifetime income vehicle after receiving a plan distribution?

In general, an in-plan annuity option could be an efficient vehicle to provide stable retirement income that mitigates investment and longevity risk inherent in a retirement plan. However, if the in-plan option does not allow the purchase of insurance company annuities, the plan sponsor will have created a defined benefit plan subject to the funding, plan provision, Pension Benefit Guaranty Corporation (PBGC) premium and participant disclosure, and notification requirements of ERISA, as well as financial accounting and disclosure requirements for defined benefit plans. Most plan sponsors likely would not willingly convert a defined contribution plan to a plan subject to the more onerous current defined benefit plan requirements. Over the past several years, plan sponsors have migrated to defined contribution plans with the primary objective of eliminating these requirements and the volatility related to the investment and mortality risk associated with defined benefit plans.

An alternative approach is a defined contribution plan design where the defined contribution plan "underwrites" the annuity and measures mortality gains/losses annually, adjusting all annuitants' benefits accordingly, similar to the way a variable annuity would adjust for investment results on a plan's portfolio.

The following advantages and disadvantages address the in-plan annuitization approach to providing lifetime income from the point of view of the plan sponsor.

The advantages of the in-plan annuitization approach are:

a) the ability to negotiate better annuity purchase rates on a volume basis and, thus, to provide more retirement income for each dollar of account balance than the participants could obtain individually,

b) a retiree's ability to eliminate, through an annuity purchase option, the longevity and investment risk that could otherwise jeopardize the ability of the plan to provide lifetime retirement income. Such an annuity offering, if communicated effectively, would increase appreciation by participants of the plan, its offerings, and the sponsor's efforts,
c) the opportunity to educate participants about the role of inflation in eroding retirement financial security over time as well as the longevity risks inherent in lump sum payments, and the opportunity to address that by providing annuity products including variable or inflation adjusted annuities. Providing these services can help build good relations with employees, and
d) the ability to insure the longevity risks of the plan participants without tying up capital in insurance company risk margins or profits—and at potentially lower administrative costs.

The disadvantages of the in-plan annuitization approach are:

a) the fiduciary risk of selecting and continuing to offer specific annuity providers, particularly if an annuity provider becomes unable to meet its commitments, even temporarily. (The plan sponsor could reduce this risk somewhat by using several different annuity providers, albeit at an increase in cost.),
b) the fiduciary risk of deciding what types of annuities to offer, particularly whether to offer potential inflation protection through variable annuities or cost-of-living options, and, if so, the appropriate underlying fund options,
c) the potential participant agitation and/or discontent if another annuity provider not offered in-plan would provide a larger annuity payment, regardless of its financial stability,
d) the future political, administrative and compliance risk for an ever-expanding list of requirements, notifications, filings, disclosures and tests, as well as additional recordkeeping costs and the potential need to continue administering benefits for the participant even after he or she leaves for another employer,
e) the expectation by retirees of continued help and support by the sponsor, particularly with addressing difficulties with payment delays by the annuity provider, and
f) the plan sponsor's need to manage the investment risks of the underlying assets if the plan is insuring the longevity risks.

10. How commonly do plan sponsors offer participants the explicit choice of using a portion of their account balances to purchase a lifetime annuity, while leaving the rest in the plan or taking it as a lump sum distribution or a series of ad hoc distributions? Why do some plan sponsors make this partial annuity option available while others do not? Would expanded offering of such partial annuity options—or particular ways of presenting or framing such choices to participants—be desirable and would this likely make a difference in whether participants select a lifetime annuity option?

Partial lump sum options are rare in single-employer defined benefit plans and defined contribution plans. Generally, the lump sum option in a defined benefit plan (if offered) is all or nothing. Some multiemployer defined benefit plans offer partial lump sums, such as 10 percent or 30 percent, and these are somewhat popular, as they allow the participant to use immediate funds to transition from a working lifestyle to retirement, such as by paying off a mortgage or relocating. Partial lump sum options are most prevalent within the public sector. Plans sponsored by governmental entities frequently offer all, or a limited group of long-term employees, some version of a partial lump sum. These are often programs originally designed to encourage long-time service workers to remain in place and are commonly referred to as DROPs (deferred, or delayed, retirement option programs), in which continued service beyond a specified retirement age allows the participant to build up an account that will be paid as a lump sum at actual retirement. Partial lump sums are also quite common in plans that require employee contributions. The accumulated employee contributions often are the source of the lump sum, with the residual employer-funded portion of the benefit paid as an annuity.

We believe that expanding the options available in plans that currently offer lump sums would be desirable. This would permit the participant to elect to preserve some element of "longevity insurance," especially if designed such that the more distant portions of the annuity stream are protected (e.g., beyond age 80, or the participant's "life expectancy"), with the near term portion converted to the lump sum.

Branding the partial lump sum as a "longevity" or "safety net" approach should help with the popularity of such options, especially if employer communications are designed to explain the potential benefits available (as compared to the naive assumption that retirement planning only needs to consider the average life expectancy) and the relatively low cost of the annuity (e.g., the lump sum might only be reduced by 10 percent to 15 percent to provide the deeply deferred annuity).

11. Various "behavioral" strategies for encouraging greater use of lifetime income have been implemented or suggested based on evidence or assumptions concerning common participant behavior patterns and motivations. These strategies have included the use of default or automatic arrangements (similar to automatic enrollment in 401(k) plans) and a focus on other ways in which choices are structured or presented to participants, including efforts to mitigate "all or nothing" choices by offering lifetime income on a partial, gradual, or trial basis and exploring different ways to explain its advantages and disadvantages. To what extent are these or other behavioral strategies being used or viewed as promising means of encouraging more lifetime income? Can or should the 401(k) rules, other plan qualification rules, or ERISA rules be modified, or their application clarified, to facilitate the use of behavioral strategies in this context?

In our view, "behavioral" strategies for achieving greater use of lifetime income arrangements should be facilitated and encouraged, as one element of an overall plan for achieving this objective. Greater financial education, while critically important and necessary, is still not sufficient, and can only take us so far, since decision making is a product of both rational analysis and human psychology. Behavioral strategies involve reframing language and presentation, or restructuring choices and defaults, and could include some or all of the following:

a) Reframing language and presentation:

   i. Use clear and relevant terminology. "Guaranteed lifetime income" is likely a more effective term than "Annuity." Better still is "Guaranteed income for as long as you live," and "One-time lump sum payment" instead of just "Lump sum."
   ii. Require presentation of accrued benefits in the form of guaranteed lifetime income, and give such presentation primacy over any presentation of lump sum amounts. Individuals respond to perceived "signals" in making decisions (an example is the "normal retirement age" in a pension plan), and presenting guaranteed lifetime income as the first option shown could be such a signal.
   iii. Require disclosure of certain financial risks associated with retirement. This would include longevity risk (the risk of outliving your assets), the likelihood of living to certain advanced ages, and the benefits of guaranteed lifetime income in addressing longevity risk. The DOL could provide a model disclosure. Retirees' desire to not "burden their children" could be worked in as well, in counterpoint to the desire to leave a bequest.
   iv. Where a plan includes an annuity option that would be covered by a private insurance company, disclose information about the degree of state guarantee in the event of the insolvency of such insurer. (A more ambitious change, put forward by some and which would require legislation, would be the establishment of a national uniform guarantee of annuity benefits up to certain amounts, which could give annuities the same stamp of assurance that FDIC insurance gives to bank accounts.)

b) Restructuring choices and defaults:

i. Require that some form of lifetime income option be offered.
ii. Allow for or facilitate the use of different forms of lifetime income, such as:
    1. Partial annuitization
    2. Deeply deferred annuitization
    3. Incremental deferred annuity purchases during the accumulation period. This can be particularly valuable to avoid the significant interest rate risk of a one-time purchase at retirement.
    4. "Test-drive" or "trial" annuities, structured as a temporary initial default into an annuity for one or two years, followed by a final election. The idea is to get retirees accustomed and attracted to the idea of getting a monthly check rather than managing a lump sum (though such a feature increases the cost of the annuity because of greater opportunity for anti-selection).
    5. Cash-refund or other annuities that provide a full or partial return of principal. Though such a feature necessarily increases the cost of the annuity and thereby decreases the longevity insurance component, it can boost annuity election rates by helping to overcome concern about dying early and "losing" most of the money.
iii. To go a step further, make some form of annuity option the default form of distribution. However, the use of default annuitization should be approached carefully.
    1. Whereas current defaults in other areas, such as participation election or default allocation during accumulation, provide a somewhat universally good outcome, provide some floor of protection, and are somewhat reversible, default annuitization is not as simple. Each participant's situation is different in terms of future base income needs, expected Social Security income, and other sources of predictable income, e.g., rent payments, other available assets, and health status.
    2. Some participants will have account balances too small to provide for retirement regardless of whether it is taken as a lump sum (that may last just a few years) or as an annuity (guaranteed for life but in an amount insufficient to cover current expenses); it is not clear what is the right answer in such situations, which might depend in part on the structure of the overall social safety net. (If a default annuitization structure were to be pursued, one approach could be to make the default a lump sum for amounts below a certain level, such as the $5,000 level used in defined benefit plans, and make the annuity the default only for account balances above that level.)
    3. For all these reasons, immediate default annuitization of the entire account balance at retirement could be a poor fit for some participants. Any such default might best be designed initially as only a partial annuitization, perhaps also incorporating the concept of incremental annuity purchases and a deeply deferred element.
iv. Standardize products to some degree to potentially help individuals make better choices, even at the cost of limiting some flexibility. Consumers can suffer from decision paralysis when there are too many choices or when it is difficult to compare products. Standardization of products and such mechanisms as regulated exchanges could also have the potential to make markets more transparent and efficient, potentially reducing prices, and price disparities, for consumers. On the other hand, if standardization is done in the wrong way, the results could be counterproductive. Standardization requires additional government involvement, and any such effort would have to be approached carefully.

12. How should participants determine what portion (if any) of their account balance to annuitize? Should that portion be based on basic or necessary expenses in retirement?

Annuitization should fill the gap between basic income needs and predictable income sources. The first level of needs is basic living needs such as housing, food, clothing, transportation, healthcare, and other such predictable needs. The next level is discretionary spending, including the decision of whether to fund any or all of this with guaranteed income or to rely on withdrawals from savings. Predictable income sources include Social Security and any defined benefit income from another plan. Another consideration is whether annuitization is needed or if some or all of the needed income, at least in the initial years of retirement, could reasonably be generated by structured withdrawals from these or other funds. Regardless, the participant should consider longevity risk and the fact that it is significantly cheaper to provide for lifetime basic needs and desired discretionary spending by pooling longevity risk through annuitization; significant educational efforts are needed in this area. (Special considerations apply to low-income/low-wealth individuals—see our answer to Question 11.)

Another perspective is that not too much should be tied up in annuitization if it conflicts with other objectives, such as having adequate liquid emergency funds and leaving desired amounts to heirs. Having liquidity for emergencies is important, but emphasis on liquid emergency funds in lieu of lifetime income can also be overstated. First, one can sometimes structure payment of emergency expenses over a period of time. Also, drawdown of emergency funds can just leave one short of retirement income thereafter. Because of the desire to leave amounts to heirs, retirement income needs and bequest motives can easily become conflated in thinking about retirement planning, potentially leading to inefficient decisions about the retirement income component. One helpful approach is to separate bequest motives from retirement security planning and consider the degree to which resources are available for each.

All considerations of annuitization should include the health status of the annuitant. If an appropriate substandard annuity is not available for an annuitant in poor health, annuitization may not be appropriate for such individuals, except perhaps if the annuity includes a long “period certain.”

13. Should some form of lifetime income distribution option be required for defined contribution plans (in addition to money purchase pension plans)? If so, should that option be the default distribution option, and should it apply to the entire account balance? To what extent would such a requirement encourage or discourage plan sponsorship?

Some form of annuity option should definitely be available. (See also our answer to Question 11.) It is unlikely that it should be the default distribution option, however, unless substantial efforts were undertaken to educate plan participants about the nature of life income options. Each person’s situation is different and it is unlikely that a singular default option would fit all participants. For the same reason, any annuitization default should not apply to the entire account value. Also, if the lifetime income distribution is in-plan, then the unfavorable impact of gender neutral rates on males would have to be considered.

We recommend that a lifetime annuity option be required to be offered from a defined contribution plan. Doing so would provide the option for a form of “longevity insurance,” which is a key feature of retirement income security. However, we support this only if the requirement is accompanied by a clear set of regulations that will allow for their effective implementation without driving plan sponsors out of the system. (Plan sponsors must be able to offer these options and educate their employees about them without exposing themselves to undue risk. If they cannot do this, then the requirement could cause sponsors to exit the system.) Finally, we think it would be reasonable to allow a plan sponsor an exemption from offering an annuity option if that sponsor provided a defined benefit plan that met certain benchmarks regarding coverage and benefit levels (and perhaps without a lump sum option as well).

At the outset of such a requirement, we do not believe that the lifetime income should be required to be the default distribution in a defined contribution plan. In general, we believe that the default options should be selected by the plan sponsor, who has the best knowledge of its employees and can factor in the other benefit programs it may provide (such as a defined benefit plan) as well as the administrative implications of any default option. In this particular area, where substantial education and understanding of the options is needed initially, it is likely premature to require a default annuity option. Over time, a required default annuitization option might be considered if the level of education and comfort increases.

Each person's situation is different and it is unlikely that a singular annuity option would fit all participants. For the same reason, any annuitization requirement should probably not apply to the entire account value and could be selected from among the following alternatives:

a) an annuity derived from a set portion (e.g., 50 percent) of the account value with the remainder payable as a lump sum,

b) a high annuitization rate (e.g., 100 percent or 80 percent) applied to a portion of the account value until a basic needs threshold of annuity income is reached, with a lower annuitization rate (e.g., 0 percent or 20 percent) applied to the rest of the account balance, without creating a deemed violation of nondiscrimination regulations,

c) a deferred annuity (selected at retirement) scheduled to start at an advanced age, such as 75, 80, or 85; the account value would be reduced by the actuarial value of that income stream. (The annuity payment amount could be set by calculating immediate annuitization of the full account, but this option would only reduce the account by the value of the annuity payments beyond the specified age), or

d) a deferred annuity that begins at a fixed future point (e.g., 10-15 years after the retirement date), with the remainder of the account value available as an immediate lump sum.

If there is a default requirement, multiple varieties could be offered as a safe harbor, with the decision on the type of default left for the plan sponsor to decide (and to change periodically for new retirees, as circumstances warrant).

Depending on the success of the default approach, and the political desire or need for a more structured means of enhancing retirement security in the future, these concepts could conceivably be extended to constitute mandated minimum lifetime income requirements.

Finally, we do not see an obvious impact on the plan sponsor's decision to maintain a plan, so long as there is flexibility on both the types of annuity offered or mandated as a default, and plan sponsors have the ability to source the annuity. The sourcing can be (i) within the qualified defined contribution plan (requiring a pricing mechanism and actuarial management of that segment), (ii) within an existing companion defined benefit plan, or (iii) with an insurer (with some regulation to ensure a "safe annuity").

Note that if the lifetime income distribution is offered within the qualified plan, then the relatively unfavorable impact of unisex rates on males (with the corresponding subsidization of rates for females) would have to be considered. 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.

14. What are the impediments to plan sponsors' including lifetime income options in their plans, e.g., 401(k) or other qualification rules, other federal or state laws, cost, potential liability, concern about counterparty risk, complexity of products, lack of participant demand?

Concerns about potential liability, counterparty risk, complexity of products, and lack of participant demand are all impediments to plan sponsors including lifetime income options in their plans. So too are increased recordkeeping and other administrative costs and the potential need to continue administering benefits for the participant even after he or she leaves for another employer

There is a wide range of options currently available and the products can have features that are difficult for lay people to understand. For many participants, the right choice of features can be important. However, making everything available to the participant inside the plan could be administratively expensive.

Many investment platforms may offer one type of proprietary annuity. However, they do not tend to offer a variety of annuities from different vendors and with different features. Adding options outside the investment platform can significantly increase the administrative burden for employers.

Selecting the best set of options, as well as the best provider, leaves the plan fiduciaries with significant liability for that choice.

15. What are the advantages and disadvantages of approaches that combine annuities with other products (reverse mortgages, long term care insurance), and how prevalent are these combined products in the marketplace?

The advantage of combining annuities with reverse mortgages is that it creates a vehicle to withdraw value from what is the primary retirement asset for many households while addressing a significant guaranteed income need. If structured appropriately, it can be an efficient method to address needs while avoiding duplication of sales expenses. Because it is the combination of two dissimilar products, each of which has its complexities, assurance of strong education and counseling is imperative, as well as adequate coordinated regulatory oversight to the extent that elements of these combined products fall under multiple jurisdictions. There are no inherent disadvantages if the two components are priced reasonably and reflect reasonably low sales costs.

The advantage of annuity/long-term care (LTC) combinations is that they provide a way to partially pay for part of the LTC benefit by drawing down value in the deferred annuity. This reduces the cost of subsequent LTC benefits, because they have a long waiting period within the combination plan. In the absence of the annuity/LTC combination, either special assets would have to be set aside for LTC emergencies or separate LTC insurance would have to be purchased. The combination annuity/LTC creates a middle ground in which benefits are prefunded at an efficient cost. The disadvantage is that if other retirement income sources prove inadequate for other needs, then it may be necessary to withdraw funds from the annuity and, thus, water down the LTC benefits.

16. Are there differences across demographic groups (for example men vs. women) that should be considered and reflected in any retirement security program? Can adjustments for any differences be made within existing statutory authority?

The most significant demographic difference is the longer expected lifetime of females vs. males (as a result, 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). The requirement of unisex annuitization within qualified plans is an impediment to annuitization by males under in-plan options. The current solution for males lies in taking lump sum distributions and then annuitizing outside the plan on a sex-distinct basis. Broader use of this solution could increase the cost of unisex annuitization within plans.

Another demographic issue is how differences in health status affect the price of income and its availability. 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 third demographic issue is found in the socioeconomic composition of a group. 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.

Participant Education

The Department of Labor issued Interpretive Bulletin 96-1 (29 CFR 2509.96-1) to clarify that the provision of investment education, as described in the Bulletin, will not be considered the provision of "investment advice," which would give rise to fiduciary status and potential liability under ERISA for plan participants' and beneficiaries' investment decisions.

17. What information (e.g., fees, risks, etc.) do plan participants need to make informed decisions regarding whether to select lifetime income or other arrangements designed to provide a stream of income after retirement? When and how (i.e., in what form) should it be provided? What information currently is provided to participants, who typically provides it, and when and how is it provided to them?

In order to make an informed decision, a participant needs to understand:

a) the need for and value of longevity protection,
b) various approaches to address the issue, including both annuities and self-managed programs such as systematic mutual fund withdrawal programs,
c) death benefits and income guarantees for surviving family members after the death of the participant,
d) the costs and available income amounts of the various approaches,
e) the limitations within the approaches, e.g., the varying levels of illiquidity in different annuity products and the uncertainty of the sufficiency of a systematic withdrawal program,
f) the risks of the various approaches, e.g., purchasing an annuity when interest rates are low, tradeoffs between income amount and guarantees of minimum returns, the impact of a market fall in the early part of a mutual fund withdrawal program, the impact of inflation if the income stream does not protect against it,
g) the basics of annuity products, especially in rollover situations, and
h) the risk of the temptation to spend down segments of a lump sum or to take undue investment risk with it, including education about the differences between "expected" returns and the possible range of returns.

Information should be provided on at least an annual basis throughout employment, perhaps with greater depth and intensity during the ten-year period prior to the normal retirement date. A combination of educational booklets and annual benefit statement communications should be the medium for all employees. Additionally, preretirement seminars should be offered for employees approaching retirement within the next 10 years. This information should also be available to the participant on request during the participant's working years in order to begin the process of planning for future events.

Currently, plan sponsors commonly provide generic articles on retirement preparedness issues, but there is little individualized information beyond a statement of current benefits provided by the retirement plan. Some employers provide preretirement 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.

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. Greater educational efforts and standardization of certain products would help in this regard.

Education is critically important, but education alone is not enough. Please see our answer to Question 11 for more in this regard.

18. Is there a need for guidance, regulatory or otherwise, regarding the extent to which plan assets can be used to pay for providing information to help participants make informed decisions regarding whether to select lifetime income or other arrangements designed to provide a stream of income after retirement, either via an in-plan or out-of plan option?

The answer may differ between defined benefit plans and defined contribution plans. In a defined benefit plan, the assets do not determine benefits; consequently, any cost flows back to the employer without an impact on the participant. The question then becomes how much the employer should be expected to spend for providing the education.

In a defined contribution plan, if there are no direct or indirect fees to reimburse the employer for the costs of the education, then the situation is the same as for a defined benefit plan. If the employer does receive administrative expense reimbursement from the plan, then there might be a need to limit the amount that can be drawn from the plan assets.

20. To what extent should plans be encouraged to provide or promote education about the advantages and disadvantages of lifetime annuities or similar lifetime income products, and what guidance would be helpful to accomplish this?

Plans should be encouraged to provide education about lifetime income products (how they work, key features, pros and cons, etc.) and the options available to them. While customized material about specific options within the plan should be encouraged (often prepared by the vendor), the DOL could provide a notice (similar to the tax notice currently provided by the IRS on distributions) that would provide generic information on the importance of income guarantees extending for life. This should include illustrations of the probability of survival to various ages beyond average life expectancy at retirement, using one of a set of standard mortality tables. Plan sponsors could also provide information on their company intranet site or during company-run HR/union meetings.

Disclosing the Income Stream That Can Be Provided From an Account Balance

ERISA section 105 requires defined contribution plans to furnish to each participant an individual benefit statement, at least annually, that includes the participant's "accrued benefits," i.e., the individual's account balance.

21. Should an individual benefit statement present the participant's accrued benefits as a lifetime income stream of payments in addition to presenting the benefits as an account balance?

Yes. 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.

22. If the answer to question 21 is yes, how should a lifetime stream of income payments be expressed on the benefit statement? For example, should payments be expressed as if they are to begin immediately or at specified retirement ages? Should benefit amounts be projected to a future retirement age based on the assumption of continued contributions? Should lifetime income payments be expressed in the

form of monthly or annual payments? Should lifetime income payments of a married participant be expressed as a single-life annuity payable to the participant or a joint and survivor-type annuity, or both?

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.

23. If the answer to Question 21 is yes, what actuarial or other assumptions (e.g., mortality, interest, etc.) would be needed in order to state accrued benefits as a lifetime stream of payments? If benefit payments are to commence at some date in the future, what interest rates (e.g., deferred insurance annuity rates) and other assumptions should be applied? Should an expense load be reflected? Are there any authoritative tools or sources (online or otherwise) that plans should or could use for conversion purposes, or would the plan need to hire an actuary? Should caveats be required so that participants understand that lifetime income payments are merely estimates for illustrative purposes? Should the assumptions underlying the presentation of accrued benefits as a lifetime income stream of payments be disclosed to participants? Should the assumptions used to convert accounts into a lifetime stream of income payments be dictated by regulation, or should the Department issue assumptions that plan sponsors could rely upon as safe harbors?

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. 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.

24. Should an individual benefit statement include an income replacement ratio (e.g., the percentage of working income an individual would need to maintain his or her pre-retirement standard of living)? If so, what methodology should be used to establish such a ratio, such as pre-retirement and post-

retirement inflation assumptions, and what are the impediments for plans to present the ratio in a meaningful way to participants on an individualized basis?

This issue is part of the broadly needed education of participants. It would appear too heavy a topic to address in a benefit statement, particularly since retirement needs are very individualized. An individual replacement ratio analysis ideally should include Social Security, defined benefit plan coverage, part-time work, plans sponsored by prior employers and non-plan savings sources, as well as any spousal retirement income. This comprehensive treatment is obviously not appropriate for an employer benefit statement.

As an alternative, participants might be given tools—e.g., a structured set of questions, perhaps online—to fill in this information themselves.

401(k) and Other Plan Qualification Rules

Income Tax Regulations that apply specifically to lifetime annuities include: 26 CFR 1.401(a)-11, 26 CFR 1.401(a)-20, 26 CFR 1.401(a)(9)-1 through 26 CFR 1.401(a)(9)-9, 26 CFR 1.417(a)(3)-1, and 26 CFR 1.417(e)-1.

25. How do the 401(k) or other plan qualification rules affect defined contribution plan sponsors' and participants' interest in the offering and use of lifetime income? Are there changes to those rules that could or should be made to encourage lifetime income without prejudice to other important policy objectives?

The required minimum distribution rules discussed in Question 28 limit the extent to which payments from a qualified plan may be deferred and define minimum amounts that must be distributed upon attainment of the participant's required beginning date under IRC Section 401(a)(9) (generally April 1 following the calendar year of attainment of age 70 ½). Requiring participants to commence benefits by their early 70s limits a plan's ability to provide adequate longevity insurance (via a lifetime income option) for those living beyond their life expectancy. Longevity insurance could be promoted by allowing the benefit payment to begin later than otherwise required if it is taken in the form of a life annuity.

An additional approach to increasing the offering and use of lifetime income arrangements would be to change the relative tax treatment of lump sum and lifetime income arrangements—by either giving a tax break to income taken in the form of guaranteed lifetime income arrangements or applying a tax penalty on qualified retirement distributions taken as a lump sum. The rationale for such a change in the tax code would be two-fold. First, it would promote greater retirement security. Second, one could argue that lump sums impose a social cost relative to lifetime income arrangements, in that electing a lump sum instead of a lifetime income arrangement increases the likelihood of later running out of money and requiring government assistance (e.g., Medicaid, welfare, SSI). Adjusting tax rates would be a way of offsetting this public subsidy.

Any such differential tax treatment of lifetime income arrangements and lump sums should be designed with the following in mind:

a) The same tax breaks or penalties would apply to both defined contribution and defined benefit plans, so as not to favor one over the other (unless that were the goal of policy).
b) While a penalty on lump sums could be expected to reduce the rate of lump sum elections (and thereby increase the rate of lifetime income elections), those who did elect a lump sum despite the penalty would be even more likely to outlive their assets.
c) The effect on election rates of a tax break on lifetime income elections versus a tax penalty on lump sum elections is likely to differ. It would be useful to attempt to anticipate potential outcomes, in part by using findings from behavioral finance.

28. How do the required minimum distribution rules affect defined contribution plan sponsors' and participants' interest in the offering and use of lifetime income? Are there changes to those rules that could or should be made to encourage lifetime income without prejudice to other important policy objectives? In particular, how are deferred annuities that begin at an advanced age (sometimes referred to as longevity insurance) affected by these rules? Are there changes to the rules that could or should be considered to encourage such arrangements?

In an indirect sense, required minimum distribution (RMD) requirements can be thought of as a substitute for annuitization insofar as RMDs themselves are a form of lifetime income; however, RMDs are inadequate for retirement planning due to the unpredictable and potentially decreasing profile of income that they provide. In the case of longevity insurance (as defined in this question to be the subset of income annuities that are deferred to an advanced age), the value of a qualified annuity is subject to RMDs between the age of 70½ and the commencement of income payments. This complicates and discourages the use of longevity insurance with tax qualified funds (except in the context of Roth IRAs) unless there is an alternative source from which to draw the RMDs generated by the longevity coverage.

To encourage the purchase of deferred-start income annuities, an exemption from RMD requirements similar to that for immediate annuities could be provided. This would exempt all life-contingent deferred income annuities from RMD. If loss of tax revenue were a concern, exemption from the RMD requirement could be limited to only the pure annuity portion of the payment option—i.e., excluding any death benefits, surrender benefits, or certain payments.

29. Are employers that sponsor both defined benefit and defined contribution plans allowing participants to use their defined contribution plan lump sum payouts to "purchase" lifetime income from the defined benefit plan? Could or should any actions be taken to facilitate such arrangements? Should plans be encouraged to permit retirees who previously took lump sums to be given the option of rolling it back to their former employer's plan in order to receive annuity or other lifetime benefits?

Currently, few sponsors allow participants in employer-sponsored defined benefit plans to purchase lifetime income annuities using a rollover from an IRA or the employer's defined contribution plan. Many defined benefit plan sponsors are grappling with issues related to cash contribution, income statement and balance sheet volatility, so they currently may be reluctant to offer this option to their employees with the defined benefit plan insuring the longevity and investment risk for this portion of the liability. In addition, these types of purchases would increase the size of the plan relative to the size of the plan sponsor, a risk factor for employers to consider. However, there are techniques available to plan sponsors to mitigate these risks in a defined benefit plan setting that are not available to individual participants insuring against those same risks. For example, a qualified plan sponsor can receive more favorable pricing on a group annuity contract from an insurance carrier than an individual is likely to receive (thus allowing a participant to access a larger monthly income stream through an employer's plan than is available through an individual annuity contract). Also, a qualified plan sponsor could implement an immunization strategy for investing the assets supporting the portion of their obligation that represents annuities purchased with defined contribution plan rollovers, thus mitigating (or even eliminating) the funding status volatility with respect to that portion of the plan's liabilities. In addition, if defined benefit plan sponsors were permitted to provide the annuities at or close to the actuarial basis used in determining the Pension Protection Act funding target, the purchases may offer the advantage of improving the funded ratio of an underfunded plan.

Providing lifetime income through a defined benefit plan 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. We believe that employers should 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. These purchase options could also be made available for a portion of the distribution (partial annuitization) or for the purchase of a deferred annuity starting at a later age (for even greater longevity insurance). (See also the response to Question 13.) However, it should be recognized that any time a choice is allowed between a lump sum and an annuity, there is some amount of anti-selection cost. And allowing retirees who previously took lump sum distributions to purchase such an annuity would subject the plan to even greater anti-selection risk.

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. To our knowledge, the PBGC has not formally opined as to the "priority category" for such benefits. Since such benefits would be fully funded upon "purchase," and transferred voluntarily from the participants' own individual accounts, we believe they would logically fall into Priority Category 1 under ERISA Section 4044. Moreover, if the benefits were to fall into a low priority category, with significantly greater risk of loss, such benefit purchases could be significantly discouraged.

To further encourage the option of using defined contribution accounts to purchase lifetime income from a defined benefit plan, plan sponsors who start a *new* defined benefit plan for this purpose only could be offered safe harbor relief from certain qualification, funding and/or reporting requirements. Plan sponsors offering this could also be encouraged or required to offer annuities with a refund feature if the participant dies within a certain period of time following the rollover to the defined benefit plan, though this always has a cost and may not be needed in a partial rollover situation.

Comments Regarding Economic Analysis, Regulatory Flexibility Act, and Paperwork Reduction Act

Executive Order 12866 (EO 12866) requires an assessment of the anticipated costs and benefits of a significant rulemaking action and the alternatives considered, using the guidance provided by the Office of Management and Budget. In addition, the Regulatory Flexibility Act (RFA) may require the preparation of an analysis of the economic impact on small entities of proposed rules and regulatory alternatives. For this purpose, the agencies consider a small entity to be an employee benefit plan with fewer than 100 participants. The Paperwork Reduction Act (PRA) requires an estimate of how many "respondents" will be required to comply with any "collection of information" requirements contained in regulations and how much time and cost will be incurred as a result.

The agencies in this section of the RFI are requesting comments that may contribute to any analyses that may eventually need to be performed under EO 12866, RFA, and PRA, both generally and with respect to specific areas identified in Questions 36 through 39.

37. Are there unique costs to small plans that impede their ability to offer lifetime annuities or similar lifetime income products as an in-plan option to their participants? What special consideration, if any, is needed for these small entities?

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.