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To: Employee Benefits Security Administration, Department of Labor
Internal Revenue Service, Department of the Treasury

Re: Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans

I am an actuary and a financial planner, and I also do research and writing on retirement income products and planning. I am a member of the Society of Actuaries Committee on Post-Retirement Needs and Risks and chair of subgroup on Decisions at the Time of Retirement. The comments that follow reflect my own opinions.

I think it is laudable that your Departments are focusing on lifetime income options within retirement plans, and I appreciate your reaching out for input. I carefully read over the Request for Information and the 39 questions, and, for me, the questions posed a bit of a dilemma. My personal view is that we need a major overhaul of the defined benefit and defined contribution plans that currently form the core of our private retirement systems. However, I also realize that incremental change may be the only practical alternative. Therefore, I offer this two-pronged response.

First, I happen to have recently submitted a paper to the Society of Actuaries Pension Council, in response to their request for proposed designs for a new Tier II Retirement System to replace the current system of defined benefit and defined contribution plans. Significant portions of that proposal involve recommendations on how to provide guaranteed retirement income as part of a new retirement system. My proposal involves considerable simplification and standardization of the overall retirement system. With the changes I propose, it would be straightforward to incorporate products that provide lifetime income. However, I realize that your Departments are looking at possible changes to the existing 401(k) structure, so you may not be currently interested in changing the whole retirement system. For your future interest, I have attached the executive summary to my paper. I would be happy to share the full paper with anyone who is interested.

Second, in the remainder of this memorandum, I'll address the approach to retirement income I would recommend in the context of existing retirement systems. I initially tried to answer each of the 39 questions, but I've decided I can provide more useful input by focusing on the following key points.

Advantages of lifetime payments—There's a misconception about the risk of buying an immediate annuity—"Buy an annuity, have the misfortune to die early, and your heirs lose out." If one thinks of buying an annuity to cover basic living expenses that will end at death, then the annuity provides a way of hedging risk. The payment stream matches up with the expense stream. If the individual does not annuitize, and uses savings to pay for living expenses, heirs may face the risk of paying for later-in-life expenses.

Why do people prefer to take lump sums? Why don't more people buy immediate annuities? I've seen a number of studies that try to develop a better understanding of individual behavior, but what seems to be underappreciated is the role of financial sales people. In simple terms, people tend to buy the financial products that are sold to them. No one, except maybe an actuary, would take the initiative to buy an annuity. Financial sales people don't like immediate annuities (sales of about $10 billion per year), but they do like variable annuities (sales of about $250 billion per year). Variable annuities can be rolled over into new variable annuities that produce new commissions—"a gift that keeps on giving"—immediate annuities cannot. Financial sales people respond to incentives.

Lifetime income products—the good, not-so-good, and the bad.

Good—Immediate Annuities*:* a simple product that directly meets the need for guaranteed lifetime income. "Pay X dollars, receive Y dollars per month for life." I'd like to see more product offerings with annual adjustments for inflation. Such products would work well as options inside retirement plans. To keep things simple and understandable, the annual inflation adjustments could be tied to the same percentage adjustments and timing that apply to Social Security payments.

Good—Standalone Living Benefits: a new product on the scene, not yet well known. The product basically involves the combination of an investment fund and a wrapper that provides guaranteed lifetime income if the investment fund is depleted. This product was the brainchild of Professor Moshe Milevsky of York University in Canada and was originally called the Ruin Contingent Life Annuity (RCLA). For a good description see:
http://www.ifid.ca/pdf_workingpapers/WP2007SEPT15_RCLA.pdf
The ideal underlying fund for this product would be an age-based bond/stock mix containing all low-cost index funds. This would be an excellent product to offer in retirement plans along with immediate annuities. This product would provide less income that the immediate annuity, but more attractive refund features in the event of early death. I'd suggest renaming this product the Guaranteed Systematic Withdrawal product.

Not-So-Good—Longevity Insurance: a relatively new product that has not taken off and likely never will. It's basically an immediate annuity with a long deferral period. For example, a 65-year-old could buy longevity insurance that begins making monthly payments at age 85. The individual could then live off savings, but with the assurance that the savings only need to last to age 85 when the payments kick in. The problem is that it's not as easy as it sounds to manage a savings portfolio to last for a fixed number of years. The Standalone Living Benefits product does a much better job—it starts paying when the fund runs out, whether due to longevity or poor investment performance.

Bad—Variable Annuities: (and, ironically, the best selling annuity product) The most popular version of this product is one containing a guaranteed lifetime withdrawal benefit. A problem is that this benefit typically only guarantees 5% of the initial investment without inflation adjustments. That's equivalent to roughly 3 ½% inflation-adjusted. An individual should be able to take 4% from a regular savings portfolio in inflation-adjusted systematic withdrawals with minimal risk of running out of funds, so the lifetime guarantee in a variable annuity guarantee isn't adding value. Annual charges on variable annuities (including fees for the guarantee rider) typically run about 3%, so the return premium for investing in stocks gets eaten up in fees. These products have a number of other bells and whistles that offer little more than sales-pitch value. I'm disappointed to see variable annuities beginning to make their way into 401(k) plans.

Fiduciary safe harbor, and financial risk in products—If we're going to add products with lifetime guarantees, it needs to be easy for plan sponsors to bring in products without confusion over product choice, or fear of violating poorly understood laws, or getting sued because the product providers go belly-up. In my proposal for an overhaul of the retirement system, I propose a Federal Retirement Board and sanctioned Registered Retirement Companies that would offer the investment and annuity products for qualified retirement plans. The PBGC would provide backup guarantees. Things are messier when trying to add guaranteed products in the existing retirement system with the existing regulatory system that involves both state and federal regulation. I don't possess an in-depth understanding of the regulatory particulars, but there needs to be some sanctioning of products so plan sponsors can be comfortable offering them, and there needs to be some way of providing meaningful backup guarantees of long-term performance.

Hybrid products—Annuities with LTC or with reverse mortgages—My proposal for overhauling the pension system provides a lot of detail advocating a "life care annuity," which is an immediate annuity with a long-term care pop-up feature that pays extra income if retiree needs long-term care (as determined by ADL criteria). A big advantage of adding the long-term care pop-up is that it helps to overcome resistance to purchasing immediate annuities because of risk of needing extra funds due to health deterioration. This feature would also reduce the aversion to immediate annuities for those in less than perfect health.

It might also be feasible to include home equity among the assets that participants can choose to annuitize or not at retirement. The biggest problem with reverse mortgages as currently offered is the huge up-front cost that make the product viable only for those who can plan to stay in their current home for a very long time There are indications that competition may be starting to bring down fees, which is a positive sign. Home equity is the largest asset for many middle and lower-income Americans, so it's worth looking at finding better ways to easily turn housing assets into retirement income.

Financial advice—I've seen various proposals about who should be allowed to give advice to 401(k) plan participants, but I think there needs to be a lot more focus on advice than any of these proposals contemplate. I like the idea proposed two years ago by Robert Shiller that the government should subsidize the provision of unbiased, fee-based financial advice. (New York Times, January 17, 2008) Currently lower and middle-income individuals receive professional advice mostly from people who are trying to sell them something. Providing incentives for unbiased, fee-based advice would help turn the advice business in a better direction. Individuals are confused now, just trying to choose among investment options. If we add in options with lifetime guarantees, we will add significantly to the confusion unless we do something about financial advice. My full proposal gets into much more detail on how to improve the advice regime, including the need to develop better financial planning software. To the extent that products can be simplified and standardized (my full proposal also advocates for low-cost index funds for investments) that will help streamline the financial planning process.

I wish you the best of luck with your project of trying to bring more focus on lifetime income to retirement plans. I will be happy to answer any questions or supply additional comments on particular topics of interest.

Sincerely,

Joe Tomlinson

1. Executive Summary (Proposal for New Tier II Retirement System)

This is a proposal for a new retirement system for the United States intended to replace the current system of defined benefit and defined contribution plans. As a proposal for Tier II, this plan addresses the retirement needs that fall between those covered by Social Security (Tier I) and those provided for by private taxable savings (Tier III).

The proposed plan consists of two principal components. The first will be a funded, inflation-linked pension that will provide secure lifetime income in addition to Social Security. This component, which I have named the Individual Pension Account, is similar in some ways to the Guaranteed Retirement Account (Ghilarducci 2008), but there are significant differences including a more prominent role for private sector insurance and investment companies. The second component, the Retirement Savings Account, will consolidate various tax-advantaged savings plans like 401(k)s, IRAs, 403(b)s, and others. This new savings plan will offer a significantly simplified and standardized menu of investment choices, along with income guarantees that employees can utilize at or after retirement. I feel that a two-pronged approach—improving retirement savings plans and adding mandated pensions--will do a better job of meeting retirement needs than placing all the emphasis on either savings or pensions.

More specifically, this proposal calls for:

- The establishment of an independent Federal Retirement Board responsible for the design, implementation, and management of a New Tier II Retirement System

- The establishment of special purpose retirement management companies, called Registered Retirement Companies, that will offer Individual Pension Accounts and Retirement Savings Accounts, and perform the functions of taking retirement plan contributions, managing investments, and offering retirement annuities and other products with guarantees

- A requirement that all employers with five or more employees set up retirement plans with Registered Retirement Companies

- The establishment of a system of Individual Pension Accounts that will be mandatory for most employees, require employee and employer contributions of 2 ½% of pay each, invest the funds in inflation-adjusted GICS, and mandate the purchase of inflation-adjusted annuities at or after retirement

- The consolidation of all existing retirement savings plans—401(k)s, IRAs, 403(b)s, and others—into a single Retirement Savings Plan with a single set of rules.

- A dramatic simplification and standardization of the menu of fund options with an age-based asset allocation fund as a default fund and low-cost index funds for most of the other fund choices

- For Retirement Savings Accounts, the offering, at retirement, of both immediate annuities and a Guaranteed Systematic Withdrawal Plan, in addition to the standard fund options

- The establishment of a Registered Retirement Advisor designation for individuals who qualify to offer retirement advice based on education, exams, and experience; and who agree to provide advice on an hourly fee-only basis

This proposal also calls for changing the tax subsidies for retirement plans:

- Tax deferral of retirement savings contributions, but with the annual limit lowered from the current $16,500 for 401(k) plans to $7,500

- $300 refundable tax credit for all employees, offsetting part of the cost of the required 2 ½% employee contributions to Individual Pension Accounts

- $25 per account subsidy payable to RRCs for Individual Pension Accounts or Retirement Savings Accounts under $10,000

- Reimbursement up to $500 per year for the use of financial planning services from Registered Retirement Advisors

Besides the mandated changes, this proposal also contains recommendations for consideration by those developing retirement products or providing retirement planning services:

- Retirement annuity products with a long-term care pop-up feature that pays additional income if the recipient needs long term care

- Changes and enhancements to financial planning software—some needed to mesh with the particulars of the New Tier II Retirement System, others to improve the usefulness of the software

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