AMERICAN ACADEMY *of* ACTUARIES

Department of Labor/Department of the Treasury Public Hearing on Lifetime Income Options for Retirement

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Oral Testimony as Delivered by
Noel Abkemeier, Member, Life Products Committee
Frank Todisco, Senior Pension Fellow

Good morning. I'm Frank Todisco, and to my right is Noel Abkemeier,[1] and we're here on behalf of the American Academy of Actuaries.[2]

We would like to commend the Department of Labor and the Department of the Treasury for addressing the issue of lifetime income security,[3] and we thank the Agencies for the opportunity to testify today.

We support the Agencies' efforts to facilitate access to, and use of, lifetime income arrangements. From an actuarial perspective, we recognize that lifetime income arrangements protect against longevity risk, the risk of people outliving their financial resources. Lifetime income arrangements are also economically efficient, since it is significantly less expensive to pool longevity risk through a lifetime income arrangement than to "self-insure" the risk by accumulating assets adequate to last until a very old age. Lifetime income arrangements also provide other benefits: they provide retirees with a budgeting signal to help protect against overspending; they help retirees avoid unnecessarily underspending out of fear of outliving their resources; and they reduce senior citizens' money management responsibilities at advanced ages, when they might be significantly less able to manage investments and finances.

A multi-pronged effort would be most effective in expanding access to and use of lifetime income arrangements, including: improving financial literacy; incorporating behavioral finance ideas in disclosures and plan design; utilizing diverse types of lifetime income options to address participant concerns and individual circumstances; and requiring that a guaranteed lifetime income option be offered in tax-qualified plans (more on this later).

We turn now to the Agencies' specific questions, starting with questions two and three, which deal with information to help participants make choices regarding lifetime income arrangements, including disclosure of account balances as equivalent lifetime income streams.

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[1] Frank Todisco represents the Academy's Pension Practice Council and Noel Abkemeier represents the Academy's Life Practice Council. Together their experience covers both retirement security issues and life insurance and annuity product issues. They also meet the professional qualification standards of the American Academy of Actuaries to render actuarial opinions on these matters.
[2] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
[3] In May, the Academy submitted written comments in response to the Agencies' *Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans*.

How much information should be provided to participants? There is a delicate balance between providing participants with adequate information to make informed choices, versus overwhelming participants with too much information and overburdening plan sponsors with excessive administrative requirements. A tiered approach can be useful. Basic information could be presented on a first page and extended information on a second page for those who wish to dig more deeply.

A set of standardized required disclosures would create uniformity across plans, so that all employees get the same message, regardless of where they work. We recommend that the Agencies provide model disclosures and safe harbors, both for information provided and the assumptions, updated annually, used to derive it, to facilitate good faith efforts to provide accurate and appropriate information. Plan sponsors could always voluntarily go further in providing additional information.

We do support showing the account balance as an equivalent monthly or annual income stream – in fact, an annual amount could provide a more useful comparison against a lump sum, and ought to be considered – and prioritizing it in the order of presentation. The specific wording used to present a lump sum and its equivalent lifetime income should be chosen carefully, based on the findings of behavioral finance, to convey fundamental risks and benefits about these options.[4,5]

In projecting future lifetime income, an assumption has to be made about when the participant will retire. Here, the participant's age for full eligibility for Social Security benefits would be a good choice, for consistency across programs. Also, an assumption has to be made about future contributions to the account. Two possibilities are a continuation of the participant's current contribution rate or a uniform specified percentage of salary for all participants.

It would also be useful to illustrate, as a variation, the effect of contributing one percent more than the assumed contribution rate, in order to demonstrate the effect on retirement security of increased savings. However, such additional information might be relegated to secondary disclosure.

Another consideration is whether the lifetime income amount should include inflation protection, a certain period or other form of death benefit, and coverage for a surviving spouse.[6]

A cautionary note should be raised here: Projecting future income or account balances creates comparability issues because a dollar in twenty years is worth less than a dollar today. Consequently, it would be useful to show projected lifetime income as a percentage of final compensation, that is, as a replacement ratio. Similarly, it would be useful to show any projected lump sum amount as a multiple of final compensation.

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[4] Consider, for example, that the two basic choices could be labeled simply as "monthly annuity" and "lump sum." But consider an alternative, where the annuity is labeled "guaranteed income for as long as you live, no matter how long"; and the lump sum is labeled "one-time lump sum payment, with no further payments thereafter." The choice of words can have a significant effect on behavior.

[5] All of this information would be helpful to both participants close to retirement and to younger participants; it would help the younger group start to think earlier about retirement security.

[6] Recognition could also be given in the disclosure of values that lifetime income can be provided not only through traditional annuities but also through withdrawal programs with lifetime guarantees. The distinction is important because the former limits access to assets while providing income and the latter maintains access to assets while generally providing a lower income, though still guaranteed for life.

A second cautionary note involves the way in which future investment return is calculated: whether to use conservative, high-quality bond yields or to include anticipated stock market returns. Including a return on stocks would be problematic, for two reasons: first, it would mean estimated investment returns that varied from participant to participant, based on each participant's asset allocation; second, the projection would be incomplete without substantial additional disclosures about the risks inherent in stock market projections.

There should also be internal consistency among all assumptions. For example, a projection of future contributions to the account requires a projection of future compensation. If compensation is projected to stay level rather than increase, implicitly that means that both inflation and productivity growth are expected to be zero, so that assumed investment return would need to be ratcheted down accordingly. An alternative assumption for future compensation growth would be a standardized rate of anticipated long-term inflation plus productivity growth.

Any projection of annuity conversion rates should reflect anticipated future mortality improvement, since guaranteed lifetime income will continue to become more expensive as longevity continues to increase.[7]

Finally, assumptions should be disclosed, along with caveats about the uncertainty inherent in projecting into the future.

I will now turn the remainder of the Academy's statement over to my colleague Noel Abkemeier.

The fourth set of questions relates to fiduciary safe harbors for selection of lifetime income issuer or product.[8] We'd like to make two points here. First, safe harbors should be expanded in order to facilitate plan sponsors offering a broader range of options, thereby broadening consumer choice concerning lifetime income products. Second, safe harbors should be extended to other lifetime income options besides annuities, again for the purpose of broadening consumer choice.

The fifth set of questions[9] concerns alternative types of lifetime income arrangements. Many solutions exist but the challenge is to raise awareness of them and educate consumers and plan sponsors of their

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[7] Annuity conversion rates could be based on surveys of individual and group annuity prices (such as the PBGC conducts for group annuity prices), which have interest rates, mortality, expense and profit margin embedded within, and then projecting these prices to reflect anticipated future mortality improvement.

[8] We leave it to others to address the specificity of safe harbor design.

[9] The Agencies' first set of questions is about participant concerns regarding lifetime income options. A few words about them here. (i) Two of these concerns are inflation risk and lack of or limits on death benefits and withdrawal options. In fact, there are out-of-plan products that include coverage of these items, albeit at a cost. To the extent participants are unaware of these options, further education is needed. As for in-plan options, in plans where a lifetime income option is offered, inflation or death benefit options often are not included; encouraging plan sponsors to offer these options could lead to increased use of lifetime income options. (ii) Another participant concern related to the long-term viability of an institution issuing a lifetime income product. Substantial protection is provided by life and health insurance guaranty associations in each state, and awareness of this should be created in the education process. Whether any stronger government guarantees should be provided is another policy issue. (iii) Another participant concern is over the fees and complexity associated with some lifetime income products. This can be addressed in part through education and appropriate illustrations and disclosure at the point of sale. Greater standardization of disclosure regarding product features and fees could be one way to improve comparability and participants' understanding of lifetime income products.

value in addressing longevity risk. Having both in-plan and outside-of-plan solutions is essential so that participants in all situations can have access to lifetime income arrangements. Many options already exist outside of plans; it would be helpful to have more lifetime income options available within plans as well.

We support a requirement that some form of guaranteed lifetime income be one of the investment or distribution options offered in tax-qualified individual account plans, provided that the requirement is accompanied by a clear set of regulations that will allow for their effective implementation at reasonable cost and without subjecting plan sponsors to undue fiduciary risk. Individual plan sponsors should also be permitted to make an annuity the default option. Having a variety of lifetime income options within plans to suit varying circumstances is critical to achieving greater use. Among the many variations are (a) partial annuitization, to provide planning flexibility, (b) deferrals to advanced ages, to coordinate with structured withdrawal programs, (c) inflation-adjusted annuities, to add inflation protection to longevity protection, and (d) death benefit options, for those who are concerned about the lack of a death benefit.[10]

Employers could also be encouraged to offer their retirees the option of purchasing an annuity from a defined benefit plan at the point of retirement as a distribution option from the employer's defined contribution plan. One potential stumbling block that would have to be addressed is the coverage by the PBGC of the annuities purchased from the defined benefit plan, in particular the PBGC "priority category" in which such purchases would be placed. The comments we submitted in May addressed this issue in further detail.

Outside of plans, there are many products to address longevity risk. It should be recognized that these are available not only for distributions from plans but also other personal savings. The potential scope of lifetime income should encompass not only tax qualified assets but also nonqualified assets.

Various types of annuities are available in the marketplace. Single premium immediate annuities provide longevity protection and frequently include an option for inflation adjustments. Deferred-start income annuities (DSIA, aka "longevity insurance") are another way to insure against living too long.[11] Required minimum distribution (RMD) rules do not exclude DSIAs; consequently, there is required distribution of assets that have already been annuitized, discouraging the use of DSIAs. One solution would be to exclude DSIAs from RMDs, perhaps up to some limit.

There are also annuity-like lifetime income structures that also address longevity risk, albeit at a lower level of guaranteed income. Guaranteed lifetime withdrawal benefits (GLWB) are available on variable annuities, indexed annuities, and some fixed rate annuities. These provide longevity protection and certain principal protection while providing full access to a retiree's assets. Guaranteed minimum income benefits (GMIB) on variable annuities provide an annuitization floor while providing certain principal protection. A mutual fund structured-withdrawal program is not guaranteed, but it could be complemented with either a guaranteed lifetime withdrawal benefit (GLWB) or a deferred start income annuity (DSIA) to add longevity protection. Disclosure of projected income under one of these guaranteed lifetime withdrawal structures could also be helpful information to plan participants.

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[10] Other approaches can be taken within plans prior to the time of distribution. Incremental annuitization during the working years could spread and reduce investment and interest rate risk. Guaranteed lifetime withdrawal benefit structures could provide longevity and investment protection while maintaining access to asset accumulations.

[11] These work, for example, by purchasing at age 65 a guaranteed income that will begin at age 85. This could be an ideal complement to withdrawal-based income prior to the commencement of the deferred annuity income.

Another important issue in encouraging lifetime income is that 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 be appropriate to allow greater statutory reserving flexibility to encourage the offering of a full range of substandard annuities.[12]

In closing, we want to reiterate our support for the Agencies' efforts to promote access to and use of lifetime income arrangements. We thank you again for the opportunity to testify, and Frank and I welcome your questions.

[12] Another issue important to note that there is an incongruity in that gender-neutral annuity rates are required within plans, while gender-distinct rates are used in the marketplace outside of plans. This creates an incentive for females to elect in-plan annuities at actuarially favorable rates and males to elect out-of-plan annuities at actuarially fair rates or to elect annuities less frequently because of the need to go outside the plan. This could disproportionately lead males to fail to annuitize, jeopardizing their retirement security as well as that of their spouses.