S. HRG. 111–762

THE RETIREMENT CHALLENGE: MAKING SAVINGS LAST A LIFETIME

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

WASHINGTON, DC

JUNE 16, 2010

Serial No. 111–19

Printed for the use of the Special Committee on Aging

THE RETIREMENT CHALLENGE: MAKING SAVINGS LAST A LIFETIME

S. HRG. 111–762

THE RETIREMENT CHALLENGE: MAKING SAVINGS LAST A LIFETIME

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

WASHINGTON, DC

JUNE 16, 2010

Serial No. 111–19

Printed for the use of the Special Committee on Aging

Available via the World Wide Web: http://www.gpoaccess.gov/congress/index.html

U.S. GOVERNMENT PRINTING OFFICE

61–707 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office,
http://bookstore.gpo.gov. For more information, contact the GPO Customer Contact Center,
U.S. Government Printing Office. Phone 202–512–1800, or 866–512–1800 (toll-free). E-mail, gpo@custhelp.com.

SPECIAL COMMITTEE ON AGING

HERB KOHL, Wisconsin, *Chairman*

RON WYDEN, Oregon
BLANCHE L. LINCOLN, Arkansas
EVAN BAYH, Indiana
BILL NELSON, Florida
ROBERT P. CASEY, Jr., Pennsylvania
CLAIRE McCASKILL, Missouri
SHELDON WHITEHOUSE, Rhode Island
MARK UDALL, Colorado
KIRSTEN GILLIBRAND, New York
MICHAEL BENNET, Colorado
ARLEN SPECTER, Pennsylvania
AL FRANKEN, Minnesota

BOB CORKER, Tennessee
RICHARD SHELBY, Alabama
SUSAN COLLINS, Maine
GEORGE LeMIEUX, FLORIDA
ORRIN HATCH, Utah
SAM BROWNBACK, Kansas
LINDSEY GRAHAM, South Carolina
SAXBY CHAMBLISS, Georgia

DEBRA WHITMAN, *Majority Staff Director*
MICHAEL BASSETT, *Ranking Member Staff Director*

CONTENTS

THE RETIREMENT CHALLENGE: MAKING SAVINGS LAST A LIFETIME

WEDNESDAY, JUNE 16, 2010

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The Committee met, pursuant to notice, at 2:06 p.m., in room SD–562, Dirksen Senate Office Building, Hon. Herb Kohl (chairman of the committee) presiding.

Present: Senators Kohl [presiding], Franken, and Collins.

OPENING STATEMENT OF SENATOR HERB KOHL, CHAIRMAN

The CHAIRMAN. Good afternoon to one and all, and we thank you very much for being here. Our hearing today is the start of a legislative debate about how we can help Americans make their retirement savings last a lifetime. So far the focus of most of our education efforts have been on encouraging people to save, but we've done very little to help the average retiree make the difficult choices about how to make their savings last.

Our goal is to find ways to ensure retirees have access to lifetime income options that provide adequate consumer protections at a reasonable cost. It goes without saying that the most important source of retirement income is Social Security. This committee has long been an ardent supporter of the program and we recently released a report on the various ways it can be fortified for coming generations. With modest tweaks, we will be able to improve solvency and strengthen benefits for those who rely on Social Security the most.

The pension landscape has changed considerably over the past several decades, with defined contribution savings plans replacing defined benefit plans, which provided individuals with a payment throughout their retirement. While individuals have more control of their finances under this new system, they do face complicated investment choices. Now when individuals retire they have a plot of savings—I'm sorry—a pot of savings and must choose how to use it over time.

With Americans living longer, the stakes are high for not adequately managing one's savings. Unfortunately, the vast majority of people have to make these difficult decisions on their own, as fewer employers provide their retirees with lifetime income options. According to Hewitt Associates, only 14 percent of defined contribution plans offer annuities and only 1 percent of the covered participants invest in them.

We need to provide employers with more guidance, more tools, and more protection to encourage them to offer a range of options to their employees. We also need to better educate workers to understand their choices. Senators Bingaman, Isakson, and myself recently introduced the Lifetime Income Disclosure Act, which would require 401(k) statements to show account holders how much their balance would pay out if they were annuitized.

However, while annuities may be the right fit for some, they can also be highly complex and in the retail market they have often been associated with aggressive sales tactics. I'm pleased to have worked with the National Association of Insurance Commissions on improving the suitability standards and the use of professional titles in selling annuities. As with other retirement instruments, we are dedicated to ensuring that all fees associated with annuities are disclosed and that they are competitively priced and also that consumers are fully educated about the risks and the opportunities of these products.

I'm also encouraged by the recent innovations in the financial services industry to develop new products that will help retirees manage their savings. This is a rapidly developing area and we want to encourage employers to consider offering such products to meet their workers' needs. However, we must also ensure that these products have adequate regulation that provides consumer protections and fosters a competitive, low fee market.

With all the talk today about encouraging options, I want to be clear that no one should be forced to purchase a lifetime income product. I will not support any kind of mandate for consumers because we recognize there is a wide range of circumstances and need. When it comes to retirement, there is no one size fits all. Instead, our aim with this hearing and through legislation is to create an environment where participants have the option of investing in a stable product that best fits their needs at a fair price.

So we're pleased that you're all here today and I'd like now to turn to Senator Susan Collins, who would like to make a statement.

OPENING STATEMENT OF SENATOR SUSAN COLLINS

Senator COLLINS. Thank you, Mr. Chairman.

Let me begin by thanking you for scheduling this hearing today on the all-important subject of retirement savings. When we think about the coming demographic shock of millions of baby boomers reaching retirement age, usually we who are involved in public policy focus on the economic challenges facing Social Security, which, as the chairman pointed out, remains the most critical component of retirement income for many Americans.

We do not spend nearly the amount of time that we should in considering how changes in the way that Americans build their retirement nest eggs and how they spend those assets after they stop working affect their ability to remain financially secure throughout their retirement years. For that reason, I commend the chairman for focusing on that issue today.

All of us are familiar with the dramatic shift that has occurred in recent years away from defined benefit plans toward defined contribution plans. Three decades ago, nearly two-thirds of those

Americans who participated in a pension plan received defined benefit. Now, however, nearly two-thirds participate only in a defined contribution plan. It's completely reversed.

Those defined contribution plans have many positive features, but they can make retirement planning especially challenging in times of stock market volatility. The decline in the market in 2008, for example, reduced total assets held by defined contribution plans by $1.1 trillion, nearly 28 percent, and all of us know seniors who were planning to retire and could not because of the drop in the value of their defined contribution plan.

While much of that loss fortunately has since been recovered, the recent economic crisis underscores how important it is that Americans approaching retirement or in retirement diversify their assets and engage in financial planning that is appropriate to their long-term needs.

This issue is tremendously important. Without better planning, millions of American workers will be facing retirement years that are anything but golden. This is particularly true given the demographics of the next few decades, when the tidal wave of retiring baby boomers will be imposing unprecedented burdens and challenges for both the Social Security System and for private pensions.

So again, Mr. Chairman, thank you for calling this important hearing.

The CHAIRMAN. Thank you very much, Senator Collins.

At this time we'll turn to the first panel. Our first witness on the first panel today is Phyllis Borzi, the Assistant Secretary of the Employee Benefits Security Administration at the Department of Labor, where she oversees the administration, regulation, and enforcement of Title 1 of ERISA. Previously Ms. Borzi was a research professor at George Washington University Medical Center and served as pension and employee benefit counsel for the House Committee on Education and Labor.

Then we'll be hearing from Mark Iwry, a Senior Advisor to the Secretary of the Treasury and the Deputy Assistant Secretary for Retirement and Health Policy. Previously Mr. Iwry was a senior fellow at the Brookings, and he also served as the benefit tax counsel at the U.S. Treasury Department, where he was responsible for tax and regulations relating to tax-qualified pensions and 401 plans.

We welcome you both and we will take your testimony now, starting with you, Ms. Borzi.

STATEMENT OF HON. PHYLLIS C. BORZI, ASSISTANT SECRETARY OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, U.S. DEPARTMENT OF LABOR

Ms. BORZI. Thank you, Chairman Kohl. Good afternoon, Senator Collins, Senator Franken. Thank you so much for inviting me to discuss the Department of Labor's activity regarding lifetime income options for participants and beneficiaries in retirement plans.

I'm Phyllis Borzi, the Assistant Secretary of Labor for the Employee Benefits Security Administration. I'm proud to represent the Department, EBSA, and its employees. We work diligently to protect the security of retirement and other employee benefits for America's workers, retirees, and their families.

The administration shares the committee's interest in examining policies to help America's workers manage their retirement savings to last a lifetime. Workers both need and deserve an opportunity for a dignified and secure retirement. As you know, today the risks for retirement security have largely shifted onto the shoulders of American workers. Workers are living longer, baby boomers are beginning to retire in larger numbers. We need to explore what we can do to ensure that workers have the information and the tools they need to both accumulate adequate retirement savings and make those savings last a lifetime.

To that end, the Departments of Labor and the Treasury published a request for information in order to start a dialog around the challenges and issues facing today's workers at retirement. The RFI asks a number of questions that are generally organized into categories under which we may decide to provide additional guidance in the future. The responses to the RFI will inform our analyses of a wide variety of issues relating to the offering and selection of lifetime income products.

We're committed to exploring what can be done through interpretation, regulation, and legislation to address these issues.

For the remainder of my testimony, I just would like to discuss a number of important considerations that have been raised in the comments and the next steps we're considering. I'm extremely pleased that the RFI has generated so many thoughtful responses with so many different perspectives. We've received nearly 800 public comment letters. As a general overview of the types of commenters, we received more than 600 letters from ordinary citizens and approximately 10 more comment letters from organizations such as labor organizations, consumer groups, representing workers, retirees, and plan participants. Approximately 40 of our comment letters are from representatives of the financial services industry, including insurance companies, investment companies, and banks. About 30 letters are from plan service providers, including third party administrators, recordkeepers, actuaries, consultants, lawyers. About ten more are from representatives of employers, plan sponsors, plan administrators. Of course, approximately ten comment letters are from government officials and members of academia.

We're still in the process of reviewing these letters and, even though we haven't finished analyzing all of them, I can certainly make a few observations about their contents today. We have received a number of comment letters from individuals who are very concerned that this RFI is the first step in a government plan to take over workers' 401(k) plans or to mandate that they invest their retirement savings in government-sponsored retirement products or treasury bonds.

Of course nothing could be farther from the truth. We do not support a government takeover of private retirement plans. I've repeatedly and publicly said that the RFI is merely intended to start a national dialog about the question of whether a lifetime income stream is a good thing and, if it is, whether and how the Department can facilitate access to and use of lifetime income streams.

Now that we've begun analyzing the comment letters, I'm even more convinced that this is an important discussion worth having. Even though it's still early in our review process, many of the commenters believe that the government can and should do more in this area. On the other hand, others disagree that there is a problem at all.

Perhaps the biggest area of disagreement among the commenters centers on whether employers should be required to provide workers with an option of a lifetime income distribution. Far less disagreement occurs, of course, on whether or not there ought to be additional educational incentives. Many commenters believe that the interest of participants as a whole will be best served by educating employers and workers on the benefits and features of lifetime income, so they'll better be able to make choices on their own.

Many commenters discuss the type of information that would be useful to workers, and in particular of course I want to thank you, Chairman Kohl, for your response to the RFI. You put a spotlight on these disclosure issues by joining, as you mentioned, Senator Bingaman and Senator Isakson in introducing the Lifetime Income Disclosure Act. We believe that providing account-specific information on lifetime income may be very useful to workers as they make critical decisions concerning their retirement accounts.

We're reviewing the RFI comments to better inform us regarding the feasibility of providing participants with this type of information.

So the number and scope of the comments reinforces our prior sense that providing lifetime income raises a lot of different issues and tradeoffs. I'm pleased to announce that we've decided to build on this dialog started with the RFI by holding a public hearing in the near future to focus on some of these critical financial technical issues that have been raised in the comments.

We're finalizing the details of the hearing and a formal announcement will appear soon in the Federal Register.

So thank you again for the opportunity to testify before you today. The Department is committed to ensuring that workers have the information and tools they need to enjoy a dignified and secure retirement, and we're happy to work with all of you on the committee and Chairman Kohl, and I look forward to taking your questions.

Thank you.

[The prepared statement of Ms. Borzi follows:]

TESTIMONY OF PHYLLIS C. BORZI
ASSISTANT SECRETARY OF LABOR
EMPLOYEE BENEFITS SECURITY ADMINISTRATION
BEFORE THE
SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

June 16, 2010

Introductory Remarks

Good afternoon Chairman Kohl, Ranking Member Corker, and Members of the Committee. Thank you for inviting me to discuss lifetime income streams and the Department of Labor's activities regarding lifetime income options for participants and beneficiaries in retirement plans. I am Phyllis C. Borzi, the Assistant Secretary of Labor for the Employee Benefits Security Administration (EBSA). I am proud to represent the Department, EBSA, and its employees, who work to protect the security of retirement and other employee benefits for America's workers, retirees and their families and to support the growth of our private benefits system. Secretary Solis' overarching vision for the Department is to advance good jobs for everyone. A good job, no matter the type or pay level, includes a pension. EBSA is committed to promoting policies that encourage retirement savings and promote retirement security for American workers.

Many workers are able to achieve retirement security through their employer-sponsored pension plans. Defined benefit pension plans, in particular, are usually designed to provide lifetime income for workers, thereby protecting them against the risk of outliving their assets in retirement. However, as you know, there has been a trend away from sponsorship of defined benefit plans and a dramatic increase in the offering of defined contribution plans such as 401(k) plans, shifting a number of risks for retirement security on to the shoulders of American workers. This trend, combined with increasing life expectancies, significantly increases the risk that retirees will outlive their retirement income.

In response to these concerns, the Department shares the Committee's interest in examining the important issue of lifetime income. As baby-boomers begin to retire in larger numbers and as more retirees live longer and bear the risk for a secure retirement, it is important that we focus not only on the accumulation stage of retirement planning, but also on the decumulation stage. Accordingly, the Departments of Labor and the Treasury are currently reviewing the rules under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code to determine whether the retirement security of workers in employer-sponsored retirement plans could be enhanced by facilitating access to and utilization of lifetime income options. Our Departments jointly issued a Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans (RFI) on February 2, 2010. The purpose of the RFI was to solicit ideas on this important issue. We are now working through the comments and trying to discern the key trends and insights provided among the exceptional number of comments we received.

My testimony today will discuss a number of important considerations that have been raised by commenters as well as trends that suggest workers are increasingly bearing the risk for a secure retirement. I will also discuss the next steps we are considering regarding the use and accessibility of lifetime income stream offerings.

Shifting of Retirement Security Risks to Workers

EBSA is responsible for administering and enforcing the fiduciary, reporting, and disclosure provisions of Title I of ERISA. EBSA oversees approximately 700,000 private pension plans, including almost 483,000 participant-directed individual account plans such as 401(k)-type plans and approximately 49,000 defined benefit plans. We also oversee millions of private health and welfare plans that are subject to ERISA.

Over the past three decades, there has been a trend away from traditional defined benefit pension plans, where workers accrue benefits based on years of service and earnings, and into defined contribution plans such as 401(k) plans, which provide a retirement benefit based on annual contributions and investment returns to an individual account. The number of active participants in defined benefit plans fell from about 27 million in 1975 to approximately 19 million in 2007. In contrast, the number of active participants in defined contribution plans increased from about 11 million in 1975 to 67 million in 2007.[1]

This trend away from defined benefit plans and towards defined contribution plans has resulted in a dramatic shift of risks from employers to workers. For instance, employers that sponsor defined benefit plans bear investment risk for the plan since the employer is responsible for making plan contributions to fund benefit payments during retirement. In contrast, workers in 401(k)-type plans now bear that investment risk because they do not receive a promised benefit or assurances as to the adequacy of their account balance. As we all know, poor investment returns and investment losses can devastate retirement savings in a 401(k)-type plan.

The risk of outliving one's assets in retirement, or longevity risk, has been placed squarely on the shoulders of workers. Defined benefit plans traditionally have offered benefit payments to participants in the form of a stream of lifetime income while 401(k)-type plans typically provide only lump sums. Today, however, many traditional defined benefit plans have converted to lump sum-based hybrid plans, such as cash balance or pension equity plans, while other defined benefit plans have added lump sum options. In fact, 52 percent of private sector defined benefit plan participants had the option of taking a lump sum distribution at retirement in 2005.[2]

When participants have a choice between an annuity and lump sum, they generally choose the lump sum option. A number of reasons have been given for this phenomenon, including the lack of information regarding annuity products, a perception that the

---

[1] The number of active participants in 1975 and 2007 are not directly comparable because of adjustments in the definition of a participant. See discussion in U.S. Department of Labor, Employee Benefits Security Administration, "Private Pension Plan Bulletin Historical Tables and Graphs," March 10, 2010.

[2] National Compensation Survey: Employee Benefits in Private Industry in the United States, 2005 U.S. Department of Labor U.S. Bureau of Labor Statistics May 2007 Table 51, page 66.

individual can invest better on his or her own, a misconception of the market risks associated with managing retirement assets for a lifetime, a preference for liquidity and the "all-or-nothing" nature of some employer annuity options, the costs associated with annuity purchases, and a belief that monthly Social Security benefits will be sufficient. While it is true that individuals who receive lump sum distributions may choose to purchase annuities, few households actually do. In 2008, only about 1 percent of adults age 65 and older reported receiving income from a private annuity.[3]

The Government Accountability Office (GAO) has highlighted the need to improve financial literacy, stating that aging workers must accumulate sufficient assets and learn how to manage those assets for a retirement in which "couples both aged 62 have a 47 percent chance that at least one of them will live until their 90th birthday."[4] The GAO notes that while ERISA provides a comprehensive regulatory framework over private pensions during the accumulation stage, once an individual withdraws his or her funds from either a defined benefit or defined contribution plan for retirement, they face a variety of risks. Typically, retirees must choose among a myriad of investment and/or insurance products without anyone, such as a plan fiduciary, acting on their behalf to screen the choices.

Concerned about the challenges now facing workers to manage these risks, in 2008, the ERISA Advisory Council assigned a Working Group to examine and review the spend down of defined contribution assets at retirement. The Working Group studied the types of guidance that could help plan sponsors and plan participants make better informed decisions regarding plan investment and insurance vehicles that provide periodic or lifetime distributions. The Working Group also provided recommendations on how Department guidance can enhance the retirement security of American workers by facilitating utilization of income stream distributions from defined contribution plans.

---

[3] Department of Labor tabulation of March 2009 CPS data.
[4] Government Accountability Office (GAO), "Retirement Income: Challenges for Ensuring Income throughout Retirement" (GAO-10-632R), April 28, 2010.

Request for Information on Lifetime Income Options

With the shift from defined benefit to defined contribution plans and an ever-increasing number of workers nearing retirement, it was clear that the Agencies – the Department of Labor and the Department of the Treasury – had an obligation to explore what they could do to ensure that all workers not only have the information and tools they need to accumulate adequate retirement savings, but also the information and tools they need to help ensure that those savings last a lifetime. We truly believe – and are guided by the principle – that today's workers both need and deserve an opportunity for a dignified and secure retirement. To that end, the Departments published a Request for Information (RFI) in order to start a dialogue around the challenges and issues facing today's workers at retirement. In this regard, we are committed to exploring what can be done through interpretation, regulation and legislation to address these issues. I am pleased that representatives of employees, employers, retirement plan service providers, academia and others have agreed to participate in this exploration.

The RFI asks a number of questions that are generally organized into categories under which we may, if appropriate, provide additional guidance. The responses to the RFI will further inform and define our analyses of a wide variety of issues relating to the offering and selection of lifetime income products by plan sponsors and plan participants and beneficiaries, as well as possible solutions to those issues.

Current Landscape

The RFI questions were designed to solicit information about the current landscape of lifetime income. We wanted to understand the products that are currently available to employers and workers, and the reasons that plan sponsors are reluctant to offer lifetime streams of income as a plan option. We also wanted to understand the choices that workers make and the reasons that workers, when given the choice to take their benefits in a lifetime income stream, typically select the lump sum option. Once we understand the current landscape, we can better evaluate steps we might take to assist plan sponsors and participants in having good choices and being able to make better decisions for their retirement security.

Would Changes to ERISA Guidance Enhance Retirement Security?

Traditional defined benefit plans with lifetime income distribution options have historically been more effective at achieving the goal of lifetime income in retirement than plans that distribute benefits as lump sums. For this reason, it is important for us to identify the most important elements, such as pooling of longevity risk, that make these retirement plans more effective in providing retirement income and determine whether those elements can be embedded within 401(k)-type plans. The RFI seeks information related to regulations and other guidance the Department has issued to help us evaluate which changes, if any, could be made to enhance workers' retirement security.

ERISA protects workers by providing standards of conduct for those who invest and manage the assets of employee benefit plans, who are called plan fiduciaries. Fiduciaries are required to discharge their duties solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits. In carrying out their responsibilities, fiduciaries must act prudently and in accordance with the documents governing the plan. If a fiduciary's conduct fails to meet ERISA standards, the fiduciary is personally liable for plan losses attributable to such failure. There are a number of ways that fiduciaries can reduce possible liability if a process is used that is protective of participants.

The Department has issued considerable guidance over the years designed to both facilitate compliance with ERISA's fiduciary standards and minimize the risk of liability for losses attributable to fiduciary breaches. One example of such guidance is a regulation that provides a compliance safe harbor for plan fiduciaries when selecting annuity providers in connection with their defined contribution plans (29 CFR 2550.404a-4). Recognizing the significance of this regulation in the offering of annuity products by employers, we specifically invited input on how this regulation is currently being used and whether it needs to be reviewed. We also asked for information about whether the safe harbor protection afforded by this regulation should be extended beyond distribution annuities to cover other similar lifetime income products.

Some plans, such as 401(k) plans, can be set up to give participants control over the investments in their accounts and limit a fiduciary's liability for the investment decisions made by participants (29 CFR 2550.404c-1). Plans designed to take advantage of this protection are typically called section 404(c) plans. Among the requirements, participants must be given sufficient information to make informed decisions about the investment options offered under the plan. We are reviewing whether section 404(c) plans currently provide lifetime income options which participants can select, and whether the regulation should be changed to encourage the inclusion of these products.

Plans that automatically enroll workers can be set up to limit a fiduciary's liability for any plan losses that are a result of automatically investing participant contributions in certain default investments. The types of investment alternatives for default investments are described in the Department's regulation relating to qualified default investment alternatives and the regulation requires that an initial notice and annual notice must be provided to participants (29 CFR 2550.404c-5). We asked whether plans are currently using default investment options that include lifetime income features. We also asked what action we should take to encourage the use of lifetime income features in default investment options.

Our review of responses to these questions and suggestions will help us evaluate whether changes to these regulations would facilitate use of lifetime income and enhance retirement security.

Is Additional Disclosure and Participant Education Needed?

Public policy initiatives have primarily focused on the accumulation stage of retirement planning. Only recently has there been a greater focus on the decumulation stage of retirement, and what workers and retirees do upon receipt of their retirement savings.

Given the potential utility of lifetime income to participants in efficiently constructing their personal retirement incomes, we will consider whether additional information could assist participants in this regard, and what impediments exist to providing such information. Some policy makers believe that providing participants with both the lump sum value of their accounts and the value of an equivalent income stream would be very valuable to workers who have to figure out how to make their savings last throughout their retirement years.

Chairman Kohl joined Senator Jeff Bingaman (D-NM) and Senator Johnny Isakson (R-GA) to introduce the bipartisan "Lifetime Income Disclosure Act" (S. 2832) on December 3, 2009. This bill would require 401(k) and other individual account plans to provide participants an annual statement providing estimates of how much their accounts would buy in lifetime monthly payments starting at normal retirement age. Plans would also be required to tell workers annually how much the money in their accounts would provide in monthly benefits (for both single and joint-and-survivor annuities) starting at age 65 if it were paid out as "a retirement paycheck for life." Under this legislation, the Department would also be required to issue tables that plans could use in order to convert account balances into annuity equivalents, along with a model disclosure for plans to use.

We appreciate Chairman Kohl's leadership in putting a spotlight on the disclosure of lifetime income. We believe that this type of information is potentially very useful for workers facing critical decisions concerning their retirement accounts. At the same time, providing such a comparison may be complex and raises practical and legal issues, which is the reason we asked for input regarding these issues. We are reviewing the comments submitted in response to our RFI to better inform us regarding the feasibility of providing participants with this type of information.

The Department believes it is important to educate participants about saving for a secure retirement and has a dedicated education campaign that uses publications, online tools, videos, PSAs, and outreach as methods to provide the information. The Department's

Saving Matters Retirement Savings Education Campaign includes a focus on participants nearing retirement which highlights the importance of not only saving but having a strategy for ensuring that retirement savings last throughout a potentially long retirement. In particular, our publication entitled "Taking the Mystery Out of Retirement Planning" addresses not only saving for retirement, but discusses the decumulation phase and includes a description of annuity-type products and how they might be utilized in this context. The RFI comments will help the Department review our existing publications to see if there are additional areas where we think education would be helpful.

We are also reviewing the Department's guidance on participant education to determine what information participants need to make informed decisions regarding whether to select lifetime income options. The Department issued Interpretive Bulletin 96-1 to clarify that investment education, as described in the Bulletin, will not be considered the provision of investment advice, which would otherwise give rise to fiduciary status and potential liability under ERISA for participants' investment decisions. We asked what, if any, legal concerns plan sponsors have about educating participants as to the advantages and disadvantages of lifetime income that might be serving as an impediment. As the financial marketplace changes and retirement risks shift more to workers, educational initiatives may need to address items not previously anticipated as well as the decumulation stage of retirement planning.

RFI Comments and Next Steps

The RFI has generated nearly 800 public comment letters, all of which are posted on EBSA's Web Site. Some of these are detailed letters with appendices well over 100 pages in length. We and our colleagues at the Department of the Treasury are still in the process of reviewing these letters. And even though we have not yet finished analyzing all of them, I would like to make a few observations about these comment letters.

First, I am very pleased that so many thoughtful responses, with different perspectives, have been submitted in response to the RFI. As a general overview of the types of commenters, we received more than 600 letters from ordinary citizens, and approximately 10 more comment letters from organizations, such as labor organizations and consumer groups, representing workers, retirees, and plan participants. Approximately 40 letters are from representatives of the financial services industry, including insurance companies, investment companies and banks. About 30 letters are from plan service providers, including third-party administrators, record keepers, actuaries, consultants, and lawyers. About 10 more are from representatives of employers, plan sponsors, and plan administrators. And, finally, approximately 10 comment letters are from governmental officials and members of academia.

Second, we have received a number of letters from individuals who are very concerned that the RFI is the first step by the government to take over their 401(k) plans. For the record, let me state clearly that nothing could be further from the truth. We do not support a government takeover of private retirement plans and I have said repeatedly and publicly that the RFI is intended merely to start a national dialogue on whether a lifetime income stream is a good thing, and if it is, whether and how the Department can facilitate access to, and use of, lifetime income streams. Now that we have begun analyzing the comment letters, I am even more convinced that this discussion is worth having.

Even though it is still early in the review process, many of the commenters believe that the government can, and should, do more in this area; others disagree that there is problem at all. Perhaps the biggest disagreement among the commenters centers on whether the government should mandate lifetime income as a distribution option. Far less disagreement exists on educational initiatives; many commenters believe that the interests of participants as a whole will be best served by educating employers and employees on the benefits and features of lifetime income.

The number and scope of the comments reinforces our prior sense that providing for lifetime income raises many different issues and tradeoffs. We are carefully weighing the full range of comments that we have received. The information from commenters will inform the process and provide a basis for determining what future actions we may take in this important area.

Of course, we continue to look forward to the participation and support of Chairman Kohl, Ranking Member Corker, and Members of the Committee as we pursue these issues so important to today's workers and retirees. We are also happy to work with the Committee on possible legislative solutions.

Conclusion

Chairman Kohl and Members of the Committee, thank you for the opportunity to testify before you today. The Department is committed to its mission to protect the retirement security of America's workers. We are working to ensure that workers have the information and tools that they need to enjoy a dignified and secure retirement.

The CHAIRMAN. Thank you very much, Ms. Borzi.
Now we'll hear from Mr. Iwry.

STATEMENT OF J. MARK IWRY, SENIOR ADVISOR TO THE SECRETARY OF THE TREASURY AND DEPUTY ASSISTANT SECRETARY [TAX POLICY] FOR RETIREMENT AND HEALTH POLICY, U.S. TREASURY DEPARTMENT

Mr. IWRY. Mr. Chairman, Senator Collins, Senator Franken. Thank you very much for holding this hearing and for the opportunity to appear before you today.

We know that most Americans enjoy a fundamental level of protection against the risk of outliving their assets, longevity risk, in the form of Social Security. That continues to provide, thankfully, a basic foundation of guaranteed, predictable lifetime income.

In addition, the private pension system plays a critical role in enhancing retirement security. But with the continuing shift from pensions, classically thought of as employer-funded programs, such as defined benefit plans, that provide predictable income for life at retirement, to account-based retirement savings arrangements that depend mostly on employee salary reduction contributions made at the initiative of the employee, and that typically make single-sum cash payments at each change in employment, we've seen a shift as financial prospects for retirement security in this country increasingly turn on how much people save and how they manage their savings.

We know it's not easy for people to manage their savings. For one thing, predicting how long we're going to live is different, if not impossible. The result is that for many people there's anxiety about how to manage the assets they've got so that they don't run out of assets during their lifetime. Some people are anxious to the point where they fall into the opposite error of hoarding the assets to a much greater extent than they needed to and not enjoying the kind of lifestyle that they could have afforded if they had had some methodical way of ensuring themselves that their assets would last for life.

This initiative that Assistant Secretary Borzi and I have been launching, and we very much applaud your leadership on these issues, not only submitting the comment, holding this hearing, and on an ongoing basis over the past several years on these retirement security issues—this project is not intended to require or mandate any particular type of payment, annuity or otherwise. It's not intended to promote or favor any particular industry or any particular type of product. But it is intended to help Americans with the difficult challenge of managing their savings during retirement, and to do so in a context where people have increasingly expressed the concern that they do not have enough advice, do not have enough realistic options to provide the appropriate mix of income security and flexible assets.

We don't purport to know what's best for people and we're not suggesting that more lifetime income or annuitization on top of what Social Security provides is necessarily the answer for everyone. As you said, Mr. Chairman, it's not a one size fits all situation. But we do think that we need to do more to help the system provide options to people, provide choices that are more realistic, more attractive, and that people better understand, choices that are reasonably priced, that are transparent in their features, that are not confusingly complex, that are, in other words, user-friendly and responsive to the needs of retirees.

We applaud the creativity of the private sector in coming up with new products and innovations that look like they would be responsive to a lot of these needs and that take advantage of the plan sponsor's ability to help individuals through their fiduciary exercise of expertise, by negotiating with providers of lifetime income or other financial products on a group basis that can reduce costs and that can give more bargaining power to the individual.

It's premature for us to say exactly what we're going to do. We are reading the comments with great care and interest. They're very thoughtful. We appreciate all the work that people have put into them and we're very much looking forward to the dialog with you today and an ongoing dialog with the stakeholders.

[The prepared statement of Mr. Iwry follows:]

REMARKS AS PREPARED FOR DELIVERY
EMBARGOED UNTIL DELIVERY

Testimony of
Senior Adviser to the Secretary of the Treasury and
Deputy Assistant Treasury Secretary for Retirement and Health Policy
J. Mark Iwry
Before the Senate Special Committee on Aging
on Lifetime Income Options for Retirement

June 16, 2010

Chairman Kohl, Ranking Member Corker, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss policies to help seniors manage their assets in retirement so as to avoid outliving their savings.

As you know, on February 2, 2010, the Department of the Treasury and the Department of Labor jointly solicited responses to a variety of questions relating to the desirability and availability of lifetime income alternatives in retirement plans. Our Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans (the RFI) was prompted in part by the increased prevalence and use of 401(k) and other account balance plans, individual retirement accounts and annuities (IRAs), and other plans that tend to define benefits as an account balance and pay benefits as a lump sum, as distinguished from traditional defined benefit pension plans that traditionally have provided lifetime income. Guaranteed lifetime income alternatives are designed to convert savings into guaranteed future income, thus reducing the risk that a retiree's savings will be exhausted during retirement or eroded by investment losses.

The joint RFI has elicited nearly 800 written comments, evidencing careful thought and considerable effort on the part of many organizations and individuals – including labor unions, consumer groups, representatives of the financial services industry, employers, plan sponsors, plan administrators, academics, government officials and committees, and plan service providers, including third-party administrators, actuaries, consultants, and legal counsel. We at Treasury, together with our colleagues at the Department of Labor, are in the process of reviewing and evaluating each of these comments, and will continue working closely together as we consider potential next steps.

Background of the Lifetime Income Issue

It is well known that workers contemplating retirement face significant financial risks. Inflation, an uncertain rate of return on investments, and the insolvency of a former employer or financial provider are external factors that can deplete retirees' assets and income. Personal risks such as unemployment, illness, disability, and even life span can lower earning capacity or raise financial need.

Fortunately, life expectancy in our country has been increasing; but a long life can be hard to manage financially. Some underestimate how long they will live, focus on average life expectancy without sufficiently taking into account the 50-percent chance of outliving it, or otherwise neglect to plan for the possibility of many years in retirement. Many find it difficult to devise and adhere to a methodical plan for managing retirement assets over an uncertain, and potentially long, time horizon. Others, fearful of exhausting their savings, may unnecessarily restrict their spending in retirement. The problem of managing longevity risk is particularly salient for women, who generally have longer life expectancies than men.

Most working Americans enjoy a fundamental level of protection against longevity risk (as well as inflation and other financial risks) through Social Security, which provides retirees a basic foundation of guaranteed, predictable lifetime income. In addition, the private pension system plays a critical role in enhancing retirement security. Defined benefit pensions traditionally have played a central part in supplementing Social Security by paying predictable lifetime income to millions of working families. However, with the continuing shift from pensions -- classically, employer-funded programs such as defined benefit plans that generally provide predictable lifetime income at retirement -- to account-based retirement savings arrangements that depend mostly on employees' salary-reduction decisions and typically make single-sum cash payments at each change in employment, Americans' financial prospects for retirement increasingly turn on how much they save and how they manage their savings.

Congress, the Executive Branch, and many in the private sector have repeatedly expressed concern that Americans do not save enough and have emphasized the importance of long-term saving both for personal financial security and in the interest of expanding investment capital, promoting productivity, and continuing to raise our standard of living. To that end, the President has proposed, and the Administration is strongly committed to pursuing enactment of legislation to achieve a major breakthrough in retirement savings coverage and encourage Americans to become a nation of savers. Building on the success of automatic enrollment in workplace payroll-based savings vehicles such as 401(k) plans, the President's FY2011 Budget would provide for automatic IRAs for those not covered by employer-sponsored retirement plans. It would also expand the Saver's Credit to encourage savings by low- and moderate-income workers in employer plans and IRAs by increasing the financial incentive to save for the tens of millions of workers who are not in the higher tax brackets, i.e., the majority of working American families. See General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, Department of the Treasury, February 2010, pp. 16-20.

Equally important is how individuals use the savings they have built up during the accumulation phase of their lifetimes. Particularly as the baby boomer generation reaches retirement age, we need to focus on how individuals manage their savings in retirement. In addition, the need for stable and assured income has increased because of longer life expectancies and retirement periods.

Traditionally, the most complete solution to this problem of managing savings to ensure a lifetime stream of income has been to protect retirees from outliving their assets through the use of guaranteed lifetime income, such as a defined benefit pension. Another option has been an annuity provided through a defined contribution plan, an IRA, or otherwise. Annuities and other lifetime income arrangements are designed to make predictable payments for as long as annuitants are alive.

Yet in recent years the use of annuities and other lifetime income streams in retirement plans has declined. Unfortunately, defined benefit pension plans, a traditional source of low-cost lifetime income, have declined; and defined benefit plans increasingly offer and make lump-sum (single cash) payments, either by adding a lump-sum option to the plan's payout choices or by converting the plan to a different, lump-sum-oriented format.

Cash balance plans are the most common example of this kind of hybrid design, in which a participant's benefit is primarily communicated as a lump sum. In addition, many employers have adopted 401(k) plans, where a worker's accumulated savings are typically paid upon retirement as a lump sum rather than as monthly payments for life. Moreover, workers who take lump sum distributions from employer-sponsored plans often roll over these distributions to IRAs which can, but typically do not, provide guaranteed lifetime income. To put this into perspective, out of total private pension assets of about $9.7 trillion at the end of 2009, only 22% were maintained in defined benefit plans, with the remaining 78% held in defined contribution plans (34%) and IRAs (44%).[1]

Objectives of the RFI

The RFI reflects the Departments' belief that, as the older segment of the population has grown, people are seeking more advice and assistance with the challenge of how to manage and draw down their retirement benefits and savings. Plan participants very commonly take their accumulated retirement savings as a lump sum payment, which requires them to manage that sum to last the remainder of their lives (or their and their spouses' lives). However, it is difficult or impossible for an individual to predict the length of his or her lifetime. Even those familiar with actuarial life expectancies have, by definition, a 50% chance of living longer than the average. Many people with retirement savings might be expected to hedge the risk of living longer than expected by taking at least some of their retirement plan or IRA distributions in a form that pools longevity risk with others and assures a continued stream of income no matter how long they may live. By and large, however, they do not, despite economists' suggestions that many more people would be better off – would maximize their utility – by choosing to take at least a portion of their benefits as a guaranteed lifetime income stream. (The economic literature sometimes refers to this phenomenon as the "annuity puzzle".)

The RFI was not premised on any preconceived conclusions as to why more plan participants and IRA owners are not choosing payment forms that guarantee lifetime income streams, what (if anything) to do about this, or whether additional lifetime income is necessarily the best choice for everyone. An individual whose retirement savings are small, for example, may be well advised to keep those amounts liquid rather than locking them away in a form where they could

[1] Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Statistical release Z.1 (June 10, 2010)

not be drawn upon for emergencies or other unanticipated events (and, in any event, annuitization would not cure the problem of inadequate savings). Conversely, providing for assured lifetime income may be unnecessary for those with so much wealth that they need not worry about outliving their resources. In addition, purchasing a lifetime income guarantee might not be desirable for someone who, because of serious illness, faces a very short life expectancy. Excluding these groups of people, however, still leaves many who might be expected to find assured lifetime income alternatives more attractive than is reflected in the actual utilization of lifetime income.

The RFI sought information intended to help determine whether Treasury, the Department of Labor, or other government agencies can take any constructive steps to ensure that retirement plan and IRA participants do not encounter unnecessary obstacles in choosing between regular income and other alternatives. We are interested in increasing the availability of lifetime income as an option and facilitating individuals' informed choice among options – without mandating any particular choice.

Moving Forward

The nearly 800 comments received in response to the RFI included many that were very detailed, and included many useful insights. We are carefully reviewing them and analyzing the issues they raise. Discussing specific administrative guidance or possible legislative proposals at this point would be premature, but a number of recurring themes are worth noting:

- There are any number of reasons why individuals may be reluctant to opt for a lifetime income alternative. Among those mentioned in comments are
    - Concern about giving up control over investments (something participant-directed 401(k) plans have conditioned participants to expect).
    - A desire to maintain asset liquidity and flexibility in order to meet unexpected financial needs.
    - A general reluctance to take all or most retirement savings in a form that may disappear after an annuitant dies.
    - A desire to leave a bequest.
    - A concern that, if a lifetime income stream does not adjust for inflation, its value could erode over time.
- The questions raised in the RFI encompass not only employer-sponsored retirement plans but IRAs as well. However, employer plans may be a particularly appropriate venue in which to present lifetime income options. Plan fiduciaries may be able to gather the information and acquire the expertise to help select or design lifetime income arrangements or products that are suitable for and appropriately protective of individuals and that are cost-effective. They may be in a better position to select providers and may be able to exercise more bargaining power in the market than individual plan participants, obtaining institutional rather than retail prices. Plan sponsors also can be a valuable source of information and education for plan participants. In addition, the prospect that

numerous plan participants may opt for more lifetime income could reduce adverse selection and thereby reduce costs.

- There is a recognition that deeply deferred annuities that might begin as late as the individual's life expectancy – sometimes called longevity insurance – could play an important role in providing lifetime income, especially by offering individuals a different type of tradeoff between retention of flexible assets and provision of future guaranteed income. Providing protection against the "tail risk" of running out of assets after age 85, for example, generally would entail less reduction in an individual's current account balance than purchase of an immediate annuity and might therefore present itself as a more attractive choice for some individuals. However, concerns have been expressed that the required minimum distribution rules under Internal Revenue Code section 401(a)(9) may impede the use of this alternative.

- Often the choice of lifetime income is presented or perceived as an all-or-nothing choice, which may have the effect of discouraging people from selecting any lifetime income. In fact, however, many individuals might best achieve their personal objectives by applying only a portion of their retirement savings to a lifetime income option, while continuing to invest the remainder and draw it down as needed.

    - We are considering whether regulations or other guidance present any unnecessary impediments to choosing partial guaranteed lifetime income.

- This all-or-nothing framing of the lump-sum versus income choice can arise in defined benefit as well as 401(k) and other plans. In fact, it may be particularly important to consider this issue in the defined benefit context, because those plans, in contrast to a majority of 401(k) plans, already offer lifetime income options (and indeed are required to make them the default option).

- Financial education is a critical part of the sustained effort likely to be needed to ensure that choices relating to lifetime income are informed choices. The choice between an income stream and a lump-sum distribution may be among the most important financial decisions a person ever makes. Because defined contribution plans (and cash balance plans) express benefits as a single sum account balance, participants may experience what some call "wealth illusion," making them feel "cash rich" even though the lifetime income stream that can be provided by that single sum (particularly taking inflation into account) may be much smaller than they might expect. Education centered on, among other things, making the relationship between the account balance and the lifetime income stream transparent and more readily understood may improve planning and encourage more adequate saving.[2] (One aspect of the choice that may not be readily

---

[2] During the Clinton Administration, the Treasury Department was very active in financial literacy and education efforts. Those efforts were formalized in 2002, with the creation of the Office of Financial Education in the Treasury Department. That office promotes access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership, and retirement planning. It also coordinates the efforts of the Financial Literacy and Education

apparent to many individuals is the asymmetry between the risks presented by variable investment experience in the spend-down phase by contrast to the accumulation phase, specifically the risk that years of investment gain can do far less to help a portfolio recover from previous years of investment loss if the pattern of loss followed by gain occurs while a retiree is regularly withdrawing from the portfolio during spend-down rather than while an active worker is regularly adding to it during the accumulation phase.)

- Information and education as to the costs and benefits of available lifetime income alternatives is important. Plans and IRAs (and the annuities or other financial products associated with them) necessarily involve expenses for recordkeeping, administration, and insurance-related charges for lifetime income guarantees. It is critical, however, that fiduciaries and individual participants be able to understand and compare, with the aid of good disclosure and clear explanations, lifetime income products (including both their benefits and costs). Ensuring access to such information should help fiduciaries and individuals make more informed choices and empower them to evaluate whether a product offered in the marketplace is appropriate for their needs. Informed individual choices, in turn, should lead to increasingly cost-effective means of delivering lifetime income.

This is by no means an exhaustive list of the issues that need to be, and will be, considered. For example, Chairman Kohl submitted to the Departments an important comment on behalf of the Committee calling attention to a helpful Government Accountability Office (GAO) report, entitled "Retirement Income: Challenges for Ensuring Income through Retirement." The comment also discussed the "Lifetime Income Disclosure Act" (S. 2832), introduced by Senators Bingaman and Isakson, together with Chairman Kohl. This bill would, among other things, require 401(k) and other individual account plans to provide participants an annual statement with estimates of how much their accounts would buy in lifetime monthly payments starting at normal retirement age.

We believe that information of this type -- the potential income equivalent of an account balance -- could be valuable for workers facing critical decisions regarding how much to save and how to deploy their resources at and before retirement. As creative work in behavioral economics has illustrated, the way potential benefits are presented or "framed" can have a potentially consequential impact on the way people approach these important decisions. Accordingly, the RFI requested comments on the possibility of providing such information. The comments submitted on disclosures in benefit statements -- which is a topic within the Department of

---

Commission, a group chaired by the Secretary of the Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. Treasury's Office of Financial Education, the Department of Labor's Saving Matters Retirement Savings Education Campaign, and the extensive financial education and outreach efforts under way in the private and nonprofit sectors (including by plan sponsors) can help give individuals the information and understanding to make more informed choices relating to lifetime income and retirement and financial security more generally.

Labor's regulatory jurisdiction -- are helpful in addressing the advisability and feasibility of providing participants with this type of information and how best to structure any such disclosures. As some of the comments point out, relevant considerations include the need to balance the value of giving participants information on the income equivalent of their accounts with any administrative burdens and costs of providing the information and with the need to avoid information overload that could discourage people from considering the information in the first place.

The RFI responses suggest that lifetime income products are evolving in ways intended to address some of the concerns of plan participants and sponsors.[3] Death benefits, withdrawal options, participation in equity returns, and other features can encourage individuals to opt for income options but also can make it more difficult for consumers to understand the options and their costs and to compare products on an "apples to apples" basis that promotes effective price competition in the market. These developments and the continued evolution of cost-effective, transparent, and readily understandable designs should help plan sponsors offer participants a variety of improved options for obtaining lifetime income. As noted, defined benefit plans have traditionally provided such income. Taking into account the increasing role of 401(k) plans and IRAs, it is important to encourage the availability in the individual-account universe of payment options that were formerly more prevalent in defined benefit plans. Meeting that goal will not be easy, and will not occur overnight, but we believe it is a goal worth pursuing.

The RFI also does not address investment risk. We have seen how investment losses can hurt individuals in or near retirement, but this project is not focused directly on that problem (although guaranteed lifetime annuity products, such as a fixed annuity purchased before retirement, may help mitigate investment risk). This Committee has exercised leadership with respect to investment risk with its hearing on the effect of the economic downturn on retirement security, particularly for those on the brink of retirement, with a particular focus on 401(k) target date funds and on the wide variety of objectives, portfolio composition, and risks that exist within same-year target date funds.

Finally, we should keep in mind that the RFI and lifetime income discussions are relevant only to the roughly half of the workforce that has tax-favored retirement savings. We also need to address the problem of insufficient savings in the accumulation phase, for example through legislation on automatic IRAs and an enhanced Saver's Credit.

Conclusion

Mr. Chairman, Ranking Member Corker, and Members of the Committee, thank you for the opportunity to appear before you today. I will be happy to respond to any questions.

---

[3] Comments also note the availability of new non-annuity products and services that address a range of retirement income needs. For example, certain managed payout funds, meant to serve as combined investment and payment vehicles, are designed to provide predictable monthly payments over an extended term, although not guaranteed to continue for life.

The CHAIRMAN. Thank you very much, Mr. Iwry.

First question for you both. We found with our investigation of target date funds the importance of making sure that retirement products are clearly defined. How can we make sure that consumers understand how lifetime income options work and what their costs and benefits are? Ms. Borzi, you want to comment?

Ms. BORZI. Well, I couldn't agree with you more that that's really the crux of the issue. The comments we've gotten from the industry say to us basically if people understood the benefits of these kinds of approaches, more people would choose them, because the difficulty is even when they're offered participants don't choose them.

These are extremely complicated products. We absolutely need more transparency. We need more explanation. We need more understanding. We need to understand what the risks are, what the rewards are. I think this whole question of disclosure is critically important.

We've gotten lots of interesting suggestions on how to deal with it, and this is certainly one of the themes that we're going to be focusing on going forward. Your bill, of course, is certainly something that we've been looking forward—we've been looking forward to working with you on that because it's one of the issues that we've been thinking about in the context of our own benefit statement regulations.

The CHAIRMAN. Thank you.

Mr. Iwry?

Mr. IWRY. Mr. Chairman, I agree with what Ms. Borzi said, Mr. Chairman. I think that there are real education needs and challenges here. I think Ted Beck from NEFE's going to be testifying on the next panel. They've done a great job of trying to promote better understanding and education in this area.

I think we all need to do more in that regard. There are basic facts that folks don't really understand, to the point where, picking up on what Ms. Borzi just said, the economic literature is full of expressions of bafflement at what they call the annuity puzzle. Why is it that folks don't pool some of their assets in order to protect themselves against longevity risk by purchasing annuity type products that will let people put in enough money to last for the average life expectancy, so that people who live longer than the average will not have to be uncertain about whether there will be enough left, folks who die earlier, their funds will in effect subsidize people who die later than the average.

People don't understand, for example, the fundamental asymmetry in up and down investment returns between the accumulation phase and the spenddown phase. In other words, we're used to thinking that if you stay invested for the long term, you buy and hold, many people say, up markets and down markets will eventually work out, the down markets will be succeeded by better times, and it will all be fine.

Well, in retirement that can also be true, but what people don't take into account is that when you're spending down on a regular basis, when you're withdrawing, a few bear market years early on cannot be recovered from as readily by some bull market years later as they can when you're in the accumulation phase.

It's not quite a symmetrical process. That's why the financial planners and the literature tell people, don't withdraw more than X percent from your retirement savings on a regular basis. In other words, if you were not to adjust and you were just to ask how much can I safely withdraw without much of a risk of running out, the literature suggests some people say 4 percent, 4.5, 5 percent, depending on how high a probability you want of not running out of assets.

Many people aren't even aware of that. They may think, well, gee, I've got a couple hundred thousand dollars in my 401(k), I'm retiring, I'm set for life. That should last me 35 years. They don't think about how to convert that large-sounding account balance into a pension paycheck, a stream of regular income that will last them for life.

If they're confronted with the proposition, do you want to use some of that account balance to buy an annuity or to buy a lifetime income of some kind, they'll often say: You mean you're only going to offer me this piddling number of dollars per month for this huge treasure I've got in my account balance? It's a wealth illusion. We're not used to thinking in income terms when we're starting with a large lump sum.

So we've got a lot of education to do, and the disclosure the framing of the benefits, as your bill would promote, in an income format, in the form of a pension paycheck or a retirement paycheck on a monthly basis is one step in getting people to start thinking in those terms.

The CHAIRMAN. Thank you.

Senator Al Franken.

Senator FRANKEN. Thank you, Mr. Chairman, for this very, very important hearing. We've all had parents who faced this very challenge. My mom got an annuity and I think it was a good thing. But very few people do get annuities, isn't that right?

Mr. IWRY. Comparatively few.

Senator FRANKEN. What are the percentages of people who get annuities in their retirement?

Mr. IWRY. Well, to give you an example from the 401(k) world, which of course is still the part of the retirement universe that's growing fastest, the percentage of people who take annuities I believe is down around 1 to 2 percent of all the payouts.

Now, defined benefit plans, a much higher percentage. But unfortunately those are dwindling.

Senator FRANKEN. So what are the barriers? I imagine it's complexity, that people are looking at these things and they're complex.

Ms. BORZI. Cost.

Senator FRANKEN. I think that people—do people by and large underestimate how long they're going to live?

Ms. BORZI. They do. As Mark said, the fact is that they have no concept of how much they will need, even in a normal retirement, even if they don't outlive the actuarial predictions. They don't really understand how much they'll need to live.

Senator FRANKEN. That's an answer to a slightly different question. I just want to know whether people actually on average underestimate how long they're going to live.

Mr. IWRY. Senator, I think that there is—yes. I think there's evidence in the behavioral economics literature and in the related literature about aging, that people do tend to underestimate how long they're going to live. Plus people tend to look at life expectancy statistics, if they're informed enough to know what the life expectancy is at any given age, and not think so much about the 50 percent chance that they'll exceed that life expectancy.

Senator FRANKEN. Also sometimes they're looking at life expectancy of the general population and not someone who's already reached their age, and not——

Ms. BORZI. Exactly.

Mr. IWRY. Exactly. But if they're looking at a table where they're 65 and they're saying, what's the life expectancy of a 65 year old, a lot of people seem to be eager to not look at how much they need to have to deal with the contingency that they'll live way past their life expectancy.

Senator FRANKEN. I'm sorry, Ms. Borzi. What you were saying is that exacerbating that is the fact that people have kind of no idea how much money they're going to need per year?

Ms. BORZI. That's absolutely right, Senator. What they particularly don't usually take into consideration is how much in medical costs they will have to spend, because we know for most people from 55 and older it's the medical costs that are the most unexpected. Hopefully, with health care reform some of that will be alleviated.

Senator FRANKEN. Well, the doughnut hole will be. But we're talking about Social Security and Medicare as really the safety nets that have—when you're talking about income security and when you're talking about paying for health care you're talking about the two basic foundations, which thank goodness we have those, right?

Ms. BORZI. Thank goodness we do. But of course, as you know, the largest bit of medical expense occurs in those pre-Medicare eligibility years.

Senator FRANKEN. Sure, the 55 to 65.

Ms. BORZI. The 55 to 65.

Senator FRANKEN. Well, speaking of which, when you talk about people learning about how they're going to get through their retirement years, have income security during their retirement years, are you mainly talking about getting this message out to 25 year olds, to 35 year olds, to 45 year olds, to 55 year olds, or to 15 year olds?

Mr. IWRY. Senator, yes.

Ms. BORZI. All of the above.

Senator FRANKEN. Well, it wasn't meant to be answered that way.

Mr. IWRY. Seriously, I think that there's a different type of strategy for each of those age groups, but that we actually need the education to start in the schools and then to be directed in an age-appropriate form to each of those age groups.

The time when people really start to care about it the most, of course, is when they reach their typically 50's or so.

Senator FRANKEN. I think that——

Ms. BORZI. The point that—I'm sorry. What I was going to say is at the point at which they're ready to make these decisions, in many respects that's the most critical, because they have no way to make up the time that they've lost. So to me the most important priority—I agree that all of these age groups need to be educated, but right now our immediate problem is to focus on the people close to retirement age, so that they begin to understand what their choices and options are, because they're much more limited than in the 30's and 40's.

Senator FRANKEN. If they started—if we started earlier with financial literacy—and I'm talking about in high school, before kids get credit cards and get student loans and all those things——

Ms. BORZI. We're working on elementary school, actually, financial literacy in elementary school.

Senator FRANKEN. You're better than me, in high school. [Laughter.]

But OK. I mean, it seems to me that one of the biggest problems here is financial illiteracy, and if we started early with kids in elementary school, say—here's an idea I have—— [Laughter.]

Ms. BORZI. It's brilliant, a brilliant idea.

Senator FRANKEN. Thank you, thank you. That's why I'm a Senator.

Then it seems to me that they'd be able to adjust during their lives and start thinking about it sooner. Anyway, probably my time has lapsed.

The CHAIRMAN. Go ahead.

Senator FRANKEN. Well, I probably don't think this is necessarily the place, but we need to make sure that Social Security is sound, and I have some theories on how we could do that. But maybe that's not what this hearing is so much about.

Yes?

Mr. IWRY. Senator, if I may just add to our response, one of the things that people in their 50's or 60's could use some more information about is the value of, in addition to the saving—as Phyllis was pointing out, it may be too late to do as much as we'd like about saving more at that point—the value of deferring retirement incrementally.

If you postpone retirement for one more year, if you can do it, if you've got the health, if you've got the job, etcetera, how much will you gain in terms of financial security?

You get an additional year of earnings. You get an additional year subtracted from the number of years you won't be earning that you have to support with the savings from your earnings. If you postpone Social Security, the time when you start Social Security, of course, that can be helpful. People haven't gotten enough information about that.

In our discussions earlier about what people don't know and the misperceptions that folks have, I'm sure I speak for Phyllis, too—we don't need to convey an attitude that people are not intelligent, that Americans aren't smart, not at all. First of all, I include myself in all of those statements, that we don't understand as much as we should, that we're not as disciplined perhaps as we should be, that we don't have as much information, we need more education.

It's true of most of us. Partly it's denial. Sure, people understand about life expectancies. They know that there's a 50 percent chance they'll live more than the average. These are sometimes painful and anxiety-inducing realities that we're grappling with. So I think we need to help people, and that's why we're embarked on this.

We've heard and we've gotten a sense from you and others here that there might be a constructive role for public policy to play in this.

Senator FRANKEN. For example, what you're talking about in terms of deferring retirement, that would be an entirely voluntary thing.

Mr. IWRY. Absolutely.

Senator FRANKEN. That's what we're talking about. It's interesting on age and life expectancy, and you were talking about denial. I would think that denial would be on the other side, that I would think it would be human nature to think: I'm going to outlive the actuarial table. But it isn't, is it?

Ms. BORZI. Actually one of the other interesting things that you discover in the literature is most people think they're going to—along the lines you're suggesting, most people assume that they're going to work a lot longer than they do. If you ask people when they think they'll retire, the overwhelming majority of people think that they're going to work until at least age 65.

But when you look at the statistics, people actually retire much earlier than that, because of health problems, because of financial problems, because of caregiving responsibilities, where they'll have—particularly women who will have to leave the work force early to care for ill spouses or children or siblings or parents.

Mr. IWRY. Because it can be harder for an older person to get a job if they lose their current job.

Ms. BORZI. So there are a lot of issues around this question about when you're going to retire, how much money you'll need, how long you're going to live, that people haven't really focused on. You're right, the misperceptions, the misunderstandings, go in both directions really.

Senator FRANKEN. Thank you. Thank you both very much. Very helpful.

Mr. Chairman thank you.

The CHAIRMAN. Thanks a lot, Senator Franken.

Thank you both for being here. You've made great contributions.

Ms. BORZI. Thank you so much.

The CHAIRMAN. We appreciate your taking the time.

Mr. IWRY. Thank you, Mr. Chairman.

The CHAIRMAN. We'll turn now to the members of our second panel. Our first witness on this panel will be Ted Beck. Mr. Beck has been the President and CEO of the National Endowment for Financial Education since 2005. Previously he was an Associate Dean at the University of Wisconsin School of Business and spent more than 20 years in senior management positions for Citibank, Citigroup.

Welcome.

Next we'll be hearing from Kelli Hueler, CEO and Founder of Hueler Companies, which is an independent data and research firm on the annuity and stable value marketplace. Ms. Hueler headed the development of income solutions and is nationally recognized as an industry expert. Welcome.

Then we'll be hearing from Bill Mullaney, President of U.S. Business for MetLife. MetLife is a leading provider of life insurance, annuities, and other retirement and savings products. Mr. Mullaney is responsible for the oversight of all of MetLife's insurance, retirement, and corporate benefit funding businesses in the United States. He will offer testimony on behalf of the American Council of Life Insurers.

Then we'll be hearing from Lisa Mensah. Ms. Mensah is the Executive Director for the Aspen Institute's Initiative on Financial Security, where she has an advisory board which investigates financial products that build wealth for working families. Previously Ms. Mensah served as the Deputy Director of economic development for the Ford Foundation. Welcome.

Mr. Beck, we'll start with you.

STATEMENT OF TED BECK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ENDOWMENT FOR FINANCIAL EDUCATION

Mr. BECK. Thank you, Mr. Chairman. My name's Ted Beck. I am President and Chief Executive Officer of the National Endowment for Financial Education, located in Denver, CO. We at NEFE would like to thank Chairman Kohl, Ranking Member Corker, Senator Franken, and the members of the Special Committee on Aging for this opportunity to share our views on retirement income.

For those of you that don't know the National Endowment, we're a private nonprofit foundation solely focused on improving the financial knowledge, capability, and wellbeing of all Americans. We have been deeply involved in the financial education arena for several years, ranging from high school on through to retirement.

I'd like to tell you about a recent development that we've been involved with. In 2006 we took a step back and looked very hard at the questions around retirement. We were very concerned about how few people were actually calculating what their financial needs were. The current estimate on that is 46 percent, actually do the calculation.

Also, only about 40 percent—excuse me. Only 60 percent of the population is currently saving for retirement. Those are 2010 numbers.

Also, research tells us that workers age 55 and older have very weak financial knowledge and skills.

So these caused great concern. As we looked at this, we also discovered that there is a limited knowledge base on decisions made in retirement on assets you've accumulated. We're especially concerned in this area in families who are making between $30,000 and $100,000 pre-retirement.

So as we looked at this situation, we thought the best thing we could do would be to assemble a task force of people. We pulled together 40 experts from consumer education, financial service industry, academic, regulation, including two of our witnesses today, Kelli Hueler and Mark Iwry from the earlier panel. We wrestled with the question of what should be done about this.

The project that came out of that is an effort that we're deeply involved with called "My Retirement Paycheck." The goal of this project is to help people generate the equivalent of a paycheck in retirement using the assets they've accumulated effectively. The program looks at eight different categories: work, home and mortgage, pensions, debts, Social Security, insurance, retirement plans, and fraud. We try to look at these categories in a holistic way and look at the interaction of what happens if you make a decision in one area and how it affects other areas.

For example, we talked a second ago about working 2 to 4 years longer. What does that do for you if you have that option? A typical retirement age right now is 62 to 63. If you are able to continue to work, how much extra security does that give you?

Likewise on Social Security, if you start taking benefits at 62 versus age 70 by delaying, it you're actually giving up 75 percent difference. So if you get $1,000 in your retirement paycheck at age 62, the equivalent of that if you wait until age 70 is $1750, a significant difference that everybody should be informed of and able to make as part of their retirement decision.

We've developed a very rich resource that is now available to the public, that was made available in 2009, and we feel that this sort of education tool will be of great importance going forward.

However, there are several next steps we need to talk about. Merely developing a new web site with the best intentions is irrelevant if people don't use it. Therefore we're spending a lot of our time on trying to figure out how to get this information to people in a manner that is acceptable to them and that they will actually respond to. That is a big function of what we do every day.

So we're very focused on retirement education. As an example, we've just finished a study at Darthmouth College that used different social marketing tools as a way to get more people involved in their 401(k) plans early in their career, and by approaching this sort of question differently we found a very significant increase in involvement.

Likewise, we think workplace is a great opportunity to do more work here, especially early in the career, not one year before retirement, as many of the programs are now. We're also very convinced that we have to spend more time on segmentation. Senator Kohl, you are absolutely right, one size does not fit all here. There are differences between social and economic groups, different levels of education, and especially with women, that we want to do more work with.

Another area that we're very concerned about is seniors who are suffering from diminished capabilities. How do we make sure that we get information to not only those individuals, but their caregivers, to make sure that they're making intelligent decisions that are informed?

Our real goal here is to help people build savings and financial planning that will allow them to make informed decisions, and we are convinced that the American people are perfectly capable of doing this.

Thank you.

[The prepared statement of Mr. Beck follows:]

NATIONAL ENDOWMENT FOR
FINANCIAL EDUCATION

Partnering for Financial Well-Being

Testimony of

Ted Beck
President and CEO
National Endowment for Financial Education (NEFE)

Before

The Special Committee on Aging
United States Senate

Regarding

"The Retirement Challenge: Making Savings Last a Lifetime"

June 16, 2010

1331 17th Street
Suite 1200
Denver, CO 80202-1586
303-741-6333
www.nefe.org

I am Ted Beck, President and Chief Executive Officer of the National Endowment for Financial Education®, (NEFE®), located in Denver, Colorado. We at NEFE would like to thank Chairman Kohl, Ranking Member Corker, and Members of the Special Committee on Aging for this opportunity to share our views on retirement income.

NEFE Overview

The National Endowment for Financial Education is the only private, nonprofit, noncommercial, nonpartisan, self-funded national foundation wholly dedicated to improving the financial well-being of all Americans. NEFE provides funding, logistical support, and personal finance expertise to develop a variety of programs and materials, including the award-winning High School Financial Planning Program® (HSFPP), CashCourse® college program, and the consumer-oriented Smart About Money public awareness campaign. NEFE also funds research and awards research-based development grants that advance innovative thinking and contribute to our understanding of financial behavior.

NEFE places a special emphasis on underserved audiences who face financial challenges not being addressed by others. To best serve these audiences and provide them with the most accessible, meaningful, and up-to-date financial education possible, NEFE collaborates with experienced and knowledgeable leaders of consumer organizations; financial planning practices; academia; national, regional, and local foundations and nonprofits; and state and federal governments. In addition, NEFE is in contact with financial services and education communities. Not only do we work with organizations such as the American Red Cross and Boys and Girls Clubs of America to create customized financial education resources, we serve in other roles as well. For example, we are an advisor to the Social Security Administration's Financial Literacy Research Consortium at both the Financial Literacy Research Center at Dartmouth College and at the Center for Retirement Research at Boston College, and funded a study at the University of Notre Dame Institute for Latino Studies entitled *La Tercera Edad: Latinos' Pensions, Retirement and Impact on Families*. In all areas of our work, NEFE supports collective progress rather than duplication of effort.

NEFE and Retirement Issues

Over the last twenty years, there's been a transfer of retirement decision making to the individual. However, research indicates that Americans aged 55 years and older struggle with basic financial concepts and terms, leaving many individuals unprepared to assume this responsibility in an increasingly complex investment environment. NEFE saw a need to provide tools and resources to these individuals in order to simplify and clarify the retirement decision making process.

NEFE tackles difficult financial education topics and looks for creative ways to advance knowledge, awareness, and behavior change among Americans. One way we do this is by hosting think tanks and symposia on topics that are generally challenging and/or have not received adequate consideration to the broad, underserved audience that NEFE seeks to assist. In 2006, observations by NEFE leaders inspired the idea of holding a retirement-based think tank event: Though strategies abound on how to accumulate retirement assets, less attention is given to formulating strategies for decumulation and managing retirement income. For millions of Americans of modest means about to enter retirement financially unprepared, strategies for decumulating their limited assets receive the least attention of all.

In consideration of the incomplete and fragmented body of knowledge on retirement decumulation, NEFE saw an opportunity to investigate this deficiency within the context of its mission: helping individual Americans acquire the knowledge and skills necessary to take control of their financial futures. In the case of retirement income decumulation, the households that are most often overlooked are those that are not on public assistance, but earn less than the mass affluent and are unlikely to pay for professional advice. NEFE refers to this group as "At-Risk Middle America," a large segment of the population that generally has a household pre-retirement income of between $30,000 and $100,000.

NEFE's Retirement Income Decumulation Think Tank and Outcomes

The goal of coordinating what would become NEFE's *Retirement Income Decumulation Think Tank* was to host a strategic gathering comprised of a diverse group of retirement experts and thought leaders representing consumer advocacy associations, research organizations, financial planners, academic institutions, financial services providers, regulatory agencies, and the federal government. The event required more than a year of preparation, including a preliminary roundtable, advance interviews with all participants, and the completion of a comprehensive research survey of academic literature conducted by the Center for Retirement Research at Boston College. This pioneering academic literature review aggregated the most commonly proposed consumer guidelines within key areas in which Americans make critical—and often irrevocable—decisions about initiating and paying for their retirement.

In December 2007, the *Retirement Income Decumulation Think Tank* was held for two days in the Boston area and generated considerable discussion about the best approach to influence better retirement decumulation decisions. The most important outcome of NEFE's think tank event was the creation of a set of universal retirement decumulation guidelines within eight critical "decision areas": Work, Social Security, Home & Mortgage, Insurance, Pensions, Retirement Plans, Debt, and Fraud. In research presentations and breakout work groups, NEFE's think tank experts dissected, debated, and defended countless considerations and specifics regarding which decision area guidelines are the most important to be communicated to At-Risk Middle America. Following the think tank, NEFE's team consolidated and summarized the experts' consensus as a strategic message document, which underwent additional expert review and revision. NEFE's considerable facilitation efforts finally produced a single, easy-to-understand set of the most important guidelines for all Middle American consumers—at-risk and not—to follow in preparing and paying for their retirement.

Currently, the primary vehicle to disseminate the messages resulting from the think tank is a consumer website (www.myretirementpaycheck.org) which features the eight most critical decision areas. The site's concept was tested among targeted consumers to make sure the language, approach, and content would be relevant and accessible. We found that the information and guidelines contained on the site are applicable to varied audiences:

- People who already are in retirement still have decisions to optimize. Decumulation is not an end point; it's an ongoing process.
- People expecting to retire within ten years have the most to gain from this information, because it creates awareness of these decisions in their planning timeframe.
- Even younger people, those in their 30s and 40s, benefit; knowing what decisions they'll face develops a realistic picture of retirement.
- Peers and loved ones of pre-retirees and retirees can put these guidelines to use as they set examples of successful decumulation decision making, pass on information, and influence opportunities for learning.

Retirement as a Holistic Process

Throughout our research and message development, we found that every decision area is important. Just as retirement planning encompasses savings, work, pensions, and Social Security, decisions about drawing down assets are interrelated as well. This synergy can work to a retiree's detriment or benefit, depending on how informed his or her choices are. By piecing together many different streams of income, taking responsibility for making wise decisions, and appropriately growing and protecting assets, Americans can make a small nest egg last longer. Academic research and evidence suggests that retirement is a holistic process, with each decision area affecting other areas of consideration. For example, a person's decision to work longer affects his or her Social Security benefits, leads to increased retirement plan contributions, and allows him or her to maintain health care benefits longer. Therefore, individuals who are informed and responsible can optimize their decision making and make their limited resources last longer, providing them with greater security and financial well-being in retirement.

This new expression of the interrelation of decumulation decisions is featured on NEFE's MyRetirementPaycheck.org. Excerpted examples across the eight decision areas include:

- Work: If you are healthy, aim to work at least until your full retirement age. It produces many benefits, including prolonging any health care coverage you have, building your retirement assets, and increasing your ability to reduce debt. Give additional consideration to how working relates to:
    - Social Security: By delaying taking Social Security, you will receive larger monthly payments over your lifetime, and Social Security retirement benefits are adjusted for inflation.
    - Retirement Plans: Working longer leads to increased retirement plan contributions. You will keep adding to your retirement nest egg instead of depleting it too quickly.
    - Insurance: You will keep your health care benefits longer, ideally to at least age 65, when you can become eligible for Medicare.
- Social Security: Taking Social Security payments too early means receiving less money each month than you would receive if you waited for even a few years. If at all possible, do not begin taking Social Security until you are at least your full retirement age. If you take Social Security benefits at age 62, your benefit will be approximately 25 to 30 percent less than if you have waited until your full retirement age. For an even bigger benefit, wait until age 70, when your payment will be at least 75 percent higher than if you started taking benefits at 62. Give additional consideration to how Social Security relates to:
    - Work: By working longer, you can delay taking Social Security benefits, and you also may be able to increase the size of your Social Security benefit based on additional years

of earnings and/or higher wages. You'll add to your nest egg and prolong any health care coverage you may have.

- Home & Mortgage: A house may be your biggest asset, but be careful about viewing the value of your house as it were a retirement plan. Housing prices fluctuate and you need other forms of savings. It's best to plan that a home's equity is one of the last assets you use in your retirement. Give additional consideration to how Home & Mortgage relates to:
  - Fraud: Protect your home equity from mortgage schemes by making decisions based on research and investigating charges, fees and other options.
  - Debt: If at all possible, plan to pay off your mortgage and otherwise reduce your housing costs before retiring.
- Insurance: Your retirement spending plan is not complete until you know how you will pay for medical and long-term care needs. Insurance companies also sell many forms of annuities. Putting at least part of your retirement savings into an immediate fixed annuity that will give you a monthly payment for the rest of your life creates a regular source of income. Give additional consideration to how Insurance relates to:
  - Work: You won't become eligible for Medicare until age 65; use your or your spouse's employer-provided health care coverage as long as possible.
  - Debt: Understand that Medicare is not a free pass; in fact, it may only pay a portion of your health care expenses. To avoid debt, one should plan to save for out-of-pocket medical expenses and premiums.
- Pensions: Your employer pension is an annuity that gives you a steady "paycheck" for your retirement. Even when you're retired, saving some of your pension benefits is a good way to protect yourself from inflation and ensure you have enough money for your later years. Give additional consideration to how Pensions relate to:
  - Work: Working longer and at higher wages can increase your pension check. Be sure you clearly understand the terms of accepting early retirement incentives and lump-sum payouts.
  - Social Security: Use your pension as a bridge to Social Security. By delaying taking Social Security, you'll receive a larger Social Security benefit. Unlike most pensions, Social Security is indexed for inflation so you'll have more purchasing power in future years.
- Retirement Plans: You do not know whether your retirement will last less than 10 years or more than 40 years. To be prepared for reaching advanced age, continue saving and making wise investments even during your retirement. At retirement, most retirees still need to invest in diversified assets that may need to last decades or help weather investment market turmoil. Give additional consideration to how Retirement Plans relate to:
  - Work: Cashing out your 401(k) savings before age 59 ½ usually will cost you money (in taxes and penalties) and have a negative impact on your ability to pay for retirement.
  - Fraud: Never forget that your retirement money is being targeted by con artists, Internet fraud, and financial scams. Never make decisions without double-checking the facts and the people they might do business with.
- Debt: To maintain a predictable cash flow in your retirement years, make every effort to pay off your consumer and credit card debt before you retire, and don't borrow money during retirement unless you know precisely how you'll pay it back. Consider the 10 years before retirement as your "debt-reduction" decade. Give additional consideration to how Debt relates to:
  - Home & Mortgage: Don't take new debt against a home but instead reduce any existing debt, if possible.

  - Retirement Plans: Don't "borrow" money by spending your 401(k) savings before you retire. It will have a negative impact on your ability to pay for retirement.
- Fraud: You've worked hard building up retirement assets. Now you need to protect them. Older Americans—even those who are experienced with investing and are financially literate—are highly targeted by scammers, misleading advertising, and fraud, so be especially on guard. Make no money decisions quickly, and never without getting a second or third opinion from people you trust. If it sounds too good to be true, it almost always is. Give additional consideration to how Fraud relates to:
  - Retirement Plans: Get good, objective advice from a qualified financial planner about how to best invest your assets to fit your personal situation.
  - Home & Mortgage: Protect your home equity from mortgage schemes by making decisions based on research. Thoroughly investigate charges, fees, and other options.

My Retirement Paycheck

The conventional approach to retirement decumulation emphasizes how an action taken (or not) within a specific decision area either produces or reduces retirement income. NEFE's research and work in this area shows that determining one's retirement paycheck involves a holistic approach to retirement. This helps individuals understand the impact of each decision, as well as have a better idea of what they can expect to pay themselves throughout retirement. The phrase "retirement paycheck" is at once relevant and practical: it describes how each decision area and income stream works together to create a "paycheck." This concept provides more opportunities for optimization and better serves Americans who do not have much leeway to make mistakes with their resources.

MyRetirementPaycheck.org is built to show interrelation and connectivity. The consumer-centric website provides a holistic and comprehensive collection of guidelines, articles, and additional links and resources to help At-Risk Middle Americans become informed, active participants in their retirement decisions. Beyond the guidelines for each decision area, users can access short articles that provide more in-depth information about special situations and considerations within each of the eight decision areas. Related links provided in each area also contain useful tools such as calculators and estimators from vetted sources such as government and nonprofit organizations.

Effective Retirement Education

In NEFE's focus groups, we found that many retirees often go to their employer as a trusted source to guide them through retirement decisions. However, many retirees aren't getting the "whole picture" when it comes to their options in retirement; it's unlikely that companies educate their employees beyond what pertains to employee benefits. Because of this narrow scope, retirement planning is often limited and incomplete. Furthermore, saving for retirement—even through an employer's plan—sometimes is perceived as daunting and unattainable. Though these attitudes are difficult to overcome, a study funded by NEFE and conducted by Dartmouth College in 2009 showed that by using simple messaging and peer education, employees are more likely to open supplemental retirement accounts on their own.

Increasing the Effectiveness of Retirement Saving Programs for Females and Low Income Employees: A Marketing Approach details this research project. The goal of the study was to encourage new employees—especially female and low income employees, since they face unique savings challenges—to voluntarily save for retirement. Specifically, the research project sought to meet three objectives: (1) to reduce anxiety about future retirement needs; (2) to increase awareness and financial knowledge, including interest in professional advice; and (3) to increase participation and contribution to supplementary retirement accounts (SRAs) among females and low income workers. To reach these objectives, researchers devised two main communication programs to overcome saving barriers for the target group: (1) a flyer that acknowledges the barriers for saving and provides specific solutions for each barrier and (2) four videos that encourage the target audience to save by providing personal testimonials from similar-type employees at the same institution.

The test group employees reported feeling less anxious about future retirement needs after exposure to the communication programs, and the programs significantly increased awareness and understanding about future financial needs. The video program resulted in a 56.2 percent increase in election behavior within 30 days of viewing the communication programs compared to SRA election rates among control group employees who were not exposed to the communication program during the same period. These differences were sustained after 60 and 90 days. Also, SRA election rates increased 147 percent amongst employees who saw the videos as compared to employees in the same time period one year earlier.

The report included recommendations that are based on the premise that there is no "one size fits all" solution to the retirement savings crisis. Recommendations include designing initiatives to overcome barriers to save for retirement. A simple flyer describing the barriers and providing simple solutions went a long way in simplifying an overwhelming financial decision process. Examples of obstacles to opening a SRA and their accompanying solutions are:

I can't afford it.	You can start with only $16 per month.
Few people like me do it.	More than 60 percent of employees contribute.
My debt is too expensive.	With the tax benefit you will save even more.
I don't know where to put money.	Make an investment selection now. You can change it at anytime.

Another recommendation emphasizes the importance of tailoring motivational and implementation materials for target audiences. For example, the videos featured peers that spoke to their own experiences in planning and saving for retirement. This speaks to NEFE's belief that in order to provide effective financial education, especially to at-risk populations, one size does not fit all. Research indicates that there are significant differences in levels of financial literacy and financial sophistication among populations that are segmented not only by income level, but by sex, age, educational levels, and race or ethnicity as well. Without some level of segmentation and customization, no program or resource will successfully address the needs of all at-risk individuals.

The Dartmouth College study shows that by using a model of messaging that makes saving for retirement achievable, employees are driven to do more to help themselves prepare for retirement. Even though this study is focused on asset accumulation, this experience may translate effectively to decumulation.

Empowerment and Encouragement

What NEFE has learned from our involvement in helping Americans make better choices for retirement is that it's more important to talk about WHY people need to optimize their savings for retirement rather than HOW they need to do it. Retirement needs to be personal, achievable, and accessible; and those planning for retirement often need encouragement. By giving them a holistic perspective about retirement and allowing them to consider all areas of retirement planning, most retirees will find a few areas in which they'll be able to make a decision that will pay off for them.

The Dartmouth study showed that once people find that they can make manageable, modest contributions to a retirement fund, they often will. Finding success in starting small translates to other areas of savings as well. In the report *Understanding the Emergency Savings Needs of Low- and Moderate-Income Households: A Survey-Based Analysis of Impacts, Causes, and Remedies,* Stephen Brobeck of the Consumer Federation of America reports that if low- and moderate-income individuals have less than $500 in emergency funds, they are often "more than twice as likely to experience financial and psychological problems than are those with more than this amount." While $500 falls considerably short of the advised three-to-nine months of living expenses, an ability to attain this modest level of financial well-being is clearly a step in the right direction.

NEFE believes that regardless of background or income level, financially informed individuals are capable of taking control of their circumstances and ensuring a stable future for themselves and their families. Once individuals have the tools and resources to start seeing the benefits of optimizing even one or two decisions, they'll likely continue to be involved, informed participants in their retirement planning. Many retirees do not have access to employer benefits and many have limited resources, but they can still make wise choices to maximize their nest eggs.

Beyond Financial Education

While financial education across one's entire financial life is important and necessary, financial education alone cannot do the job of meeting the retirement challenge. Product regulation and disclosure can inform Americans and enhance financial capability as they approach retirement. Americans need to clearly understand the consequences of engaging in either positive or negative financial behavior, and we want to empower Americans to make their own decisions about which products and strategies will maximize their financial well-being, while discouraging them from making uneducated, irreversible choices that are especially destructive to those with limited resources.

Disclosure and transparency: The terms and use of products need to be clearly defined and disclosed to consumers. The same is true for financial advisors.

For example, increased transparency for products might mimic the recent inclusion of information on a credit card statement from the CARD Act. There, a box placed on the statement includes the time and cost involved in making only the minimum payment on a credit card. This shows the credit card user the power of compounding interest on the debt side. Many employers, consumer educators, and the financial services community promote and illustrate the power of compounding for retirement savings accumulation.

Consider a box that could accompany retirement products and/or statements, showing the income stream that can be provided from an account balance. While complexity and assumptions surround such illustrations, its potential as a basic educational tool is powerful and complements the types of basic numeracy examples identified above. Alternative approaches could include the use of basic or core visual scenarios, information that parallels and complements content in Social Security statements, or referrals to income stream calculators at the Department of Labor.

Clear product design/use of technology: In NEFE's *Retirement Income Decumulation Think Tank,* participants agreed on a priority that must be addressed: the need for far wider availability of consumer-centric retirement planning and management services for lower-to middle-income households, while simultaneously creating new products and services to meet the unique needs of those who are most likely to spend down their limited resources too quickly.

Behavioral finance: Much of the challenge of retirement planning is about starting the process. Automatic enrollments and proposed innovations like the auto-IRA are powerful tools for retirement savings and access that do not conflict with inherently difficult-to-overcome financial behaviors and instincts.

Public awareness: Not only does public awareness bring attention to the why and how of retirement planning, it also highlights the relevance of retirement planning to individuals' personal financial futures. This could mirror *Financial Fitness Check Up for Everyone*, a report and model public awareness campaign prepared for The President's Advisory Council on Financial Literacy in 2009. This initiative was based on a recommendation that Americans take a financial fitness checkup similar to a health checkup. The checkup enables Americans to understand their level of financial fitness, provide them with resources to enhance their knowledge, and encourage them to take responsibility for their financial health. Similar recommendations have been made for people to calculate their net worth. The same could be done for retirement: People need to understand what they've already saved and how they will pay themselves throughout their retirement.

Sensitivity to issues of age, health, and external factors: In our economy, one cannot control important factors like inflation or changing tax and retirement policies. Nor can other circumstances be easily predicted: Retirement planning is more than just working until a target date on the calendar. Many people who wish to continue working simply cannot do so. Poor health drives many into unwanted premature retirement. In other cases, diminished capacity for numeracy and critical thinking hinder financial decision making in later years of retirement. NEFE has experience developing financial education programs and resources that respect special circumstances. Our work with the Alzheimer Association, Hospice and Palliative Care Organization, Generations United and many other health-related nonprofits such as the American Cancer Society and the American Stroke Association reflects this sensitivity. We realize the national importance of information for consumers, caregivers, and financial professionals to receive and impart these messages and key milestones of financial information delivered at the right time, in the right manner, being both objective and clear.

The Future of Decumulation Planning

We know that the challenges of retirement decumulation will affect more Americans as the baby boomers age, and it will affect them differently as traditional retirement income vehicles diminish. Already, 401(k) employer matching contributions are undergoing the stress of the economic recession, with some becoming reduced or eliminated; pensions are becoming obsolete; and health care is changing. More than ever, Americans have to build their own retirement paychecks and take individual responsibility for their financial well-being in retirement.

We recognize that all these factors, along with ever-changing products, regulation, and legislation, exist in a constantly shifting landscape. Effective evolution of decumulation education must happen in a state of ongoing attention. Organizations like NEFE and the Social Security Administration's Financial Literacy Research Consortium are monitoring the retirement landscape and we're always prepared to share what we learn with this committee, the financial literacy community, financial planners, and the Americans we serve.

For more information about retirement issues and NEFE's work in this area, contact:

Ted Beck
President and CEO
TBeck@nefe.org
303-224-3526

Brent A. Neiser, CFP®
Director, Strategic Programs and Alliances
ban@nefe.org
303-224-3501

Mary Hoch
Associate, Strategic Programs and Alliances
meh@nefe.org
303-224-3513

More information about NEFE's programs and resources can be found at:
www.nefe.org
www.smartaboutmoney.org
www.myretirementpaycheck.org
http://hsfpp.nefe.org
www.CashCourse.org
www.spendster.org
www.financialworkshopkits.org

The CHAIRMAN. Thank you so much.
Ms. Hueler.

STATEMENT OF KELLI HUELER, FOUNDER AND CHIEF EXECUTIVE OFFICER, HUELER COMPANIES

Ms. HUELER. Good afternoon, Chairman Kohl, Senator Franken, a fellow Minnesotan.

Senator FRANKEN. Yes, I was going to say.

Evidently, Mr. Chairman, we have two votes or something?

The CHAIRMAN. Yes. We probably will get through her testimony and then we'll have to call a break.

Senator FRANKEN. OK, is that what we're going to do? Good.

Ms. HUELER. Should I continue?

Senator FRANKEN. Welcome from——

Ms. HUELER [continuing]. Members of the committee as well. My name is Kelli Hueler. I'm founder and CEO of Heuler Companies. I want to express my sincere thanks to both of you for holding this hearing today, and Chairman Kohl particularly in your efforts to champion this issue and concern.

We're very grateful for the opportunity to be here at the hearing today on what we believe to be one of the most important economic issues facing our Nation, ensuring greater retirement income security for millions of Americans.

Our company's been providing independent data and research to large institutions and employers since 1987. Hueler's written submission provides background and extra information regarding our experience.

I'm honored to come before you today to discuss how overall retirement income levels can be substantially improved and ultimately the use of annuity and lifetime income programs can be more broadly accepted. If plan participants are provided access to lifetime income and annuity alternatives by their employers and IRA providers through independent, institutionally priced, competitive offerings, they are in fact able to pensionize their hard-earned savings into a paycheck for life and increase their monthly income by an average of 6 percent or more over what they could likely achieve in the retail market.

Not only can the income amount be dramatically improved, but this type of approach allows retirees to transfer some of the key risks associated with longevity, inflation, and unforeseen market losses to a preestablished group of qualified providers.

As shown by the data in our written submission, the economic benefit of combining institutional or group pricing with competition among providers is substantial, and we can simply not afford to ignore this fact.

Statistics show that participants have basically rejected traditional annuity distribution offerings. For that to change, we believe lifetime income and annuity products need to be presented in a simple, easy to understand format, requiring quote responses to be standardized, to promote straightforward apples to apples comparison and objective review.

Participants need flexibility. As we've been talking about, there is no one size that fits all. They need educational tools to help them determine not only how much of their nest egg—what percentage of their nest egg to convert into income, but what features best meet their personal financial goals.

It's worth noting that the calculators on our web site are the most frequently visited pages and that we typically see participants request on average of four quotes before they make a decision.

Participants also need to be encouraged to diversify across multiple providers and to pensionize in increments over time to additionally limit provider and investment risk. Institutional offerings must eliminate the bells, whistles, and marketing hype that hide relative costs, create substantial confusion and suspicion, and ultimately lead to inaction or poor decision making.

Some key observations we can make are that when professional, objective assistance is provided to participants during the decision-making process, there is far greater purchase activity than those programs that are delivered purely on line in a self-serve format; and there is a direct correlation between employer communication and participant activity. Both quote and purchase activity increase dramatically following directed, targeted communication by a plan sponsor to the key demographic participant group.

This leads me to a critical point. Participants have a high degree of trust with their employers when it comes to financial decisions. If employers do not endorse lifetime income or annuity programs, participants will shy away from them, even if they're being offered.

Hueler's research shows fiduciary liability relative to issuer selection and appearance of endorsement as two of the top roadblocks for employers to offer any form of lifetime income distribution. While our program can be offered either as a plan distribution or a voluntary IRA rollover, better than 98 percent of the sponsors choose the IRA rollover.

Additionally, sponsors cite two main reasons for adopting that type of program: the competitive multi-issuer format and the independent issuer selection and ongoing due diligence.

Providing a fiduciary safe harbor that reflects legitimate plan sponsor concerns is critical if we expect them to encourage and endorse lifetime income alternatives. Given the recent financial crisis and persistent market volatility, the need for mitigating risk is urgent and the time is now for promoting education around and access to alternatives for converting retirement savings into lifetime income. Without low-cost income alternatives being widely accessible to plan participants, the defined contribution system will have severe limits going forward in terms of serving the public interest and meeting the needs of an aging population.

Increased life expectancy is a wonderful, albeit expensive, gift and I believe it's incumbent upon all of us to work together to improve the likelihood that individuals will be able to financially sustain themselves with dignity during their retirement years.

Thank you very much.

[The prepared statement of Ms. Hueler follows:]

HUELER COMPANIES Stable Value Market Data www.hueler.com Annuity Purchase Platform www.incomesolutions.com
10400 Viking Drive, Suite 190
Eden Prairie, MN 55344
Phone: (952) 941-5351
Fax: (952) 941-5744

Hueler Companies

Written Statement for the Record

for

**"The Retirement Savings Challenge:
Making Savings Last a Lifetime"**

Before the

United States Senate Special Committee on Aging

**June 16, 2010
2:00 p.m.
Dirsken Senate Office Building, Room 562**

Hueler Companies Written Statement for the Record
"The Retirement Income Challenge: Making Savings Last a Lifetime"
Senate Special Committee on Aging
United States Congress
June 16, 2010

Kelli Hustad Hueler
President and CEO, Hueler Companies

I want to thank you for holding this important hearing and for inviting Hueler Companies to provide testimony on such a critically important issue. We are grateful to Chairman Kohl (D-WI) and Ranking Member Corker(R-TN) for their willingness to address the challenge of ensuring retirement income sufficiency for millions of Americans.

By way of background, Hueler Companies was founded in 1987 as an independent consulting firm assisting plan fiduciaries and trustees with research, product selection, and ongoing oversight of their stable value investment funds. Our hallmark has been independent research, analytical reporting, and continued efforts to improve transparency through standardized reporting. Today Hueler Companies acts as an independent source of industry data, market research, analytical reporting, and related services to all major market segments. The Hueler Analytics Pooled Fund Universe tracks approximately 85% of professionally managed stable value pooled funds. The Universe constitutes approximately $100 billion in assets representing close to 40,000 retirement plans.

In 2000, Hueler Companies pioneered the development of a web-based platform that facilitates efficient, transparent, low cost delivery of lifetime income annuity options to *transitioning employees,* those employees at, near or in retirement. The broader mission of this effort was to create a platform that transformed annuity delivery to plan participants by leveraging the institutional purchase process, eliminating the inherent conflicts of interest, and allowing for open affordable access to all plan sponsors. After several years of research and development directly with plan sponsors and annuity providers, Hueler launched the Income Solutions® annuity program in 2004. In July of 2005, Hueler provided testimony before the ERISA Advisory Council Working Group on Retirement Plan Distribution Options.

To date over 1,000 plans have adopted the Income Solutions® program in order to extend access to lifetime income alternatives to*transitioning employees*. It is important to note that, while the program was designed to facilitate implementation as either an in-plan distribution option or a voluntary IRA rollover, 98% of plans choose the voluntary IRA rollover distribution alternative. We will comment further on survey data gathered around why this is the case. Adoption is generally facilitated through large plan administrators, as integration with the existing benefits portal is optimal (three of the top six plan administrators and six of the top 17 plan administrator firms are currently providing access to the program). Based on new adoptions scheduled for 2010 these numbers will continue to show meaningful growth. Access to this alternative is currently offered to millions of participants. Monitoring activity and analyzing actual results, both positive and negative, has afforded us the opportunity to observe what does and does not work, identify continued roadblocks, and develop solutions for improved utilization.

Our experience throughout the last decade in working with a variety of plan administrators, plan sponsors, and participants will be the basis for my comments today. I hope to offer insights from our direct experience and empirical data we have compiled. My comments will address five important areas of consideration: 1) Participant behavior and decision making, 2) The benefits of utilizing an institutional delivery framework, 3) Mitigating key financial risks for participants, 4) Plan Sponsor behavior and decision making, and 5) The role of technology.

It is also worth noting that Hueler does not manufacture any form of investment or insurance products, so we are neutral to the actual product type and structure. However, our interest and experience is with those products that provide guaranteed lifetime income, lend themselves to transparent comparison, can be selected based on competitive results, and are delivered at low cost.

Participant Behavior and Decision Making

Industry statistics show that plan participants rarely select annuitization options out of their defined contribution plans and a majority of plan sponsors report that participants rarely ask for annuities. While this may be factual information, it does not offer any insight as to why there is such a low take up rate for annuities among participants and why plan sponsors have largely eliminated the option from their plans.

There is a fair amount of behavioral research that points to why people would choose lump sums over a stream of monthly payments (desire for control, a chance to buy their dream, belief that they can do a better job managing the money, issues of trust, fear of the unknown, etc..). We refer to the obvious lump sum payment preference as the "lottery affect." Bottom line: participants are put in a very similar position as a lottery winner. In most cases, they are offered a check for more money than they have ever seen or hoped to have at their disposal in their lifetime. They are faced with the decision of taking the lump sum, having control over their money, and living their dreams, or letting someone else decide how much of "their own" money they will be allowed to have each month.

Adding to the "lottery affect", the annuity being offered typically comes in the form of an all or nothing proposition. Hueler has surveyed groups of participants and professionals from varying walks of life in forums across the country and the results are consistent. When we describe the choice of receiving a lump sum check that individuals can use to make decisions as they see fit in the time frame that makes sense for their lives versus transferring the entire balance of their life savings to a single source in return for monthly payments for the rest of their life, typically only 1-2 % of the group responds affirmatively. Depending on the audience, the responses may be as low as zero or as high as 5%. At a minimum, plans should be strongly encouraged to allow for partial distributions.

In our experience it is not the annuity or lifetime income alternative that participants react negatively to, it is the packaging and method of delivery. Interestingly, when you change the proposition and give the audience a more flexible set of options, as outlined below, the results radically improve. At least 1/3 of the group typically answers affirmatively and in some cases up to 2/3rds can be expected to do so:

Flexible Proposition

1) The option to decide how much money to set aside for lifetime income payments using only a portion of their savings and leaving the balance in their plan
2) Individuals decide when to begin receiving payments
3) Competitive low cost quotes not available after you leave the plan
4) Multiple insurance companies to choose from
4) Quotes are customized to reflect personal income needs
5) Inflation protection is an option
6) Indviduals can buy from more than one company
7) No obligation to purchase

Another key contributing factor is that participant education has been virtually devoid of references to lifetime income for several decades. In most cases, the communication and education provided has focused on the benefits of saving more, taking investment risk, having a long-term horizon, dollar cost averaging, and to some extent, preserving principal. Taking steps to appropriately "pensionize" retirement savings is largely a foreign concept for baby boomers, yet they are now facing critical decisions about securing income for life. The decisions made at this juncture could have substantial impact on an individual's ability to sustain themselves financially for the duration of their lives.

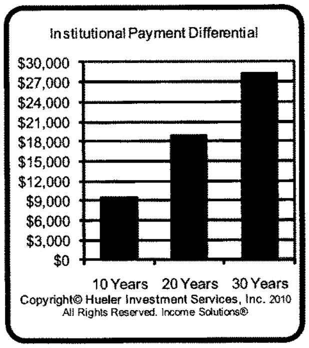
Finally, you cannot underestimate the natural inclination to take the "path of least resistance." The lump sum payout is infinitely easier to choose for the reasons outlined above and other additional perceived constraints.

Unless changes are made to the packaging, delivery method, and education practices around annuitization and lifetime income alternatives nothing will change. Plan participants will not properly pensionize their retirement savings and will remain at significant risk.

The Benefits of Utilizing an Institutional Delivery Framework

If annuity products are purchased after a participant leaves the plan they will likely be retail arrangements and will not offer the same benefits provided by institutionally delivered products. Commission based planners and captive agents offer products that encourage assets to flow out of low cost employee sponsored retirement plans into higher commissioned products. High costs will have a substantial negative impact on the value of an individual's retirement savings and will conversely limit the total income available over a 20-30 year period.

The illustration below shows the approximate financial benefits an individual may expect to receive when institutional pricing and competitive quoting are combined.



For example, a $200,000 single life only annuity for a 65 year old male resulted in a monthly payment of $1,311 when purchasing an annuity through the Income Solutions® program versus $1,232 a month when buying a traditional retail annuity. This example is a difference of 6.4% or a $79 increase in your monthly income. Over a 10 year period this differential equates to $9,500, over 20 years it is approximately $18,900 and over 30 years the difference grows to $28,400. Depending on the type of annuity and data provided, monthly income amounts for competitively bid, institutionally priced annuities are typically higher than the monthly income amount provided by retail priced annuities.

(This data is based on Hueler's independent research from February 2010. Actual pricing will be dependent on each individual's quote information, market conditions and sponsoring organization. While institutional pricing is typically more competitive than retail pricing, this may not always be the case. No time value of money was factored into the differentials shown on the graph so it is a conservative depiction.)

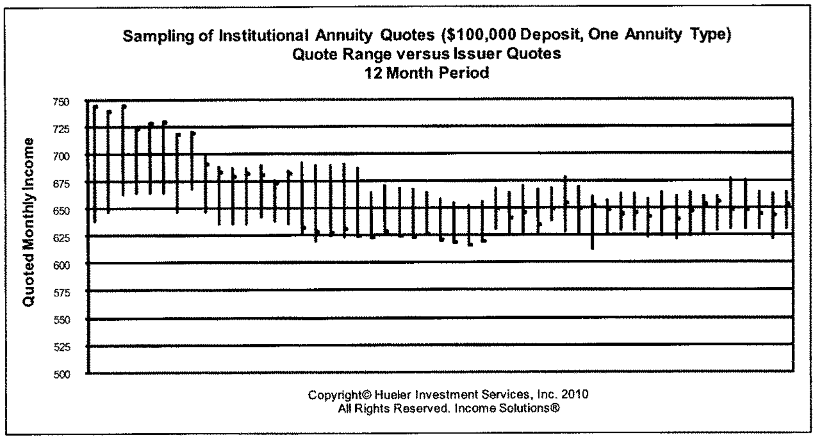
In addition to the above data, Hueler conducted a 12 week analysis of institutional annuity quotes versus five possible annuity retail offerings for a $100,000 annuity. The results showed on a consistent basis that institutional quotes produced higher monthly income amounts than those available in the retail annuity market. When comparing institutional quotes to five retail sources on over 400 individual annuity quote scenarios, the average difference showed a 6.37% advantage over the retail sources. It is important to note that the maximum difference was in the double digits (approximately 15%) from a single provider retail offering. Over time, these differentials significantly impact the guaranteed income individuals receive.

When lifetime income and annuity products are provided through employers, they should be delivered through an institutional framework. This includes institutional pricing, the benefit of due diligence for issuer selection, fee transparency, objectivity, unbiased education, and competition. Pricing data shows the variability of insurance company pricing can create substantial differentials between issuer quotes. This data speaks volumes about the potential impact on lifetime income results for individual participants.

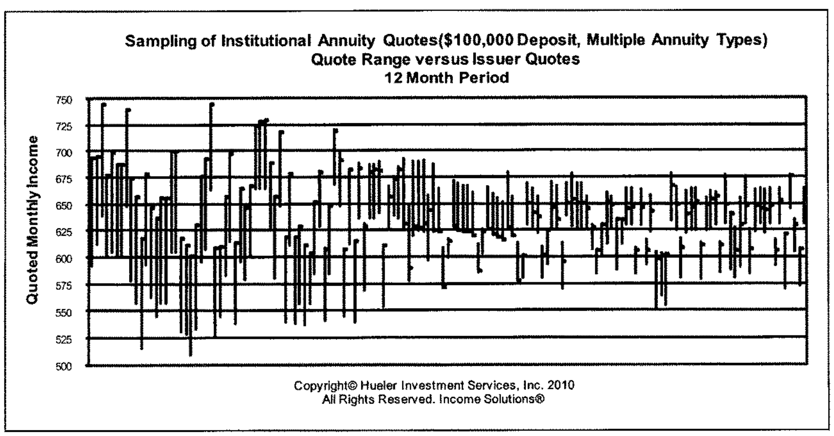
Institutional or group pricing is only part of the equation. Without competition, individual participants could have vastly different outcomes relative to how competitive the lifetime income amount is at the time they decide to retire. Competition ensures each participant will benefit from the best possible market pricing at the lowest possible cost and will be able to maximize their income amount for life.

The two charts below illustrate the variability of one individual insurance carrier's pricing across random quote scenarios of multiple insurance carriers.

This first graph illustrates one individual carrier's quote position against multiple insurance providers for one specific annuity type over a 12 month period. Each line represents the range of the high to low annuity quotes across multiple insurance providers for each scenario. The box represents the same individual insurance carrier across each quote scenario.



The second graph expands the data from above to include a broader sample of annuity data containing multiple annuity types. The graph illustrates one individual carrier's quote position against multiple insurance providers for multiple annuity types over a 12 month period. Each line represents the range of the high to low annuity quotes across multiple insurance providers for each scenario. The box represents the same individual insurance carrier across each quote scenario.



Mitigating Key Financial Risks for Particpants

There are significant financial benefits for participants who use some portion of their retirement savings to create a supplemental "paycheck for life" using an institutional framework to guarantee a baseline level of income. Converting some percentage of retirement assets into guaranteed income at the lowest possible cost will increase the likelihood that retirees will not outlive their assets and allow them to transfer some of the serious financial risks they face in retirement to a qualified third party. There are three primary risks to consider:

1) Longevity risk: It is a well-established fact that people are living longer than the previous generation and this could significantly increase the number of years an individual lives in retirement. Increased life expectancy is a wonderful, albeit expensive gift with new risks both known and unknown. Establishing a baseline income level, preferably one that adjusts either partially or fully for inflation, guards against the risk of outliving one's retirement savings and increases likelihood of income sufficiency.

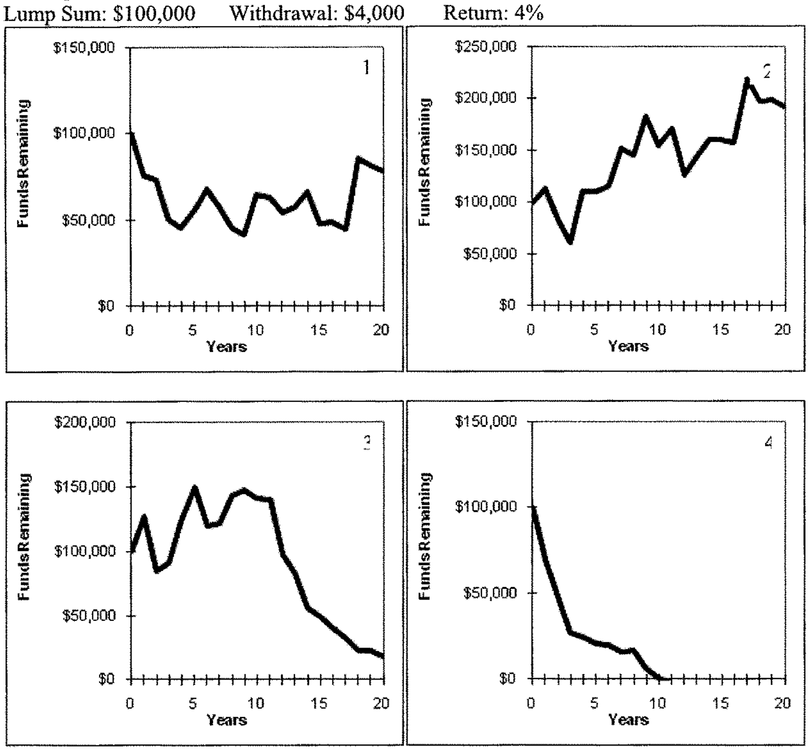
2) Investment risk: After the market correction that began in 2008, investors were stunned by the market losses they suffered. Many participants saw their retirement savings fall dramatically. For those participants who had not begun drawing down their savings as a necessary supplement to their retirement income, the situation was less dire because they may still have a chance to dollar cost average more savings into the market and recover over time. For those participants who needed to begin drawing down their balance to supplement income or had already begun drawing down their savings, the effect will have lasting and yet undetermined affects. In the first quarter of 2009 we saw quote and purchase volume through the platform increase by four times from the first quarter of 2008.

Through a random simulation of returns, the following charts help show dramatically different outcomes for the same drawdown strategy and risk profile. The graphs below illustrate the vastly different portfolio outcomes given the sequence of returns and the timing of when they occur during the drawdown phase.

The difference in outcome is based on when the timing of a given return sequence occurs during the draw down phase.

Chart 1 and 2 demonstrate how an individual portfolio experiencing positive returns early in the drawdown phase could stay at the same value or increase over time. You can see in charts 3 and 4, how negative returns early in the drawdown phase can have devastating effects. These two scenarios could leave a retiree with only a subsistence income level due to a severely reduced asset base or possibly devoid of any remaining financial resources long before their average life expectancy.

Assumptions:
Lump Sum: $100,000 Withdrawal: $4,000 Return: 4%

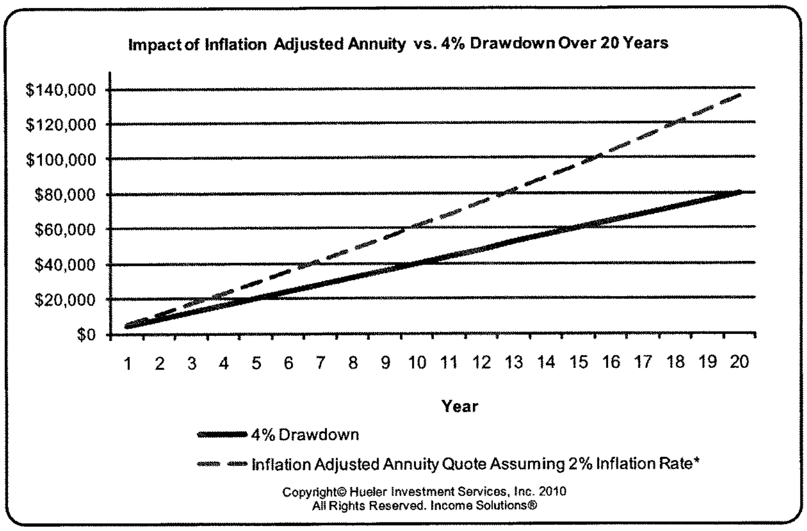


Savage, Sam. "An Annuity Example." The Flaw of Averages. 8 October 2000. Web. 27 April 2010 http://analycorp.com/SJM-animations/[1]

3) Inflation risk: Erosion of buying power over time seems to resonate with most participants at or in retirement. In fact, it is one of the justifiable deterrents to and concerns often expressed about buying a fixed annuity that does not adjust for inflation. Unfortunately, the conventional wisdom espoused by many investment professionals has been that if you invest in equities (increase your risk profile) over time your returns will outpace inflation. The 4% drawdown method has been promoted vigorously for years by the financial planning and retail brokerage community. Participants/retirees have been led to believe that this is sustainable and that such risk taking will likely mean their investments will keep pace with inflation.

The current monthly income amount for a $100,000 Single Life Only 65 Year Old Male for an inflation-adjusted annuity is $464.49 or $5,573* for the first year. [2]

The traditional 4% drawdown method on a $100,000 would result in $4,000 per year. Assuming a constant amount of $4,000 per year in comparison to the inflation adjusted annuity at an assumed 2% annual rate of inflation, the difference in income payments over 20 years is substantial.



Consider the basic pros and cons for each option:

4% Drawdown on $100,000 = $4,000 per year

- Market Risk (Potential Loss of Principal)
- Longevity Risk
- Inflation Adjustments Unknown
- Potential for Market Gains
- Potential for Remaining Assets Available for Heirs

Inflation Protected $100,000 Single Life Only Annuity = $5,573 [2] first year and annual minimum lifetime payment

- Above Risks are Eliminated
- 46% Increase in Initial Monthly Income
- Annual Inflation Adjusted Income Increase
- No Remaining Assets Available for Heirs
- Provider risk

Plan Sponsor Decisions/Behavior

EBRI's 2010 confidence survey[3] shows that participants place a higher degree of confidence in private employers than other large institutions, insurance companies, banks, and Federal Government. However, the vast majority of sponsors are reluctant to offer education about or access to lifetime income or annuity products due to the perception of liability. With the decline of pension plans and the inherent limits of Social Security, the burden of responsibility for income sufficiency in retirement is rapidly shifting to individuals, yet their most trusted source is hamstrung and unable to participate in essential education.

The conundrum is that plan participants will not get comfortable with lifetime income or annuity options until plan sponsors are free to do a better job of educating, communicating, encouraging consideration of, and providing access to low cost competitive solutions. Information about lifetime income alternatives needs to be fully integrated into the normal flow of 401(k) investment communication and prominently displayed in the distribution process. It is imperative that individuals are encouraged to consider cost effectively "pensionizing" a portion of their retirement savings when they are still affiliated with their employer-sponsored plan.

Data compiled by Hueler shows a direct correlation between sponsor communication efforts and increased site activity. This typically holds true for both annuity quote activity and purchase activity. When a plan sponsor communicates specific information about the benefits of the annuity program, activity typically increases for a period of up to two to three months following the specific outreach. Consistent quarterly communication will boost awareness and consistently increase activity. Without practical clear guidance, however, the vast majority of plan sponsors will not be willing to offer important communication and education about lifetime income alternatives.

This issue has become very polarizing for sponsors, consultants, and product providers. In many cases, ERISA counsel recommends against providing any type of distribution option even when the sponsor is inclined to do so. In some cases, we have seen counsel rebuke consultants for recommending that the plan sponsor client even consider providing access to lifetime income on a voluntary basis.

Based on results compiled from surveying organizations currently using the program and discussions with plan administrators, plan sponsors, consultants, and ERISA attorneys, we know that the primary concerns about offering an annuity arrangement (even outside the plan as an IRA rollover) are: "potential fiduciary liability" and the "appearance of endorsement". A good indicator of these concerns is the fact that 98% of plans who adopt the program choose to implement it as an IRA rollover or voluntary distribution alternative rather than an in-plan option even though the program can accommodate either. The second most commonly cited concern is related to fiduciary liability but separately articulated as issuer selection. Our survey results show that for over 90% of plan sponsors there are three key reasons for adoption of the program: 1) it is an IRA rollover alternative rather than an in-plan option, 2) the qualified third party objective issuer selection process, and 3) the competitive multi-issuer format.

It is worth mentioning that even when a plan administrator or plan sponsor has chosen to offer access to the program they are often required to create a disclaimer page that participants must acknowledge before requesting quotes to avoid the perception of "endorsing" the program.

When this is the case, we see more than a 50% drop off rate after participants see that their employer **does not** endorse the program. The disclaimer may as well be a large "Danger Proceed with Caution" sign.

Plan sponsors will not change their behavior until there is a safe harbor for issuer selection that reflects legitimate fiduciary responsibility, but takes into account the increasingly complex industry landscape. The recent meltdown of the financial markets, the fact that some of the most prominent financial and insurance institutions fell prey to unanticipated consequences, and the failure of the public rating agencies to render credible ratings decisions before or after the crisis, leaves few plan sponsors willing to take on the fiduciary liability associated with issuer selection. Plan sponsors who are willing to utilize outside expertise either directly or through a qualified third party should be encouraged to utilize independent due diligence to meet their fiduciary obligation. As an example, Hueler augments its internal research and expertise with independent research from ALIRT, an organization that specializes in insurance company analysis (http://www.alirtresearch.com). Costs associated with independent insurance company analysis and due diligence for the purpose of performing or assisting with issuer selection should be considered a legitimate plan expense, as it directly benefits participants.

The Role of Technology

Technology is essential for creating an efficient delivery framework for basic annuitization and other lifetime income products on a cost effective basis. Plan sponsors cannot individually afford to manage competitive bidding programs or develop and maintain internal operations sufficient to facilitate efficient delivery of these products. Acceptable, independent, and automated platforms should be easily accessible to plan sponsors and designed to ensure:

1) Competition
2) Organized product comparability
3) Fee transparency
4) Objectivity (no pay to play provider conflicts)
5) Best case pricing (low cost delivery)
6) Flexibility (staged annuitization and issuer diversification)
7) Reporting oversight

This type of platform should provide simple on-line tools that allow people to determine if they have an "income gap" and what they need to set aside to cover that gap. These tools help provide answers to questions about how much a participant should annuitize and how much income they need to cover baseline expenses. The Income Gap calculator and the Income Calculator at Hueler's web-site are two of the most frequently visited pages. We estimate that 95% of the visits to the site include use of these tools. Additionally, the program encourages participants to begin thinking about pensionizing a portion of their account balance years before they need to make a firm decision. Over 50% of all quote activity is driven by participants between the ages of 55-65, while 78% of the purchase activity is by participants over the age of 61. The combination of easy to use tools, unbiased education, and low cost delivery can empower individuals to make more financially sound decisions that reflect their personal life circumstances. It is interesting to note that approximately 50% of purchases through the voluntary platform are joint and survivor (J&S). Additionally, this type of platform can be easily integrated with professional assistance or advisory services for participants. Several plan administrators make service centers available to assist participants with questions and offer assistance as they move through the quote and purchase process. In the setting where participants have access to advisors or assistance with purchases, the percentage of people who choose inflation protected products increases substantially. We believe including objective guidance to participants will improve the take up rate of lifetime income arrangements, but first plan sponsors must feel free to provide access to and promote consideration of lifetime income arrangements without concern over additional liability.

Default options have the potential to be a positive catalyst for change in bringing lifetime income arrangements to plan participants. Given the persistently low take up rates, allowing for a qualified default option for annuitization seems prudent. Technology can play a key role in facilitating default options. One example to consider is what Hueler refers to as a "diverse annuity." Many fiduciaries and professionals believe diversification is a fundamental step towards mitigating provider concentration risk. Many participants express similar concerns. The basic concept is that participants should not annuitize 100% of their balance at one time or invest 100% of their annuity dollars with one provider.

Using technology, sponsors could offer a fully automated default option designed to facilitate establishment of a pre-determined set of criteria for purchasing individual annuities for participants. (i.e. state guarantee fund limits, total dollar amount per contract, or a percentage of total premiums) They may also want to consider the recent survey results from EBRI where 38% of participants favored being required to use $100,000 of their account to purchase lifetime income or 50% percent whichever is less[3]. Once the plan sponsor sets the criteria for diversification, the purchase system would automatically process participants as they were defaulted. The system would calculate the appropriate premium amount to be used for an individual purchase, request a diversified quote across multiple issuers, select the winning quotes starting with the highest income amount, present the monthly payment amount to the participant, and notify parties of the pending withdrawal. This automated default option attempts to address common concerns about concentrating participant retirement savings with one provider and concerns related to offering a single issuer solution that may produce a less than competitive outcome for participants.

Another example where technology could improve delivery is in facilitating the concept of trial annuitization on an automated basis. Trial annuitization may be very appealing to some participants due to the desirable liquidity feature, but others may need or want to maximize their current income amount, which can best be achieved with a lifetime income quote. By automating the process, each participant would always see two quote options. The first quote would reflect a trial annuity that offers enhanced liquidity with a lower monthly income amount. The second quote would offer a monthly lifetime income quote that provides less liquidity but higher monthly income. If the participant did not provide a response, the system would automatically default them into the more liquid trial annuity and if competition is available in this product type, the system could initiate the same diverse annuity quote process outlined above.

Summary

Receiving lifetime income payments from converted retirement savings that provide a reliable level of financial certainty and reduce very real risks, will promote better financial outcomes and enhance the quality of life for millions of Americans. In order for this to happen, plan participants must be given access to low cost, transparent, annuitization and lifetime income options through an institutional framework. In addition, plan sponsors need a safe harbor that reflects the complexity of today's financial environment relative to issuer selection and they must be encouraged to provide the critical education needed as part of the process. Finally, technology is vital to holding down cost and offering broad based access to lifetime income options.

Works Cited

[1] Savage, Sam. "An Annuity Example." The Flaw of Averages. 8 October 2000. Web. 27 April 2010 <http://analycorp.com/SJM-animations/>

[2] IncomeSolutions.com
Retrieved June 10, 2010 from Income Solutions® (U.S. Patent 7,653,560) website.
website: http://incomesolutions.com,

[3] Employee Benefits Research Institute. Ruth Helman, Craig Copeland, and Jack VanDerhei, "The 2010 Retirement Confidence Survey: Confidence Stabilizing, But Preparations Continue to Erode," EBRI Issue Brief, no. 340, March 2010.
<http://www.ebri.org/pdf/briefspdf/EBRI_IB_03-2010_No340_RCS.pdf>

Kelli H. Hueler Biography
Kelli Hueler is CEO and founder of Hueler Companies, an independent data and research firm providing reporting and systems designed for the annuity and stable value marketplace. Hueler Companies was founded in 1987 and today the firm's data, market research, and analytical reporting are considered the industry standard.

Under Ms. Hueler's leadership, the company developed and launched Income Solutions®; a ground breaking annuity purchase platform. The platform was designed to empower transitioning employees in need of creating a personal lifetime income stream by providing on-line access to competitively bid, institutionally priced annuities. Today the Income Solutions® program is the leading model of its kind for delivery of lifetime income annuities to retirees. The program has been adopted by some of the industry's leading plan administrators and plan sponsors.

Ms. Hueler is nationally recognized as a key contributor on the topic of lifetime income creation. She has testified before the DOL ERISA Advisory Council on annuitization at the point of retirement, presented at the Wharton Pension Research Council, and was tapped to participate in the National Endowment of Financial Education's think tank on income sufficiency. Ms. Hueler presented at the Employee Benefit Research Institutes' National Forum on retirement income sufficiency and at the AARP's "Divided We Fail" initiative in Washington DC. She is a founding member of the DCIIA (Defined Contribution Institutional Investment Association) serving on the Retirement Income Committee and also participates on the Society of Actuaries Committee on Post-Retirement Needs and Risks.

Along with being recognized as a forward thinker in the retirement income arena, Ms. Hueler is also an industry expert in the field of stable value investments. In 2009 she testified before the DOL ERISA Advisory Council regarding Stable Value Funds and Retirement Security in the Current Economic Conditions. She has authored and appeared in numerous articles and spoken internationally on the topic. Ms. Hueler has appeared on investment programs such as *CNN News, CBS' Wall Street Journal Report*. She served on the Board of Directors for the Stable Value Investment Association (SVIA) for six years and additionally served on the SVIA Executive Committee chairing the association's Communication and Education Committee. During Ms. Hueler's tenure, she has also authored chapters for both *"The Handbook of Stable Value Investments"* by Frank Fabozzi and *"Guaranteed Investment Contracts-Risk Analysis and Portfolio Strategies-Edition 2"* by Kenneth L. Walker.

Prior to founding Hueler Companies, Ms. Hueler held the role of Registered Representative for Kidder Peabody & Company and IDS Life where she was responsible for institutional and retail clients. She holds a B.A. from St. Olaf College.

The CHAIRMAN. Thank you so much.

We'll now have a break for two votes of 15 minutes, maybe 20. Thank you.

[Recess from 2:57 p.m. to 3:29 p.m.]

The CHAIRMAN. Mr. Mullaney.

STATEMENT OF WILLIAM J. MULLANEY, PRESIDENT, U.S. BUSINESS, METLIFE, REPRESENTING THE AMERICAN COUNCIL OF LIFE INSURERS

Mr. MULLANEY. Good afternoon, Mr. Chairman and members of the committee. My name is Bill Mullaney. I'm the President of MetLife's U.S. Business Division, testifying on behalf of the American Council of Life Insurers.

ACLI member companies represent more than 90 percent of the assets and premiums of the U.S. life insurance and annuity industry and offer insurance contracts and investment products and services to qualified retirement plans and individuals. As both providers and employers, we believe that saving for retirement and managing assets throughout retirement are critical economic issues facing individuals and our Nation.

Today's hearing focuses on the crisis that retirees face in managing their assets in retirement and the need for public policy to help them avoid outliving their savings. I applaud the committee's foresight and appreciate the opportunity given the industry to offer insights and potential solutions.

My written testimony highlights issues and recommendations that the industry submitted in response to the Department of Labor and Treasury's request for information regarding lifetime income annuities and similar lifetime income options available to defined contribution plans.

Today I will discuss the role of annuities in providing retirement income security, product features and innovations, how public policy can enhance the use of guaranteed lifetime income, and consumer protections.

Retirement begins with a fundamental transition, from living off one's wages to living off one's savings. With this transition comes multiple risks for individuals to manage, the most difficult of which is longevity risk, the risk of outliving one's savings.

Today most Americans won't receive a guaranteed monthly paycheck for life from their employers when they retire. For many people, defined contribution plans such as 401(k)s have become their primary retirement savings vehicle. Guaranteed lifetime income products shift the risk of outliving one's savings to a life insurer.

In addition to guaranteed income for life, today's annuity products address survivor benefits, liquidity for emergencies, and inflation. Annuities with optional guaranteed living benefits can provide protection against both longevity and investment risk.

Employers play a key role in helping employees understand the benefits of and to gain access to the protection provided by guaranteed lifetime income products.

ACLI has included a number of legislative and regulatory recommendations in its written statement which can help employers assist their employees in obtaining guaranteed lifetime income. Among those recommendations are simplifying the fiduciary standard by which the employer chooses an annuity provider and allowing insurers to administer the joint and survivor rules for married individuals.

In addition to employer efforts, participants need education about the value of guaranteed lifetime income. To that end, ACLI thanks Chairman Kohl and Senators Bingaman and Isakson for their bipartisan sponsorship of S. 2832, the Lifetime Income Disclosure Act, a bill that would provide a lifetime income illustration on workers' 401(k) statements. With this information, workers can decide whether they need to increase their savings, adjust their 401(k) investments, or reconsider their retirement date if necessary to assure the quality of life they expect in retirement.

ACLI also asks the Treasury Department to modify some of their notices to workers to include information on guaranteed lifetime income and the availability of lifetime income distribution options. Furthermore, ACLI supports legislation to facilitate a worker's election to use a portion of her account to obtain guaranteed income for life. Most notably, ACLI supports H.R. 2748, the Retirement Securities Needs Lifetime Pay Act, which contains three proposals which we hope this committee will endorse:

First, to facilitate the use of longevity insurance in employer plans and IRAs, it excludes the longevity insurance premium amount when calculating an individual's required minimum distribution.

Second, to encourage employees to take a portion of their retirement savings as guaranteed lifetime income, it includes a limited tax incentive.

Last, for those individuals with an individual deferred annuity, it would permit partial annuitization of that annuity. This last proposal was included as part of the administration's 2011 budget proposal.

As the committee considers these recommendations, it is important to note that all insurance products are regulated by the States. State insurance departments have a number of safeguards in place which not only protect the consumer, but ensure life insurers' unsolvency and provide protection to the consumers in the rare instance of an insolvency. Each State has laws and regulations governing the activities such as licensing requirements, sales practices, market conduct regulations, and product approvals.

I want to thank the committee again for holding this hearing and for inviting the ACLI to testify. The goal of helping Americans achieve personal retirement income security is one of the industry's top public policy issues, and I'm happy to answer any questions that you have.

[The prepared statement of Mr. Mullaney follows:]

ACLI
Financial Security. For Life.

The American Council of Life Insurers

Written Statement for the Record

for

**"The Retirement Challenge:
Making Savings Last a Lifetime"**

Before the

United States Senate Special Committee on Aging

**June 16, 2010
2:00 p.m.
Dirksen Senate Office Building, Room 562**

American Council of Life Insurers (ACLI) Statement for the Record
"Managing Retirement Assets: Ensuring Seniors Don't Outlive Their Savings."
Senate Special Committee on Aging
United States Congress
June 16, 2010

The American Council of Life Insurers (ACLI) commends this Committee for holding a hearing about the challenges workers and retirees face when managing retirement savings for their lifetime. We applaud Chairman Kohl (D-WI) and Ranking Member Corker (R-TN) for drawing attention to this vital matter and hope our recommendations will contribute to meaningful deliberations about solutions to the imminent retirement income security crisis.

The American Council of Life Insurers represents more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies represent more than 90% of the assets and premiums of the U.S. life insurance and annuity industry. ACLI member companies offer insurance contracts and investment products and services to qualified retirement plans, including defined benefit pension, 401(k), 403(b) and 457 arrangements. ACLI member companies also are employer sponsors of retirement plans for their employees. As service and product providers, as well as employers, we believe that saving for retirement and managing assets throughout retirement are critical economic issues facing individuals and our Nation.

As the first wave of the baby boom generation reaches retirement age next year, policymakers are looking at the current retirement plan system's ability to provide sufficient retirement income for these and future retirees. Many current retirees are fortunate in that they are receiving both a Social Security benefit as well as an employer-provided pension. That situation is rapidly changing. Today, we are seeing an increasing number of workers retiring with only Social Security and their own savings. This change in retirement financing leads to the question of how they might manage these savings to last throughout their lifetime. These workers should consider augmenting Social Security with additional amounts of guaranteed lifetime income, so that anticipated monthly expenses can be covered by a guaranteed lifetime income stream, thereby shifting the risk of outliving one's savings to a life insurer. ACLI believes that, given information about guaranteeing some level of savings, workers will have the knowledge to make informed decisions about their lifetime income options and therefore make decisions that enable them to maximize their guaranteed lifetime income. ACLI does not support a requirement that workers annuitize their savings.

This statement summarizes ACLI's submission to the Departments of Labor and Treasury's ("Departments") Request for Information regarding lifetime annuities and similar lifetime income options available to defined contribution plans. It describes the:

- role of life insurers in providing guaranteed lifetime income and other risk protection products to employer plans (in-plan) and directly to individuals (out-of-plan);

- important role employers have played in helping employees protect against risks by providing information about and access to life insurance, disability insurance, annuities and other risk protection products;
- variety of annuities and other guaranteed lifetime income options that are available today; and
- legislative and regulatory recommendations to enhance the retirement income security of participants and individuals by facilitating the use of guaranteed lifetime income options.

This statement also outlines consumer protections for purchasers of guaranteed lifetime income products.

When the ACLI and its members describe lifetime income, we are describing payments guaranteed for the life of an individual or individuals. In our financial system, such guarantees are only available from life insurers who are regulated under a system of insurance laws and regulations that are focused on the protection of policyholders. In the case of annuities and other risk protection products, those laws and regulations address rules governing reserves and capital necessary to meet the long-term commitments made by life insurers.

Life Insurers

The life insurance industry provides protection for individuals and families against the risk of adverse financial consequences due to premature death, long-term care needs, disability, and outliving one's financial assets or living at a substantially reduced standard of living. Financial protection provided by the life insurance industry to American households reaches across all ages and income levels. For example, in 2009, life, disability, long-term care, and annuity products provided over $142 billion in benefits to contract beneficiaries.[1] This protection is offered both directly to individuals and through employers.

Employers

Employers are key stakeholders in helping individuals obtain financial protection provided by life insurers. Employers offer financial protection to employees on a group basis which enables the employer to pass cost savings along to their employees. Half (51 percent) of all employees report obtaining the majority of their financial protection products, such as life, disability income, and long-term care insurance, as well as annuities and retirement savings plans, through the workplace.[2] This commitment by employers helps to increase employee awareness and understanding of the nature and benefits of these products. Whether employers pay for all or part of these products or permit employees to pay for them through payroll deduction, by making these products available at the workplace employers encourage employees to take action to protect themselves and their families.

ACLI members provide these financial protection products through employers (in-plan), directly to individuals (out-of-plan), or on a combination in-plan and out-of plan basis. Employer engagement has helped Americans understand the importance of life insurance and disability insurance. The financial protection that can be provided by guaranteed lifetime income may be less understood than the benefits of life and disability insurance and other insurance products.

---

[1] ACLI calculations based on preliminary data release of 2009 NAIC annual statement data.

[2] 7th Annual Study of Employee Benefits Trends, MetLife (2009).

This difference may be partly attributed to the prevalence in the past of defined benefit plans which provided lifetime income without the need for the employee to make a decision to obtain the benefit. As more and more employers choose to offer defined contribution plans rather than defined benefit plans, we believe that employers should play a key role in helping employees understand the benefits of, and gain access to, the protection provided by guaranteed lifetime income.

Guaranteed Lifetime Income Products

Guaranteed lifetime income products have evolved significantly over the past decade. The industry has responded to both individuals' interests and concerns with traditional annuities. The lifetime income products that exist today are significantly different from those that were being sold even six years ago. As we sometimes say, "This isn't your father's annuity." Today, there is an array of guaranteed lifetime income options that are generally available through ERISA and non-ERISA employer-sponsored plans, as well as on an individual basis.[3] The new products include more traditional payout or "income" annuities that provide periodic payments, typically for life, commencing "immediately" after purchase as well as new products that provide for payment on a "delayed" or "deferred" date past retirement, e.g., at age 85 (a "longevity annuity" or "longevity insurance,"). Newer payout (income) annuities can be purchased with a single premium or incrementally on a periodic basis, e.g., by monthly payroll deductions.

Annuities offer many additional features that enable the purchaser to customize the income stream to meet their particular needs, thereby enabling the purchaser to only pay for the protection that is needed. Annuities can include a variety of optional features to address needs such as survivor benefits, liquidity for emergencies, and inflation. Deferred accumulation annuities may include optional guaranteed living benefits that provide protection during the life of the owner against investment risk by guaranteeing a level of annuity payments and/or withdrawal amounts prior to annuitization. Annuities may include features that insure against premature death such as annuities based on joint lives, annuities that refund the remaining premium, or annuities with minimum payment period guarantees. Annuities may include some form of adjustment for inflation. Life insurers offer a variety of lifetime income protection products to address a variety of needs.

Recommendations to Enhance the Use of Guaranteed Lifetime Income

Academics write of the "annuity puzzle," i.e., why so few retirees annuitize defined contribution benefits when annuities provide much needed income protection. ACLI believes that efforts to educate employers and employees about the value of guaranteed lifetime income and to reframe individuals' thinking of defined contribution plan savings as a source of guaranteed lifetime income will help to solve the annuity puzzle. From a recent survey, employees are interested in guaranteed lifetime income options and find it valuable to see how much guaranteed lifetime income they could obtain by using their retirement plan savings.[4] It is important to note that ACLI believes that most workers should annuitize **some** of their retirement savings to support their monthly expenses and that annuitizing all of one's savings is not appropriate for most people.

---

[3] The Employee Retirement Income Security Act of 1974 ("ERISA") covers private employer sponsored qualified retirement plans. Governmental plans and many not-for-profit plans are exempt from ERISA.

[4] ACLI Study on Retirement Choice, Mathew Greenwald & Associates 2010 (see Appendix 2).

New laws and regulations can help employers assist their employees in obtaining guaranteed lifetime income in the same way they have assisted employees in obtaining life insurance, disability insurance, and other financial protection products. New laws and regulations can also create an incentive to use guaranteed lifetime income as part of an employee's overall retirement income plan.

Recommendations to Encourage Employers to Offer Annuities

1. Provide Employers with Guidance on Lifetime Income and Education. In our RFI submission, we urged the DOL to revise and extend Interpretive Bulletin 96-1 beyond guidance on investment education to include guidance on the provision of education regarding lifetime income and other distribution options, both "in-plan" and outside the plan, to assist participants and beneficiaries in making informed decisions regarding their distribution choices.

2. Help Employers Select an Annuity Provider. The DOL took an important step by changing the so-called "safest annuity standard" in Interpretive Bulletin 95-1 by adopting a safe harbor for the selection of annuity providers for individual account plans. While this regulation provided some helpful guideposts, it contains a requirement that the fiduciary "conclude that the annuity provider is financially able to make all future payments." This standard is difficult to meet, in part because it is hard to know how to draw this conclusion. While it is part of a "safe harbor," this prong makes it difficult to use the safe harbor and thus is an impediment to the offer of annuities in defined contribution plans. ACLLI believes that changes can be made to these rules which will make it easier for employers to meet their duties while at the same time ensuring a prudent selection. We plan to work with the Department of Labor to simplify this requirement so that an employer can more easily and objectively evaluate the financial stability of the annuity provider.

3. Annuity Administration. Employers take on a number of duties in administering a retirement plan, and the administration of an annuity option would increase those duties. The qualified joint and survivor annuity ("QJSA") rules provide important spousal protections. The notice and consent requirements provide spouses with an opportunity to consider the survivor benefits available under a joint and survivor annuity. However, these rules add an additional layer of administrative complexity as well as technical compliance issues that most plan sponsors choose to avoid by excluding annuities from their plans.

   There are a number of ways that the rules can be modified to make it easier for employers to administer this important requirement while protecting survivors, including:

   - model plan amendments for employers to add guaranteed lifetime income options;
   - simplify QJSA notice requirements; and
   - the use of electronic signatures, widely accepted in financial transactions today.

   ACLI proposes allowing those employers who choose to do so to transfer the duties and liabilities of administering qualified joint and survivor annuity rules to an annuity administrator. Also, employers need guidance that confirms that a participant's purchase of incremental deferred payout annuities should not be subject to the QJSA rules until the participant has elected to take the annuity payout.

4. Partial Annuitization Option. Some employers view annuitization as an "all-or-nothing" distribution offering. In our RFI submission, we asked the Departments to provide guidance making clear that plans may provide retirees with the option to use a portion of the account value to purchase guaranteed lifetime income, including model amendments to simplify the adoption of such provision.

Recommendations to Encourage Workers to Elect Annuities

1. Illustration. To reframe retirement savings as a source of lifetime income, ACLI supports legislative proposals to include an illustration of participant accumulations as monthly guaranteed lifetime income on defined contribution plan benefit statements. ACLI thanks Chairman Kohl, and Senators Bingaman and Isakson for their bi-partisan sponsorship of S. 2832, the Lifetime Income Disclosure Act, which will help workers understand how their retirement savings might translate into guaranteed lifetime income.

2. Information. In our RFI submission, we asked the Treasury Department to modify the 402(f) rollover notice requirements and the safe harbor notice to include information on guaranteed lifetime income, including the importance of income protections and the availability of lifetime income plan distribution options, if any, as well as lifetime income options available outside the plan.

3. Using a Portion of a Retirement Account to Purchase Guaranteed Lifetime Income. ACLI supports efforts to facilitate a retiree's election to use a portion of his or her defined contribution account to obtain guaranteed income for life. All of the following provisions can be found in H.R. 2748, the "Retirement Security Needs Lifetime Pay Act," that ACLI fully supports and encourages this Committee to support.

   - "Longevity Insurance" in Employer Plans and IRAs. The current required minimum distribution rules discourage the use of longevity insurance, i.e., deferred payout income annuities with an annuity start date later in retirement, such as age 85. H.R. 2748 includes a provision that would facilitate the use of longevity insurance in qualified plans and IRAs by excluding the longevity insurance premium amount when calculating an individual's required minimum distributions.

   - Partial Annuitization. ACLI supports efforts to facilitate a retiree's election to use a portion of his or her account to obtain guaranteed income for life. The Administration's budget and H.R. 2748 would permit the partial annuitization of an individual's annuity savings.

   - Tax Incentive for Guaranteed Lifetime Income. Current tax policy provides equal tax treatment to payments in any form made from defined contribution plans. Guaranteed lifetime income is treated the same as a single sum distribution (i.e., taxable at ordinary rates). H.R. 2748 includes a limited tax incentive to encourage individuals to take all or a portion of their retirement savings as an annuity that guarantees lifetime income.

Consumer Protections

Each state has comprehensive laws and regulations governing, but not limited to, licensing requirements, sales practices, and market conduct regulation, as well as product approvals. Companies routinely offer a free-look period following an individual annuity purchase. During this period (usually 10 days), the individual purchaser has the right to review the contract and return it for a full refund of the purchase price. The company then will cancel the contract and, depending on the state, will refund the initial contribution (purchase price) or the account value.

State regulators have endorsed a comprehensive package of sales practice regulations aimed at protecting consumers, with a focus on seniors, during the annuity sales process. The NAIC model regulations governing the use of senior-specific designations, annuity disclosure, and annuity suitability provide states with a robust regulatory scheme to assure that consumers receive the information and protection they deserve. Senator Kohl's Senior Investment Protection provision in the financial services reform legislation encourages state adoption of both the NAIC suitability and designations model regulations. Consistent with Senator Kohl's goals, the ACLI has actively supported the NAIC designations, disclosure and suitability models. ACLI will continue to work with the states as they adopt the new NAIC suitability model.

State insurance departments oversee life insurance companies to ensure their solvency by adopting NAIC uniform rules for the establishment of reserves, the valuation of assets and liabilities, risk-based capital requirements, required capital as well as financial condition examinations. Finally, consumers are protected from the unlikely event of an insurer insolvency. Each insurer is required by law to be a member of that state's guaranty association. Guaranty associations are financial safety nets –much like the FDIC -- established for each line of insurance (life/health and property/casualty, respectively). In the rare instance where an insurer fails and an insurance commissioner obtains court approval to liquidate the company, state guaranty associations become involved so that coverage and benefits continue to resident policyholders.

Conclusion

Workers need better tools to plan for retirement. A lifetime income illustration will help workers visualize how their savings will address their basic month-to-month living expenses after retirement. With this information, workers can better decide whether they need to increase their savings, adjust their 401(k) investments or reconsider their retirement date, if necessary, to assure the quality of life they expect when their working days are over.

Similarly, workers need more information on guaranteed lifetime income options and the risks of outliving their savings. Long-term retirement planning can be a daunting task for workers. Guaranteed lifetime income options can help ease that burden by providing workers with a "paycheck for life" they can count on no matter how long they live.

Encouraging workers to consider guaranteed lifetime income options, such as by facilitating the availability of longevity insurance and partial annuitization, represents sound public policy as the baby boom generation reaches retirement age.

While employers are understandably concerned about increased fiduciary responsibilities, we believe any added burdens can be eased through adjustments in existing regulations. These include making it easier for employers to meet their fiduciary duties in selecting annuity providers and allowing insurers to assume the duties of administering the QJSA rules.

Taking these important steps today can help address tomorrow's retirement income security crisis.

Attachments:

"ACLI Retirement Choices Study," by Mathew Greenwald & Associates, Inc, April 2010
"Encourage Annuity Options for Defined Contribution Plans," ACLI proposal, February 2009
General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, p. 74

ACLI Retirement Choices Study

Online Survey with

Near-Retiree Defined Contribution Plan Participants

Report of Findings

Prepared for:

ACLI
Financial Security. For Life.

by:

Mathew Greenwald & Associaties, Inc.

April 2010

Table of Contents

Introduction and Methodology

In an effort to gauge retirement plan participants' interest in (1) having their employers offer additional options for what they can do with their retirement plan accumulations after they retire and (2) being able to see an illustration of how much guaranteed lifetime income they may be able to get using the money in the plan, the American Council of Life Insurers (ACLI) commissioned independent research firm, Mathew Greenwald & Associates, to conduct a study of plan participants nearing retirement.

An online survey was conducted with 750 workers ages 45 to 65, who are participating in a defined contribution plan available through their current employer. Respondents were also screened to ensure that they had a minimum retirement plan account balance of at least $40,000 and were not expecting any retirement income from a defined benefit pension plan.

- Potential respondents for this study were selected from among members of eRewards Consumer Research Panel.
- The survey fielded between March 26 and March 31, 2010.

The survey data were weighted by gender, age, and education to reflect the composition of retirement plan participants ages 45 to 65 with account balances of at least $40,000. Population statistics were based on data from the 2007 Survey of Income and Program Participation (SIPP).

A similarly-sized random sample of 750 respondents would have a margin of error at the 95% confidence level of plus or minus 3.7 percentage points.

Key findings and a detailed discussion follow this section.*

*Percentages in the tables and charts may not total to 100 due to rounding and/or missing categories.

Key Findings

Seeing an illustration of how much guaranteed monthly income they could get for life may prompt many plan participants to save more.

- Just over nine in ten respondents say that it would be valuable to have their employer show them an illustration of how much monthly income they could get guaranteed for life based on the value of their retirement plan account, including more than half who feel that it would be very valuable.
- Three out of five say that if this illustration showed that the monthly income that could be generated would not be enough to meet their needs, they would start saving more immediately. Another one-third say that, after seeing this illustration, they would monitor how their savings affected the illustration and consider saving more later.
- Eighty-five percent express an interest in having this information available in their regular retirement statement or on a secure website hosted by either their employer or their plan provider.

An overwhelming majority support the idea of having employers offer an option in their retirement plans that would use some of their retirement plan savings to provide employees with guaranteed monthly income for the rest of their lives once they retire.

- Nearly nine out of ten plan participants surveyed report that they favor a proposal to have employers offer an option that would use their plan savings to generate a guaranteed stream of income for life.
- A similar share – fully 90% – say they favor the idea of their employer offering them this type of option, and would be interested in learning more about it, if it were available.

Given the overall favorable impression of this option, it's not surprising that positive statements about why such an option should be made available resonate more than arguments against it.

- More than nine in ten agree that employers should be encouraged to offer choices to help employees attain financial security, and nearly all agree that an option that offers to guarantee income for life can help accomplish this.
- Although a large majority of respondents say they feel at least somewhat confident about their ability to personally manage their finances after they retire, this confidence may be an overstatement, since more than nine in ten agree that it is difficult for "many workers" to know how to manage their money after they retire, and feel it would be helpful if employers offered an option to help with this.

- Likewise, seven in ten disagree that employees know how to use their savings to generate a retirement income for themselves and don't need an option from their employer to do it for them.
- Half disagree with the statement that "employers have no responsibility for helping employees determine what to do with their retirement plan savings after they retire."

Respondents' confidence in being able to manage savings and investments after retirement is lower than their confidence about managing money prior to retirement.

- Currently, eight in ten plan participants feel at least somewhat knowledgeable when it comes to selecting the savings and investment options within their plan that are best for them.
- Yet, fewer seem as optimistic about their ability to manage their assets after they retire – including being able to pick the appropriate savings and investment products, determine the right withdrawal amounts, and making their money last for the rest of their lives. While about one-quarter strongly agree that they are knowledgeable about selecting their investments right now, half as many describe themselves as being very confident in their ability to manage their money after they retire.
- Moreover, just 7% feel very confident in their ability to make savings and investment decisions once they reach their 80s or 90s.
- Perhaps as a result, three out of four plan participants indicate that they are concerned about not having enough money in retirement to meet their needs.

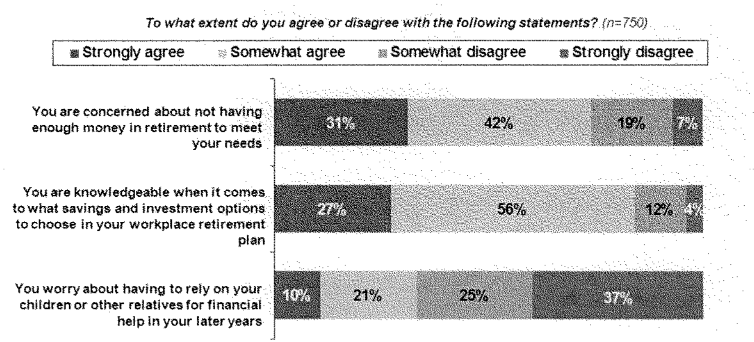
Detailed Findings

Retirement Outlook

Eight in ten plan participants say they are knowledgeable when it comes to selecting investment options inside their workplace retirement plan.

- Most plan participants (83%) describe themselves as knowledgeable when it comes to selecting savings and investment options within their employer-sponsored retirement plan, though just one-quarter strongly agree that they are knowledgeable in this area (27%).
  - Men are more likely to feel knowledgeable about selecting retirement plan investment options (86% v. 78% women).
- At the same time, nearly one-third (31%) strongly agree that not having enough money in retirement is a concern, and another four in ten (42%) suggest they are at least somewhat concerned about running out of money.
- In fact, one out of three (31%) agree that they are worried about having to rely on their children or other relatives for financial help in their later years. Women are especially likely to worry about this (38% v. 27% men).

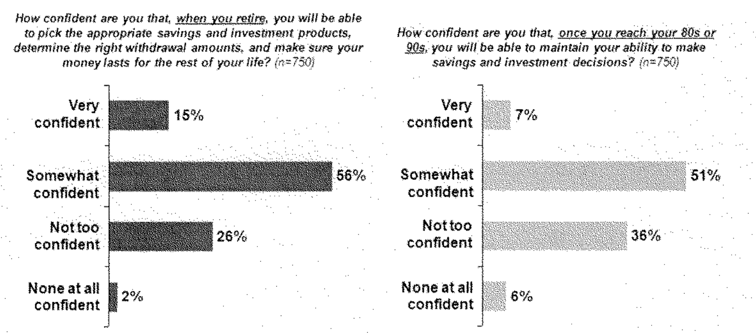
Retirement Outlook



Fewer feel confident that they will be able to pick the appropriate products, determine withdrawal amounts, and make their money last after they retire.

- Although 27% strongly agree that they are knowledgeable about selecting current retirement plan options, only 15% of plan participants feel very confident that – when they retire – they will be able to pick the appropriate savings and investment products, determine the right withdrawal amounts, and be able to make their money last for the rest of their of lives.
- A far larger share (56%) feel somewhat confident, and one-quarter (28%) say they are not too or not at all confident in their ability to manage their money in retirement.
- Even fewer feel very confident (7%) that they will maintain their financial decision-making ability into their 80s or 90s, though most (51%) remain at least somewhat confident that they will be able to make sound savings and investment decisions in their later years.

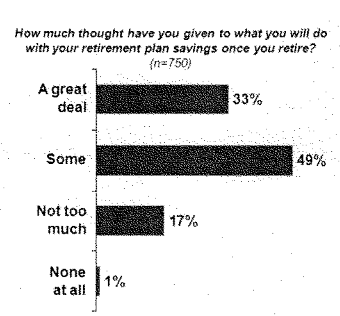
Confidence in Managing Retirement Finances

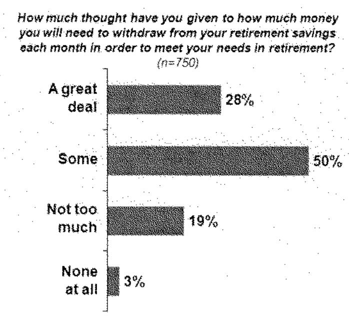


A majority have given at least some thought to what they will do with their retirement plan assets when they retire and how much they can withdraw each month.

- More than eight in ten retirement plan participants (82%) say they have given at least some thought to what they will do with their retirement plan assets once they retire. Still, only one-third have given this a great deal of thought, and two in ten (18%) indicate that they haven't given it too much thought at all.
  - Not too surprisingly, the likelihood of having thought this issue through increases with age (and proximity to retirement), such that 92% of those ages 60 to 65 say they have given at least some thought to what they will do with their plan assets, compared to 73% of those ages 45 to 49.
- Nearly as many say they have given at least some thought to how much they will need to withdraw each month from their retirement savings in order to meet their financial needs, though half (50%) say they have given this just some thought.
  - Those who are older (and closer to retirement) (88% of those age 60-65) are more likely than younger plan participants (72% of those age 45-49) to say they have thought about this to at least some extent.

Thought Given to Retirement Plan Assets and Withdrawals



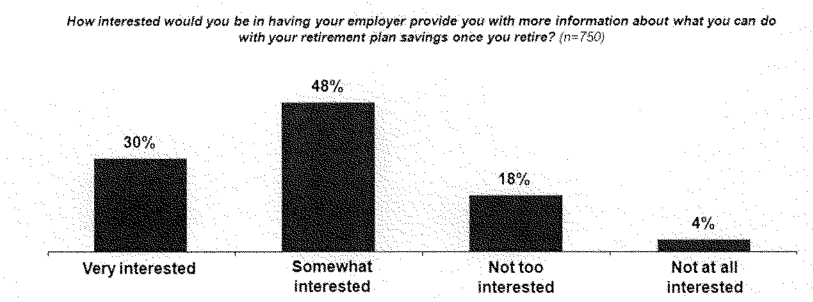


Interest in Information On and Options for Guaranteed Lifetime Income

Almost eight in ten would be interested in having their employer tell them more about what they can do with their retirement plan assets once they retire.

- Nearly eight out of ten (78%) express an interest in having their employer provide them with more information about what they can do with their retirement plan savings once they retire, including three in ten (30%) who would be very interested.

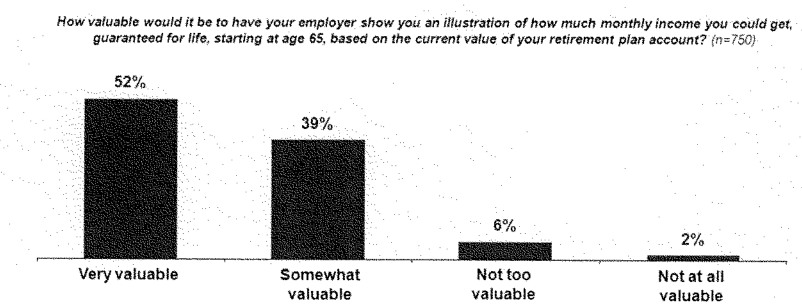
Interest in Information On Options for Retirement Plan Assets



An overwhelming majority feel it would be valuable to see how much guaranteed lifetime income they could get using their retirement plan savings.

- Just over nine out of ten plan participants (91%) suggest that it would be valuable to have their employer show them an illustration of how much guaranteed monthly income they could get for life, starting at age 65, based on the current value of their retirement plan account. This includes more than half (52%) who feel such an illustration would be very valuable.
  - Plan participants who presumably still have more time to plan for retirement (92% of 45-59 year olds) are more likely than those who are older (86% of 60-65 year olds) to feel that this illustration would be at least somewhat valuable.
  - Those with incomes under $100,000 (95%) are also more likely than their counterparts (89% of those with $100k+) to feel an illustration of how much guaranteed monthly income they could get would be valuable.
  - Interestingly, those who have not given a lot of thought to what they will do with their retirement plan savings after retirement (96%) are especially apt to say this type of illustration would be valuable, compared to those who have already thought about what they will do (90%). This suggests that showing plan participants this type of illustration may help some begin thinking about how to use their retirement savings who haven't previously given it much thought.

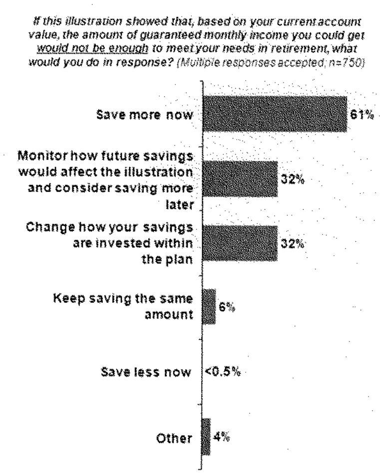
Value of Guaranteed Monthly Income Illustrations



An illustration of how much guaranteed monthly income could be generated would prompt many to save more, if the current amount seemed insufficient.

- Six in ten plan participants (61%) say that if they saw an illustration that suggested the amount of guaranteed monthly income that could be generated by their retirement plan account would not be enough to meet their needs, it would prompt them to start saving more.
  - Plan participants between the ages of 45 and 49 (68%) are particularly likely to suggest they would start saving more (v. 58% of those ages 50-65).
  - Those with incomes of $100,000 or more (69%) are more apt than those with lower household incomes (55%) to react by saving more.
- One-third (32%) say they would continue to monitor how their savings affected the illustration and would consider saving more later.
- Others (32%) indicate that seeing an illustration like this would cause them to re-evaluate and change their asset allocation.
- Only 6% say they would continue saving the same amount and less than 1% would save less as a result of seeing the illustration.

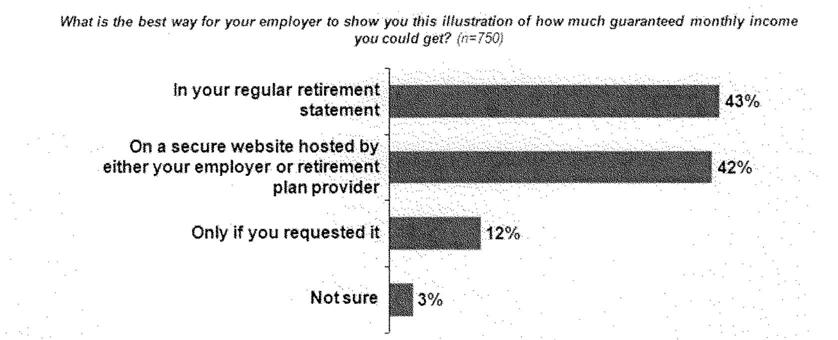
Response to Inadequate Income Illustration



Five in six (85%) want to see an illustration of how much guaranteed monthly income they could get on a regular basis, only 12% want it available only on their request.

- Eighty-five percent of plan participants indicate that the best way for them to see an illustration of how much guaranteed monthly income they could get is either in their regular retirement statements or on a secure website hosted by either their employer or their retirement plan provider.

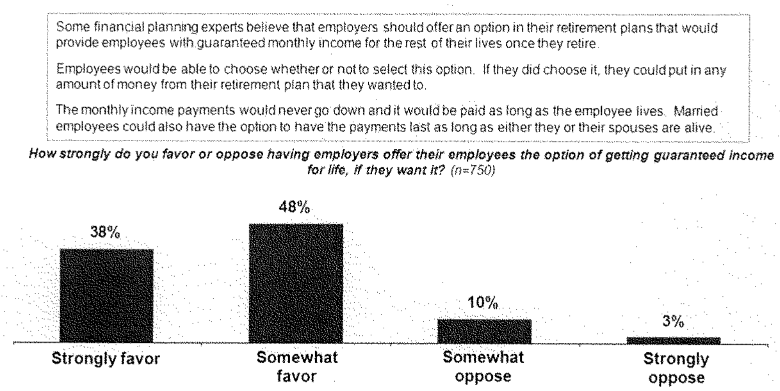
Showing Illustration of Guaranteed Monthly Income



Nearly nine in ten plan participants favor a proposal to have employers offer an option of receiving guaranteed income for life.

- Eighty-six percent of plan participants surveyed favor a proposal that would have employers offer their employees an option in their retirement plan that would use some of the participants' assets to generate a guaranteed stream of income for life.
  - Women (92%) are significantly more likely than men (83%) to favor this proposal.
  - This proposal is viewed especially positively by plan participants nearing retirement, as 48% of those ages 55 to 59 say they strongly favor the proposal, which is significantly higher than those older (32% of 62-65 year olds) and those younger (36% of those age 45-54).
  - Those with incomes under $100,000 (91%) are more likely than higher earners (82%) to express their support.

Attitude Toward Employers Offering Guaranteed Income for Life Option

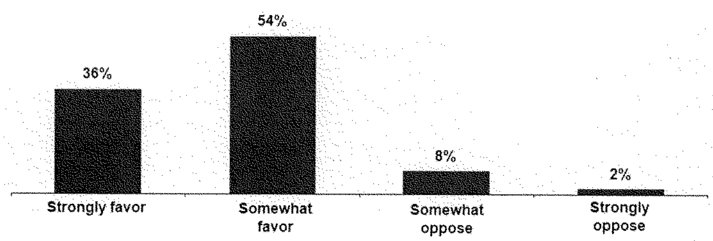


Nine in ten favor the idea of their own employer offering them an option for guaranteed lifetime income.

- Fully ninety percent say they strongly (36%) or somewhat (54%) favor the idea of their employer offering an option that, once they retire, they could use some of their retirement plan savings to produce a guaranteed monthly income for the rest of their lives.
  - Again, women (94%) and those with household incomes under $100,000 (93%) are more inclined than their counterparts to say they favor the idea of their employer providing this option (88% of men, 87% of those earning $100,000 or more).
  - Plan participants who say they tend to be investment risk averse (52%) are more likely than those who are willing to take average to above average investment risk (35%) to strongly favor having their employer offer this option.

Desire for Own Employer Offering Guaranteed Income for Life Option

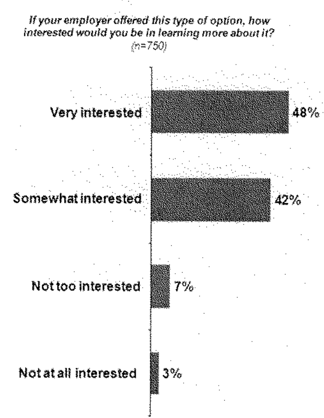
To what extent would you favor or oppose your current employer offering you an option that, once you retire, could use some of your retirement plan savings to produce a guaranteed monthly income for the rest of your life? (n=750)



Given these positive reactions, it's not surprising that nine in ten also say they'd be interested in learning more about this option, if it were available.

- Nearly half of plan participants (48%) say they would be very interested in learning more about this option, if their employer offered it. And another four in ten (42%) say they would be somewhat interested in learning more.
  - Those who favor the proposal overall (96%) are more likely than those who oppose it (56%) to say they would be interested in learning more.
  - However, plan participants who have not previously given much thought to what they will do with their retirement plan assets (97%) are especially likely to say they would want to learn more about a guaranteed lifetime income option (v. 89% of those who have already given some thought), suggesting that the very offer of this option might prompt some to think through these issues in more detail.
  - Those with retirement plan account balances between $40,000 and $75,000 (96%) are more apt than those with higher balances (87%) to express an interest in more information on this option.

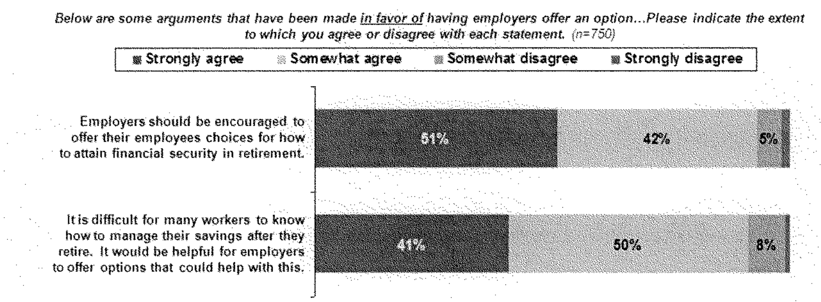
Interest in Learning More About Guaranteed Income for Life Option



Nine in ten believe that employers should offer choices to help employees attain financial security in retirement; many feel it may be difficult to do this on their own.

- Half of plan participants (51%) strongly agree, and more than four in ten somewhat agree (42%), that employers should be encouraged to offer their employees choices for how to attain financial security in retirement.
- Moreover, 91% of plan participants strongly or somewhat agree that it is difficult for many workers to know how to manage their assets after they retire and it would be helpful if employers offered options to help with this.

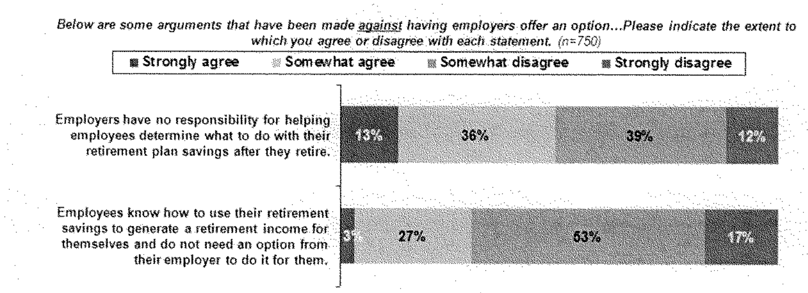
Agreement with Statements in Favor of Employers Offering Guaranteed Income Option



Seven in ten disagree that employees know how to use their income to generate income in retirement and do not need the help of employers.

- Half (51%) disagree with the statement that employers have no responsibility for helping employees manage their retirement plan savings after they retire.
- Still, the vast majority – seven in ten (70%) – disagree that employees know how to use their retirement savings to generate retirement income for themselves and therefore do not need an option from their employer to do this.

Agreement with Statements Against Employers Offering Guaranteed Income Option



February 2009

Encourage Annuity Options for Defined Contribution Plans

Problem: Currently, about one-half of employees' retirement savings is in defined contribution plans. Most defined contribution plans do not contain guaranteed lifetime income (annuity) distribution options notwithstanding that annuitization of account balances on retirement is the best way of assuring that retirement funds will not be exhausted during the participant's life. Early exhaustion of account balances may also adversely affect surviving spouses.

A major reason that defined contribution plans do not provide guaranteed lifetime income options is that, if they do so, the plan must then comply with burdensome statutory requirements relating to joint and survivor annuities. The J & S rules impose costly and burdensome administrative requirements involving notifications to spouses, waivers by spouses, and prescribe the form and amount of spousal benefits. A major reason for the shift to defined contribution plans is a desire by employers to avoid the administrative cost and complexity associated with defined benefit plans, including compliance with joint and survivor annuity requirements.

A potential solution to this problem would be for the plan sponsor to outsource the administration of the joint and survivor annuity rules to the annuity provider. However, in the event of a failure of the annuity provider to properly administer the rules, the plan and plan sponsor would still be liable for a claim for benefits under Section 502 of ERISA.

Solution: Where the plan sponsor and the annuity provider have agreed that the annuity provider will be responsible for administration of the joint and survivor annuity rules, provide that enforcement actions for failure to comply with the joint and survivor annuity rules may only be maintained against the annuity provider, provided that the plan sponsor or administrator has prudently selected and retained selection of the annuity provider. Make this provision applicable only to administration of the joint and survivor annuity rules under defined contribution plans. The electronic delivery rules should be modified to allow greater use of electronic means for administration of the J & S rules.

Rationale: The ability to shift responsibility for the administration of the joint and survivor annuity rules would make guaranteed lifetime income (annuity) options more attractive to plan sponsors and could result in significantly wider availability of such annuity payment options under defined contribution plans. While this approach would retain the cost and complexity of the annuity rules, it would preserve spousal protections and would permit the plan and plan sponsor to shift responsibility to an experienced third party annuity provider. This provider would be an insurance company with experience in annuity administration and a secure financial ability to pay annuities. These factors makes shifting responsibility to annuity issuers more beneficial to and protective of plan participants, beneficiaries (including surviving spouses) and the plan sponsor than leaving responsibility with the plan and plan sponsor.

Electronic administration is more cost efficient and has become more widely used. DOL has indicated that they are modifying their regulation on electronic delivery, although it is not known whether the modification will cover the QJSA rules.

Encourage Annuity Options for Defined Contribution Plans

SECTION __

(a) AMENDMENTS TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974.---

(1) IN GENERAL --- Section 402(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1102(c)) is amended ---

(A) in paragraph (2) by striking "or" at the end;

(B) in paragraph (3) by striking the period at the end and inserting "; or"; and

(C) by adding at the end the following new paragraph:

"(4) that a named fiduciary, or a fiduciary designated by a named fiduciary pursuant to a plan procedure described in section 405(e), may appoint an annuity administrator or administrators with responsibility for administration of an individual account plan in accordance with the requirements of Section 205 and payment of any annuity required thereunder."

(2) Section 405 (29 U.S.C. 1105) is amended by adding at the end the following new subsection:

"(e) Annuity Administrator

If an annuity administrator or administrators have been appointed under section 402(c)(4), then neither the named fiduciary nor any appointing fiduciary shall be liable for any act or omission of the annuity administrator except to the extent that ---

(1) the fiduciary violated section 404(a)(1) ---

(i) with respect to such allocation or designation, or

(ii) in continuing the allocation or designation; or

(2) the fiduciary would otherwise be liable in accordance with subsection (a). "

(3) Section 205(b) (29 U.S.C. 1055) is amended by adding at the end the following new sentence:

"Clause (ii) of subparagraph (C) shall not apply if an annuity administrator or administrators have been appointed under section 402(c)(4)."

(b) AMENDMENTS TO THE INTERNAL REVENUE CODE OF 1986 ---

(1) IN GENERAL ---Section 401(a)(11) of the Internal Revenue Code of 1986 (relating to requirements of joint and survivor annuities and preretirement survivor annuities) is amended by adding at the end the following new sentence:

"Clause (iii) (II) shall not apply if an annuity administrator or administrators have been appointed under section 402(c)(4) of the Employee Retirement Income Security Act of 1974."

(c) ELECTRONIC DELIVERY

(1) IN GENERAL --- The Secretary of the Department of Labor shall modify the regulations under section 104 or section 205 of the Employee Retirement Income Security Act of 1974 to provide a broad ability to administer the requirements of section 205 of the Employee Retirement Income Security Act of 1974 by electronic means.

General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals

Department of the Treasury
February 2010

PERMIT PARTIAL ANNUITIZATION OF A NONQUALIFIED ANNUITY CONTRACT

Current Law

If a taxpayer receives an amount as an annuity under a nonqualified, deferred annuity contract, a proportionate part of the amount received is excluded from gross income because it is considered to represent a return of premiums or other consideration paid for the annuity. The proportionate part that is excluded from gross income is determined by an exclusion ratio, which equals the investment in the contract as of the annuity starting date divided by the expected return under the contract as of that date.

If, on the other hand, an amount is received under an annuity contract but not as an annuity, the amount either is included in gross income (if received on or after the annuity starting date) or is included in gross income to the extent allocable to income on the contract (if received before the annuity starting date).

The annuity starting date is the first day of the first period for which an amount is received as an annuity. This date is generally the later of the date on which the obligations under the contract became fixed, or the first day of the period that ends on the date of the first annuity payment.

Reasons for Change

Under current law, a taxpayer may exchange a portion of an existing annuity contract for a second annuity contract and, under certain circumstances, annuitize one of the contracts involved in the exchange. An exclusion ratio then applies to determine the extent to which amounts received as an annuity under the annuitized contracts are included in gross income. Current law does not, however, address the treatment of a transaction (sometimes known as a partial annuitization) in which the holder of an annuity contract irrevocably elects to apply only a portion of the contract to purchase a stream of annuity payments under the contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis. It is appropriate that these transactions be treated consistently.

Moreover, the possibility that a partial annuitization could be taxed on an income-first basis rather than on a proportionate basis discourages some taxpayers from annuitizing existing deferred annuity contracts at a time when annuity payments are needed to fund their retirement.

Proposal

An exclusion ratio would apply to each amount received as an annuity with regard to a portion of a nonqualified deferred annuity contract that is partially annuitized. This treatment would be available only if: (1) the taxpayer irrevocably elects to apply a portion of the contract to purchase a stream of annuity payments; (2) the stream of annuity payments is either for at least ten years or for the life of one or more individuals; and (3) the exclusion ratio is computed based on the expected return and investment in the contract with regard to the portion of the contract that is annuitized.

The proposal would be effective for partial annuitizations that are effected after December 31, 2010.

The CHAIRMAN. Thank you, Mr. Mullaney.
Ms. Mensah.

STATEMENT OF LISA MENSAH, EXECUTIVE DIRECTOR, ASPEN INSTITUTE INITIATIVE ON FINANCIAL SECURITY

Ms. MENSAH. Thank you, Chairman Kohl, and my thanks as well to Ranking Member Corker.

My name is Lisa Mensah and I'm the Executive Director of the Aspen Institute Initiative on Financial Security. It's an honor to be here today. I'm the granddaughter of an Iowa insurance agent and the daughter of an African engineer who comes before you today as a personal witness to America's greatest promise, that we can all share in the prosperity of this land if we can grab hold of the basic tools we need to succeed. I believe savings is one of those basic tools.

I spent 13 years at the Ford Foundation working in some of our poorest areas, including the Delta counties of Tennessee and the Iron Range of Wisconsin. Workers there and elsewhere in America are struggling to get off the hamster wheel of just making ends meet, and we've failed to give them an accessible and robust system of savings.

I founded Aspen IFS with a simple dream: to help bring about the policies and the financial products that enable all Americans to join the savings and wealth-building system in America.

We commend the administration for its fresh look at retirement savings and we were pleased to be hosted recently by you, Senator Kohl, to describe our hopes for an automatic IRA system that builds large nest eggs. At Aspen IFS we believe the journey to financial security is not just a people problem, but also it's a product problem, and that we really need simple and secure financial products to help all Americans save, invest, and own.

So today I come before you with a message of hope, but also a message of caution. I'm filled with hope because this hearing is really the first serious consideration of helping Americans manage their nest eggs in retirement.

This summer we celebrate the 75th birthday of the Social Security System, perhaps our most popular government policy. Social Security provides the securest of lifelong income, but it was never intended to be the only income in retirement.

So I believe our question is: How can we build a better private savings system for the next 75 years?

Now my cautions. We can say confidently that everyone needs to save, but we can't say that everyone needs to annuitize. There is an all too common refrain that if we don't force people to do what's best for them, those people can just head to Vegas or buy an RV with their nest eggs.

I think this is a painful stereotype. I propose instead that we keep annuities voluntary, but make them easier, safer, and a better deal.

We've heard from everyone that we'll need more than one choice or one default, and we've heard that one size does not fit all. Some people are very healthy and look forward to a long retirement. Many others are not. Some have grown children and a spouse with a pension. Others are in a second marriage and have a young family. Many are sandwiched, supporting parents and children or grandchildren. Some have children with special needs who must be cared for when they've gone. Some have large 401(k) balances and other savings and others have very modest assets, but have paid up their house.

So there really is more to consider here than just an account balance. That's where we bring us to the challenges. First, the workplace challenge. While we think the employer plan system can play an important role, let's not experiment with the whole system until we have broad agreement on the suitable products for our extremely diverse workforce. We risk jeopardizing the entire noble effort of making savings last a lifetime if we start too big and create a backlash of opposition.

In addition, annuity options will add another layer of complex laws and regulations to plans and entail greater fiduciary liabilities for employers. Will the small and medium employers accept this or will they head for the exits? Will workers accept being defaulted into products they don't value or understand?

So the second risk I'd like to talk about is the default risk. An annuity is a promise that can last for decades and it's only as good as the insurance company standing behind it. We've been in such a tumultuous time with the solvency of our financial system. Who will secure the promise of the annuities in 401(k) plans? Will it be the insurance companies, State guarantee funds, the employers, or will it fall to the Federal Government?

Last, I'd like to speak about the value challenge. What consumer love about Social Security is both longevity and inflation protection. It does little good to promise paychecks for life if they don't keep up with inflation. Value must also be judged by cost. Until we can offer our consumers a product with inflation protection and at a reasonable cost, we must proceed with caution.

These are all big issues, but it doesn't mean we can't get started. So I believe we could start by helping the over 3 million baby boomers who reach retirement each year convert their savings into modest monthly checks by piggybacking onto our Social Security System. Aspen IFS has proposed a new public-private partnership to market security-plus annuities through the Social Security Administration. Seniors who are deciding to claim Social Security could opt to buy an additional layer of Social Security-like income with their own money and have it added to their monthly checks. Private companies would underwrite these basic immediate annuities, which could be priced reasonably on a group basis.

The key point here is that it's better to start small with a voluntary system that's simple and secure.

In closing, I want to return to my hope. I have a hope that we can demand more innovation from our private insurance providers. It's time for better products that match today's consumers and we believe the industry is ready to deliver. I also have a hope that we can regulate annuity products so they'll be suitable, safe, and good value. Finally, I hope that we'll learn much more about what Americans actually want with a lifelong income product. Once we do, we'll be able to deliver and improve on our system of savings so that it really can deliver lifelong income for a very diverse America.

Thank you very much.

[The prepared statement of Ms. Mensah follows:]

INITIATIVE ON FINANCIAL SECURITY

THE ASPEN INSTITUTE

The Initiative on Financial Security at the Aspen Institute is a leading policy program focused on bold solutions to help all Americans at every stage of life to save, invest, and own.

www.aspenifs.org

THE ASPEN INSTITUTE INITIATIVE ON FINANCIAL SECURITY
WRITTEN STATEMENT FOR THE RECORD FOR
"THE RETIREMENT CHALLENGE: MAKING SAVINGS LAST A LIFETIME"
BEFORE THE UNITED STATES SPECIAL COMMITTEE ON AGING

JUNE 16, 2010
2:00 PM
DIRKSEN SENATE OFFICE BUILDING, ROOM 562

The mission of the Aspen Institute Initiative on Financial Security (Aspen IFS) is to promote sound public policy that enables all Americans, especially low- and moderate-income Americans, to build financial security that lasts a lifetime. As President Obama has stated, "Americans who work hard their entire lives have earned the right to retire with dignity and security. That's the promise that each of us wants to be realized within our own families, and it's a promise we must keep for all American families." A dignified and fulfilling life in retirement rests on financial security – financial security that matches longevity and enables seniors to contribute joy, wisdom and other resources to their families rather than burden them financially.

This hearing before the Senate Special Committee on Aging marks an important step towards a national policy on preserving income from savings throughout retirement. Turning savings into income that will last throughout retirement is a difficult task. Over the next 20 years, more than 80 million baby boomers will retire. Many of the 76 million eligible for Social Security—the universal, baseline annuity for all Americans—will need some lifelong income beyond those benefits in retirement. As defined benefit plans continue to disappear, the generations that follow will need even more help in managing the nest eggs they have accumulated in 401(k) plans so that they will last a lifetime.

Framing the nation's first private annuity policy that supplements Social Security will be a difficult and complex task and should be undertaken only with extreme caution. What the government blesses as policy will affect millions of Americans and billions of investment dollars. It could significantly alter the structure of our private savings system and dramatically affect the operation and organization of the financial services industry. Aspen IFS believes that critical work of analysis and debate must be undertaken before the nation embarks upon a broad-based, expansive policy on lifelong financial security.

It would be tragic if, as a nation, we fail to learn from some of the significant policy failures in 401(k) plans over the last twenty years. Many believe that they originate in what Aspen IFS calls the "people" problem, that is, on the behavioral challenges of turning people into savers and savers into investors. There is a large element of truth in that belief. We have learned the hard way not to place too much investment risk and responsibility on the shoulders of savers and not to burden them with complex choices. Aspen IFS believes, however, that equally important is what it calls the "product" problem, that is, the prevalence of opaque investment options with high fees and expenses. The magnitude of the product problem is well-illustrated by the current controversy over the use of poorly-understood target-date funds as a default 401(k) investment. The world of annuity design and marketing is vast and complex, and its products, like any other investment product, can be subject to high fees and expenses.

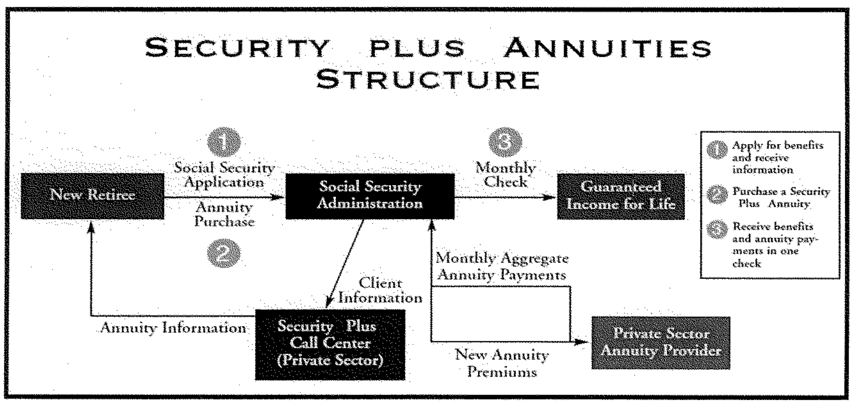
Before we "nudge" or perhaps even mandate millions of Americans into lifelong income products that will bind them for decades, we have an obligation to carefully consider the needs and abilities of diverse groups of savers as well as critical product design and regulatory issues. This is particularly important now that the Obama Administration seeks to expand pension coverage significantly beyond the roughly 70 million active savers now in employer-based defined contribution plans. The Automatic IRA proposal, if passed, would more than double the size of our private retirement saving system by adding some 78 million new savers, many of them low- and moderate-income workers. Millions of them, and millions more savers in 401(k) plans, will be content to remain in default products blessed by statute or regulation. We owe these savers a rigorous debate over the core elements of appropriate lifelong income products before they become a routine feature of investment menus.

This is particularly true because even preliminary questions surrounding lifelong income products as a policy are complex and there are no clear answers. Which savers should purchase such products? How much of their savings should be devoted to lifelong income products? Aspen IFS believes that a sizeable portion of those who do not annuitize at least some of their retirement nest egg could benefit from doing so. The academic literature, however, provides no easy-to-apply rules for potential purchasers. It does suggest that decisions about lifelong income needs in retirement are highly personal and require careful analysis of family circumstances and other financial assets, over and above retirement plan account balances. When should savers purchase such products, i.e., over their work lives, at retirement, or perhaps only for extreme old age? Again, this is a subject of considerable debate among academics and financial professionals.

At the same time, the design of lifelong income products is evolving rapidly. A popular product for today may look very different in five or ten years. How well can we shape public policy to incorporate the dynamic nature of industry innovation? Alternatively, how well can public policy address some persistent issues raised by current lifelong income products? For example, what products – new or old – best serve low and moderate-income savers? What role should an employer play, if any? Is the current state-based regulatory scheme for such products suitable for a diverse, highly mobile workforce? Many state guarantee funds limit their liability to only $100,000 in present value, and protection can vary depending on state of residence. Moreover, while lifelong income products can play an important role in reducing longevity risk, they do not guard against other significant risks to retirement income. For example, few products are available today that protect retirement income against inflation. In addition, lifelong income products remain subject to default risk, the risk that promised payments will not be made if a provider becomes insolvent.

Realistically, given the complexity of the issues, it could take years of consensus-building, legislation and regulation before lifelong income products become routinely available through 401(k) plans and IRAs. In the meantime, however, 3-4 million baby boomers will be reaching retirement age each year without easy access to a simple and secure lifelong income product. To assist them and as a first step toward a national policy for all, we should explore already successful public policies that provide lifelong income. For that, we have only to turn to Social Security. Social Security provides a popular, almost universal annuity that protects against default, inflation and longevity risks. Aspen IFS believes that the popularity of Social Security income could be leveraged as the first stage of a new national policy on lifelong income. Partnering with Social Security would endow lifelong income products with the familiarity, convenience, and trust enjoyed by the Social Security program. This approach also adds the benefit of comparability because monthly Social Security benefits are the yardstick by which those who are about to retire or who have just retired measure their real retirement income.

In its report, Savings for Life, Aspen IFS has proposed utilizing the resources and goodwill associated with Social Security to market and distribute "Security Plus Annuities" through a public/private partnership. A Security Plus Annuity would primarily be a "starter" annuity suitable for savers who would like to annuitize at least a portion of a small nest egg. Retirees who wish to buy larger annuities or additional annuities later in life would be encouraged to obtain them from the private sector. The graphic below provides a depiction of how the Security Plus Annuity proposal works.



A Security Plus Annuity is a basic, immediate, inflation-adjusted, life annuity that would enable retirees to buy an additional amount of Social Security-like income for life. Security Plus Annuities would offer all new retirees a one-time opportunity in their first year of receiving Social Security benefits to buy as large a Security Plus Annuity as they wish available in up to $100,000 in purchase amount. For married retirees, Security Plus Annuities would offer spousal benefits. Security Plus Annuity payments would be automatically added to monthly Social Security benefit checks.

Through a competitive bidding process, the federal government would pre-select a private market annuity provider to underwrite Security Plus Annuities on a group basis. The federal government would act primarily as an intermediary providing record-keeping, marketing, distribution, and other administrative services while the private sector would play its customary role as an underwriter of group annuities. Insurance companies would invest premium payments to support retirees' guaranteed lifelong payments. Moreover, a private-sector call center under contract to Social Security would also be available to explain Security Plus Annuities, provide individualized cost estimates and purchase assistance, and remind retirees when their eligibility will end. A summary of Security Plus Annuity features is provided below.

Security Plus Annuity Features

- A Security Plus Annuity is an immediate, inflation-adjusted, life annuity that provides an initial layer of Social Security-type income.
- Retirees have a one-time opportunity in their first year of receiving Social Security benefits to buy as large Security Plus Annuity as they wish (up to $100,000 in purchase amount).
- For married retirees, Security Plus Annuities will offer spousal benefits.
- Security Plus Annuity payments are added automatically to monthly Social Security checks.
- Through a competitive bidding process, the federal government pre-selects a private market annuity provider to underwrite Security Plus annuities on a group basis.

In conclusion, Aspen IFS believes that many savers will want and need to convert at least some of their retirement nest eggs into lifelong income. Federal policy should assist them to do so. The first step should be to consider how we can build a lifelong income policy based on what is already popular and effective. In addition, any federal policy must be mindful that increasing the take-up of lifelong income products involves more than an effort to fix the "people" problem. It must also involve a serious focus on the "product" problem so that all savers, but especially low- and moderate-income savers, have access to a suitable and secure lifetime income option.

INITIATIVE
ON
FINANCIAL
SECURITY
THE ASPEN INSTITUTE

The Initiative on Financial Security at the Aspen Institute is a leading policy program focused on bold solutions to help all Americans at every stage of life to save, invest, and own.

The CHAIRMAN. Thank you very much.

Mr. Beck, in your testimony you talk about how workers can improve their lifetime income by delaying taking Social Security benefits. In the last Congress I introduced an older workers bill to allow seniors to earn Social Security tax credits up to the age of 72. How do you feel about that proposal?

Mr. BECK. I think anything that improves the flexibility available to the worker is a positive thing. The key thing, though, from our point of view is does the person understand what that flexibility means to them? If somebody has the ability to defer beyond age 70 as it currently sits and that doesn't create a burden on them, that puts them in a much better position. So I think it's a very positive factor available to workers, so long again as they understand what they're doing and how they would go about making that fit into their monthly budgets.

The CHAIRMAN. All right. Ms. Hueler, you said that many employers are reluctant to take on the responsibility for offering lifetime income products. How can we remove some of the barriers so as they would be more willing to offer these options, as well as educating their workers?

Ms. HUELER. That's one of the really—we call it kind of the conundrum, where the employee and the employer's behavior is inextricably linked. If the employer doesn't offer or encourage, the employees are not going to move.

But the employers have this burden or concern that's very legitimate over issuer selection and the language that's utilized in the Department of Labor regulations relative to that issue. So I think what we see is that employers have a willingness of heart, but they face the concern over the specific liability. So if we offered safe harbor language that would give them a simple road map to something that they know they could comply with—and it's important, too, to think about it this way. You have the HR-benefits side of the house and you have the finance side of the house. So there's a lot of consideration that goes into the financial risks relative to offering annuitization. So if you gave them a simple road map where they could diversify and ensure low costs and know that they were providing a real value to those participants that mitigated certain risks like inflation and other things, then they are going to be far more receptive to adopt programs that fit within a safe harbor.

In essence, the safe harbor can't just be for the heck of providing a safe harbor. It has to really reflect the plan sponsors concerns about their participants.

The CHAIRMAN. On the way over to the vote, Senator Franken said to me: Well, what happens if somebody buys an annuity from a company and the company goes out of business?

Ms. HUELER. We've got an issuer at the table.

The CHAIRMAN. Do you want to answer that question, Mr. Mullaney?

Mr. MULLANEY. Sure. I think first of all, if you think about the insurance industry, the insurance industry has been paying annuity benefits to millions of people for a number of years. Over the last 10 years or so, insurance companies have continued to see the capital requirements that States require for them to operate continue to increase. I think as we've gone through this recent financial crisis, insurance companies have held up very well in terms of their financial strength and their ability to continue to provide benefits to their policyholders.

You know, the State regulation of insurance really allows for State insurance regulators to look very closely at the financial performance of an insurance company, the capital requirements, the reserves associated with the liabilities that that insurance company has written. If there's any sign that an insurance company might be in trouble, State regulators step in early and begin to take the necessary steps to resolve an insurance company's issues.

In the rare event that there is an insolvency, there are State guarantee funds that can step in and continue benefit payments.

The CHAIRMAN. So you don't consider that to be a major problem?

Mr. MULLANEY. I do not consider it to be a major problem.

Ms. HUELER. Chairman Kohl, if I could respond as well.

The CHAIRMAN. Ms. Hueler.

Ms. HUELER. I think one of the other issues is concentration of risk. By having multiple providers, you also do reduce the risk of exposure to any single incident or any single event that might occur at a given insurance entity, not only all the protections that Bill describes. But that's a really important aspect of not concentrating risk into one single provider and assuming that a provider will stay the same for eternity.

The CHAIRMAN. That's a good point.

Mr. MULLANEY. Just maybe to follow up on that if I could, Mr. Chairman. The competitive landscape in the annuity industry is very robust. There are dozens of companies that provide annuities to millions of Americans. So there's plenty of competition in the annuity industry for consumers and employers if they choose to do so, to offer a wide range of product providers and solutions to their employees.

The CHAIRMAN. Thank you.

Ms. Mensah, we've heard the value of educating participants, of course, is extremely pertinent here. While your security-plus annuity proposal would be relatively simple for participants, what education efforts do you think would be needed to ensure that Americans were aware of and fully understood this option?

Ms. MENSAH. Thank you, Chairman Kohl. What we love about this idea is that it's catching people right at the moment when they're retiring. It's saying at the time that you sign up for Social Security, you could receive information at this point from the Social Security Administration. You could be directed to a call center, to say: Would you like to purchase some additional income? So that you would be making—this is the perfect time to have a comparative yardstick, something that you're going to get from Social Security and what else you'd like to do with your nest egg.

So we think it's not only educating, because that's the focus on just people only. It's matching people and a product at the right time in their life. We've heard a lot about how education is more effective at the right moment. So we think that that's the power of this, that you could do this talking about it, and it would be from a trusted source. Here it could be your Social Security Administration giving you the information or with a private call center that would help direct those questions.

So it seems to us a timing question, to time the education with the purchase decision.

The CHAIRMAN. To the rest of you: The security-plus annuity proposal, would you critique it a little bit for the rest of us? Mr. Beck?

Mr. BECK. Just from an education point of view, it's an interesting idea. The challenge I would have from an educational point of view is is the consumer at that point aware of alternatives available to them? There's a big difference between financial knowledge and financial sophistication. If you're being offered a product at a specific time and you have no comparative program to look at and do not necessarily understand the pluses and minuses—I would be more comfortable with the concept if the education process had that comparative component into it, rather than saying, here's an add-on to an existing trusted source product delivery.

The CHAIRMAN. Ms. Hueler, would you agree with that?

Ms. HUELER. I do. I agree with Ted's comments. From our perspective in dealing directly with employers, I guess there's a couple of issues. If you really look at the participant, they place a high degree of trust in their employer. We need—we believe we need employers to be involved, both public and private, to be involved in this process.

I think it would be difficult to have them excited about a proposition like this. I do think that would be one of the big hurdles. It may look very easy on the surface, but the appetite for more emphasis on a government-sponsored program, even if it's just the perception, I think that that's a big challenge.

I think government support is very different, government encouragement, providing the framework and allowing the private sector to really come through with programs that meet the needs of the participants. So I think you have to really consider what the participants face in this decisionmaking process and who their sources, who their trusted sources really are.

The CHAIRMAN. Yes, Ms. Mensah?

Ms. MENSAH. Yes, just to say, we also design this for so many people who are not in plans. That's really 50 percent of our workforce. So while I would not disagree, when you have an employer who can play that role for you you're in a privileged position, and I wish more Americans were there. But there are many employers who won't.

Just to make very clear, we've always seen this. We designed this in partnership with CEOs from the financial sector. So this is a private product. It's a public-private partnership. It's private companies who would underwrite.

Also, we've always said that it should be a starter annuity. It isn't everybody's choice, Ted, you're correct on that. This would be a way to get started for some people who want to annuitize some of their nest egg. You could do it in a trusted way, and maybe this is your starter and you would make your way to other products that might give you more flexibility and control.

But for some people, just the chance to add an additional $100 to that Social Security check, it would make sense at that moment. That's our contention.

The CHAIRMAN. Mr. Mullaney, you're sitting between these two adversaries. Would you like to offer a little illumination to us?

Mr. MULLANEY. I would, yes. Thank you, Mr. Chairman. I think the proposal that Lisa has put out there is elegant in its simplicity, but one of the things that I would be concerned about is the fact that retirement planning for individuals is somewhat complicated, because it's a function of each individual's unique circumstances. In the earlier panel that we had before, we heard about how long people expect to live. In studies that we've done, over 60 percent of the people don't expect to live as long as the mortality table suggests that they will.

There are issues around how much money people need to save to cover things like medical expenses in retirement. So the industry's view is that it's important for people to be able to get the appropriate level of advice, to be able to customize a retirement program that includes some amount of guaranteed income where appropriate, so that a person will never run out of income in retirement. While your point is well taken that many people are not in plans today, there's a very robust market where, in the retail space, people can go out and get some advice and counsel, and some of the products and solutions they might need to be able to provide guaranteed income in retirement. So that's just not something that's available to people who are at work.

The CHAIRMAN. Ms. Hueler?

Ms. HUELER. Sure, if I could clarify a couple things. We don't view plans as the only source of retirement savings, for sure. There's a lot of individuals that are not covered by plans, and that's a very legitimate position.

But even in the IRA sector, we believe this group institutional approach for all participants in qualified plans, whether that be individual IRA plans or retirement plans that are sponsored by employers, can be done efficiently and cost effectively. If there's a starter program, I can understand the value, the true value of that. But I think we also have to look at the broadest base of where people have their savings, who they're utilizing as their resources for this type of educational and financial planning information, and we have to provide them access through those channels if we really expect it to work in a meaningful way.

The CHAIRMAN. All right.

Mr. Mullaney, I think we're all pleased to see the development of new and innovative products to provide consumers with lifetime income. Obviously that's key. But I'm concerned that they have adequate consumer protections, such as spousal protections and reasonable fees. How is your industry guaranteeing that these products are designed in the interest of your consumers?

Mr. MULLANEY. First of all, as we think about product designs and new innovations that we might want to bring to our products, the first place we start is with the consumer, to understand what the consumer needs are. If you look at guaranteed lifetime income products from where they started many years ago to where they are today, many features have been added to these products. Those features really reflect the needs that consumers have expressed to us in terms of the type of features that they would like to see in guaranteed lifetime income programs.

Whenever you design these programs, you also have to consider the cost, and we believe very much in making sure that the products that are offered in the marketplace are suitable to the people who buy them and that there's full disclosure around how those products work and the fees and the costs associated with those products.

As I said before, there's a very competitive market for the sale of lifetime income products. So the value that consumers look for and the competitive nature of the market certainly keeps the prices associated with these programs well in line with what consumers can afford.

The CHAIRMAN. Mr. Beck, have you found any particular retirement challenges among specific demographic groups, and what suggestions do you have to help?

Mr. BECK. We have been doing some studies on specific issues related to different groups. We have been doing research specifically on Hispanic households with the University of Notre Dame for several years. There are different challenges and there have to be sensitivities.

But I think understanding those is the first key. We do not yet have something that we could say specifically do this for this group, be it different racial groups, be it different age groups, be it different income groups. So the message from us is this is something we need to study and do more research on.

The greatest risk here is doing ready, fire, aim. So we're still in the research and data gathering mode to see what sort of suggestions might be available to people to be more sensitive and more applicable to different groups.

The CHAIRMAN. Ms. Hueler, can you explain the large variations in the price of annuities and share your recommendations with us on how to bring down the price of annuities for all Americans?

Ms. HUELER. The comments we provided to you stem from better than two decades of observing insurance company price variability. It's inherent in the nature of the way that products are designed and priced. Even in the case where issuers are providing you their very best price of the day, at very low cost or no cost, they may not in fact be competitive with their peer at a given point in time for a given type of annuity product.

It doesn't mean they're not doing a great job and it doesn't mean they're not delivering at low cost. But their price models are fluid and there is no one insurance company's model that can deliver the best the market has to offer on any given day.

So when you include peers who are doing best case pricing, low cost delivery, low fees, you have the opportunity to provide to the individual at the point in time that they're converting the best the market has to offer. It's not to say that insurance company A, B, and C are not all doing their best job. But they will have a different price at any given point in time on a particular annuity benefit, and that's just the nature of the business.

We've done study after study, so we're confident in that data, and we know the way to resolve that is to have apples to apples comparative quote capabilities, so that when a person asks for a particular type of benefit there's no confusion, there's no additional bells, whistles, etcetera, and it's very easily compared one to another, and the issuers have had the opportunity to compete on that given day at that point in time for that piece of business.

The CHAIRMAN. Good.

Well, I think you've all done very well and offered a lot of illumination into something that's emerging and very important in our society as we continue to go forward. So we thank you for being here, thank you for your contributions. At this time I think we'll terminate the hearing.

[Whereupon, at 3:58 p.m., the hearing was adjourned.]

A P P E N D I X

MR IWRY'S RESPONSES TO SENATOR KOHL'S QUESTIONS

Question. A March 29, 2010, Treasury Inspector General for Tax Administration (TIGTA) report identified a significant loss in Federal funds due to individual noncompliance with Individual Retirement Account (IRA) excess contribution and minimum distribution requirements. The report estimates that these two forms of IRA noncompliance amounted to nearly $300 million in tax revenue losses for tax year 2006 and 2007. The report also states that IRA noncompliance has continued to grow since tax year 2005. The IRS agreed to address the problem when it was first identified over two years ago in an earlier 2008 TIGTA report, but the noncompliance has continued to grow unchecked. With the possibility of losing significantly more than $300 million in tax revenue over the next two years due to IRA noncompliance, what can be done now to protect these Federal funds?

Answer. To respond to your questions about what more can be done to protect Federal revenues from noncompliance with the IRA excess contribution and minimum distribution requirements, we have consulted with the IRS. The information they have provided is reflected in our responses to your questions, below.

The IRS completed an IRA study late last year that responded to GAO and TIGTA audit findings involving both the IRA Required Minimum Distributions (RMD) and IRA Excess Contributions. TIGTA originally proposed use of the IRS Automated Under Reporter (AUR) matching program for working these IRA issues. However, the IRS study concluded that neither issue is a good fit for AUR: RMD cases are not well suited for AUR inventory because of difficulties with accurate matching and the complications created by the need for two years of data to determine non-compliance. Additionally, IRA cases involving excess contributions are not well suited for AUR inventory because of difficulties with accurate matching, multiple year issues, and the low average penalty for an IRA excess contribution, resulting in average potential assessments in the $300 range.

It became evident to IRS management that a broader strategy was needed for addressing IRA non-compliance, and that examinations would be only one component of a more comprehensive approach that would also consider amending regulations, modifying existing forms and publications, conducting additional research studies, and developing outreach and education. Subsequent to the Committee's hearing, the IRS convened a cross-functional group using executives in its Candidate Development Program to review the TIGTA data and identify activities that might be effective in preventing the loss of revenue. The group consisted of key personnel in Wage and Investment (W&I), Small Business/Self Employed (SB/SE), Tax Exempt and Government Entities (TE/GE), Large Business and International (LB&I) and Modernization and Information Technology Services (MITS). This cross-functional team developed several high-level suggestions, including initiatives for working toward a broad-based strategy to effectively address the issues while focusing on aspects such as forms and regulations.

Question. In response to the report, the IRS has proposed a Service-wide strategy to address IRA noncompliance in regards to excess contributions and non-disbursements of required minimum distributions, with a proposed implementation date of October 15, 2012. How do you feel about the IRS's timeline, and do you believe this much time is necessary to successfully implement the strategy?

Answer. We believe that the IRS has appropriately accelerated its original timeline for implementing its proposed Service-wide strategy to address IRA noncompliance relating to excess contributions and required minimum distributions. While some elements of the strategy can be implemented in 2011, successful implementation of other elements can be expected to take until the Fall of 2012.

More specifically, it will take a significant level of effort to address the myriad and complex issues surrounding IRA noncompliance and develop a comprehensive strategy encompassing all of the interrelated issues. There would be a considerable opportunity cost if the IRS redeployed extensive exam resources to work cases with relatively small average potential assessments compared to other workload categories. But if we do not pay sufficient attention to individual IRA cases because the average assessments are small, then we risk forgoing the substantial total assessments that are involved when the small dollar per case average is multiplied by the large universe of potential cases. We believe the answer is to find ways to prevent the IRA compliance issues from occurring in the first place, and relying less on remedying those issues with exams after they have already occurred.

The suggestions developed by the cross-functional IRS team referred to earlier should have a positive impact on the level of non-compliance while limiting unnecessary contacts with the taxpayer. To follow up, the IRS will be are convening a strategy team in the first quarter of FY11 to develop an overarching compliance strategy for addressing IRA noncompliance. The team has been charged with identifying both "quick hits" and longer term proposals. The quick hit recommendations will be options that can be implemented in calendar year 2011. The proposed timeline of 2012 is needed to coordinate the substantial activity connected with properly working the longer term options, including systems changes and significant outreach and education. Researching and implementing actions such as these require a balancing of other IRS priorities related to IT and Counsel resources and cannot be accomplished in a relatively short timeframe.

Question. The Inspector General recommended the development of processes to identify individuals who do not comply with retirement provisions as well as the development of compliance efforts to address the noncompliance. The IRS has stated that their Service-wide strategy will contain compliance, education/guidance, and outreach components. What are the most critical elements of a strategy of this nature and how would you envision this strategy being the most quickly and effectively implemented?

Answer. A strategy of this nature relies on continued vigilance on the compliance side, but also, in particular, initiatives grounded in education/guidance and outreach. These types of initiatives may hold the promise of being particularly efficient by preventing noncompliance in the first place.

The IRS has indicated that, in connection with education/guidance and outreach, the IRS strategy team will examine options such as enhancing IRS Web-based service and information offerings; presenting lists of common mistakes and how to avoid them; increasing the clarity of published guidance; modifying existing forms and publications, and examining the potential for a "soft notice" campaign. The IRS team plans to identify any quick-hit action items that can be put into place promptly, while the more time- and resource-intensive solutions are developed by the Service.

If the Senate Aging Committee staff would find it helpful to have more detail or to discuss this strategy with the IRS and Treasury, we would be glad to meet with Committee staff for a discussion of these efforts.

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.

1850 M Street NW Suite 300 Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948 www.actuary.org

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
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

[1] The American Academy of Actuaries is a professional association with over 16,000 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.

1850 M Street NW Suite 300 Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948 www.actuary.org

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.

U.S. Department of Labor
Lifetime Income RFI

May 3, 2010

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,

Ethan E. Kra, FSA, MAAA
Vice President – Pension
Chairperson, Pension Practice Council

Arthur V. Panighetti, FSA, MAAA
Vice President – Life
Chairperson, Life Practice Council

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

Cande Olson, FSA, MAAA
Chairperson, Life Products Committee

U.S. Department of Labor
Lifetime Income RFI

May 3, 2010

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.

CERTIFIED FINANCIAL PLANNER
BOARD OF STANDARDS, INC.

STATEMENT OF

CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.®

BEFORE THE

UNITED STATES SENATE

SPECIAL COMMITTEE ON AGING

June 16, 2010

Mr. Chairman, Ranking Member Corker, and Members of the Special Committee, thank you for the opportunity to submit this statement as part of the record for the Senate Special Committee on Aging hearing regarding retirement issues. Certified Financial Planner Board of Standards, Inc. (CFP Board) is uniquely positioned to provide input to the Special Committee as it considers ways to improve the ability of elderly Americans to enjoy a comfortable retirement. CFP® professionals perform an important role in counseling individuals about retirement.

I. Background on CFP Board

CFP Board is a non-profit organization that acts in the public interest by fostering professional standards in personal financial planning through setting and enforcing education, examination, experience, and ethics requirements for financial planner professionals who hold the CFP® certification. Our mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard of excellence for personal financial planning. CFP Board currently regulates over 61,000 CFP® professionals who agree on a voluntary basis to comply with our competency and ethical standards and subject themselves to the disciplinary oversight of CFP Board.

Financial planning professionals provide services that integrate knowledge and practices across the financial services industry. Financial planners work with their clients to determine whether and how they can meet their life goals through the proper management of their financial resources. Financial planning typically covers investment, income tax, education, insurance, retirement, and estate planning.

II. Unique Role of CFP® Professionals in Retirement Planning

CFP® professionals provide financial planning services to Americans at all phases of their working life—from newly minted college graduates trying to figure out how much to contribute to an IRA or their new employers' 401(k) plans, to individuals at or near retirement age who seek professional assistance regarding how best to utilize their retirement savings once they leave the workforce. Additionally, CFP® professionals provide essential retirement planning services to Americans across all racial, social, geographic, and economic lines. As professionals who spend their days helping individuals and families meet both their short-term and long-term financial goals, CFP® professionals have a unique understanding of the specific challenges faced by individuals in trying to achieve adequate retirement security.

CFP® professionals take a holistic approach to retirement planning. CFP® professionals talk to individuals considering retirement about various issues affecting their decision-making process, such as the risk that a retiree will outlive her savings; whether she has adequate savings to retire or needs to keep working and saving; ways to maintain a reasonable standard of living; and the need to plan for and anticipate unexpected expenses. While longevity risk is an important piece of the retirement security puzzle, it is only one piece, and we cannot lose sight of the bigger picture. Put simply, it would be an enormous mistake to focus on de-accumulation of assets at the expense of issues that are arguably more important—in particular, the need to increase retirement savings.

III. CFP Board Supports Efforts to Help Americans Live Within Their Means and Save More for Retirement

There are a number of significant challenges that limit Americans' ability to achieve adequate retirement security. CFP Board recently conducted a survey of CFP® professionals in which it asked about five factors that can challenge an individual's ability to achieve adequate retirement security. Notably, the most significant challenges identified were inadequate retirement savings, living beyond one's means, and longevity risk.

Factor	% of Survey Respondents Indicating that the Factor is a "Significant Challenge"
Inadequate retirement savings	88%
Living beyond one's means	64%
Longevity risk	63%
Individuals retiring too early	38%
Unforeseeable expenses	36%

The fact that inadequate retirement savings and living beyond one's means were classified as significant challenges by the greatest percentage of survey respondents should not be surprising. A 2007 Government Accountability Office (GAO) report found that the total median account balance in 2004 for workers age 60 to 64 was only $60,600.[1] More recent data from the Employee Benefits Research Institute (EBRI) indicate that the average American worker continues to have far too little retirement savings. In fact, 54% of workers surveyed as part of EBRI's 2010 Retirement Confidence Survey (RCS) reported "that the total value of their household's savings and investments, excluding the value of their primary home and any defined benefit plans, is *less than $25,000*."[2] Further, 27% of workers (up from 20% in 2009) reported having virtually no savings and investments, with "less than $1,000 in savings."[3]

Thankfully, history has demonstrated that rules can be established at the federal level to help change individual savings behavior in positive ways. Perhaps the best and most recent example of this is with respect to the use of automatic enrollment and automatic increase (collectively, auto-enroll) in connection with employer-sponsored 401(k) plans.

Although auto-enroll was used by some employers prior to 2006, it was not until the enactment of the Pension Protection Act of 2006, which provided for an express safe harbor for qualifying auto-enroll arrangements, that we saw employers adopt such arrangements in meaningful numbers. In fact, data from GAO indicate that as of 2004, just 1% of American

---

[1] U.S. GOV'T ACCOUNTABILITY OFFICE, PRIVATE PENSIONS: LOW DEFINED CONTRIBUTION PLAN SAVINGS MAY POSE CHALLENGES TO RETIREMENT SECURITY, ESPECIALLY FOR MANY LOW-INCOME WORKERS 16 (Nov. 2007) [hereinafter 2007 GAO REPORT].

[2] Ruth Helman et al., *The 2010 Retirement Confidence Survey: Confidence Stabilizing, but Preparations Continue to Erode*, EBRI ISSUE BRIEF, No. 340, March 2010, at 15, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_03-2010_No340_RCS.pdf (emphasis added).

[3] *Id.*

employers used auto-enroll in connection with their 401(k) plans.[4] By 2009, the percentage of American employers using auto-enroll increased to 19%, with even higher rates of adoption among large plan sponsors.[5] Moreover, all available data indicate that auto-enroll has been very successful in helping Americans save more for retirement. Recent analysis by EBRI found that automatic enrollment is very likely to result in significantly increased 401(k) plan accumulations, especially for low-income workers.[6]

Partly in response to the success of auto-enroll, several related ideas have recently been put forth by stakeholders to assist the average American in saving more for retirement. These ideas include, among others, the establishment of auto-IRAs and mandatory auto-enroll in connection with 401(k) plans. Some have also suggested increasing the scope and amount of the Saver's Credit. CFP Board is generally supportive of establishing new rules that help Americans save more for their retirement. CFP Board encourages Congress to continue to use its legislative authority to establish rules that help increase Americans' savings rates because such rules are likely to have the greatest positive effect on Americans' ability to achieve adequate retirement security.

IV. **Further Study Is Needed Regarding the Use of Annuities in Retirement Plans**

There is no consensus in the financial planning community over the use of annuities in retirement planning. Many CFP® professionals view annuities as important elements in the retirement planning toolbox, and use a wide range of annuity products in retirement planning. However, other CFP® professionals never or rarely recommend annuities because of a number of structural barriers that make annuities less attractive than other options for managing longevity risk, such as a program of systematic withdrawals from retirement savings. Given this lack of consensus, CFP Board believes significant study of the issue is necessary before any legislative or administrative changes are made to facilitate the inclusion of lifetime income options in retirement plans. Specifically, CFP Board opposes proposals to require mandatory or default annuitization, and is skeptical of proposals to require annuities as plan options. To the extent changes are made, care must be taken to preserve important participant protections, including fiduciary oversight in employer-maintained plans.

There is, however, some common ground. CFP® professionals generally agree that there is a pressing need for greater sensitivity to longevity risk and the importance of careful retirement planning. CFP Board strongly supports efforts to educate all Americans about the need to plan for retirement, and believes that greater transparency and disclosure in annuity pricing and fees would be helpful.

---

[4] U.S. GOV'T ACCOUNTABILITY OFFICE, RETIREMENT SAVINGS: AUTOMATIC ENROLLMENT SHOWS PROMISE FOR SOME WORKERS, BUT PROPOSALS TO BROADEN RETIREMENT SAVINGS FOR OTHER WORKERS COULD FACE CHALLENGES 14 (OCT. 2009).

[5] *Id.*

[6] Jack VanDerhei, *The Impact of Automatic Enrollment in 401(k) Plans on Future Retirement Accumulations: A Simulation Study Based on Plan Design Modifications of Large Plan Sponsors*, EBRI ISSUE BRIEF, No. 341, Apr. 2010, at 5, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_04-2010_No341_Auto-Enrl.pdf.

A. CFP Board Does Not Support Mandatory or Default Annuitization

Annuities are unlikely to be a suitable option for all individuals in terms of managing longevity risk. Through careful planning, individuals can often manage longevity risk without the use of commercial annuities. For example, individuals can manage their longevity risk through holistic retirement planning, including systematic withdrawals and an appropriate life style. In many instances, approaches to managing longevity risk that do not involve commercial annuities may be preferable because they may involve relatively lower fees and/or provide increased flexibility for individuals over the course of retirement. Over 60% of CFP® professionals recently surveyed agree that retirees have better alternatives to commercial annuities for purposes of managing their longevity risk.

For these reasons, and the reasons discussed throughout this letter, CFP Board does not support proposals that would require mandatory or default annuitization of defined contribution plan or IRA account balances, whether with respect to a participant's full account balance or some portion thereof. In fact, the vast majority of CFP® professionals surveyed oppose defaulting participants or IRA owners into annuities—over 90% do not believe retirement plan participants or IRA owners should be defaulted into annuities if they do not opt out of annuitization.

Another approach suggested by some would be to couple mandatory or default annuitization with a time-limited window (e.g., two years), during which an individual could opt out of an annuity. Although CFP Board does not support the use of mandatory or default annuitization, at a minimum, any allowance for default annuitization must provide individuals with the flexibility to opt out of an annuity. CFP Board is concerned that even a narrow, time-limited trial period is unlikely to provide much benefit to participants on the whole because unexpected life events can happen at any time following one's retirement. It may be many years before participants fully comprehend the downsides that can accompany the use of annuities—most notably, the inability to access retirement savings as needed to meet unexpected living expenses, such as unplanned medical, housing, or automotive expenses.

Others have suggested that plans should be required to include at least one annuity as a distribution option or as both an investment and distribution option. Although CFP Board generally supports initiatives that provide for enhanced participant choice, CFP Board believes that it is premature to mandate annuities as plan options, absent further study regarding how a plan sponsor can satisfy its fiduciary obligations in selecting an annuity option, particularly the fiduciary duty to ensure that the insurer will be able to make all payments due under the contract. Moreover, CFP Board believes that any such approach must preserve essential ERISA protections, while ensuring that smaller-size employers, who may have more limited resources, can comply with those rules. Otherwise, requiring plans to include at least one annuity as an investment or distribution option could have a chilling effect on the uptake and maintenance of defined contribution plan arrangements.

B. Annuities Can Be a Useful Tool to Minimize Longevity Risk

Annuities can be a very useful tool in helping some individuals to minimize the risk that they outlive their retirement savings. Annuities accomplish this in large part by providing a guaranteed stream of payments for some specified duration, typically life, and may or may not include similar payments for a surviving beneficiary, such as a surviving spouse or child. In a random survey of CFP® professionals, CFP Board found that approximately 71% of respondents at least occasionally recommend commercial annuities when helping people plan for retirement.

CFP® professionals use annuities in a variety of ways. Some recommend the use of immediate fixed life annuities to cover a portion of expected fixed expenses while leaving other savings available for unexpected expenses and supplemental income. Others use variable annuity contracts with living benefits, such as guaranteed lifetime withdrawal benefits, to provide a hedge against both longevity risk and investment risk. Still others recommend longevity insurance, which pays a lifetime income stream only if a participant lives beyond a typical life expectancy, for example, by commencing payments only upon attainment of age 85.

Even for CFP® professionals who often recommend the use of annuity products, annuities are unlikely to be a realistic option for many individuals given that, on average, Americans have very limited retirement savings. As noted in the 2007 GAO report, the total median account balance in 2004 for workers with a current or former defined contribution plan (including rolled-over retirement funds) was only $22,800.[7] For workers age 55 to 64, the median account balance was $50,000,[8] and for workers age 60 to 64, the median account balance was $60,600.[9]

One rule of thumb in the current interest rate environment is that a 65-year-old individual can expect to receive as annualized annuity payments about 4 to 7% of the total amount annuitized. For example, a 65-year-old individual who converts the median defined contribution account balance of $60,600 to an annuity generally can only expect to receive monthly income of between $200 and $350. As this example demonstrates, unless an individual has substantial savings, annuitizing all or even some part of her account balance likely would deprive her of income necessary to meet essential daily living expenses. Thus, our sense is that annuities are more frequently used by participants with better-than-average savings, rather than individuals with low account balances that need assistance the most.

C. There Are a Number of Structural Barriers to the Use of Annuities

As we discuss below, annuities also have several structural barriers to their use—barriers that, in many instances, do not appear to lend themselves to easy solutions.

Inherent insolvency risk. One barrier to the increased use of annuities is that commercial annuities generally are subject to insolvency risk: the risk that the insurer will become insolvent and be unable to deliver the promised annuity payments. As recent history has demonstrated, insolvency risk should not be underestimated by the retirement plan participant or

[7] 2007 GAO REPORT, *supra* note 1, at 15.
[8] *Id.*
[9] *Id.* at 16.

financial planner, as even the largest and most well-capitalized insurers are not always safe from financial distress. Approximately 43% of CFP® professionals surveyed believe that insolvency risk is a significant or major contributing factor as to why individuals may forego annuities.

Unfortunately, there does not appear to be an easy solution to the issue of insurer insolvency risk. One approach CFP® professionals use to mitigate this risk is to counsel clients to spread their annuity purchase across several different providers. This has the effect of diversifying the insolvency risk across several providers and allowing the participant to maximize the applicable state insurance guarantees in the event of insolvency. Although this approach may be appropriate for individuals making significant investments in annuities, it is oftentimes unsuitable for individuals seeking relatively smaller investments in annuities. This approach is likely to have limited application given the relatively low level of retirement savings of the average American worker. In fact, this may present a riskier option where the person does not have the funds to diversify annuities. Short of establishing federal guarantees with respect to promised annuity payments similar to those provided by the Pension Benefit Guaranty Corporation (PBGC) with respect to accrued pension benefits—which likely would be very complicated and involve a significant outlay of public funds—there may be no good solutions to the risk of provider insolvency.

Market volatility and interest rate risk. Another structural barrier to annuitization is that commercial annuities generally are subject to market volatility and interest rate risk. Market volatility refers to the fact that a participant's ability to purchase more or less annuity can vary depending on the extent to which her retirement plan contributions have appreciated or depreciated as of the time she chooses to retire and invest in an annuity. Interest rate risk, which is closely related to market volatility, refers to the fact that a participant's guaranteed annuity payment may be more or less depending on prevailing interest rates at the time of a participant's retirement. These risks can significantly affect the amount of guaranteed annuity payments a given individual receives post-retirement, regardless of how diligent and responsible one may be in saving for retirement. Evidence of this is demonstrated most easily by reference to the market downturn that accompanied the recent financial crisis.

Products are being developed that are meant to address market volatility and interest rate risk. One such product is a deferred fixed annuity contract that allows participants to purchase a lifetime income stream commencing at normal retirement age. Such an arrangement allows participants to lock-in current interest rates and mortality tables and purchase annuity income on a payroll deduction basis, thereby mitigating interest rate and mortality risk in much the same way that the practice of dollar cost averaging tends to average the unit cost of an investment over time. Another product, the variable annuity with living benefits, may also prove helpful in addressing market volatility and interest rate risk, as well as longevity risk. A variable annuity with living benefits essentially promises an annuitant a minimum monthly payment in the event of adverse changes to the annuitant's investment or the interest rate market by promising the greater of (i) a monthly benefit determined based on the actual investment performance of the annuitant's account, or (ii) a specified percentage (e.g., 5%) of a notional account balance.

Although these types of products are fairly new, it is CFP Board's understanding that some plan sponsors may be hesitant to include them in their defined contribution plans because of uncertainty regarding how ERISA's existing fiduciary duties apply to the consideration and selection of these products. Moreover, it is CFP Board's understanding that some plan sponsors may be hesitant to include annuities in their plans as investment options because of concerns regarding how the spousal consent rules apply to a participant's decision to invest in a deferred life annuity for purposes of asset accumulation only. Accordingly, CFP Board believes it is necesssary to consider whether existing rules regarding fiduciary oversight might be made clearer and more comprehensive to address the uncertainty surrounding the use of annuities in defined contribution plans. Additionally, CFP Board believes it is necessary to reexamine the extent to which existing spousal consent rules should apply to amounts invested in a deferred life annuity when used for investment purposes only.

CFP® professionals have developed several techniques to help minimize the risks associated with market volatility and interest rate fluctuations. One approach, known as "laddering," has an individual purchase annuities over an extended period of time, such as by payroll deduction over her working life. This has the effect of mitigating the risk of purchasing one annuity at a time when interest rates or mortality tables are particularly unfavorable, or at a time when market performance has reduced a participant's account balance, and thus reduced the amount of annuity that the participant can purchase. Although approaches such as laddering can help reduce the inherent risks associated with market volatility and interest rate fluctuations, they may have little utility where the individual has limited resources or funds. Additionally, they may have little appeal for employers, plan sponsors, and participants because of the cost of implementing them.

Generally irrevocable in nature. Once an individual elects to annuitize her defined contribution plan account balance or IRA, she cannot change her mind. On the one hand, this can be quite positive in that it provides for an unchanging and guaranteed stream of payments that can be relied upon by the annuitant for the duration of her life. On the other hand, this can be a significant drawback if an annuitant incurs unexpected or catastrophic expenses, such as unexpected medical, housing, or automotive expenses. Notwithstanding annuities' potential benefits in managing longevity risk, many individuals choose not to elect an annuity in the first instance because they are unable or otherwise unwilling to be locked into a distribution form that does not take into account life's unintended events—events that while unexpected for any given individual are almost certain to happen to all persons at some time over the course of retirement. Of CFP® professionals surveyed, approximately 92% identified the irrevocable nature of an individual's decision to annuitize as a significant or major contributing factor as to why many individuals forego annuitization. Moreover, of all of the factors that CFP Board polled on, irrevocability was identified by the most respondents (approximately 52%) as a major contributing factor as to why many folks avoid annuities.

No, or costly, death benefits. Another structural barrier to the use of annuities is that many annuities do not provide for contingent benefits in the event of an annuitant's death (i.e., death benefits). The absence of death benefits can be a significant stumbling block for many individuals in choosing to annuitize their defined contribution plan benefits. This is especially so where 401(k) plan benefits are at issue because such individuals often are uncomfortable with the notion that if they annuitize some or all of their plan benefits and die before reaching average life expectancy, the annuity provider generally is not required to provide any death benefits.

To address this issue, many annuity providers now allow annuitants to purchase death benefits at an additional cost to the annuitant. This additional cost often takes the form of a reduced monthly annuity payment. Unfortunately, given the relatively low retirement savings of the average American worker and the relatively low monthly annuity payment that necessarily follows, most individuals cannot afford to receive the lesser monthly payments that would accompany the purchase of death benefits.

Consumer confusion. Finally, for many Americans, annuities can be very confusing and hard to understand. Approximately 84% of CFP® professionals surveyed agree that a lack of knowledge of annuities and how they work by plan participants and IRA owners is a significant or major contributing factor to the current low rates of annuitization. In fact, over half of the respondents identified such lack of knowledge of annuities as a major contributor to low usage rates.

One reason annuities are so confusing to so many Americans is that there are a myriad of commercial annuities available in the marketplace, along with other products that provide a guaranteed stream of income for some specified period of time. For many individuals, these products can seem overly complicated and hard to differentiate. As a result, many individuals confronted with the decision to annuitize their benefit may decide to forego an annuity in favor of more easily understood and familiar distribution options, such as rolling over defined contribution plan assets to an IRA from which they can then take periodic distributions to meet living and other unanticipated expenses.

One way of addressing consumer confusion, which CFP Board strongly supports, is to facilitate increased consumer education regarding annuities and how they work. Additionally, education at the participant level could go a long way in helping individuals better appreciate both the advantages and disadvantages associated with using annuities to manage longevity risk.

D. CFP Board Supports Increased Participant-Level Education and Fee Disclosure Regarding Annuities and Lifetime Income Options

CFP Board strongly supports increased participant-level education regarding longevity risk and retirement planning generally. A 2010 study by EBRI makes clear that many individuals have little comprehension of longevity risk and how much money they need to save for retirement. Specifically, as part of its 2010 RCS, EBRI found that "[m]any workers continue to be unaware of how much they need to save for retirement."[10] In fact, "[l]ess than half of workers (46 percent) report they and/or their spouse have tried to calculate how much money they will need to have saved by the time they retire so that they can live comfortably in retirement."[11] Of those workers who performed a retirement needs calculation, 44% "determined the amount they needed to save *by guessing*."[12] Perhaps most significantly, data from the 2010 RCS indicate that "the retirement savings calculation appears to be a particularly

---

[10] Helman et al., *supra* note 2, at 22.
[11] *Id.*
[12] *Id.* (emphasis added).

effective tool for changing retirement planning behavior."[13] More specifically, EBRI found that 44% of workers who calculated a retirement goal amount in connection with the 2008 RCS report having made changes to their retirement planning as a result, with 59% reporting that they have started saving more for retirement.[14]

These findings clearly demonstrate that many American workers currently lack sufficient knowledge regarding longevity risk and the costs associated with retirement generally. They also indicate that individual savings rates can be positively affected merely through increasing an individual's awareness of his own retirement needs. Accordingly, CFP Board believes steps should be taken to facilitate increased participant-level education regarding longevity risk and de-accumulation generally.

CFP Board recognizes that individuals will continue to invest in commercial annuities as a way to manage longevity risk. Thus, CFP Board is hopeful that any initiative to increase participant-level education would include increased participant understanding of annuities, not only as an option for managing longevity risk but also with respect to how annuities operate generally. Over 84% of CFP® professionals surveyed agree that participants in retirement plans or IRAs need greater access to and knowledge of fees and other essential features of annuities.

CFP Board also believes increased transparency regarding the fees associated with commercial annuities and other lifetime income options is necessary. As discussed above, many individuals are confounded by the annuity options available in the marketplace, including the amount and nature of fees associated with the purchase of annuities. For example, just because an annuity may cost less from one annuity provider than from another provider does not necessarily mean that a participant is better off with the lower-cost annuity. The reduced cost could be the result of numerous factors, such as the absence of contingent benefits or the fact that the provider is subject to increased insolvency risk. Only through increased disclosure of fees and related participant-level education can participants be confident that they are in fact making the correct choice in choosing a commercial annuity or other lifetime income option when planning for the spend-down phase of retirement.

V. Target Date Funds Should Be Subject to Greater Scrutiny and Oversight[15]

Much of the debate regarding target date funds involves whether a target date fund's glide path should be designed to change "to" or "through" the target date, with many arguing that a fund's glide path should continue to change through the target date. CFP Board believes, given the reasonable expectations created by the name and marketing of the fund, that a target date fund's glide path should be designed to change "to" the target date. First, investors understand the target date in a fund's name to mean the date at which they expect to access the savings in the fund. The focus on a "to" or "through" determination should focus on investor expectations and not on the desires of fund managers. Second, target date funds are marketed as "cruise control" retirement savings tools that will meet the investor's retirement goals at the target date.

---

[13] *Id.* at 25.

[14] *Id.*

[15] CFP Board previously submitted a statement as part of the record for the Special Committee on Aging hearing on October 28, 2009, titled "Default Nation: Are 401(k) Target Date Funds Missing the Mark?"

However, these marketing materials do not clearly explain that investment decisions by the fund managers often take into account factors beyond the retirement date, including other investments, time horizon, and risk aversion, and thus continue an aggressive investment strategy past the target date. Finally, the name of the fund is the most important consideration to investors as even if they read and comprehend disclosure materials, no amount of disclosure can override the misleading nature of a target date fund's name.

The use of a target date in a fund's name carries with it a generally understood message to investors. For example, the name "Target Date 2010" says to the investor: "This fund will invest in an appropriate mix of investments for someone retiring around the year 2010."[16] The use of the year 2010 in the name of the fund implies that, by 2010, the fund will contain an asset allocation of equity and fixed-income investments that will be subject to relatively low market volatility and will provide the investor with ready access to cash assets. In contrast, a Target Date 2050 Fund would be expected to contain an allocation of equity and fixed-income investments that would subject the fund to substantially more risk, which is necessary to allow for growth in the fund over time that will, at a minimum, outpace inflation.

The asset allocations in target date funds should reflect the anticipated timeframe in which the investor will need to access those funds. Yet target dates are being used to label funds that have combinations of investments that are well outside expected, generally accepted asset allocations for the targeted investor. In fact, as Securities and Exchange Commission (SEC) Chairman Mary Schapiro has recognized, target date funds are subject to widely varying strategies among fund managers, with 2010 target date funds ranging in performance from minus 3.6% to minus 41% in 2008.[17] A loss of up to 41% of assets from a fund labeled 2010 is completely inconsistent with an investor's reasonable expectation that his or her assets would not be subject to such high market volatility. We recognize that less than one year later, these losses have been partially recovered as the market has rebounded from historic losses. However, this type of volatility—losses of up to 41% one year followed by gains of up to 30% the following year—is exactly what target date funds are supposed to avoid as the target date approaches.

Target date funds are marketed as "auto pilot" or "cruise control" investments pegged to an investor's expected retirement date. By their very name, they create a reasonable expectation that such a fund will have sufficiently reduced volatility and its assets will be available for the investor's use as of the target date. Target date funds are not the appropriate vehicles for implementing aggressive retirement investment strategies for those nearing retirement. Inappropriate asset allocations in target date funds affect not only 401(k) plans, but also 529 plans. As with target date funds, the asset allocations in 529 plans should reflect the anticipated timeframe in which the investor will need to access those funds. To go one step further, as Chairman Schapiro recognized, "A target date fund underlying a college investment or so-called 529 plan . . . would need to more closely track its target date since it is far more likely that investors would need access to their investment at or near the fund's target date."[18]

---

[16] Letter from Fund Democracy & Consumer Federation of America to Mary Schapiro, Chairman, Securities and Exchange Commission (Apr. 7, 2009) (on file with author).
[17] Mary L. Schapiro, Chairman, Securities and Exchange Commission, Address to Mutual Fund Directors Forum Ninth Annual Policy Conference: Critical Issues for Investment Company Directors (May 4, 2009).
[18] *Id.*

It is not an answer to say that misleading fund names can be cured with effective disclosures. Appropriate disclosures must be required and provided; but we must recognize, in determining appropriate investor protections, the reality that disclosures are very often not read and more often not fully understood. Despite our ongoing education and efforts to engage consumers in reading disclosures, CFP Board continues to hear from CFP® professionals who explain that their clients do not want to receive, let alone read, disclosure documents. Under current rules, a Target Date 2010 Fund could have an 80% stock/20% fixed-income allocation as long as the fund's extremely aggressive investment objectives and strategies are disclosed in the fund's prospectus. We believe that this is fundamentally misleading to investors and that no amount of disclosure is adequate to counteract the reasonable expectations created by a fund's name.

CFP Board believes industry standards for asset allocations in target date funds can and should be established to protect investors. The SEC can and should take steps to strengthen its securities regulations to protect investors from the use of misleading target date fund names. In 2001, the SEC adopted a misleading fund names rule—Rule 35d-1—that defines four types of funds for which the name may be materially deceptive and misleading. Because of the latitude under the rule for fund managers to correct misleading fund titles through disclosures in the fund's prospectus, the rule has not been enforced as to target date funds in a manner that provides adequate investor protection. We believe the SEC should amend Rule 35d-1 to provide that a target date fund's name is materially deceptive and misleading unless the fund's investments fall within an acceptable range of asset allocations consistent with its name.

We recognize that there are differing viewpoints among investment professionals regarding the appropriate allocation of assets as investors approach retirement, and agree that some variation is entirely appropriate and that there is no such thing as a "perfect" allocation. Nevertheless, we believe that appropriate ranges of asset allocations, based on reasonably accepted industry practices, can be established for each date reflected in a target date fund. The goal would be to align target date funds' glide paths and asset allocations with investor expectations—namely that a target date fund's glide path is designed to change *to* the target date. Establishing industry standards for asset allocations in target date funds is a reasonable undertaking. A panel of experts in retirement planning and investment allocation could be established from the financial services industry, including experts in ERISA, registered investment advisers, and CFP® professionals. They could be tasked with developing a schedule that lists acceptable ranges for categories of investments that are consistent with reasonable industry practices for each date reflected in a target date fund. The ranges of allocations would identify acceptable industry parameters that would reduce the fund's exposure to market volatility consistent with the fund's target date.

Establishing acceptable ranges of asset allocations for target date funds is especially important given that target date funds qualify as qualified default investment alternatives, also known as QDIAs, under the Pension Protection Act of 2006. The fact that the federal government has qualified target date funds as QDIAs sends two important messages. First, it conveys to employers that the government believes that the allocations in target date funds are appropriate for individuals based on their expected date of retirement. Second, qualification of target dates funds as QDIAs conveys to employees that the government is making an appropriate investment decision on their behalf. The presumption of government approval leads many investors to assume that their retirement funds are invested in a fund designed to ensure their retirement security. Yet without additional government guidelines, many default target date funds have proven to have inappropriate asset allocations for individuals approaching retirement age.

We urge the Special Committee to encourage the SEC and Department of Labor to establish appropriate protections to ensure that target date funds can continue to be used as QDIAs with confidence that they reflect appropriate, industry-sanctioned investment decisions on behalf of plan participants. While we commend the SEC and the Department for the actions they have taken to enhance disclosures to investors in target date funds, enhancing disclosures is not the sole answer and more must be done.[19] In June of last year, we urged the Department to work with the SEC to put in place a process to develop accepted industry standards that would ensure that target date funds are not misleading to consumers on either extreme—too much cash for the young investor or too much equity for the investor near retirement. Should the SEC fail to move toward needed investor protections in the management of target date funds, we believe the Department should proceed on its own to regulate target date funds, or alternatively, should rescind such funds' eligibility as QDIAs.

VI. <u>CFP Board Encourages the Agencies to Use Their Rulemaking Authority to Change Existing Messaging Regarding Appropriate Retirement Age</u>

Another significant challenge to Americans achieving retirement security is the fact that a great many Americans retire from the workforce too soon. It is perhaps not surprising that Americans are living longer than ever before. In fact, "[f]or a healthy 65-year-old couple, there is a 67% chance that at least one of them will live to age 90 and a 38% chance that one will live to age 95."[20] Notwithstanding increased longevity, a significant percentage of Americans continue to retire in their 50s and 60s. In fact, recent data from EBRI indicate that nearly 52% of workers expect to retire permanently from the labor force prior to age 65.[21]

Why exactly do Americans retire too soon? The answer to this important question is undoubtedly very complicated. Nonetheless, one likely contributing factor is that existing federal laws send a strong message to Americans that they should or can retire at an age that may be far too young, especially based on an individual's productive abilities and amount of savings. Approximately 65% of CFP® professionals surveyed agree that current federal laws setting social security eligibility at age 65 and the default normal retirement age for tax-qualified plans at 55 or 62 encourage people to retire too early. Moreover, nearly 50% agree that current federal laws allowing penalty-free withdrawals from tax-qualified plans at age 55 and mandating required minimum distributions after an individual attains age 70 ½ encourage people to retire too early.

---

[19] *See* U.S. Department of Labor, EBSA Field Assistance Bulletin No. 2009-3 (Sept. 8, 2009), *available at* http://www.dol.gov/ebsa/regs/fab2009-3.html; Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546, 4564 (Jan. 26, 2009).
[20] Geoffrey Stiff, *When Your Client's Retirement Plan Is Washed Away, You Can Rebuild It*, ON WALL STREET (Dec. 1, 2009), *available at* http://www.onwallstreet.com/ows_issues/2009_12/when-your-clients-retirement-plan-is-washed-away-you-can-rebuild-it-2664635-1.html.
[21] *See* Helman et al., *supra* note 2, at 28.

Notwithstanding the slight divergence in results regarding the extent to which existing federal laws encourage people to retire too soon, there can be little doubt that all parties involved would be well served by a review of existing federal rules to determine if, and to what extent, those rules may in fact send a message to America's workers to retire too early. To the extent those rules do, in fact, encourage individuals to leave the workforce too soon, CFP Board believes Congress should consider what changes are necessary to ensure that individuals are not incorrectly sent the message that they should or can retire when in fact personal circumstances (such as accumulated retirement savings to date, retirement goals, expected longevity, and productivity) indicate the contrary.

The ramifications of sending a message that encourages individuals to retire too soon cannot be understated. Such messaging may encourage individuals to choose to retire without a full understanding of their own expected longevity and/or the potential inadequacy of their existing retirement savings. Individuals who then retire may not realize until some later date that they should have in fact worked longer or that they have insufficient retirement savings. Moreover, for individuals in their 50s and 60s, getting back into the workforce is often very difficult, if not impossible. Even if such individuals are fortunate enough to make their way back into the workforce, it is often at a much-reduced pay and/or with new employers that may subject them to waiting periods and/or vesting schedules with respect to employer-sponsored plans in which they may seek to participate.

CFP Board acknowledges that changing current federal rules regarding retirement may be very difficult and, in certain instances, very costly. Nonetheless, CFP Board believes that the first step on the path to ensuring retirement security for all Americans is to make sure that we as a society are sending the right messages about retirement savings and security. One cannot, and should not, underestimate the role played by federal laws in this regard.

VII. CFP Board Supports Efforts to Curb Abusive Practices by Financial Intermediaries, Especially Those Involving Elderly Americans

In 2009 and 2010, CFP Board surveyed CFP® professionals as to whether they knew or had been approached by a client or prospective client who had experienced fraud or abuse at the hands of a financial advisor. Around 59% of the nearly 4,000 CFP® professionals who responded to the survey knew a client or prospective client who had been abused by an advisor. Over 41% reported that such abuse involved individuals between 61 and 75 years old—indicating that senior citizens are the most likely target of financial abuse. CFP Board received almost 1,600 stories of abuse calling into question practices performed in the financial services industry.

Examples of the most frequent instances of abuse include:

- An elderly woman, who was easily confused and suffering from some memory loss, attended a financial seminar by an individual calling himself a financial planner and was convinced to transfer all of her investments into annuities without being told that she would be unable to access the funds for many years except under heavy penalties.

- An 80-year-old married man, with an estate estimated at $500,000, was sold an equity indexed annuity with a 17-year surrender period, leaving him unable to withdraw the funds without paying heavy penalties.

- An 87-year-old widow was convinced by an insurance agent/securities broker to sell her husband's blue chip stocks and buy a $400,000 cash value life insurance policy and place the remaining proceeds in a trust that the insurance agent/securities broker controlled. The insurance agent/securities broker made loans out of the trust to himself and friends, leaving it virtually empty.

- A client's tax preparer, who claimed to be a financial adviser, tried to convince the client that he should borrow against his home and invest the proceeds into a variable annuity sold by the tax preparer.

- An individual calling himself a financial planner conducted a Ponzi scheme, convincing clients that their money "can't lose" through several investment vehicles. The money was never invested in anything.

Curbing abusive practices by financial intermediaries, especially those involving elderly Americans, is essential to enhancing the ability of all Americans to enjoy a comfortable retirement. CFP Board looks forward to working with the Special Committee on ways to address this issue.

VIII. <u>Conclusion</u>

CFP Board appreciates the opportunity to provide this statement to the Special Committee on Aging. If you should have any questions regarding CFP Board, the financial planners it certifies, or the CFP® marks, please contact Marilyn Mohrman-Gillis, Managing Director of Public Policy and Communications, at 202-379-2235, or visit CFP Board's Web site at www.CFP.net.

Testimony of
Amy Matsui, Senior Counsel,
National Women's Law Center
Senate Special Committee on Aging
June 16, 2010

This testimony is submitted by the National Women's Law Center on behalf of the American Association of University Women, the National Consumers League, the National Organization for Women (NOW), OWL (the Older Women's League), and the Pension Rights Center: all nonprofit, nonpartisan public policy organizations committed to promoting women's retirement security. The undersigned commend Chairman Kohl for making women's retirement security a priority of the Senate Special Committee on Aging and appreciate the opportunity to submit written testimony for the Committee's hearing on expanded access to lifetime income payments.

Summary

In brief, this testimony will explain why ensuring access to a stream of lifetime income is especially important to women. This Committee has already explored options for strengthening Social Security, the foundation of women's economic security in retirement. In this testimony we focus on the importance of lifetime income for women's retirement security, and recommend a number of policy changes to improve access to lifetime income from employer-sponsored retirement plans and from Individual Retirement Accounts (IRAs).

The Importance of a Stream of Lifetime Income to Women's Retirement Security

Recent losses in the stock market and poor economic conditions underscore that many U.S. workers are at risk of not having an adequate income in retirement, as this Committee's earlier hearings have highlighted. Even before the current economic recession, research indicated that retirement savings are likely to be inadequate for many Americans, particularly women. While there is a substantial gender gap in all sources of retirement income, the disparity between women's and men's pension income is especially pronounced and exists in levels of retirement plan participation, pension benefits, and defined contribution account accumulations. This gender gap in retirement income is largely attributable to women's experience in the labor force: women spend fewer years in the workforce, are more likely to work in part-time employment, and historically earn less than their male counterparts. Unfortunately, women need more, not fewer, retirement savings than men, because they are likely to live longer than men and spend more years living alone. In 2008, almost 12 percent of women 65 and older lived in poverty, compared to 6.7 percent of men 65 and older. The risk of poverty is particularly high for older women living alone. Women 65 and older living alone had a poverty rate of 18.9 percent, compared to 12.4 percent for men 65 and older living alone.[1]

The continuing shift from defined benefit to defined contribution plans has exacerbated the challenges women face in securing adequate retirement income. Over the last two decades,

[1] NWLC calculations based on U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplement (2009) (using CPS Table Creator, *available at* http://www.census.gov/hhes/www/cpstc/cps_table_creator.html).

much of the risk and burden of financing retirement has shifted from employers to employees as coverage has moved away from traditional defined benefit (DB) plans, in which workers typically accrue monthly benefits based on years of service and earnings, in favor of defined contribution (DC) plans, in which participants accumulate balances in self-directed individual accounts, such as 401(k)s. Across the board, DC plan balances are typically inadequate for a secure retirement, and this is especially pronounced for women. One study found that the median female worker near retirement with a DC plan or IRA held $34,000 in her retirement accounts while her male counterpart held $70,000 in 2004.[2]

Moreover, the very structure of these plans, in which workers bear responsibility for the investment decisions, poses risks for all workers. In DC plans, workers are responsible for allocating their funds among a range of options and individually bear the investment risks. If investments do not perform as well as expected, workers will have less money in their DC plans to provide income in retirement.

In addition, the fact that most workers, including women, do not spend their careers in a single job has additional negative implications for women. When a worker leaves a job, he or she can leave any retirement savings accrued in an employer's DC plan with the employer, as long as the account balance is above a certain minimum level. However, workers leaving jobs often take distributions from their DC plans – either withdrawing the savings (often subject to a tax penalty if they have not reached retirement age) or rolling the savings over into another tax-qualified retirement savings vehicle (such as another employer-sponsored DC plan or an individual retirement account). Women, however, are less likely than men to roll over a "lump-sum" payment when leaving a job.[3] Twenty-seven percent of men compared with 23 percent of women re-invested their lump sum in one of these other savings vehicles.[4] This reduces women's already lower retirement savings.

Likewise, because DC plans like 401(k)s typically pay out in lump sums as opposed to annuities, workers bear the risk of managing their account balances so they can provide additional support over their lifetimes and, for many, the lifetime of a surviving spouse. This "longevity risk"—in which a retiree may live longer than expected and thus exhaust his or her retirement savings—is especially manifest for women. Because women on average live longer than men, their 401(k) balances must be able to produce an income stream over a longer stretch of time. A woman whose 401(k) plan does not offer an annuity option but who wishes to ensure lifetime income currently can use her 401(k) balance to purchase an annuity from a private insurance company. Small annuities purchased on the open market, however, are generally burdened by high fees and low effective rates of return, which can reduce their attractiveness notwithstanding the value of a lifetime stream of income. Women, in addition, generally face the disadvantage of having to purchase annuity products from insurance companies that are priced using gender-distinct

---

[2] Leslie E. Papke, Lina Walker, & Michael Dworsky, The Retirement Security Project, Retirement Security for Women: Progress to Date and Policies for Tomorrow 4 tbl.1 (2008), *available at* http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Retirement_security/RSP-PB_Women_FINAL_4.2.2008.pdf.

[3] Moreover, women also lag behind men in re-investing the funds in other savings vehicles such as savings accounts, stocks, bonds, or the purchase of a home.

[4] Lois Shaw & Catherine Hill, Inst. for Women's Policy Research, The Gender Gap in Pension Coverage: What Does the Future Hold?, at 8 (2002), *available at* http://www.iwpr.org/pdf/d447.pdf.

mortality tables (in contrast, defined benefit and money purchase plan annuities are calculated without regard to gender, as required by Title VII of the Civil Rights Act of 1964). This can amount to an appreciable decrease in retirement income.

Social Security benefits, which are lifelong, inflation-adjusted, and virtually universal, are therefore the foundation for women's retirement security. Accordingly, the undersigned commend this Committee's work to research and evaluate options to strengthen Social Security with regard to solvency and benefit adequacy, particularly for vulnerable populations. But while protecting and strengthening Social Security is critical for ensuring women a secure basic benefit, Social Security benefits were not designed to be the sole source of income in retirement. Thus, women would generally benefit by increasing their ability to receive distributions from their retirement savings accounts as lifetime income payments, whether in the context of the employer-based retirement system or in savings accounts such as individual retirement accounts (IRAs), to supplement Social Security and bring them closer to achieving a secure retirement.

Accordingly, in order to increase access to lifetime income options, especially for women, the undersigned recommend that (1) employer-sponsored defined contribution plans be required to offer lifetime income options; (2) the spousal protections that currently attach when married participants in defined contribution plans select life annuities be maintained; (3) plan administrators be required to accept rollovers from qualified retirement savings accounts; and (4) significant policy changes related to the sale of annuity products by insurance companies be considered.

Proposals to Increase Access to Lifetime Income Options From Employer-Based Retirement Savings Accounts

Most Americans who save for retirement do so through the employer-based retirement system. Yet, participation in the employer-based retirement savings system is far from universal. Only half of workers have access to retirement savings plans through their employers.[5] And only 40 percent of women participate in an employer-based retirement savings plan.[6]

As mentioned above, defined benefit pension plans, which pay benefits in the form of a life annuity (or, for married participants whose spouses did not waive this option, joint-and-survivor annuities), predominated in the employer-based retirement system for many years. Increasingly, however, employers offer defined contribution plans such as 401(k)s or 403(b)s. Few 401(k) plans offer options for participants to receive some or all distributions in the form of lifetime income payments,[7] and most participants in 403(b) plans elect to receive lump-sum payments.

Require Lifetime Income Option

[5] In 2008, 50.6% of all workers worked for an employer that sponsored a retirement plan, and 40.4% of all workers participated in a retirement plan. Craig Copeland, Employee Benefit Research Inst., Issue Brief No. 336, Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2008, at 8 fig.1 (2009), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_11-2009_No336_Ret-Part.pdf.
[6] Copeland, *supra* note 5, at 9 fig.2.
[7] In 2008, only 14% of surveyed employers that offered a 401(k) plan offered an annuity option to participants. Hewitt Assocs., Research Highlights: Trends and Experience in 401(k) Plans 7 (2009), *available at* http://www.retirementmadesimpler.org/Library/Hewitt_Research_Trends_in_401k_Highlights.pdf.

Increasing the availability of lifetime income options from employer-sponsored DC plans would benefit women. There are distinct advantages to lifetime income payment options offered through employer-sponsored plans, as compared to annuities purchased from a private insurance company (the lifetime income option available to IRA owners or participants in 401(k)s that do not offer annuity options). First, as mentioned above, women generally face higher prices than men when purchasing annuities outside an employer-sponsored plan, on the open market. For example, one online annuity quote generator estimates that a 64-year-old female in Wisconsin purchasing an annuity with $50,000 would receive a monthly payment of $284, whereas a 64-year-old male in Wisconsin purchasing an annuity with the same amount would receive a monthly payment of $310—a difference of 9.2%.[8] But federal law prohibits employers from requiring women to pay more than men for annuities offered through employer-based retirement savings plans.[9] In addition, employer-based retirement savings plans may be able to negotiate lower fees overall, premised on a group rate—which is particularly important for workers with lower account balances (who are disproportionately women). Further, it is to be hoped that as increasing numbers of participants in employer-sponsored plans select annuities, costs (and risk) could be spread out and the price of annuities would drop further.

In addition, small employers, as well as low- and moderate-income workers, could benefit from the creation of low-cost, reliable, inflation-adjusted alternative annuity products, as discussed below in connection with increasing lifetime income options from individual retirement accounts. Thus, we would strongly recommend that 401(k) and other employer-based DC plans be required to offer a lifetime income option. Gender-neutral pricing should be mandated, as under current law.

We recognize that account balances below a certain amount present administrative burdens and are unlikely to result in meaningful lifetime income payments. Yet in our experience, even relatively small amounts of dependable lifetime income can be significant for low- and moderate-income workers. In addition, DB plans and the federal Thrift Savings Plan contemplate very small monthly payments—DB plans must annuitize benefits with a present value in excess of $5,000,[10] and the Federal Thrift Savings Plan must do so for account balances above $3,500.[11] A participant should thus be given the option of receiving his or her account balance (or portion of the account balance) amount as an annuity, so long as the amount to be annuitized at least equals some commensurate minimum threshold.

---

[8] ImmediateAnnuities.com, Instant Annuity Calculator, www.immediateannuities.com (search run by NWLC June 10, 2010).

[9] Equal Employment Opportunity Comm'n, Compliance Manual, Chapter 3: Employee Benefits, Title VII/EPA Issues, II(A) (2000) ("Although women as a class generally live longer than men, Title VII requires that each woman -- and each man -- be treated as an individual. As a result, employers may not use sex-based actuarial tables -- which rely on generalizations about women's and men's life expectancies -- to calculate . . . the amounts that it will charge its male and female employees for those benefits.") (citing *Arizona Governing Committee v. Norris*, 463 U.S. 1073 (1983); *Los Angeles Dep't of Water and Power v. Manhart*, 435 U.S. 702 (1978)), *available at* http://archive.eeoc.gov/policy/docs/benefits.html.

[10] 26 U.S.C. § 411(a)(11).

[11] 5 U.S.C. § 8435(g).

We also recognize that even when employers offer lifetime income options from their DC plans, an unfortunately small percentage of employees selects such options.[12] Commentators and policymakers have raised various reasons for which many individuals, including women, may select lump sums rather than a lifetime income stream.[13] In addition, although workers understand that traditional DB pensions provide a lifetime income stream, few workers conceptualize their DC plan balances in terms of a lifetime stream of income.[14] Consequently, lifetime income options should be offered in conjunction with significant educational efforts for plan participants. For example, one study indicated that when individuals were asked whether they preferred an annuity or an actuarily equivalent lump sum, 41% of respondents preferred the annuity.[15] Thus, providing participants with benefit statements that estimate the annuity that could be purchased with the existing account balance, as proposed by the Lifetime Income Disclosure Act,[16] introduced by Senators Bingaman, Isakson, and Kohl, could help prepare the workforce to think of their retirement savings in terms of lifetime income. Pilot projects with intensive education efforts also may prove effective.

If the lifetime income option were made the default form of benefit, the percentage of individuals selecting lifetime income options would likely increase. However, while the potential for lifetime income is significant, the fact that the purchase of an annuity cannot be easily unraveled, if at all, means that careful consideration must be given to when, and how, annuities might be made a default option. Recent changes to the law that permit employers to automatically enroll eligible employees in DC plans, giving employees the option to opt out,[17] have been demonstrated to significantly increase participation.[18] Established and effective participant education and possibly a trial period[19] would be important to consider.

Spousal Protections

In addition, lifetime income options offered through employer-based retirement plans would benefit women because they would trigger important spousal protections.

---

[12] In 2009, only 1% of retirees who were offered an annuity option in their DC plan elected elected that option. Ken McDonnell, *Retirement Annuity and Employment-Based Pension Income, Among Individuals Age 50 and Over: 2008*, EBRI Notes (Employee Benefit Research Inst., Washington, D.C.), May 2010, at 17, *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_05-May10.IAs.pdf (citing 2009 data from Hewitt Associates).

[13] *See generally, e.g.*, U.S. Gen. Accounting Office, GAO-10-632R, Retirement Income: Challenges for Ensuring Income Throughout Retirement 9–10 (2010) (citing the fact that putting all income in an annuity does not leave liquid cash to address "large unplanned expenses" in retirement and that some retirees plan to leave bequests to heirs as reasons that retirees may put only some assets into an annuity, or not select an annuity at all), *available at* http://www.gao.gov/new.items/d10632r.pdf.

[14] *See id.* at 10.

[15] *See id.*

[16] S. 2832, 111th Cong. (2009).

[17] *See* Pension Protection Act of 2006, Pub. L. No. 109–280, § 902, 120 Stat. 780, 1033 (codified at 26 U.S.C. 401(k)(13) (West, Westlaw through P.L. 111–174)).

[18] Jack VanDerhei, Employee Benefit Research Inst., Issue Brief No. 341, The Impact of Automatic Enrollment in 401(k) Plans on Future Retirement Accumulations: A Simulation Study Based on Plan Design Modifications of Large Plan Sponsors 5 (2010), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_04-2010_No341_Auto-Enrl.pdf.

[19] *See, e.g.*, William G. Gale et al., The Retirement Security Project, Increasing Annuitization in 401(k) Plans with Automatic Trial Income 12 (2008), *available at* http://www.brookings.edu/~/media/Files/rc/papers/2008/06_annuities_gale/06_annuities_gale.pdf.

Women have fewer retirement assets than men, and more women rely on their spouses' pensions than men.[20] And among widowed spouses, 21 percent of widows compared to just 5 percent of widowers receive pension benefits based on the pension of a deceased spouse.[21] Spousal protections in retirement savings are therefore extremely important for women as demonstrated by studies conducted after Congress passed the Retirement Equity Act of 1984 (REA).[22] The REA made a lifetime annuity with a survivor annuity for a spouse the default form of benefit from DB pension plans for married workers.[23] Following the enactment of the REA, the number of married men who provided a survivor annuity for their spouses increased 15 percent, ensuring a more secure retirement for many more widows.[24]

However, as discussed above, DB plans have been increasingly supplanted by retirement savings plans such as 401(k)s. Most participants in DC plans take distributions of their benefits in the form of a lump sum at retirement, or roll their account balances over into another tax-qualified retirement savings plan when they change jobs prior to retiring. But no spousal protections are available to the spouses of married participants who do so, meaning that the participant can make the decision to take a lump-sum or rollover distribution without any input from the spouse.[25] In contrast, under current law, if a 401(k) or similar DC plan offers annuities and a married participant selects an annuity, spousal protections equivalent to those in DB plans apply: the participant must choose a lifetime annuity with a survivor annuity of at least 50 percent for a spouse, unless the spouse waives the survivor benefit.[26] Thus, when DC plans offer annuity options, important spousal protections are triggered.

Because of the importance of robust spousal protections for lifetime payments from retirement savings, lifetime income options offered by DC plans should be limited to those that would fall within the statutory definition of annuity.[27] Second, the spousal protections that apply to annuities offered by DC plans under current law should be maintained. There should be no difference between spousal protections for lifetime income received from DC plans and that received from DB plans. This is particularly important because spousal protections have already been weakened by permitting spousal consent to be transmitted through electronic

---

[20] According to NWLC calculations based on the 1998 Health and Retirement Study, 87% of married women as opposed to 31% of married men relied on their partner's pension income.
[21] Pension & Welfare Benefits Admin., U.S. Dep't of Labor, Retirement Benefits of American Workers: New Findings from the September 1994 Current Population Survey tbl.D11 (1995), *available at* http://www.dol.gov/ebsa/programs/opr/redbook/d_11.htm.
[22] Retirement Equity Act of 1984, Pub. L. No. 98–397, 98 Stat. 1426.
[23] Pub. L. No. 98–397, § 103 (codified at 29 U.S.C. § 1055(a)–(b)).
[24] U.S. Gen. Accounting Office, GAO/HRD-92-49, Pensions Plans: Survivor Benefit Coverage for Wives Increased After 1984 Pension Law 7 (1992) (examining data from 1984–1989), *available at* http://archive.gao.gov/t2pbat6/146159.pdf.
[25] Some spousal protections do apply in 401(k) plans. Specifically, a participant in a 401(k) plan must obtain spousal consent before designating a beneficiary other than the spouse who would receive the account balance if the participant died while participating in the plan. 26 U.S.C. § 417(a)(2). This means, effectively, that a spouse is protected against having the 401(k) assets go to someone else if the participant dies while enrolled in the plan, but *not* against having the assets go to another beneficiary if the participant changes jobs and rolls over the 401(k) balance into an IRA.
[26] *See* 26 U.S.C. § 401(a)(11); Internal Revenue Service Publication 6391 Explanation No. 3, Joint and Survivor Determination of Qualification 3 (2009), *available at* http://www.irs.gov/pub/irs-pdf/p6391.pdf.
[27] We believe that this can be accomplished by regulation.

technologies.[28] Third, in the event that lifetime income options are made the default form of benefit, it should be clarified that a participant must obtain spousal consent not only to take a single life annuity, but also a lump sum or other form of benefit, as under the federal Thrift Savings Plan.[29]

Rollovers from Other Qualified Plans

There are several reasons for the limited ability of low- and moderate-income individuals to accumulate savings through an employer-sponsored DC plan. Although participants can contribute up to $16,500 per year under current law, few workers, especially low- and moderate-income workers, do so.[30] Tax incentives for retirement savings are skewed to higher earners,[31] disproportionately male. Among women making a contribution to a 401(k)-type plan in 2005, only 6 percent made the maximum contribution.[32]

Since the average worker has multiple jobs during his or her career,[33] he or she may have accumulated retirement savings with a number of employers. Under current law, workers with retirement savings in an employer-based plan can either keep the account balance in the employer's plan (if they have more than a minimum amount of savings), or roll the account balance into another tax-qualified retirement savings account—such as another defined contribution or defined benefit plan, if it accepts rollover contributions, or, more likely, an IRA.[34] Thus, as a worker nears retirement, he or she may have retirement savings in one or more employer-based retirement savings accounts, and/or in one or more IRAs.

---

[28] Commentators, including some of the organizations joining in this testimony, submitted that the use of electronic media to waive a survivor annuity presents authentication concerns, among other things. *See* Use of Electronic Media for Providing Employee Benefit Notices and Making Employee Benefit Elections and Consents, 71 Fed. Reg. 61,877, 61,882–83 (Oct. 20, 2006) *available at* http://edocket.access.gpo.gov/2006/pdf/E6-17528.pdf; 26 C.F.R. § 1.401(a)–21(d)(6) (2009), *available at* http://edocket.access.gpo.gov/cfr_2009/aprqtr/pdf/26cfr1.401(a)-21.pdf. Notwithstanding, a number of comments submitted by industry groups to the Departments of Labor and Treasury sought to further weaken spousal consent requirements by expanding the use of electronic technologies beyond what is currently permitted under current regulations of the Department of the Treasury. *See, e.g.*, American Council of Life Insurers, Response to Department of Labor RFI 17, May 3, 2010 ("[T]he use of electronic means of QJSA administration is needed to promote efficiencies and reduce costs.").

[29] 5 U.S.C. § 8435(a)(1). Again, the undersigned believe that this could be accomplished by regulation and that legislation would not be necessary.

[30] In 2005, only 1.3% of workers with a family income between $20,000 and $29,999 and making a contribution to a 401(k) type plan made the maximum contribution while 14.6% of those with incomes of $75,000 did so. Craig Copeland, *Ownership of Individual Retirement Accounts (IRAs) and 401(k)-Type Plans*, EBRI Notes (Employee Benefit Research Inst., Washington, D.C.), May 2008, at 6 fig.3, *available at* http://www.ebri.org/pdf/EBRI_Notes_05-2008.pdf. In 2010, individuals 50 and over can contribute a maximum of $22,000 a year.

[31] Eric J. Toder, Benjamin H. Harris, & Katherine Lim, Tax Policy Ctr., Distributional Effects of Tax Expenditures 17 (2009), *available at* http://www.taxpolicycenter.org/UploadedPDF/411922_expenditures.pdf.

[32] Copeland, *supra* note 30, at 6 fig.3. In comparison, 11.7% of men made the maximum contribution in 2005. *Id.*

[33] The average person born in the later years of the baby boom (individuals born from 1957 to 1964) held 10.8 jobs from age 18 to age 42. Press Release, Bureau of Labor Statistics, Number of Jobs Held, Labor Market Activity, and Earnings Growth Among the Youngest Baby Boomers: Results from a Longitudinal Survey (June 27, 2008), *available at* http://www.bls.gov/news.release/pdf/nlsoy.pdf.

[34] 26 U.S.C. § 408(d)(3)(A). Workers can also withdraw some or all of the account balance, subject to a tax penalty if they are not yet of retirement age. 26 U.S.C. § 72(t)(1).

Many women have saved enough throughout their careers to provide for a modest, but not insignificant, supplement to Social Security. In 2004, the median 401(k) and/or IRA account balance for women ages 55 to 64 was $34,000.[35] One annuity calculator estimated that a 64-year-old female in Wisconsin who purchased a fixed immediate single-life annuity with $34,000 from an insurance company could expect monthly annuity payments of $193.[36] Although it would be difficult to live off these monthly payments alone, they would provide an important boost to Social Security payments, which average about $1,000 per month.[37] Even such a modest annuity could allow many low- and moderate-income participants to feel more secure in their retirement.

Unfortunately, unless an individual could aggregate his or her accumulated retirement savings in the 401(k) account that offered a lifetime income payout, he or she would be unable to maximize his or her lifetime income payments. Under current law, a DC plan may, but is not required to, accept rollovers from other qualified retirement accounts.[38] We therefore recommend that plan administrators be required to accept such rollovers, to give low- and moderate-income workers an opportunity to receive larger lifetime income payments.[39]

Proposals to Increase Access to Lifetime Income Options From Individual Retirement Accounts (IRAs)

A significant amount of retirement assets are deposited in IRAs as rollovers from 401(k) or other DC accounts when individuals leave a job before retiring.[40] Individuals may have more assets with which to purchase lifetime income payments in an IRA than in their current 401(k) or other DC plan or plans.

But even if women have enough assets in an IRA to purchase an annuity that would meaningfully boost their retirement security, they face disadvantages when seeking to do so as individuals from insurance companies on the open market.[41] As discussed above, annuity

---

[35] Papke, Walker, & Dworsky, *supra* note 2, at 4 tbl.1. In comparison, the median 401(k) and/or IRA account balance for men ages 55 to 64 was $70,000 in 2004. *Id.* The average account balances for this age group, which includes a small number of high-earning individuals, are much higher: $91,700 for women and $219,500 for men. *Id.*

[36] ImmediateAnnuities.com, Instant Annuity Calculator, http://www.immediateannuities.com (search run by NWLC June 10, 2010).

[37] The average monthly Social Security retired worker benefit for women in March 2010 was $970.56. *See* Soc. Sec. Admin., Beneficiary Data, Benefits Awarded by Type of Beneficiary, http://www.ssa.gov/OACT/ProgData/awards.html (search run by NWLC June 10, 2010).

[38] 26 U.S.C. § 401(a)(31)(E); 26 C.F.R. § 1.401(a)(31)-1, Q&A 13 (2009).

[39] We believe that this could be accomplished through regulation, but may be easier if effectuated through legislative changes.

[40] In 2008, $3.61 trillion dollars in retirement assets were held in private-sector IRAs, mostly as a result of rollovers from 401(k)s or other defined contribution accounts. Craig Copeland, Employee Benefit Research Inst., EBRI Issue Brief No. 333, Individual Retirement Account Plans: An Analysis of the 2007 Survey of Consumer Finances, with Market Adjustments to June 2009, at 4 fig.1, 24 fig.12b (2009), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_8-2009_No333_SCF.pdf.

[41] A few providers are apparently offering institutionally priced rollover IRA annuities. *See* MetLife, Response to the Request for Information Regarding Lifetime Income Options 8–9 (May 3, 2010) ("Under this arrangement, a participant is provided with multiple insurers to choose from and these annuities are offered at institutional prices, thereby offering a higher benefit at a lower cost. Access to on-line quotes and other relevant information is also

products are expensive, although they provide an important guarantee of lifetime income in return. Further, few annuities that provide inflation-adjusted monthly payments are available from insurance companies, and the effects of inflation can be significant.[42] Also, as discussed above, insurance companies generally charge similarly situated women more than men for an annuity. Moreover, as discussed above, there are other reasons for which individuals may be reluctant to purchase annuities, such as the desire to leave a bequest or have enough liquid assets to deal with unplanned expenses.[43] Although insurance companies offer options that address some of these disadvantages, increasing the number of options reduces lifetime income, increases costs, and also creates complexity. In addition, individuals who purchase annuities on the open market face the risk of the insurance company offering the annuity going out of business or filing for bankruptcy, and thus becoming unable to fulfill its obligation, in full or in part, to provide the annuitant with lifetime income.[44]

For all of these reasons, we recommend that a number of policy changes with regard to annuity products offered by insurance companies be considered. These could take the form of recommendations to state insurance industry regulators, or changes in federal law to ensure that protections are available to individuals purchasing annuities in every state.[45] Changes could include prohibiting discriminatory pricing and creating standard alternatives to the annuity products currently available to individuals on the market. One alternative could be low-cost annuities with limited options, administered through a government clearinghouse (such as the PBGC or an entity based in the federal Thrift Savings Board). Another option could be retirement savings bonds (R-bonds), backed by Treasury securities and payable only at retirement, which would include an option to pay out as lifetime income. We encourage policymakers to explore and support the creation of these, and other, annuity products that would supplement the annuity products currently on the market. Without affordable, reliable annuity products, encouraging individuals, especially low- and moderate-income individuals, to purchase lifetime income products could have little practical positive impact. Other changes to the laws governing IRAs, including adding spousal protections to rollover accounts, should be considered. Given the amount of rollover assets in IRAs, failing to address the barriers to obtaining secure lifetime income from IRAs in the private insurance market, under the current legal framework, would create a significant policy gap.

Recommendations for Increasing Access to Lifetime Retirement Income

---

provided that allows the participant to compare and contrast prices and features before purchasing the immediate annuity."), *available at* http://www.dol.gov/ebsa/pdf/1210-AB33-695.pdf. It is unclear how many such platforms are available to, much less chosen by, employers.

[42] *See* U.S. Gen. Accounting Office, *supra* note 13, at 9.

[43] *See supra* notes 13–15 and accompanying text.

[44] State insolvency guaranty funds provide some relief from that risk, up to certain levels of liability. *See* AnnuityAdvantage.com, State Guarantee Funds, http://www.annuityadvantage.com/stateguarantee.htm (last visited Apr. 28, 2010). However, their protections may not extend to annuity purchasers who have moved to another state. Nat'l Academy of Social Insurance, Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy 82 (2005), *available at* http://www.nasi.org/sites/default/files/research/Uncharted_Waters_Report.pdf.

[45] For example, in recent comments to the Departments of Labor and Treasury, AARP recommended creating a federal agency, similar to the FDIC, that would regulate lifetime income products. AARP, Response to Request for Information on Lifetime Income 7–8 (May 3, 2010), *available at* http://www.dol.gov/ebsa/pdf/1210-AB33-659.pdf.

We thank Chairman Kohl and the members of this Committee for making expanded access to lifetime income a focus of the Senate Special Committee on Aging, both through their work on strengthening Social Security and this hearing. As the foregoing testimony demonstrates, the ability to convert retirement savings into lifetime income is extremely important for women. In order to increase women's access to lifetime income options, we recommend that (1) employer-sponsored defined contribution plans should be required to offer lifetime income options; (2) the spousal protections that currently attach when married participants in defined contribution plans select life annuities should apply to these new lifetime income options; (3) plan administrators should be required to accept rollovers from qualified retirement savings accounts; and (4) significant policy changes related to the sale of annuity products by insurance companies should be considered to eliminate gender discrimination in the pricing of private annuities and increase access to secure, low-cost options.

Thank you for the opportunity to submit testimony on these important issues.

To: The Honorable Herb Kohl
Chairman, United States Senate Special Committee on Aging
From: Leonard M. Glynn, Managing Director, Policy, Putnam Investments

For: The June 16, 2010 Hearings on Lifetime Income Policy

Putnam Investments is pleased to respectfully submit these reflections on policies to strengthen the ability of America's existing workplace savings systems to deliver reliable lifetime income to future retirees.

The Growing Need for Income Solutions

Millions of defined contribution workplace savers face the challenge of converting the assets they have accumulated over a lifetime of work into reliable lifetime income streams. Efforts to meet that need are urgent, because the structure of American retirement finance is changing rapidly in the direction of placing more responsibility on individuals. Workplace savings have become a central pillar of retirement security. And while the Pension Protection Act of 2006 made dramatic steps towards solving for higher accumulation in workplace plans – via auto-enrollment, savings escalation and guidance to better allocation models – the challenge of successfully drawing lifetime income from workplace savings remains open.

Like the preceding generation, many of today's retirees draw a major share of their income, from preprogrammed sources such as traditional pensions and Social Security. But both Social Security and defined benefit pensions are on track to decline in terms of their ability to replace shares of future retirees' incomes. Social Security's replacement rate is already programmed to fall under current law (due to increases in retirement age and deductions for Medicare costs). Defined benefit pension coverage is in a steady, long-term fall to the point of now covering less than 20% of America's private sector workforce.

The 76 million-plus Baby Boom generation now reaching retirement age is thus the lead edge of what will be a continuing wave of future retirees who will be relying in ever-increasing measure on their work-based defined contribution saving plans for retirement income. Each year going forward, future retiree cohorts will have to find ways to convert a growing share of their own savings, mainly from workplace plans, to provide dependable lifetime income.

At Putnam, we believe that the ability to replace the income people make while working is the best measure of success or failure of any retirement system. Clearly, providing for future income is the prime rationale for the tax advantages granted to defined contribution savings plans like 401(k)s, 403(b)'s 457s and others. But this central goal – lifetime income – has often been obscured by an industry – and individual -- focus on asset accumulation, account balances, investment choices, asset allocation and other issues.

We strongly believe that the focus of workplace savings policy needs to shift. The transition to stronger accumulation models begun by PPA should be continued and refined. But much more needs to be done – and soon – to address the distribution phase. We need to provide workplace savers with access to better education, guidance, analytic tools and a variety of income products they can choose from to convert accumulated retirement plan balances into reliable lifetime income streams.

That said, the workplace savings system itself remains the most effective means of both savings accumulation and preparation for lifetime income. What is needed now are a variety of ideas on how to build lifetime income options – in the form of either annuities or other insured non-annuity income streams – directly into workplace plans or to offer them to plan participants as options on termination or "rollover."

Obstacles to Adoption

Experience to date suggests that simply providing lifetime income options in workplace plans hasn't been sufficient. Usage of assured income products has remained low even in plans where they have been made available. This low usage – which many economists refer to as "the annuity puzzle" reflects 1) a widespread lack of understanding – among both participants and plan sponsors -- of how lifetime income options might be used and what benefits they might provide to the individual. 2) An understandable wariness among plan sponsors about the legal and fiduciary risks involved in offering annuities or other lifetime income solutions to their participants. Other obstacles to solving the "annuity puzzle" across the workplace savings system include:

- The complexity and opacity of so many existing annuity and assured income offerings
- The "wealth illusion" – i.e. the common inability to reasonably discount the value of a sizeable sum of life savings when they are expressed in terms of guaranteed lifetime income

- Participants' reluctance to cede control of a sizeable share of their life savings
- Participants' concerns about reducing potential bequests to heirs
- Worries about inflation risk on fixed annuity offerings
- Plan sponsors concern about the potential credit risk from any specific insurance provider (for either annuity or non-annuity guaranteed solutions)

Multiple changes in approach – by industry and government, asset managers and insurers, plan sponsors and providers -- will be needed to overcome these obstacles to the more widespread use of lifetime income options. But a combination of private industry and academic innovation with public policy reform -- much as was seen in the years leading up to the passage of the Pension Protection Act of 2006 – can, in our view, drive significant, positive change.

Key Changes Needed

1. From the beginning of an individual's retirement savings journey, the lens through which workers view their job-based retirement savings plan should be changed from a focus on the accumulated savings balance to the assets' potential for generating reliable income for life.

2. Simpler income options need to be provided -- where simpler means less complicated product features, clearer fee structures, easier portability across accounts, etc.

3. Public policy incentives – namely tax advantages and/or credits -- should be offered to encourage plan sponsors to offer and participants to adopt assured income options.

4. To fully realize the potential of lifetime income options – and provide the workplace savings system with an effective solution set for the distribution phase -- a new national insurance charter, a new regulatory body and a new FDIC-like insurance fund would need to be created. Absent such reforms, we fear, the uptake of lifetime income options in workplace plans or at rollover will be limited – even if the first three changes mentioned above do come about.

A New Lens

Workplace savers need to better understand what they are doing by seeing their savings balances through a new lens. For years, workplace saving plans have taught investors to focus on total balances, investment choices and rates of return. A more appropriate approach, in our view, would be to focus workplace savers first and foremost on exactly what the lifetime income generating capacity of their plans really is – based on their current balances, age, contribution levels and projected retirement date.

To that end, our own new 401k Participant web site offers immediate access – as the first information displayed – to Putnam's Lifetime Income Analysis Tool®, which enables plan participants to measure how much income their savings can be reasonably estimated to generate in retirement, see whether they are on track to have sufficient income to maintain their current lifestyle once they stop working – and take immediate action to get on track or close any income gap the tool discloses.

Through this site, then, the "lens" has been changed – and while traditional balance data is readily available – it is not primary. A lifelong income planning view is the first angle from which participants see their own progress and they are "educated" – dynamically – throughout their participation in the workplace plan to measure their progress in terms of income replacement, rather than only by raw asset accumulation.

To make such an income "view" an effective motivator, it is vital that financial service providers be permitted to use hypothetical methods (such as Monte Carlo simulations or estimates and scenarios based on the actual, long-term investment performance of various asset classes) to calculate the income potential of workplace savings at future retirement ages – not convert current assets into current potential annuity income. The latter approach can actually undermine confidence and de-motivate savers.

We believe that participants who learn to interpret their workplace savings through the "lens" of their future potential to generate lifelong income will be much more willing as they approach retirement age to consider products and services designed to convert their balances into lifetime income streams.
This kind of experience-based "education" can – and should – be supplemented over time by traditional communications and information to participants about the benefits and trade-offs inherent in either annuity or non-annuity lifetime income products and strategies.

Regulatory and policy action that encourages financial service providers and plan sponsors to emphasize an "income" view of workplace savings could help speed the adoption of such an approach – and begin changing workplace savers' mindset about their goals. We would also support efforts to offer plan sponsors and advisors strong legal safe harbor for advocating or adopting plan design elements that emphasize a lifetime income "view" or offer participants education and guidance to appropriate lifetime income products and strategies.

Simple Options

The real or perceived complexity of many annuity and non-annuity income products has significantly retarded their adoption for many years. Any actions that regulators and policy makers can take to encourage clear, brief, straightforward lifetime income products – with their terms expressed in plain English and with full disclosure of fees and benefits – would help channel innovation and competition in this area in the right direction.

It might well be appropriate for regulators to work with asset managers and insurers to develop very basic templates for pure annuity and non-annuity income offerings – without, however, limiting competition or innovation to only such basic models.

Overcoming Obstacles to Lifetime Income Adoption

Government can play an important role in encouraging plan sponsors to offer and plan participants to seriously consider lifetime income products and strategies. Lifelong income options can have a very positive benefit for many workplace savers – in managing longevity risk and raising the lifetime income baseline even for those retirees who deplete all other personal assets. But converting life savings into lifelong income is even more challenging for most people than accumulating a nest egg in the first place.

Negative market experiences in 2000-2002 and 2008-2009 illustrate the severe risks that "fat tail" or "black swan" events can pose even to diversified retirement portfolios. These risks are seriously compounded if an individual needs to be actively withdrawing from declining asset portfolios to provide current income. Selling into a downturn sharply heightens depletion risk. Having a substantial element of guaranteed income can lower that risk – and provide a higher baseline income even if depletion occurs.

Yet a variety of obstacles mentioned earlier – such as loss of control of assets and inability to reasonably value lump sums in terms of lifetime income – make the decision to commit to a long-term income solution quite difficult. We therefore, believe that it would be reasonable for public policy to offer workplace savers some real financial incentives to consider choosing an assured lifetime income option.

Specifically, we believe that workplace savers who choose to adopt lifetime income guarantees – whether annuity or non-annuity versions -- should receive additional tax breaks for choosing a more secure withdrawal strategy. Perhaps the first $10,000 a year in protected income should be tax free. But we do have one vital caveat: There should be no bias between annuities and non-annuity lifetime income products.

Today's financial services industry is actively innovating in the income arena – and neither current policy nor future legislation should stymie this fruitful ferment by defining a single exclusive income product as the government-favored option. To the contrary, policy-makers and regulators should foster lively competition, debate and collaboration on lifetime income options between asset managers and insurers. We should also consider creating a national institutional infrastructure that could help make lifetime income options more attractive and more widely available.

A Regulatory Infrastructure for Lifetime Income

Putnam believes that if we want to see more widespread, systemic adoption of lifetime income vehicles, we will need to see game-changing, psychology-changing reforms at the national level. Specifically, we favor the creation of an option national insurance charter, a new national regulatory body focused on lifetime income offerings – and a national fund analogous to the FDIC in banking, to back-up lifetime income product promises and make participants whole in case of a specific provider's failure.

Such reforms, in our view, would change America's entire view of the value and reliability of lifetime income products and strategies. The way would be opened for intense competition and innovation in these products by both insurers and asset managers. With a coherent national market, a regulator empowered to approve or deny approval to both annuity and non-annuity income products, and an industry-based fund to back them up, we would see the full potential of an American lifetime income industry unfold – freely, and in accord with the needs of individual retirement savers.

Political and Policy Pitfalls to Avoid

There are, however, some key political risks and policy pitfalls which could derail or delay any chances of such an outcome.

- Neither annuities nor non-annuity income options should be forcibly mandated. Even though they have real value for many retirement savers, these options are not appropriate for everyone. We strongly believe, for example, that the option for workplace savers to choose – or decline – a lifetime income option should remain exactly that – a choice. There is much data to show that Americans do not want – and would actively resist – a forced mandate to either annuitize or choose some non-annuity income vehicle.

- A far better course towards more widespread adoption of income options lies through adopting a new "lens" or focus on income, plus workplace-based education plus the explicit tax incentives for assured income that were mentioned above.

- At the same time, policy-makers should consider strong legal safe harbor coverage for plan sponsors who structure their plans to emphasize income and offer their participants education and information on lifetime options. Experience pre-and-post the Pension Protection Act shows that absent such protection uptake of new plan policies is glacial – with it, adoption becomes very rapid. Taken together, these policy elements would be a "nudge" not a mandate. But we believe they could significantly lift the share of workplace savers who choose assured income solutions in retirement – without triggering sharp, potentially crippling resistance.

- Both annuity-based solutions, and non-annuity assured income options should be encouraged – with no bias between them. It is critical that retirement income policy foster robust innovation and experiment – not lock in or privilege any specific product-based solution. Besides curbing the dynamism of an American lifetime income industry, any such effort to limit choices to a single solution would also generate major political resistance – and needlessly.

- Policy makers and legislators concerned with retirement income should therefore make every effort to foster collaboration and inclusion of asset managers, insurers and other financial service providers as this debate proceeds. We need as broad a coalition as possible to solve America's lifetime income security challenge.

#####

Submitted by:

Leonard M. Glynn
Managing Director, Policy
Putnam Investments
617-760-1074
Leonard_Glynn@putnam.com

WorldatWork
The Total Rewards Association

Statement for the Record

By

WorldatWork

Before the

Special Committee on Aging

Hearing on Lifetime Income Options

June 16, 2010

WorldatWork commends the Senate Aging Committee for holding this hearing on the importance of securing a lifetime stream of income for the American workforce. WorldatWork members are human resources professionals who design and administer programs — including retirement plans — to attract, motivate and retain employees. These members believe there is a powerful exchange relationship between employer and employee, as demonstrated through the WorldatWork Total Rewards Model. Total rewards involve the deliberate integration of five key elements that effectively attract, motivate and retain the talent required to achieve desired organizational results. The five key elements are: compensation, benefits, work-life, career development and recognition.

Employers are committed to helping their employees save adequately for their retirement years; a 2009 WorldatWork study found that 91% of respondents provided a defined contribution plan for employees, and 94% of those provided an employer match. Retirement plans are also a win-win for employers and employees as, according to a 2007 WorldatWork study, the vast majority of companies offering both defined benefit and defined contribution plans report they have a moderate or high impact on their ability to attract and retain a talented workforce.

In order to respond to the Department of Labor's recent request for information on lifetime income options for participants and beneficiaries in retirement plans, WorldatWork conducted a snapshot survey in March 2010 of members in order to gauge what current employer practices were regarding lifetime annuity options. A total of 64 members and nonmembers participated, and of those respondents: 53% currently offer a lifetime annuity option with: their defined benefit plan (33%); with their defined contribution plan (11%); or with both their defined benefit and defined contribution plans (9%). Of the 47% who do not offer a lifetime annuity payout option, 14% are considering adding an annuity payout option in the future.

Among those companies that did not offer lifetime annuities, the most common reason was a lack of participant demand (29%), followed by 401(k) or other qualification rules (21%) and administrative issues (17%). Of the respondents who offer a lifetime annuity payout option, a majority (52%) cited wanting to provide a way for employees to secure a lifetime income stream from their retirement savings as the primary reason for offering such an option. Based on the results of this survey, the barriers to offering lifetime annuities are in the regulations surrounding annuities and a lack of demand on the participant side. Those employers who do offer annuities do so because they recognize their value in providing a lifetime income stream.

Responses from a focus group also conducted on this topic mirrored the findings from the survey. The advantages that the focus group members identified centered on securing lifetime income streams for their employees and enhancing the employer-employee exchange relationship ("Annuities seek to offer protection against longevity risk. Guaranteed income from an annuity provides a steady stream of income to the participant."). The disadvantages that the focus group members identified centered on the administrative costs for employers, the increased fiduciary risk, lack of participant interest, and cost of current annuity products ("I do not believe that participants will recognize or value this option.").

In conclusion, employers are committed to helping employees save for retirement and to help them have access to streams of income throughout their lives. WorldatWork looks forward to continuing to work with the Committee, and we stand ready to provide further expertise and information when called upon.

AARP

Written Testimony Submitted to the

U.S. Senate Special Committee on Aging

on

<u>The Retirement Challenge: Making Savings Last a Lifetime</u>

Wednesday, June 16, 2010

562 Dirksen Senate Office Building

Washington, D.C. 20510

For further information, contact
Tom Nicholls
Government Relations & Advocacy
202-434-3765

As the largest nonprofit, nonpartisan organization representing the interests of Americans age 50 and older and their families, a major priority for AARP is to assist Americans in accumulating and effectively managing adequate retirement assets to supplement Social Security. Nearly half of our members are employed, full or part-time, with many of their employers providing retirement plans. Over the last few decades, however, several trends have made achieving and maintaining an adequate income in retirement more challenging than ever before.

First and foremost, many employers have moved away from providing defined benefit (DB) pension plans to their employees and increasingly offer only defined contribution (DC) plans, such as 401(k) plans. Participation in 401(k) plans is voluntary and these plans transfer investment, longevity, inflation, and interest rate risks entirely to the individual. Today, only about 17 percent of workers have DB pension coverage on their current job compared to 41 percent who have DC plan coverage.

Traditional DB plans have historically provided lifetime streams of income, while only a small fraction of DC plans offer an annuity or other lifetime income option. Moreover, many DB plan sponsors today offer lump-sum benefits and many retirees are opting for them. Younger workers are more likely than older workers to have only a DC plan, and the number of workers retiring and receiving their retirement account balances as a lump-sum is growing. It is not clear how, or how well, beneficiaries will manage those assets throughout decades of retirement.

The shift away from DB plans to DC plans places significant responsibility on individuals to make appropriate decisions concerning their contributions, their investments and how they will manage their money once they retire so that they will have adequate income to fund their retirement years. The recent financial turmoil and scandals underscore the importance of these decisions.

Perhaps in response to these trends, there is good reason to believe, however, that interest in annuities and other guaranteed income products will grow. Even middle class Americans who have diligently contributed to their 401(k) plans and IRAs for most of their working lives will find that they have accumulated significant balances in their accounts by retirement. Annuitization of at least a part of this balance may become an increasingly attractive option to them. A new survey by AARP suggests that workers nearing retirement are quite interested in lifetime income products – at least in theory. Nearly a third of older workers who have an annuity option in their DC plan say they plan to annuitize all or part of their plan balance. About half of older workers in DC plans who are not offered an annuity would like to have this option. In addition, many older workers say that they are interested in innovations such as partial annuitization, trial annuitization or in-service annuities. These findings suggest that if options for obtaining lifetime income were more flexible and readily available, interest and take-up would grow.

At the same time, it is important to recognize that annuities or other lifetime income products are not for every retiree. Annuities are particularly ill-suited for those who have small account balances, those whose wealth in retirement is already substantially annuitized, those who need liquidity for substantial immediate expenses, and those with more limited life expectancy. It is therefore necessary to maintain individual choice, and to ensure that workers and retirees are well educated about the suitability of lifetime income options to their particular circumstances.

AARP has long been concerned about the ability of our members to accumulate the resources they need to maintain an adequate standard of living throughout their retirement years. Similarly, AARP is also concerned that -- unlike Social Security benefits -- many Americans will outlive the retirement assets they have accumulated due to the combined effects of longer life expectancies and the overly optimistic assumptions many individuals make when spending down these assets. Effectively managing this decumulation phase of retirement can be especially complicated, but it is essential for the long term economic security of millions of American workers who can no longer count on the guaranteed lifetime income stream once provided by workplace DB pension plans.

AARP would therefore like to thank to Chairman Kohl and Ranking Member Corker for holding this important hearing. We appreciate the opportunity to present our views on the issues surrounding lifetime income and look forward to continuing to work with the Committee to improve our existing retirement system.

The Move from Defined Benefit to Defined Contribution

One quite striking feature of the U.S. employer-provided pension is the constancy of its rate of coverage of the workforce: at any given time over the past three decades, about one in two workers have either been covered by an employer-provided plan or contributed to an IRA. As is by now well known, this uniformity of coverage masks a disconcertingly large slide in the coverage of the traditional pension plan. As of 2007, only about 17 percent of workers were covered by a traditional DB plan at their current job.[1] In contrast, 41 percent were covered by a DC plan.

Both reduced demand on the part of workers and reduced supply on the part of employers have been working to reduce the role of the traditional pension. The employer's willingness to offer a traditional DB pension may have been eroded by many factors, including plan cost, changes in accounting standards, and the negative impact of market volatility on the plan sponsor's balance sheet. Some experts have pointed to the so-called perfect financial storm of 2000-2002, experienced again during the recent financial crisis, when plan balance sheets were assailed by declining interest rates and falling securities prices. The enhanced funding standards adopted in the Pension Protection Act of 2006 have also increased the immediate cost burden of DB plans.

On the demand side, greater mobility and the lack of portability has made DB plans more unattractive for the average worker, given the trend to shorter average employment tenure. Confidence of plan participants in the on-going solvency of plan sponsors has probably also eroded, notwithstanding the backstop insurance that the Pension Benefit Guaranty Corporation (PBGC) provides. A desire to maintain control of one's assets, a preference for liquidity, and excessive discounting of future income and needs further increase the attractiveness of pensions that offer a lump sum benefit. In total, the forces acting to diminish the role of the traditional pension will not be easy to reverse.[2]

---

[1] See Sandy Mackenzie and Ke Bin Wu. 2009. *Employer-provided pensions: Less to Count On.* AARP Public Policy Institute.

[2] See George A. (Sandy) Mackenzie. 2010 forthcoming. *The Decline of the Traditional Pension—a Comparative Analysis of Threats to Retirement Security* (Cambridge University Press) for a thorough treatment of these issues.

The Shift from Annuitized to Lump-Sum Distributions

The same forces that are behind the DB-DC shift also lie behind the increasing frequency of lump-sum distributions. The share of traditional plans offering a lump-sum option has increased in part because plan sponsors shed longevity risk and pension costs by increasing the take-up of lump-sum distributions by plan members. As for DC plans, although more of their participants may be interested in the annuity option than had been previously thought, the lump sum option is still the overwhelming choice.[3] Inevitably, these same forces have increased the number of workers opting for a lump sum.

In addition to the popularity of the lump sum option among DC plan participants, DC plan sponsors may be reluctant to offer an annuity as an in-plan option because of the added fiduciary responsibility this option raises. In particular, the Employee Retirement Income Security Act (ERISA) fiduciary standards require the plan fiduciaries to perform due diligence in selecting and monitoring an annuity product provider and products to incorporate into the retirement plan. Failure to perform the monitoring function will expose the plan administrator to statutory liability for fiduciary breach.

In addition to these fiduciary concerns, the plan sponsor may have to field complaints from employees/plan participants who are dissatisfied with the products or services of the provider the plan administrator has chosen.

[3] An AARP survey of the distribution choices made by workers and retirees with pension plans found that there was definite interest in the annuity option. Specifically, it found that about 31 percent of workers and 25 percent of retirees with DC plans that offered one or more options other than lump sum withdrawal were planning to select or had already selected the annuity option. See Kathi Brown et al. 2010. *Annuities and Other Lifetime Income Products: Their Current and Future Role in Retirement Security*. AARP Public Policy Institute, Factsheet 189 (May).

The Hazards of Excessive Reliance on Lump-Sum Distributions

Retirees who choose to take a lump-sum distribution rather than an annuity from their plan must manage their assets to last their lifetime. Even if individual retirement life spans were predictable, this would not be an easy task for retirees who lack financial sophistication. Uncertainty about longevity in retirement—longevity risk—further complicates the task of asset management. If retirees live longer than planned, they may end up in extreme poverty or destitute. Alternatively, they may die prematurely, leaving a larger than expected estate or having foregone consumption that could have made them better off.[4]

The great advantage of lifetime income products is that by guaranteeing income for life, they provide longevity insurance. By taking some or all benefits as lifetime income, participants will not outlive their resources or be forced to significantly reduce their consumption in their final years because they lived longer than planned. Annuities and other lifetime income products can work most effectively by pooling mortality risk across individuals with differing life expectancies and paying only while the retiree remains alive.

Lifetime income products purchased through employer plans can be particularly beneficial to women. Employer plans, in determining the benefit, may not differentiate by the life expectancy of the annuitant. As a result, since women live longer than men, they

[4] For example, one simulation shows that a retiree who withdraws a constant amount equal to 5 percent of their real initial account balance beginning at age 65 faces a 25 percent chance of exhausting the account balance by age 90, even though the average balance remaining at that age would exceed half the initial balance. See Sandy Mackenzie. 2010. *Hybrids and Other Alternatives to the Traditional Pension.* AARP Public Policy Institute, Research Report 2010-04.

face more favorable pricing on lifetime income products purchased through employer plans.

Another advantage, albeit not one unique to lifetime income products, is that guaranteed monthly payments for life reduce the need for asset management, which some retirees may find quite daunting. A 2007 AARP/American Council of Life Insurers (ACLI) survey found that 55% of surveyed participants were not very confident that they would be able to manage their finances to last the rest of their or their spouse's life. In particular, women were less confident in this respect than men.

Lifetime income arrangements can also reduce transaction costs for both plan sponsor and participant because once the lifetime income arrangement is made, payments are regularly provided. A monthly payment that requires minimal management to meet their retirement income needs could make many individuals better off.

Improving DC Plans

The number of workers retiring with significant retirement account balances received as a lump-sum is growing. Many of them would benefit from an annuity or other lifetime income option to protect them from investment and longevity risk. Employer plans should provide a lifetime income option, and could be assisted in doing so by education and guidance in selecting plan options.

S. 2832 – The Lifetime Income Disclosure Act. One clear improvement to DC plans would be to increase employees' understanding of the stream of income that their account balances will provide. AARP has therefore endorsed S. 2832, the Lifetime Income

Disclosure Act. This legislation would provide individuals with a better understanding of the lifetime value of their 401(k) plan assets by including in a yearly benefit statement a conversion of their total accrued benefits into a monthly dollar amount as if they had opted to receive a lifetime annuity. This information would provide the longer term outlook 401(k) participants need to get a more accurate picture of the lifetime value of their plan and help them make better decisions about how to wisely manage their retirement assets. It may also provide them with an incentive to save more.

ERISA's Fiduciary Responsibilities and Annuities in 401(k) Plans. ERISA requires that a 401(k) plan fiduciary act as a well-informed, prudent expert would when making decisions that affect the plan's investments or expenses. Obligated to act in the best interest of the participants, fiduciaries must independently investigate the merits of any proposed investment, including annuity products that may be on the plan's menu of investment options. They need to understand annuity product features, fees charged, and the merits of the product relative to other similar offerings in the marketplace. Fiduciaries who neglect these duties can be held accountable if they cause the plan to lose money or the investments fail like in the case of Executive Life.

In order to alleviate many concerns that plan sponsors and plan fiduciaries have about selection and monitoring of annuity providers and products, it may be well to consider the implementation through statutory enactment or agency regulation of a safe harbor for plans and their fiduciaries in respect of these issues. It should probably be taken as presumptively correct that variable annuities (as presently marketed) are generally unfavorable products for inclusion within qualified retirement plans. Therefore, the points that follow are intended to refer to fixed annuity product selection issues.

A safe harbor provision might consist of something as minimalist as a recitation of prescribed standards or criteria for annuity products and/or providers, compliance with which would suffice *per se* to insulate a plan fiduciary from further scrutiny or accountability with respect to selection of the product or provider. At the other extreme, it is conceivable that one or more governmental agencies, such as the Department of Labor, Treasury, etc., could devise and maintain a list of approved annuity providers and products to 401(k) plans based upon established criteria or experience. There are probably other approaches that could be taken to credential annuity products and providers as suitable for use within 401(k) retirement plans.

Addressing 401(k) fiduciary concerns related to provider and product selection by establishing an accessible and rational safe harbor could help encourage the inclusion in plans of annuity options.

Other Options. While we have not solved the retirement savings accumulation problem by any means, we have made substantial progress through auto-enrollment, auto-escalation and qualified default investment account options. These successes offer useful lessons, but designing default options for the spend-down phase presents some unique challenges. There is little risk of saving too much, but there is risk associated with tying up too much of one's nest egg in an annuity. Lifetime income options probably need to be more customized than accumulation options need to be.

To this point, providing partial annuitization options is key, and experience with the Thrift Savings Plan (TSP) and elsewhere suggests that partial options increase take-up of annuities. Trial annuities are also promising, and may be useful in helping new retirees create “a paycheck budget” without locking into a decision too soon.

Two relatively new financial products endow 401(k) plans with some of the features of a traditional pension. The first grafts a variable annuity onto the 401(k) plan with a guarantee. The plan invests a member's account balance in a diversified portfolio from which he or she can draw once retired. The instrument provides a minimum income guarantee (in nominal, not in real terms) in the form of a specified percentage value, like 5%, of some measure of the plan's value to date. If withdrawals exceed this value, the guarantee benefit is reduced. The guarantee applies for life, but is financed by an earmarked fee, and not by mortality risk pooling. The guaranteed rate of return the plan can offer is not as a result particularly high. Given our above concerns about variable annuities, these products should be carefully analyzed and reviewed by the fiduciary and, ideally, the participant.

The second product is the in-service annuity, which annuitizes contributions to 401(k) plans as they occur. The conversion of contributions into a deferred annuity as they occur minimizes investment risk, and the continuous nature of conversions reduces the risk of an excessively high premium, which may occur when annuitization is effected through one or two purchases near retirement. Too little is known about this product to say anything definitive about the role it might play in financial security, which will depend on the cost of financial intermediation and the ability to hedge liabilities of long maturity.

Consumer Protection Considerations

As annuities or other lifetime income products are not appropriate for every retiree, it is therefore necessary to maintain individual choice, and to ensure that workers and retirees are well educated about the suitability of lifetime income options to their particular circumstances. Barriers to employer offerings and employee adoption of lifetime income solutions should be reduced; but, at the same time, consumer protections must be preserved and strengthened.

Insurer Solvency. One of the obstacles to annuitizing retirement income through private insurers has been the perception, exacerbated in the recent financial climate, that the insurer could become insolvent and unable to make the required payments. Thus even though an employer or employee chooses a financially secure company when buying the annuity, it is possible that the company's financial condition could change over the decades as the stream of income pays out. Unlike ERISA plans and banks, the solvency of insurers and the guaranty funds that make payments in the event of insurer insolvency are regulated by the 50 states and the District of Columbia, not the federal government. Although this system has worked relatively well in the past, provisions vary across states and the funds do not have federal government backing, unlike the PBGC or Federal Deposit Insurance Corporation (FDIC).[5]

Although each insurer is primarily regulated by one state, all states have similar laws and requirements that are designed to require companies to provide an adequate

---

[5] It is also important to note that AIG's state regulated insurance subsidiaries did not cause AIG's problems; an unregulated holding company subsidiary put the company at risk and gave rise to the federal bailout. However, the AIG case does illustrate that the sound regulation of insurance products depends ultimately on the regulation of the financial system as a whole.

margin of safety for the risks they insure. State insurance regulators require companies to use conservative accounting principles and to meet risk-based capital and reserve requirements specifically designed for the types of policies they cover. Regulators monitor insurer compliance through quarterly financial reporting, analysis, and periodic examination. In addition, the National Association of Insurance Commissioners ("NAIC"), an organization of all the state insurance commissioners, has formed the NAIC Financial Analysis Working Group, which works with states to help oversee any nationally significant financially troubled insurer. The NAIC also examines and accredits states that achieve a required level of solvency regulation; at this time all 50 states and the District of Columbia are accredited.

Because of this increased oversight, it is rare for even an insolvent insurer to lack significant assets that may be used to pay policyholders who have priority over other unsecured creditors under insurance insolvency law. In addition, all states have set up state guaranty associations to cover the shortfall in payments by an insolvent insurer and to pay claims in a timely manner while the insurer's estate is being settled. The guaranty associations are not prefunded, but may call on insurers in the same line of insurance, such as life insurance, to pay a small percentage, usually 2%, of their premiums in that state into the state guaranty fund to cover payments due to an insolvent insurer's policyholders. Guaranty associations also have other sources of income and the ability to borrow against future payments. They have generally made timely payments to beneficiaries. However, the amount guaranteed varies from state to state. Most states cover only the $100,000 present value of the annuity contract, although some states cover substantially more and the NAIC has recommended that all states raise the coverage cap for annuities to $250,000. There is also great uncertainty as to whether this system could handle a number of large life insurers becoming insolvent at the same time.

ERISA and Preemption of Consumer Remedies in 401(K) In-Plan Annuity Purchases. In connection with the prospect of annuities being offered as options for investment of 401(k) contributions, it is advisable to examine the implications for consumer protection surrounding the relationship between the annuity issuer and the plan participant who chooses to direct his/her funds to an annuity.

For plans that offer in-plan annuity purchases, generally we may presume that the annuity products offered would be pursuant to a group plan. In the setting of a group provider to plan participants, ERISA has historically constrained the remedies available to the plan participant who has grievances with respect to the group provider's performance or product. For example, a requirement of the participant's exhaustion of internal plan claim procedures is typical. This requirement generally gives the plan the right to assert control over the claims process in the event of disputes. Further limiting recourse for plan participants who challenge the acts or omissions of plan group providers is the frequency of lodging discretion in the plan to make determinations concerning the merits of the participant's challenge. This practice tends to create a dispute scenario that forces disputes between annuity issuer and plan participant to play out on a field that is not level. These issues are generally addressed in the context of ERISA preemption, in particular the preemption of state law remedies.

Attention must be given to the advisability of preserving the full panoply of legal remedies that would ordinarily be available to purchasers of annuity products outside of a plan (i.e., unconstrained by ERISA's general scheme in the context of pensions, health care claims and disability income benefit claims). Generally speaking, this could be accomplished by disavowing ERISA's claims provisions as the exclusive remedies available to plan participants who purchase an annuity within a plan. Instead, state law consumer remedies could co-exist along side of ERISA's remedial scheme, although it would be well to rule out the internal plan claims process as a requirement for challenges.

As for plans that have no in-plan annuity purchase options, participants in those plans who wish to purchase annuity products would have to take a plan distribution and roll the distribution into an annuity purchase. Presumably, state remedies available to consumers in ordinary arms-length transactions would be available. It may still be advisable to clarify in statutory language that ERISA presents no limitations of state remedies in such circumstances.

Conclusion

A combination of efforts will be needed to ensure the economic security of future retirees. In the lifetime income sphere, these include: further research, participant and sponsor education, and new public policies to promote a larger and more efficient market for lifetime income products. These policies could reduce unnecessary barriers to employer and employee participation in lifetime income solutions, increase the efficiency of annuity markets by such means as the facilitation of group sales, and ensure that consumers are informed and protected from unsuitable products, including those with excessive fees and expenses.

Concerns about the importance of a secure stream of retirement income highlight the critical importance of Social Security, which is the largest source of annuitized wealth for most workers. Social Security is the principal source of family income for about half of older Americans, and roughly one quarter of those aged 65 or over live in families that depend on Social Security benefits for 90 percent or more of their income.

Social Security keeps more than a third of older Americans out of poverty and provides a steady source of income that keeps pace with inflation and never runs out, no matter how long one lives. Social Security is the cornerstone of retirement security for virtually all Americans and must be preserved and strengthened. Moreover, delayed claiming of one's Social Security benefit is a cost-effective way to increase the share of a retiree's annuitized wealth. Nonetheless, Social Security was never intended to be the only source of retirement income and it is important to explore ways to increase annuitized wealth or guaranteed sources of income, particularly for workers in the middle of the income range.

AMERICANS FOR
SECURE RETIREMENT

Statement by Thomas Bartell
Chairman of Americans for Secure Retirement

Senate Special Committee on Aging Hearing
"Turning Retirement Savings Into Lifetime Income"
June 16, 2010

Mr. Chairman and distinguished members of the committee, on behalf of Americans for Secure Retirement (ASR), I welcome the opportunity to submit for the record our statement on policy recommendations to help Americans plan and save for their golden years.

Americans for Secure Retirement is a broad-based coalition of more than 70 member and affiliate organizations committed to raising awareness of the increasing challenges Americans face in having a financially secure retirement. In particular, ASR often focuses on those Americans with little or no access to employer sponsored plans. Our coalition includes organizations that advocate for Hispanics, women, small business, farmers and others, united in an effort to ensure that all Americans have access to guaranteed streams of retirement income that cannot be outlived.

We are pleased that this committee recognizes the importance of helping Americans effectively manage their assets throughout retirement to ensure that they do not outlive their savings. The management side of the retirement policy equation has received relatively little attention, but it is an increasing concern for many Americans. This hearing is both timely and of great interest to the millions of baby boomers who will soon rely on America's retirement system.

There are a number of important factors contributing to the conundrum many face in planning for retirement, including increased longevity, a decreased ability to rely on regular monthly income from Social Security and pensions and, for many, no access or participation in any kind of employer-sponsored retirement plan. The question, then, for policymakers is how to encourage Americans to adequately save and manage those savings so they last for 20 to 30 years or more in retirement. For the reasons outlined below, ASR believes one important policy prescription is to promote individuals' ability to turn their savings into a guaranteed stream of income in retirement – or a 'paycheck for life' – through retirement vehicles such as lifetime annuities.

The United States is facing a looming retirement crisis. People are living longer, and traditional sources of guaranteed retirement income, like pensions and Social Security, cover less and less of what they need in retirement. At the same time, fewer American workers have access to any kind of employer-sponsored retirement plan. For those whose employers do offer a retirement plan, defined contribution plans, such as 401(k)s, have become far more common than defined benefit plans. Making matters worse, the recent stock market declines have driven the average balances in 401(k) plans down to about $60,000.

In fact, workers aged 45-54 who have been making contributions to a 401(k) plan for at least 20 years saw the value of their retirement fund decrease by nearly 30 percent in 2008. A study conducted by Ernst & Young for ASR last year found that the average recently retired married couple, without any guaranteed source of retirement income, is left with only a 6 percent chance of financial success (not outliving their savings) in retirement if they retain their pre-retirement standard of living. The study also determined that many Americans will be forced to reduce their standard of living, some by as much as 51 percent, to avoid outliving their financial assets.

All Americans at some risk

In policy circles, the notion of the "three legged stool" of retirement security is commonly used to illustrate the basic components necessary for maintaining a healthy living standard throughout retirement. The traditional means of financial security in retirement for Americans rested on 1) Social Security, 2) employer based retirement plans such as pensions, and 3) personal savings.

For many of the upcoming baby boomer generation retirees, Social Security will be the main source of income in retirement. While there is no denying the importance of this program, the unfortunate fact remains Social Security currently replaces only about 40 percent of pre-retirement income. And for those who retire before age 65 – which is more than 75 percent of retirees today - benefits are reduced and Social Security replaces even less. Financial planners have traditionally recommended at least 70-80 percent of pre-retirement income to maintain a retiree's standard of living.

Similarly, the second leg of that stool, employer-based retirement programs, now supports less than half of all working Americans. Historically, many retirees have depended on pension plans to supplement their Social Security benefits. Participation in traditional defined benefit plans, which were a staple of retirement benefits in the past, has decreased sharply in recent years. The percentage of full-time employees in medium and large private establishments who are covered by defined benefit plans has fallen from 80 percent in 1985 to just 33 percent in 2008 as the trend shifts from offering defined benefit plans to defined contribution plans (e.g. 401(k) plans). [1] Even taking into consideration 401(k)s, half of American workers -- around 80 million -- do not have access to or participate in any sort of employer based retirement plan. [2]

According to Dr. Jeffrey Brown, a former senior economist for the White House Council of Economic Advisers and author of The New Retirement Challenge, "these [pension plan] changes represent an historic shift in our retirement landscape, and together place more responsibility on individuals to manage their savings so that they last for a lifetime. It is important for us, as a nation, to find ways to encourage retirees to secure additional and reliable sources of lifelong income so that they can achieve lifelong financial security."

The shift in demographics in our country means that there is an even greater need for new policies that help Americans ensure a steady income throughout retirement. Today, the life expectancy of a 65-year-old is close to age 83, more than four years longer than in 1960. In fact, half of all retirees will live beyond average life expectancy. And, unprecedented numbers will be living into their 90s and past 100. The likelihood of living longer compounds both the savings and financial management challenge for individuals and families: retirees not only need to save

---

[1] Employee Benefit Research Institute, "Percentage of Employees Participating in Retirement and Accumulation plans, medium and large employers;" Table 10.1d
(http://ebri.com/pdf/publications/books/databook/DB.Chapter%252010.pdf)

[2] Employee Benefit Research Institute, "Percentage of Various Work Forces who worked for an employer who sponsored a retirement plan and the percentage who participated;" Table 10.10b.
(https://docs.google.com/viewer?url=http://ebri.com/pdf/publications/books/databook/DB.Chapter%252010.pdf)

more, they also need to manage these resources effectively so they provide a sufficient income to sustain a steady standard of living for 20 to 30 or more years.

Some Americans are more at risk than others

There are certain segments of the American population that face more difficult challenges in retirement. Women, minorities, small business owners, and farmers generally have less access to, and lower participation rates in, employer-based retirement plans.

Women live longer than men, spend more time in retirement and are widowed more frequently. A typical 65-year-old woman has a 31 percent chance of living to age 90 or older, as compared to only 18 percent for a typical 65-year-old male. Today, nearly 60 percent of older American women are single, with more than 45 percent widowed. On average, women have fewer full-time working years than men and have median annual earnings that are about $10,000 less than those of working men. Furthermore, many women work part time for all or part of their working years and therefore accrue less Social Security benefits, and fewer still participate in employer-provided retirement plans. These disparities lead to lower savings and retirement income and smaller payouts from Social Security, ultimately resulting in a greater risk of poverty in retirement.[3]

Minority groups, such as Hispanics, also face significant challenges. While Hispanics work in all sectors of the economy, they are more heavily concentrated in jobs that lack traditional retirement options and typically earn a lower income, affecting their ability to save for retirement. For example, a recent study conducted by The Hispanic Institute and ASR reported that only 25.6 percent of Hispanics are covered by pension plans, compared to 42.5 percent of whites and 40 percent of African-Americans.[4]

Farmers are in a similar situation. Compared with non-farm workers, farmers are less likely to participate in employer-sponsored retirement plans, further limiting their sources of retirement income. Less than 30 percent of agricultural workers in America work for an employer with some form of retirement plan. Even more troubling is the fact that less than one quarter of agriculture workers participate in any retirement plan. That means the vast majority of farm workers have no other guaranteed sources of retirement income beyond Social Security. [5] America's rural and farming communities are influenced by factors that make obtaining a secure retirement uniquely difficult. In addition, there is extreme variability in farm income due to largely uncontrollable fluctuations in commodity prices, weather, and macroeconomic policies making it more difficult for farmers to adequately plan and save for retirement. [6]

Small business owners also face unique challenges that put them at risk of falling short in retirement. Many small business owners reinvest significant portions of their income into their businesses, and therefore cannot afford the cost of establishing and maintaining traditional defined benefit or defined contribution plans for themselves and their employees. These entrepreneurs often expect to use the proceeds from the future sale of their business to finance their retirement.

---

[3] Americans For Secure Retirement: The Female Factor, 2008; by Cindy Hounsell, WISER (Women's Institute for a Secure Retirement); (http://paycheckforlife.org/uploads/ASR-white_paper_FINAL.pdf)
[4] Hispanics And Retirement: By The Hispanic Institute, For Americans For Secure Retirement 2009, (http://paycheckforlife.org/uploads/white-paper-hispanics-and-retirement-english.pdf)
[5] Employee Benefit Research Institute, "Retirement Plan Sponsorship, Participation and Vesting 2003;" Table 10.9.(http://ebri.com/pdf/publications/books/databook/DB.Chapter%252010.pdf)
[6] Lifetime Income Crucial to Farmer's Retirement Security," American Corn Growers Association and Americans for Secure Retirement, (http://paycheckforlife.org/uploads/Ag_Issue_Brief_FINAL.PDF)

Policy recommendations

A central challenge for policymakers is the need to make retirement options that provide steady, lifetime benefits more accessible to Americans. It is also important to ensure these opportunities reach the populations, particularly women, small business owners, farmers and minority groups, that have the least access to employer based retirement programs, or get the least from these and Social Security.

Annuities are the only product that can provide Americans with a guaranteed stream of lifetime income through retirement - a "paycheck for life" – to ensure that they will not outlive their income. An annuity provides lifetime payment at regular intervals. These lifetime payments begin when the retiree determines that the payments are needed and continue for the lifetime of the retiree and, if selected, his or her spouse.

ASR would encourage the committee to seriously consider policy changes to give more Americans access to vehicles that will provide this guaranteed lifetime income in retirement. For example, ASR supports the Retirement Security for Life Act, S. 1297, introduced by Sen. Kent Conrad (D-ND) and Sen. Pat Roberts (R-KS), and similarly, HR 2748, the Retirement Security Needs for Life Act, introduced by Representatives Earl Pomeroy (D-ND) and Ginny Brown-Waite (R-FL). Both of these measures would encourage Americans to invest a portion of their savings in lifetime annuities to secure a guaranteed source of income in retirement.

These bills take a sensible approach to encouraging Americans to plan for the long-term. It should be among our top priorities to make sure that Americans are provided with the tools to help them adequately prepare for retirement and manage those savings so they last a lifetime.

Also of note, earlier this year the Obama Administration announced initiatives to help middle income Americans achieve a financially secure retirement, recognizing the challenges faced by these Americans and the need to do more to give families better choices to reach a secure retirement. The Administration stated their commitment to increasing the availability of guaranteed lifetime income through annuities and other forms of guaranteed income. ASR supports policy and rules changes that would remove obstacles and provide incentives to encourage employers to provide their employees with the option to annuitize all or a portion of their defined contribution retirement accounts, and to encourage employees to take advantage of such options. Similar incentives should be available for the large number of Americans whose retirement savings are held outside of employer plans, such as in individual retirement accounts and annuities.

We are encouraged by this committee's demonstrated interest in addressing retirement challenges and look forward to helping you in these efforts. Thank you.

###

Brian K. Atchinson
President and CEO

INSURANCE MARKETPLACE STANDARDS ASSOCIATION

Committed to honesty, integrity and ethics

June 15, 2010

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

Re: Testimony Submitted for the Record
Insurance Marketplace Standards Association
June 16, 2010 Hearing – The Retirement Challenge – Making Savings Last A Lifetime

Dear Senator Kohl:

The following written testimony is submitted on behalf of The Insurance Marketplace Standards Association ("IMSA"), an independent nonprofit organization comprised of life insurance companies committed to high ethical practices in the sale of individual life insurance, annuity and long-term care insurance products sold in the United States concerning the June 16, 2010 hearing before the U.S. Senate Special Committee on Aging regarding The Retirement Challenge – Making Savings Last a Lifetime. We appreciate this opportunity to provide testimony concerning the important role that annuity products can play in providing lifetime income options for participants in defined contribution plans.

IMSA was created by the life insurance industry in 1996 to promote and monitor ethical business practice standards in the annuities, life insurance and long term care insurance marketplace. IMSA and its qualified companies achieve this objective by agreeing to abide by IMSA ethical standards embodied within IMSA's Principles and Code of Ethical Market Conduct. IMSA qualified companies make a commitment to ethical marketplace behavior that helps to protect consumers of annuities, long-term care insurance and life insurance products.

On June 10th, 2010, AARP and IMSA co-hosted a Summit Meeting in Washington, D.C. on the challenges in the annuities marketplace and its regulation that included participants from the U.S. Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the U.S. Department of the Treasury, state insurance regulators and other stakeholders.

As Americans take on increased responsibility for managing their retirement savings through defined benefit plans such as 401(k) plans as a means to provide income in their retirement years, we believe that annuities properly marketed and sold to consumers may be a valuable component in this planning. Annuities offered through life insurers can provide an opportunity for individuals to establish lifetime income streams they can never outlive, thereby establishing a baseline stream of income for retirement security.

In doing so, it is important that Americans are provided with suitable annuity options designed to meet their individual insurable needs and financial objectives. IMSA and its qualified companies have a long-standing reputation of promoting suitable annuity product sales. IMSA maintains suitability standards for annuity sales that are designed to allow consumers to receive appropriate disclosures to make a fully informed decision regarding the appropriate annuity products to meet their retirement planning objectives. IMSA also played an important leadership role in deliberations leading to recent revisions to strengthen the requirements of the NAIC Suitability in Annuity Transactions Model Regulation.

IMSA and AARP have co-hosted a series of Annuity Suitability Summit Meetings over the past several years to allow all annuity marketplace stakeholders including representatives from the SEC, FINRA and state insurance departments as well as consumers, distributors, producers and life insurance company representatives to explore appropriate practices to provide annuity products to America's consumers in a suitable manner. Our most recent IMSA-AARP Annuity Suitability Summit Meeting held in Washington, DC on June 10 examined retirement income options in a regulated marketplace and the appropriate role that annuity products can play in meeting of the income needs of America's retirees in 2010 and beyond. These forums serve as a unique opportunity to allow the sharing of important viewpoints and perspectives on the critical role that annuities will undoubtedly play in the retirement planning of consumers in the years ahead.

IMSA and its qualified companies believe annuities can be an important option to provide lifetime income for retirees participating in defined contribution plans. To that end, IMSA would be pleased to offer our expertise to the US Senate Special Committee on Aging as it explores ways to meet the lifetime income needs of America's retirees.

We thank you for this opportunity to provide this written testimony for the Committee's hearing concerning The Retirement Challenge – Making Savings Last a Lifetime and look forward to additional opportunities to share IMSA's perspectives.

Sincerely,

Brian K. Atchinson

Brian K. Atchinson

SENATE SPECIAL COMMITTEE ON AGING
HEARING "THE RETIREMENT CHALLENGE: MAKING SAVINGS LAST A LIFETIME."

TESTIMONY

CATHERINE J. WEATHERFORD
CEO & PRESIDENT
INSURED RETIREMENT INSTITUTE

JUNE 16. 2010

IRI

Insured Retirement Institute

June 16, 2010

Chairman Kohl, Ranking Member Corker and Members of the Committee, my name is Cathy Weatherford and I am President and CEO of the Insured Retirement Institute (IRI). On behalf of our member companies, IRI appreciates the opportunity to provide testimony for your hearing entitled: "The Retirement Challenge: Making Savings Last a Lifetime". As you know, IRI has been very engaged on the Request for Information (RFI) on lifetime income arrangements from the Departments of Labor and Treasury and with the Government Accountability Office study request by this Committee. We applaud the Committee's focus on retirement security and the benefits of annuities and other guaranteed lifetime income strategies.

IRI is dedicated to the growth and better understanding of guaranteed lifetime income products. IRI represents all segments of the annuity, insured retirement product and retirement planning industries with over 300 member organizations, including insurance companies representing over 85% of the market, distribution firms, including broker-dealers and banks, investment management firms, and industry service providers. IRI's mission is to promote consumer confidence in the value and viability of insured retirement strategies by: supporting and encouraging industry adherence to high ethical principles; promoting better understanding of the insured retirement value proposition; developing and promoting best practice standards to improve value delivery; and advocating before public policy makers on critical issues affecting insured retirement strategies.

As you may know, I have over 30 years of regulatory experience, including over half of that time as an elected Insurance Commissioner and Insurance Department staff in the State of Oklahoma. Most recently, I served as CEO of the National Association of Insurance Commissioners for 12 years where I worked with over 50 state insurance commissioners to craft important consumer protections, including critical measures aimed at safeguarding our senior citizens. I joined IRI because my life's work is perfectly aligned with the mission of the organization.

Need for Guaranteed Lifetime Income Products

As Americans are living longer and spending 20-30 years in retirement, they are facing greater obstacles to saving for retirement. The role of guaranteed investment products in helping investors achieve a financially secure retirement has never been more important. According to AARP, someone who lives to be 62 has an almost 50% chance of living to be older than 90. And, we know that 33% of all boomers have not saved anything for retirement. Annuities are the only financial products that guarantee lifetime income throughout retirement. When you consider the retirement reality in America – defined by the unsure footing of Social Security, the near disappearance of pension plans, and the record losses in 401(k) plans – it is clear that Americans planning for retirement must have a second form of guaranteed retirement income.

More and more, financial advisors are seeing the value of guaranteed lifetime income products. Historically, in the financial advisor channel, as distinguished from the traditional life agent channel, only about 20% of financial advisors used annuities in developing client portfolios. A survey conducted in December 2009 by Mainstay Investments of financial advisors found that in the wake of the market crisis, most investors were extremely concerned about market risk and that almost all (91%) of the financial advisors surveyed were making changes to their client's retirement portfolios.[1] The increased use of guaranteed income products is a major component of the change, with 75 percent of the financial advisors surveyed stating that they are now selling guaranteed lifetime income products to their clients. Furthermore, among those who do not presently offer guaranteed lifetime products, 20 percent indicated that they plan to offer them in the "near future". Clearly, we see a strong trend in the use of insurance retirement products to help all Americans take advantage of the benefits of guaranteed lifetime income strategies. The laws and regulations governing these products need to assure that all consumers, including workers in 401(k) plans, have access to these products.

Guaranteed Lifetime Income Products Available to Consumers

We are aware that the Committee knows what an annuity is, but given this is a public testimony, let me briefly share what an annuity is and what types of products are available to consumers today. An annuity is a retirement savings and income product—a tool that can first build a person's savings and then convert those savings into a guaranteed stream of income during retirement no matter how long a person lives. In 2008 alone, life insurers paid almost $1 trillion in annuity benefits payments to citizens across the country, and as of the end of 2008, Americans had more than $2.2 trillion invested in all types of annuity contracts. In a variable annuity, earnings are linked to the performance of subaccounts of the annuity, which are similar to mutual funds, as selected by the contract owner.

Over the last 5-8 years, based on market demand, insurers have developed new annuity features to protect against market fluctuation, called guaranteed minimum living benefits (GLBs), most often referred to as a GLB rider. At least eighty-four percent (84%) of all variable annuities are now sold with these guaranteed minimum benefits, like the most popular Guaranteed Minimum Withdrawal Benefit (GMWB). This feature guarantees that the contract owner will receive the same minimum payout in retirement even if the value of the owner's investment goes down, like so many did over the past two years. For example, if $100,000 invested drops in value to $65,000, the investor's income stream stays at 5% of at least $100,000, not 5% of $65,000. We know annuity owners have been greatly satisfied in the product performance after seeing the value of the promised income stream from their annuities remained constant and not decrease during the market crisis. In short, GLBs allow variable annuity contract owners to take advantage of market gains with downside protection from potential market losses for purposes of receiving guaranteed income for life.

In the case of defined contribution plans, such as 403(b), 401(k) and Section 457 plans, some include one or more annuities as an investment alternative (more prevalent for public employers and for smaller plans of private sector employers), while others may limit participant investments to a variety of mutual funds. The standard distribution choices at retirement for these plans are lump sum or systematic withdrawals for a period of years or for life based on an Internal Revenue Code life expectancy calculation. Generally, most participants elect a lump sum distribution, which exposes the participants to investment or life style risks, and results in them potentially outliving their benefits. For this reason, plan sponsors should be encouraged to offer annuities as a distribution option. For those plans or IRAs that either consist of or include annuity contracts, individual or group, such contracts generally offer a broad range of annuitization options. Those options generally encompass most if not all of the options commonly available under

[1] MainStay Investments, "*Financial Advisors Study*", April 6, 2010.

defined benefit plans. The contracts also provide additional options, as well as a contractual right to any other form of annuity that is mutually agreed upon by the parties to the contract. The following types of annuity contracts are available through employer-sponsored plans:

Immediate Annuity-An annuity that is purchased with a single lump sum. Income payments begin within a short period—less than 13 months. Immediate annuities can be either fixed or variable.

Deferred Annuity- An annuity contract that is purchased either with a single premium or with periodic payments to help save for retirement. The contract owner determines the point at which accumulated principal and earnings are converted into a stream of income.

Guaranteed Minimum Living Benefits (GMLB)- A benefit that protects against investment risks by guaranteeing the level of account values or annuity payments. There are three types—guaranteed minimum income benefits, guaranteed minimum accumulation benefits, and guaranteed minimum withdrawal benefits.

Guaranteed Minimum Income Benefit (GMIB)- A guarantee that ensures, under certain conditions, that the owner may annuitize the contract based on the greater of (a) the actual account value or (b) a payout base equal to premiums credited with a defined interest rate or the maximum anniversary value of the account prior to annuitization.

Guaranteed Minimum Accumulation Benefit (GMAB)- A guarantee that ensures that the contract value of a variable annuity will be, at least, equal to a certain minimum amount after a specified number of years.

Guaranteed Minimum Withdrawal Benefit (GMWB)- A guarantee that promises that a certain percentage (usually 5-7%) of a guaranteed benefit base (often paid premiums) can be withdrawn annually until the base is completely recovered, regardless of market performance or the actual account balance, or for the lifetime of the contract owner or both spouses, depending on the type of product selected.

IRI's Response to the Administration's RFI

In April 2010, IRI provided a comprehensive response to the Administration's RFI regarding Lifetime Income Options for Participants in Retirement Plans. (See attached full IRI RFI response) IRI's RFI responses were developed through a two-month process involving over 70 experts from a wide cross-section of our members who provided input for our response. The IRI working group included guaranteed lifetime income experts from all of the various industries who are members of IRI including: insurance companies, distribution firms, including broker-dealers and banks, investment management firms, and industry service providers. In order for the Agencies to promote the use of guaranteed lifetime income strategies, we requested the Administration to take the following steps:

- Implement measures that will incentivize employers to make guaranteed lifetime income strategies available for employees inside employer-sponsored retirement plans;
- Help to make guaranteed lifetime income solutions attractive for investors outside of employer-sponsored plans, including in individual retirement accounts, by incentivizing their use and educating Americans about their benefits;

- Simplify rules and relieve administrative burdens for employers who wish to include guaranteed lifetime income products as investment or distribution options in their retirement plans; and
- Encourage the provision of high-quality educational materials to individuals by eliminating the current administrative barriers and regulatory uncertainty.

In our complete RFI response, we focused on the following specific issues among others:

Education

- **Plan Sponsor Fiduciary Liability for Providing Educational Material about Lifetime Income Products.** We advocated for changes to Interpretive Bulletin 96-1 to clarify that plan sponsors providing information about guaranteed lifetime income products will not constitute investment advice, and therefore, providing such advice will not create liability for the plan sponsor.

- **Required Disclosure of Lifetime Income Payment on Benefit Statements**. We promoted a required disclosure of an estimate of accrued benefits as a guaranteed lifetime income stream of payments on individual benefit statements. We specifically referenced our support for the Lifetime Income Disclosure Act sponsored by Senators Bingaman, Isakson, and Chairman Kohl as a good template for the Department of Labor to develop assumptions and guidelines for a model disclosure.

- **Sufficient Information about Guaranteed Lifetime Income Products**. The ERISA 404(c) regulations require a plan sponsor to provide participants with "sufficient information" to make investment decisions between plan options. We asked for clarification about what constituents "sufficient information" in the case of guaranteed lifetime income.

Plan Sponsors Duties

- **Plan Sponsors' Liability for Selecting and Monitoring Lifetime Income Products and Providers**. There is a need for clarity surrounding the duty of a plan sponsor to prudently select and monitor lifetime income investment options and the providers of such options. There was wide agreement that the safe harbor provided in Department of Labor regulations that plans sponsors currently follow during the selection process should be revised. We believe that the safe harbor has not been widely utilized because of concerns about the current provider elements. We also believe that the safe harbor is just as appropriate for other guaranteed lifetime income products as they are for distribution annuities.

- **Plan Sponsors' Potential Liability for Participants' Election of a Lifetime Income Product.** Plan sponsors of participant-directed defined contribution plans rely on ERISA 404(c) for limited relief from fiduciary liability for any losses that might otherwise result from a participant's imprudent election of an investment option under the plan. However, 404(c) does not make reference to a participant's election of a guaranteed lifetime income product that leads to a particular type of payout of the account. These products carry the additional risk regarding the claims-paying ability of the provider in the distant future. Thus, a participant's election of a guaranteed lifetime income product is more than just an investment decision. It is also permanent election of a form of payout.

We asked the Agencies to clarify if 404(c) relieves a plan sponsor of fiduciary liability for a participant's irrevocable election of a form of payout benefit.

- **Plan Sponsors Potential Liability for Investing Participants' Accounts in a Default Investment.** The Department of Labor has issued a safe harbor that provides limited fiduciary relief for certain default investments. The Qualified Default Investment Alternative (QDIA) regulations do not permit stable value funds (which often carry a lifetime income option) to be a QDIA; however, there is language in the regulation which states that funds that meet the qualification requirements of the regulations (such as retirement date funds) can have "ancillary" features such as "annuity purchase rights, investment guarantees, death benefit guarantees, or other features." We have advocated for regulatory certainty that products that otherwise qualify as a QDIA do not become disqualified simply because they have guaranteed lifetime or withdrawal rights. We also argued that DOL should revisit its exclusion of stable value products (such as fixed products that include guaranteed annuity purchase rates) as one of the options that could be used as the QDIA. The fact that there is a guaranteed feature should not disqualify these products from being QDIAs.

<u>Portability</u>

- **Lack of Portability (Provider Change or Product Removal).** We discussed the lack of portability as a big concern for plan sponsors, and the IRA rollover rules do not currently offer a clear solution. If plan sponsors change plan service providers and move the plan to another vendor, the lifetime income product may not be portable to the new provider, and the participants will lose the benefit of the guarantees for which they have already paid. We look forward to working with this Committee and the Treasury Department to address this portability issue. We think it is essential to determine if statutory changes to the Internal Revenue Code are necessary with respect to provisions related to 401(k), 403(b), 457(b) and other plan types.

<u>Notice, Waiver and Spousal Consents</u>

- **Qualified and Joint Survivor Rules Current Administrative Burdens.** We outlined the administrative burdens and complexities when the QJSA rules are applied in the context of guaranteed lifetime income products, including the requirements for notice, waiver, revocation, and spousal consents. Under current IRS rules, if a participant selects payment in the form of a life annuity, the exception to the survivor annuity rules is no longer available, and plans must comply with the QJSA and QPSA rules. It is not clear under the IRS Code or its Private Letter Ruling whether guaranteed lifetime income products like GLWBs that do not involve annuitization of participant accounts trigger application of the survivor annuity rules. We advocated for clarification that guaranteed lifetime income products in which the participants maintain control of an account balance supporting the lifetime income guarantee are not life annuities for the purposes of the survivor annuity rules. We believe that a plan participant's election of guaranteed living benefits (or automatic enrollment into such a structure) should not trigger QJSA/QPSA rules until such time that income has been deemed irrevocably annuitized and the income start date has been determined.

Required Minimum Distribution Rules

- **Changes to the Required Minimum Distribution (RMD) Rules.** The current RMD rules for annuity contracts inhibit offering annuity features that could address the following concerns: (i) longevity risk, (ii) retirees' anticipated inflation risk, and (iii) material unanticipated changes in a retiree's cash-flow needs during retirement. Among other requests that we made, we believe that pure longevity annuities (i.e., lifetime payout starting at an advanced age at/near life expectancy) should be carved out of the RMD rule.

We would welcome the opportunity to work with the Committee and the Administration in the future as you consider changes to the laws and regulations that would break down the barriers to the availability and use of guaranteed lifetime income products by all Americans including workers in employer-sponsored retirement plans. We hope that this testimony will be useful as we all continue to work toward the goal of helping all Americans achieve real retirement security.

INVESTMENT
COMPANY
INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

Hearing of the United States Senate Special Committee on Aging
"The Retirement Challenge – Making Savings Last a Lifetime"

Statement of the Investment Company Institute
June 16, 2010

The Investment Company Institute[1] is pleased to provide this written statement in connection with the hearing in the U.S. Senate Special Committee on Aging titled "The Retirement Challenge – Making Savings Last a Lifetime." The Institute strongly supports efforts to meet the needs of American retirees to manage retirement savings, which will increasingly consist of assets in defined contribution plans. We applaud the Committee and the Obama Administration for examining how American workers can manage their retirement assets with a view to obtaining a stream of income over their retirement years. As the Committee is aware, the Departments of Labor and Treasury recently requested and received public comments on lifetime income options. These comments are meant to guide the agencies in determining whether and how they could or should enhance retirement security for participants in employer-sponsored retirement plans and IRAs by facilitating access to, and use of, products or arrangements designed to provide a lifetime stream of income after retirement.[2] The extraordinary response to the Request for Information (RFI) illustrates the significance of this issue to the American people.

I. Introduction

Defined contribution plans such as 401(k) plans are proving to be highly effective in helping Americans save for retirement and are particularly well-suited for today's mobile workforce. Institute survey research shows that Americans in large majorities value the tax benefits and disciplined approach to saving that individual account plans provide and believe these plans will help them meet their retirement goals. Research by the Employee Benefit Research Institute and ICI, modeling a full career

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $11.97 trillion and serve almost 90 million shareholders.

[2] Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5253 (Feb. 2, 2010). To date, the agencies have received more than 700 comments in response to the RFI. The Institute's May 3, 2010 letter responding to the RFI is available at http://www.ici.org/pdf/24278.pdf.

for a group of actual plan participants, finds that participants will replace a significant amount of their pre-retirement income with their plan balances and Social Security.

Because most Americans will have several jobs during a working career, they likely will have several potential sources of retirement income – including other defined contribution plans, IRAs, defined benefit plans, and other savings or assets, as well as Social Security. Participants have the task of determining how to manage those combined assets in retirement.

As the Committee examines this important issue, which is very broad in scope, we urge the Committee to take into account the following key considerations, discussed in greater detail below:

- Participants have distribution choices and effective strategies to manage assets in retirement, including annuity and non-annuity approaches. For example, systematic withdrawal plans from mutual funds and other payout-oriented mutual fund products can be used to generate lifetime income.
- Because all strategies have tradeoffs, and participants have different circumstances and needs, decisions on managing assets in retirement must be made on an individual basis. Institute research shows that people act responsibly with their defined contribution plan balances at retirement.
- It is critical to raise awareness of retirement income options and help plan sponsors and participants understand and evaluate their choices. Providing high quality information, education and advice should be a shared priority of government and the private sector.
- Low take-up rates for annuities among retirement plan participants who have distribution choices is not necessarily evidence of a market failure or bias caused by how the annuity decision is "framed." Most retirees already hold most of their lifetime wealth in annuity-equivalent form.
- The government should not mandate or incentivize particular retirement income products, because of the wide variation in individual circumstances, the difficulty inherent in attempting to delineate which products should qualify for special treatment, and Americans' desire for flexibility with their 401(k) plan accounts. Rather, government policy should recognize that both annuity and non-annuity approaches to lifetime income are valid.

II. What Retirement Distribution Options Are Available and What Do People Choose?

Participants have choices at retirement. The most common forms of distribution available in defined contribution plans are lump sums, installment payments (whether pre-determined or ad-hoc), annuities, and systematic withdrawals based on a percentage of the account or other formula. In the PSCA's annual survey of profit-sharing and 401(k) plans, 21 percent offered an annuity option at retirement, 52 percent offered installment payments, and nearly 100 percent offered a lump sum.[3] A survey by Hewitt Associates puts the annuity offer rate at only 7 percent of plans, though they highlight the fact that another 2 percent expect to offer the option next year.[4]

Participants and IRA owners seeking to obtain a lifetime stream of income in retirement have a range of options. Multiple products and strategies are available to meet individuals' varying needs.

Installment payments and systematic withdrawal plans. Installment payments and systematic withdrawal plans (SWPs) from a plan account are methods to spread income from retirement savings over one's retirement. With installment payments, which are common in defined contribution plans today, a participant selects a period of years over which his or her account balance is to be distributed (typically 10 or 20 years). In a systematic withdrawal plan, a participant or IRA owner elects to receive a specified percentage or amount from the account on an established schedule. Financial planners recommend various ways to determine these payment streams. For example, some financial planners recommend individuals withdraw 3 percent to 4 percent of the initial account balance at age 65 and to increase that dollar amount by 3 percent for inflation in subsequent years.[5] These recommendations, which derive from these financial planners' modeling and Monte Carlo simulations, typically are based on a time horizon of 30 years.[6]

Life expectancy withdrawals. Another approach designed to ensure the retiree will not exhaust his or her savings before death is to calculate withdrawals based on remaining life expectancy, similar to

---

[3] *See* Profit Sharing/401k Council of America (PSCA), *52nd Annual Survey of Profit Sharing and 401(k) Plans (Reflecting 2008 Plan Experience)* (2009). The annuity offer rate does not vary systematically with plan size. Nearly 75 percent of plans surveyed allowed participants to retain their account balances in the plan. In addition, all plans, as required by law, permitted direct transfer to an IRA or other qualified retirement plan.

[4] *See* Hewitt Associates, *Survey Findings: Trends and Experiences in 401(k) Plans* (2009).

[5] *See, e.g.*, Harris, "Market Cycles and Safe Withdrawal Rates," *Journal of Financial Planning* (Sept. 2009), at 44 (research into safe withdrawal rates have resulted in "findings that range from 3 to 8 percent, with the most prevalent finding being 4 percent to 5 percent"). If an individual retires significantly after age 65, he or she might use a higher percentage, such as 5 percent.

[6] If retirees experience a bear market just after retirement (such as in 2008), experts recommend different ways to adjust the withdrawal strategy to sustain a high chance of not outliving one's assets. While the most effective tactic is to reduce withdrawal amounts, another option – less drastic to a retiree – is to forego pre-planned inflation adjustments for a number of years. *See* "Strategies for Coping After Retiring Into a Bear Market," *T. Rowe Price Report*, Issue No. 99 (Spring 2008), at 14.

a required minimum distribution (RMD) calculation in an IRA or qualified plan. Under this method, the withdrawal amount is recalculated each year by dividing the account balance by the individual's remaining life expectancy. As the account balance decreases, so will the denominator (life expectancy) in this calculation, and the resulting payment will never be zero. This method has the advantage of automatically satisfying the required minimum distribution rules and, as discussed later, Institute research shows that, for those IRA owners who take a withdrawal, the most common method cited for calculating the withdrawal is to meet the required minimum distribution rules.

Annuities. Insurance company annuities are another method of generating lifetime income from the participant's retirement accounts. The term annuity generally means any right to receive regular payments. In the insurance context, an annuity is a financial contract between an individual (the "annuitant") and an insurance company, in which the annuitant agrees to pay the insurance company a single premium or multiple premiums in return for income guaranteed for a specified time period, typically the remaining life of the annuitant. The purest form is a fixed immediate life annuity, in which the payment is either a fixed nominal amount or a fixed real amount that increases with inflation and the annuitant receives payments over his or her lifetime only. Several other features can be layered onto an annuity, such as guaranteed minimum withdrawal benefits, inflation protection, and death benefits.

Longevity insurance. Participants also can combine installments or SWPs with longevity insurance. Longevity insurance is a type of single premium deferred life annuity; that is, at a certain age (e.g., age 65) an investor would purchase a life annuity that does not begin to make payments until a later date (e.g., age 85). Because there is a significant chance that the annuitant will never receive a payment, longevity insurance is significantly less expensive per dollar of regular income than an immediate annuity. The remainder of the retiree's portfolio can remain invested in the market, but the longevity insurance provides a floor beneath which income of a long-lived retiree cannot fall regardless of the age to which the annuitant survives.

Managed payout and other new products. Today, new products and services are coming to market to speak to a wide range of retirement income needs. Some mutual fund companies offer funds designed to be investment vehicles and payment vehicles all in one. Commonly known as managed payout funds, these mutual funds are managed with sophisticated payout designs meant to provide a predictable monthly check. Some managed payout funds are designed to preserve principal throughout the life of the investment, and others are designed to distribute the entire account, including principal, over a set number of years. Some insurance companies are developing and offering products that combine mutual fund investments with annuities. For example, the investment option in the plan could consist of a mutual fund portfolio or target date fund alongside an annuity purchased over time with participant or employer contributions. Alternatively, instead of buying a single investment product, individuals can build portfolios – either on their own or with the help of an adviser – that combine both investments in mutual funds and fixed immediate life annuities. One way to do this is to target a certain percentage of the portfolio to be invested in immediate annuities and to buy annuities ratably over time to reach the desired portfolio allocation.

Delay Social Security benefits. Another strategy that may be advantageous for individuals who have assets in addition to Social Security is to live initially on the additional assets and delay taking Social Security benefits. An individual can, in effect, purchase annuity income by delaying receipt of Social Security benefits. For example, every month that an individual delays receiving Social Security benefits after age 62 and before reaching age 70, his or her monthly benefit is increased by anywhere from half of 1 percent to three-quarters of 1 percent, or about 7 percent to 8 percent a year. One advantage of this strategy is that, because benefit adjustments are approximately actuarially fair, a dollar spent delaying Social Security receipt buys more annuity income than a dollar spent purchasing a private-sector annuity.

Annuity demand is low. Two recent studies show that the two most common distribution methods used by plan participants (each used by about one-third of older workers leaving their jobs) are rolling over their accumulated balances into an IRA or leaving the balances to continue accumulating earnings in the employer's plan.[7] The fraction of participants who withdraw their funds without rolling them over is about 15 percent and the remaining 15 percent or so report some "other" distribution. These studies also estimate that the fraction of older workers leaving their jobs who convert their defined contribution balance to an annuity (either through an in-plan option or externally) is somewhere between 3 percent and 4 percent. Another study found that in defined contribution plans that offer in-plan annuities, the annuity option is chosen only around 6 percent of the time.[8]

---

[7] *See* Johnson, Burman, and Kobes, "Annuitized Wealth at Older Ages: Evidence from the Health and Retirement Study," Urban Institute (2004), available at www.urban.org/UploadedPDF/411000_annuitized_wealth.pdf; and Hurd and Panis, "The Choice to Cash Out Pension Rights at Job Change or Retirement," *The Journal of Public Economics* (2006).

[8] *See* Hewitt Associates, *Survey Findings: Trends and Experiences in 401(k) Plans 2003, 2005* (2005). Given that the overall use of annuities by older workers leaving their jobs is 3 percent to 4 percent, and at most 20 percent of plans offer annuities, this estimate of the take-up rate when a plan offers an annuity could be at the lower bounds of the overall population take-up rate, possibly due to the survey's sample. The Institute's own research based on a sample of retired workers suggests take-up rates among retirees from 401(k) plans who recall having an annuity option is just over 20 percent. *See* Sabelhaus, Bogdan, and Holden, *Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007*, Investment Company Institute Research Series (Fall 2008); available at www.ici.org/pdf/rpt_08_dcdd.pdf. The inclusion criteria for ICI's study were: (1) be the primary or co-decisionmaker for saving and investment decisions; (2) have retired from his or her lifetime occupation in 2002 or later; (3) have personally

The low level of annuity demand seen within defined contribution plans is consistent with the current take-up of annuities in defined benefit plans. In defined benefit plans, annuities are required and serve as default options in that spousal consent is required to opt out of the annuity. One study showed that overall, only 11.5 percent of participants leaving defined benefit plans that provided a choice of distribution option chose the annuity option, including 34.8 percent of separating defined benefit plan participants over 60 years of age.[9] Additional evidence that defined benefit plan participants desire alternative (non-annuity) payouts comes from considering the evolution of plan designs over time. Just over a decade ago, 76 percent of private sector defined benefit plans of medium and large businesses offered annuities as the only distribution choice.[10] By 2005, more than half of private-sector defined benefit plans offered a full or partial lump-sum distribution option.[11]

Evidence from outside of employer-sponsored plans also suggests that, when provided the option, investors rarely purchase immediate life annuities. Although all non-qualified deferred

---

contributed to a defined contribution plan or some other individual account plan at the organization from which he or she retired; and (4) determined how his or her account balance was invested before retiring. One indication of how this sample differed from the general population is that the fraction who recalled having an annuity option (or said the annuity was their only option) was 44 percent, while (as noted above) the estimates for 401(k) plans generally are on the order of 20 percent or less.

The highest estimates of annuity take-up in defined contribution plans are found in plans run by TIAA-CREF, where just under half of retirees took the annuity option in 2001. *See* Ameriks, "How Do Retirees Go from Stock to Flow?" *in* Mitchell and Utkus, *Pension Design and Structure: New Lessons from Behavioral Finance* (2004), pp. 237-58. This may suggest differential demand for annuities across the retiree population. Because the population served by TIAA-CREF (employees in higher education) has generally higher incomes and typically lacks defined benefit pensions, their higher propensity to annuitize is consistent with their greater need to supplement Social Security to achieve some target annuitization of lifetime wealth. It is also worth noting that in TIAA-CREF the annuity was the only option until 1989. After lump-sum and other distribution options were added, the take-up rate for annuities began falling steadily from 100 percent in 1988 to 45.1 percent by 2001 (the last year for which the TIAA-CREF data are available). If the decline in annuitization continued after 2001, the take up of annuities within TIAA-CREF may be coming into line with estimates from other sources.

[9] *See* "Choosey Employees Choose Lump Sums!" *Watson Wyatt Insider* (April 1998), available at www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=7249. Other estimates from defined benefit plans are within this range of annuity demand. *See* "Immediate Income Annuities and Defined Contribution Plans," *Vanguard Center for Retirement Research*, Volume 32 (May 2008), available at https://institutional.vanguard.com/iam/pdf/CRRADC.pdf. The Vanguard study also notes that the annuitization rate from the federal employees' Thrift Savings Plan is only 1 percent, but that group also has a substantial defined benefit plan.

[10] *See* U.S. Department of Labor, *Employee Benefits in Medium and Large Private Establishments, 1997* (1999), *p. 107*, available at www.bls.gov/ncs/ebs/sp/ebbl0017.pdf.

[11] *See* U.S. Department of Labor, *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2005* (2007), p. 66, available at www.bls.gov/ncs/ebs/sp/ebbl0022.pdf.

annuities include the option to annuitize, few investors take advantage of the option. For example, less than 5 percent of deferred variable annuities are converted to an immediate annuity.[12]

III. What Factors Determine Whether Participants Select Annuities or Other Options?

Choosing retirement income products or solutions involves tradeoffs. The various distribution forms described above – from fixed immediate life annuities to systematic withdrawals from plan accounts, and everything in-between – have advantages and disadvantages. Annuities allow individuals to receive a regular stream of income without worrying about market volatility and outliving one's assets.[13] On the other hand, buying an annuity usually means not having access to savings in case of emergency and the ability to leave unused assets to heirs.[14] There are annuities available with features designed to mitigate these problems, such as annuities that provide lump-sum cash-out options, promise minimum distribution benefits, or provide death benefits to survivors. Adding these features to an annuity reduces the monthly payment amount that continues regardless of how long the annuitant lives. With systematic payout arrangements, the participant typically has a higher rate of return, remains in control of the assets, can access money in an emergency, and can pass on any remaining assets to heirs. Systematic payment options do not, however, come with a "guarantee" – the contractual promise to continue regular payments over the holder's lifetime. The money in the participant's account remains invested and subject to market risk, and there is no guarantee that the return on the account will allow the anticipated payments to continue as planned.

Whether an annuity or other lifetime income option is appropriate is a highly individualized question. While there are certain risks that apply universally – longevity, declining markets, and inflation – there are many other factors that vary from individual to individual. Participants must take account of their personal circumstances, including other assets or income, health status and life expectancy, the need to have cash available for emergencies, goals in retirement and interest in leaving assets to heirs. Participants may have personal preferences relating to the cost and complexity of financial products or a desire to keep control of their money. All of these relevant considerations could lead individuals to different conclusions as to their most appropriate retirement income arrangement.

---

[12] See Margaret E. Haering, "A Bad Marriage? Variable Annuities and 401(k) Plans," *Workforce Management* (May 2006), *available at* www.workforce.com/section/02/feature/24/37/11/index.html.

[13] The guaranteed income of an annuity depends on the insurance company's ability to pay. This guarantee typically is backed up by a state guaranty association, subject to any maximum benefit limits the state sets that may operate to limit the amount of the insurer's obligation on any annuity contract that the guarantee fund provides. *See* www.nolhga.com/policyholderinfo/main.cfm/location/questions.

[14] If the annuity does not include an increase for inflation, annuitants face the risk that their relative annual income will fall due to inflation.

The current low rate of annuitization among plan participants and IRA owners does not indicate a market failure or societal problem. The extent to which a retiree may want to annuitize his or her wealth will depend on the factors described above. There are several practical reasons for not electing to annuitize a defined contribution plan account balance.

First, as explained in more detail later, an individual may already be highly annuitized through Social Security and defined benefit pension income.[15] It is important to recognize that many individuals will get the bulk of their retirement income in the form of an inflation-indexed immediate life annuity; that is, in the form of Social Security benefits. For example, looking at individuals age 65 and older in 2006 who reported they did not work, 51 percent of all income received by the group came from Social Security benefits, with 14 percent coming from private-sector pensions (both defined contribution and defined benefit) and 12 percent coming from government pensions.[16] Ranked by income, *the bottom half of individuals in this group get 85 percent of their income from Social Security benefits.*[17]

Second, retirees may place a high value on being able to address a health shock or other unexpected life event in retirement. For example, retirees may face situations (or perceive they may face situations) where they will need funds to pay for an expensive medical procedure, maintain their residence, or enable them to continue to live independently. As described below, Institute research shows that these are exactly the types of expenses listed by IRA holders in explaining how they manage their IRA balances.

There are other factors that also could make someone reluctant to annuitize, such as the problem of adverse selection. Adverse selection can occur when those with a shorter than average expected lifespan select out of the insurance pool, thus making the insurance more expensive for the remaining individuals, and less of a "good deal."[18] Another possible reason is counterparty risk, or the

---

[15] Although coverage of private-sector workers in defined benefit plans has declined, there still are many Americans who will retire with a defined benefit pension, especially if they spent all or part of their career in the public sector.

[16] Statistics reported are ICI tabulations of Bureau of Labor Statistics, Current Population Survey (CPS) data. *See* Submission from Paul Schott Stevens, President and CEO, Investment Company Institute, to Honorable George Miller, Chairman, Committee on Education and Labor, U.S. House of Representatives (March 10, 2009), for the record in connection with Education and Labor Committee Hearing on February 24, 2009.

[17] The importance of Social Security has not changed much over time, as the story was much the same three decades ago (based on ICI tabulations of CPS data). Whatever changes may be made to Social Security in the future, we assume it will continue to provide significant income to lower-wage workers in retirement.

[18] An "actuarially fair" investment is one that is expected, in present value, to provide a dollar of benefit for a dollar invested. For the average individual, a dollar invested in a fixed immediate life annuity is expected to pay out less than a dollar of benefits over the individual's lifetime. There are two reasons for this. First, as with all financial products, there are sales and administrative expenses that must be covered, and these are typically paid out of the proceeds used to purchase the annuity

risk that the insurance company will default on its obligation.[19] Individuals may be uncomfortable with turning over all or a significant portion of their assets to a single company that could cease to exist several years in the future or fail to provide the level and quality of service they seek.

Some have advanced behavioral hypotheses for lack of annuity demand, including the principles of "regret aversion" and "framing." Regret aversion refers to the notion that an individual will overweight a possible outcome that he would particularly dislike, such as discovering a terminal illness soon after purchasing a life annuity. Framing involves the argument that the way the annuity transaction is presented to the individual will impact the decision to buy or not buy the annuity.[20] For

---

or by reducing the rate of return of the investment. These charges can vary depending on how the annuity is sold (for example, a group annuity versus and individual annuity) and on the efficiency of the administrative services.

However, the primary reason that annuities are not actuarially fair for the average individual is because of asymmetric information and adverse selection: Typically individuals have a better estimate than an insurance company as to how long they will live. If an insurance company offered an annuity that was actuarially fair for the average individual (that is, paid out a dollar in expected benefits for a dollar invested), those who had private information indicating that they would live longer than average would choose to annuitize and those who had private information indicating that they would live shorter than average would choose not to annuitize. As a result, any insurance company that offered an annuity that was actuarially fair for the average individual would lose money. To stay in business, the insurance company needs to increase the price of (reduce the payments from) the annuity. The end result is that annuities are priced so that they are not actuarially fair for the average individual, and only a portion of individuals, who in aggregate expect to live longer than average, will annuitize their wealth. (Leaving aside sales and administrative expenses, annuities are presumably actuarially fair for the average annuitant; the average annuitant lives longer than the average individual.) The typical estimate is that the average individual can expect a nominal annuity to pay out 80 cents to 85 cents for each dollar invested. *See, e.g.*, Mitchell, Poterba, Warshawsky, and Brown, "New Evidence on the Money's Worth of Individual Annuities," *American Economic Review*, vol. 89, no. 5 (1999), pp. 1299-1318.

Even when annuities are offered as a distribution option from a defined contribution plan, as long as participants can choose not to elect the annuity (as most do), the problem of adverse selection continues to exist. In other words, the government could not solve the pricing effect of adverse selection by mandating that all plans offer an annuity as an investment option.

[19] The Department of Labor recognizes the importance of considering the ability of an insurance company to meet its obligations. *See, e.g.*, 29 C.F.R. § 2550.404a-4(b)(4) (safe harbor for selection of annuity providers satisfied if, among other things, fiduciary "[a]ppropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract").

[20] The principle of "framing" suggests that the way in which the tradeoff is presented to potential annuitants matters a great deal in how they perceive the contract. If the description of the contract focuses on the annuity as one of two possible investment decisions, they might tend to downplay the possible gains (income for life) relative to the possible losses (their investment vanishes if they die soon after purchasing the annuity). However, if the contract is "framed" as a choice between two consumption decisions—where the lump sum is characterized as an uncertain spending stream that might be exhausted before the person dies—their view of the annuity might change. *See* Brown, Kling, Mullainathan, and Wrobel, "Why Don't People Insure Late-Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle," *American Economic Review*, vol. 98, no. 2 (2009): pp. 304-09. In assessing the validity of any study on the effects of framing, it is important to consider the exact wording of the questions posed and whether information pertinent to the decision was left out. Asking survey participants to compare two possibilities with limited details may lead to a shift in responses, but does not necessarily mean that the survey participant would make the same choice in the real world.

example, if the annuity is presented as a transaction in which the purchaser loses money if he does not live beyond a certain age, it will be viewed less favorably than if presented as obtaining a predictable spending stream that will never run out. Underlying calls to "reframe" the annuity contract, or use other behavioral strategies, to influence more Americans to choose annuity income is the presumption that for large numbers of Americans not electing an annuity is an irrational choice. We strongly believe, for the reasons we explain, this assumption is false.

Most retirees already hold most of their lifetime wealth in annuity-equivalent form. Social Security, defined benefit plans, and owner-occupied housing represent significant annuitized wealth for most retired Americans.

Social Security. For most Americans, their claim to Social Security benefits represents the largest component of their overall wealth. Social Security not only provides regular income for the life of the recipient, it also adjusts the payments for inflation. In addition, Social Security benefits are progressive, so they replace a higher percentage of pre-retirement earnings for workers with lower lifetime earnings than they replace for higher earners. A recent Congressional Budget Office (CBO) report estimates that scheduled Social Security benefits will replace about 43 percent of average earnings for the median worker born between 1950 and 1959.[21] The median replacement rate for the 20 percent of workers with the lowest earnings in this group is projected to be 70 percent.

Defined benefit plans. A second source of annuitized income is defined benefit pension plans. Although fewer private-sector companies offer defined benefit plans today, many retired private-sector employees and many approaching retirement still have claims to annuity payments from defined benefit pension plans. In addition, government employees typically have defined benefit pensions and, to date, there is no indication that defined benefit coverage has fallen among this group. Perhaps not surprisingly for a benefit designed to supplement Social Security, pension coverage is more common among workers with higher earnings.

Owner-occupied housing. Another type of wealth that can be considered "annuitized" is owner-occupied housing. If a household did not own its home, it would be required to pay rent to live in the home. The primary benefit of owner-occupied housing is that it provides imputed rental income in excess of expenses, which reduces the need for a regular stream of income from other sources. For many households, the home is the most valuable asset. According to tabulations of the Federal Reserve Board's 2007 *Survey of Consumer Finances*, of households with a household head age 65 to 74, 85

---

[21] *See CBO's Long-Term Projections for Social Security: 2009 Update* (August 2009), Table 4, available at www.cbo.gov/ftpdocs/104xx/doc10457/08-07-SocialSecurity_Update.pdf.

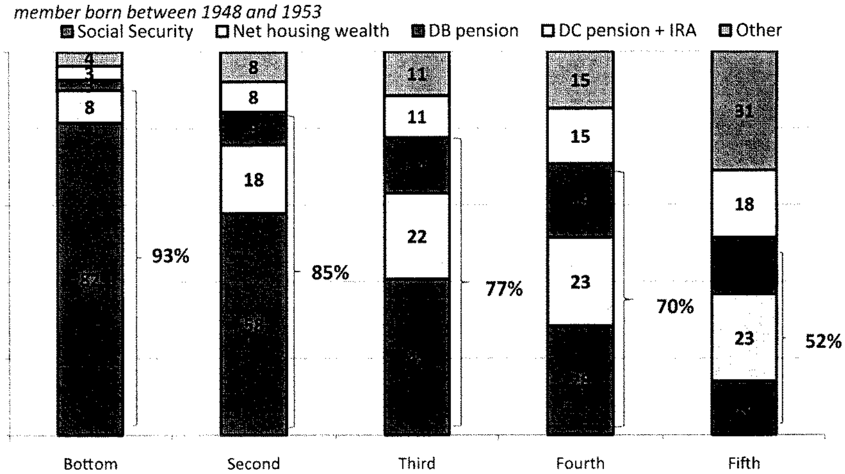
percent own their home; and about half of these homeowners, or 42 percent overall, own a home unencumbered by mortgage debt.

A recent study looked at the components of wealth in 2006 for households with at least one member born between 1948 and 1953 (between 53 and 58 years of age in 2006).[22] To calculate Social Security wealth, the authors used detailed data of each individual's earnings history to project future benefits and then calculated a present value for that stream of income. For most households, the bulk of wealth was already in annuitized form – that is, either Social Security wealth, net housing wealth, or accrued defined benefit pension benefits. For the bottom 20 percent of the wealth distribution, annuitized assets accounted for 93 percent of wealth. Even for households in the second highest wealth quintile, annuitized assets accounted for 70 percent of wealth. The top 20 percent of the wealth distribution had a comparably low proportion of wealth annuitized, with 52 percent. These statistics suggest that it is higher-income households that are most likely to desire supplemental annuity income, not lower-income households.

[22] Gustman, Steinmeier, and Tabatabai, "What the Stock Market Decline Means for the Financial Security and Retirement Choices of the Near-Retirement Population," Michigan Retirement Research Center Working Paper WP2009-206 (Oct. 2009).

Most Retirees Already Hold Most Lifetime Wealth in Annuity-Equivalent Form

Percentage of wealth by wealth quintile in 2006 for households with at least one member born between 1948 and 1953



Note: Households with top and bottom 1 percent of total wealth excluded. Components may not add to 100 percent because of rounding. Source: Gustman, Steinmeier, and Tabatabai, "What the Stock Market Decline Means for the Financial Security and Retirement Choices of the Near-Retirement Population," Michigan Retirement Research Center Working Paper WP2009-206, October 2009.

Institute research shows that, by and large, people act responsibly with their defined contribution plan account balances at retirement. Few retirees cash out their balances; most select reinvesting a lump-sum distribution, installment payments, annuities, or leaving the balance in their employer's plan.

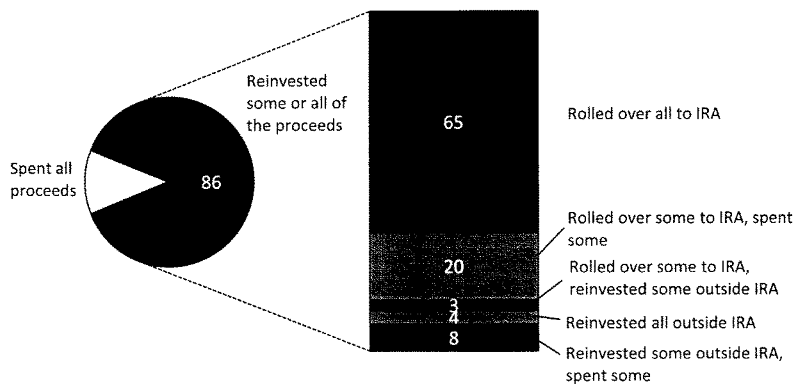
Participants' use of plan assets upon retirement. In late 2007, ICI surveyed recent retirees who had actively participated in defined contribution plans (including 401(k), 403(b), and governmental defined contribution plans) about how they used plan proceeds at retirement.[23] Respondents reported a wide variety of options, but the dominant outcomes were distribution through a reinvested lump-sum, installment payments, annuities, or leaving the balance in the employer's plan. Of those that chose

---

[23] For the complete report, *see* Sabelhaus, Bogdan, and Holden, *Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007*, Investment Company Institute Research Series (Fall 2008); available at www.ici.org/pdf/rpt_08_dcdd.pdf.

a lump-sum distribution, only 14 percent spent all the proceeds of the distribution. Notably, for those that spent all the proceeds, the median value of the lump-sum distribution was only $25,000. The remaining participants rolled over some or all of the balance to an IRA or otherwise reinvested the assets. The fact that higher balances tend to be rolled over means that "leakage" from the defined contribution system is low; the Institute's study found that 7 percent of the value of lump-sum distributions were cashed out (and possibly spent), and that represented only 3 percent of all total accumulated defined contribution account balances (because lump sums represented about half of the total).

Bulk of Lump-Sum Distributions at Retirement are Rolled Over
Percentage of respondents



Note: Individuals retired from a defined contribution plan between 2002 and 2007. Data as of fall 2007.
Source: ICI Defined Contribution Plan Distribution Decisions Survey, 2007

In making their distribution decision, retirees with a choice of options often consulted multiple sources of information. Forty-two percent indicated they sought advice from a professional financial adviser that they found on their own. Three in 10 indicated they attended a seminar or workshop offered by their employer; 29 percent reviewed printed materials provided by their employer; and 13 percent used a professional financial adviser provided by their employer. Fifteen percent sought advice from a publication and 10 percent considered information provided in mutual fund company materials.

Use of IRA assets by IRA owners. A large portion of the assets distributed from employer plans are rolled over into IRAs. In a separate survey of IRA owners, ICI found that households that own

IRAs tend to be responsible stewards of their IRA assets.[24] In May 2009, ICI surveyed households that owned IRAs and asked a series of questions about withdrawals. Overall, few households withdraw money from their IRAs in any given year, and most withdrawals are retirement related. Of households with traditional IRAs in 2009, 19 percent reported taking a withdrawal in tax year 2008. Withdrawals were typically modest: the median withdrawal is $6,000 and 32 percent of withdrawals totaled less than $2,500. The median ratio of withdrawals to account balance was 8 percent. The most common method for calculating a withdrawal, cited by 64 percent of households that took withdrawals, was to meet minimum distribution requirements under the Internal Revenue Code.

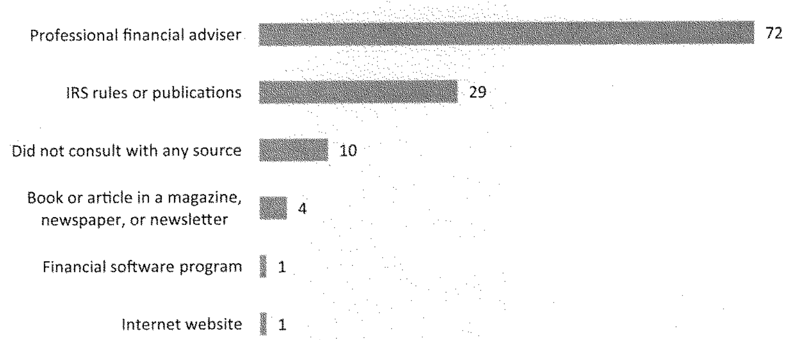
Among the traditional IRA–owning households that took withdrawals where either the head or spouse was retired, the most commonly cited use of the funds (44 percent of respondents who took withdrawals) was to pay for living expenses. That suggests the minimum distribution guidelines are a benchmark that retirees use to determine how much they should spend out of their IRAs, which is a conservative approach because the minimum distribution rules are based on life expectancy. Other reasons for taking withdrawals cited by respondents included spending it on a healthcare expenses (19 percent), using it for an emergency (14 percent), and using it for home purchase, repair, or remodeling (15 percent). These motives for making IRA withdrawals underscore the fact that retirees have differing needs and desire the flexibility to manage their own funds should unexpected life events occur.

IRA-owning households that took withdrawals in tax year 2008 usually consulted outside sources to determine the amount of the withdrawal. Among households owning traditional IRAs in 2009 that took a withdrawal in tax year 2008, 72 percent consulted a professional financial adviser to determine the amount to withdraw. The second most-cited source of information for the distribution decision was IRS rules or publications, consulted by 29 percent of traditional IRA–owning households with withdrawals.

---

[24] *See* Holden and Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2009," *ICI Fundamentals*, vol. 19, no. 1 (Jan. 2010), available at www.ici.org/pdf/fm-v19n1.pdf. *See also* Holden and Schrass, "Appendix: Additional Data on IRA Ownership in 2009," *ICI Fundamentals*, vol. 19, no. 1A (Jan. 2010), available at www.ici.org/pdf/fm-v19n1_appendix.pdf.

The Majority of Households Consult with a Professional Financial Adviser to Determine the Amount of Traditional IRA Withdrawals
Percentage of traditional IRA–owning households that made withdrawals in tax year 2008

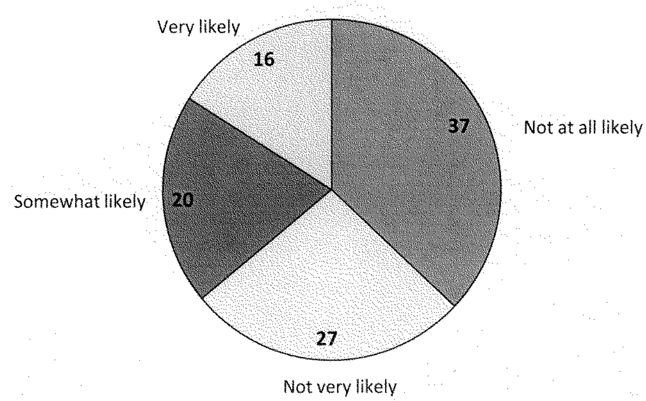


Note: Multiple responses are included.
Source: Investment Company Institute IRA Owners Survey, 2009

Because current withdrawal activity may not be a good indicator of future withdrawal activity, ICI also asked about future plans. Among traditional IRA–owning households in 2009 that did not take a withdrawal in tax year 2008, 64 percent said that they were unlikely to take a withdrawal before age 70½. The most commonly cited planned future use of IRA withdrawals was to pay for living expenses, although 67 percent of traditional IRA–owning households without withdrawals indicated a future use of the monies could be to cover an emergency. The expectations revealed by future retirees are consistent with the actual use of withdrawals among current retirees, and once again highlight the competing risks and priorities that retirees face when deciding how to manage their wealth.

Likelihood of Withdrawing from Traditional IRA Before Age 70 ½

Percentage of traditional IRA–owning households that did not take a withdrawal in tax year 2008



Source: Investment Company Institute IRA Owners Survey

In sum, Institute research provides evidence that retirees are not quick to spend their retirement savings. Instead, research illustrates rational decision-making by defined contribution plan participants at retirement. Retirees often consulted multiple sources of information in making their distribution decision. Only a very small portion of defined contribution plan retirees took a lump sum at retirement and spent the entire distribution. Those that did so tended to have small balances that could not be annuitized or gradually withdrawn over retirement on a reasonable basis. IRA owners tend to leave assets in the IRA for as long as legally possible, as part of an overall strategy for managing assets in retirement. In formulating this strategy, it is common for IRA owners to consult a professional financial adviser. The behavior of IRA owners suggests that 401(k) plan participants would make use of greater access to education and advice as they retire.

IV. Should Some Form of Lifetime Income Distribution Option be Required for Defined Contribution Plans?

The government should not mandate or incentivize particular retirement income products. Plan sponsors should determine what distribution options to make available within their plans and whether to implement a default distribution option. Plan participants should be free to select among the options available to them, including seeking lifetime income options or draw-down strategies outside of their workplace plans.

First, because of the wide variation in individual circumstances, it would be a mistake for the government to institute mandates or artificial incentives (such as a tax benefit for annuity income) in favor of one particular retirement income product. In a government mandate for an annuity, it would be impossible to formulate a legitimate general rule as to how much of the account should be annuitized and what features should be part of the annuity. The general rule would not be suitable for all, or even most, individuals.

Second, our research shows that Americans are overwhelmingly against being required to annuitize some portion of their 401(k) plan accounts. At the end of 2009, ICI surveyed American households about their thoughts on retirement accounts and retirement plan reforms suggested in policy circles.[25] Seven in 10 U.S. households indicated they opposed the government requiring retirees to trade a portion of their retirement plan accounts for a fair contract that promises to pay income for life, whether from the government or an insurance company. Opposition to such a proposal was more than 80 percent among older, higher-income groups, for whom annuitization is a more salient issue. Survey responses also indicate that households value the discipline and investment opportunity that 401(k) plans represent. Households' views on policy changes revealed a preference to preserve retirement account features and flexibility. Ninety-six percent of all U.S. households indicated they did not want the government to take away retirees' ability to make decisions about retirement assets and income.

Third, creating incentives or mandates for annuities necessarily would involve the government in extensive line-drawing as to what products qualify for the incentive or mandate. When policymakers discuss annuitizing income, they typically have in mind a fixed immediate life annuity, in which the payment is either a fixed nominal amount or a fixed real amount that increases with inflation and the annuitant receives payments over his or her lifetime only. Annuities of this form are pure insurance because individuals insure against the risk of outliving assets by pooling their assets. But annuities take many different forms. Some products labeled as an "annuity" are not what policymakers mean when they use the term annuity. For example, some are designed to accumulate assets rather than provide regular income. Although these products typically have a provision that allows investors to convert the account balance to an immediate annuity at some point in the future, that option is rarely exercised.

[25] Questions were asked in a series of national telephone surveys that GfK Custom Research North America fielded every other weekend from November 20, 2009, through December 20, 2009, covering a total sample of 3,000 U.S. households. Survey results are described in Holden, Sabelhaus, and Reid, *Enduring Confidence in the 401(k) System: Investor Attitudes and Actions*, available at www.ici.org/pdf/ppr_10_ret_saving.pdf.

Others have features, such as guaranteed payments and death benefits, that reduce the amount of pure insurance offered by the annuity. Any government policy to incentivize or mandate particular lifetime income options would be flawed unless it looked beyond the form of the product and extensively analyzed its economics and how it typically is used.[26]

Finally, and most important, there is no "one size fits all" solution for obtaining lifetime income in retirement. The annuity and non-annuity options available to Americans involve tradeoffs and government policy cannot and should not posit that one approach is preferable for all or even a majority of Americans. Rather, government policy should recognize that both annuity and non-annuity strategies are valid.

The government should not seek to influence behavior by automating retiree choices. Some proposals aimed at increasing annuitization, such as making an annuity the automatic default distribution option, seek to use inertia to result in allegedly more rational choices. The trend of automation works well in the accumulation phase of employer-sponsored retirement savings but we do not believe automation is appropriate in the distribution phase. Today's automated plan features are simple, easy to understand and easy to apply to a whole participant population. The goal of automatic enrollment in 401(k) plans is to kick-start the retirement savings process. If one can afford to save for retirement, it is generally a good idea to participate in one's plan and to increase the level of contribution over time. The basic principles of investing (i.e., diversification) can generally apply to most retirement savers. Most importantly, for a participant who does not feel that the automatic choices (whether the default contribution rate or the default investment) are right for him or her, undoing the automatic election is easy and does not involve significant cost.

In the distribution phase, the needs of individuals can vary widely based on such factors as health status, family situation, goals for retirement, and other sources of income that the individual has, such as Social Security and defined benefit pension income. Automation of the retirement income decision is less advantageous. The choice of a spend-down product or approach is an individual decision. For these reasons, a plan sponsor that determines to designate a default distribution option may want to select one that participants can undo easily and without great expense. The decision to use automatic accumulation features such as automatic enrollment and escalation in plans rests with plan sponsors. Likewise, the decision on what distribution option will be the default also should rest with plan sponsors.

---

[26] In the past, bills have been introduced in Congress that would provide tax incentives for annuities even if the payments vary with market returns or they contain features not designed to provide lifetime income streams. *See, e.g.,* "Retirement Security for Life Act of 2009," S. 1297, 111th Congress (2009).

In assessing the economic impact of any policy proposal to encourage or mandate annuitization, it is important to consider risks to the government and risks to sub-groups of Americans. If the government enacts policies designed to shift significant retirement savings into annuities, the U.S. government may be compelled to step in to guarantee the annuities purchased if something that affects all insurance companies were to occur, such as a big jump in life expectancy or another financial crisis that imperils financial services firms.[27]

Another factor to consider is how costs would be borne by those groups of workers that are incentivized, defaulted, or mandated to accept an annuity. The basic financial result of an annuity is to transfer assets from individuals who live shorter than average to those who live longer than average. Although each individual is different, certain groups tend to live longer than others, and the longer-lived group will tend to benefit from annuity payouts bolstered by those who did not live long enough to need the annuity insurance. If governmental mandates or incentives are applied to defined contribution plans or IRAs, then one effect could be a transfer of wealth, on average, from one group of Americans to another—such as from those who are poorer to those who are richer.[28]

V. What Influences Plan Sponsor Decisions to Include Annuities in Plans?

While factors like regulatory complexity and fiduciary compliance costs play a role, plan sponsors decide to offer annuities largely based on participant demand, or lack thereof. For a plan sponsor, the prospect of selecting and monitoring an annuity provider involves fiduciary considerations and may not be worth the time and expense given the low number of participants who may be interested in buying an in-plan annuity. Another consideration for the plan sponsor is the ability to change providers when the selected provider or product is no longer deemed appropriate under the plan's ongoing fiduciary process – switching to a new provider for an in-plan annuity may not be easy

---

[27] The typical hedge for the risk of increasing life expectancy for an insurance company that writes annuities is for the insurer also to write life insurance policies, because payouts from life insurance policies should decline as payouts from annuities increase. There may be limits, however, to the extent that insurance companies can hedge these risks, and some have suggested that the government should step in and create a hedge for aggregate mortality risks. *See* Brown and Orzag, "The Political Economy of Government-Issued Longevity Bonds," *Journal of Risk and Insurance*, vol. 73, no. 4 (2006); Friedberg and Webb, "Life Is Cheap: Using Mortality Bonds to Hedge Mortality Risk," *B.E. Journal of Economic Analysis and Policy: Topics in Economic Analysis and Policy*, vol. 7, no. 1 (2007). The government would need to consider the risks of this approach to the taxpayers, who not only have no natural hedge against the risks, but already face substantial risks from increased life expectancy through Social Security and Medicare.

[28] For evidence of differences in life expectancy by income – what demographers refer to as "differential mortality" – *see* Attanasio and Hoynes, "Differential Mortality and Wealth Accumulation," *Journal of Human Resources*, vol. 35, no. 1 (2000). *See also* Gong and Webb, "Mortality Heterogeneity and the Distributional Consequences of Mandatory Annuitization," *Journal of Risk and Insurance*, vol. 75, no. 4 (2008) (discussing the redistributive effect of mortality differentials under mandated annuities).

due to surrender charges and other contract obligations. Understanding annuity products also can be daunting to some plan sponsors.

While cost, potential liability, and complexity together may deter a plan sponsor from offering annuity options, we believe that lack of participant demand is one of the key reasons why annuities are not common in defined contribution plans. If participant demand were greater, more plan sponsors likely would offer annuities, notwithstanding the fiduciary and administrative burdens involved. In the end, a sponsor may want to assist employees with securing retirement income, but may feel that other methods better serve the needs of a participant population that is not disposed towards annuities – such as installment payments and systematic withdrawal plans and offering education and advice to participants about retirement income strategies and options.

Mandating that annuities be offered in plans would impose new fiduciary obligations that could discourage plan sponsorship or increase the costs of sponsoring plans unnecessarily, given the low interest level of participants in annuities. Mandating that an annuity option be the default distribution option choice in a plan also would create new administrative hurdles for sponsors and for participants,[29] who will likely end up selecting the same form of distribution that they otherwise would have selected absent the default regime. Increasing administrative burdens for employers will do nothing to encourage plan sponsorship. Employers that are interested in making lifetime income options, including annuities, available to their participants can do so without mandates.

VI. What Are the Advantages of In-Plan Lifetime Income Options vs. Out-of-plan?

Several factors determine whether it is preferable to make use of a lifetime income product or strategy within a plan or outside a plan. There are some advantages to participants as a group if an employer decides to make annuities available inside of a plan. Plan participants could benefit from

[29] Under Code section 401(a)(11), a defined contribution plan may not allow a married participant to elect a single life annuity unless the participant's spouse consents in writing. This consent must be witnessed by a plan representative or notary. No consent is required if the participant elects a lump-sum distribution or elects the qualified joint and survivor annuity. While the Institute has not taken a position on whether Congress should consider relaxing the spousal consent rule, we would support efforts to streamline the administrative process associated with spousal consent. We question, however, whether relaxing the spousal consent rules would significantly increase the number of defined contribution plans that offer annuities as a distribution option. Plan sponsors decide to offer annuities largely based on participant demand, or lack thereof, and we see no reason the low demand for annuities is due primarily to the spousal consent rules. Plan sponsors who believe participants will use and value annuities as a distribution option will offer them regardless of the specific regulatory boxes they must check, except at the margins. Further, since participants in defined benefit plans that offer lump-sum distributions commonly select the lump-sum option, we know that the requirement to obtain spousal consent is not a significant impediment to participants who wish to select a lump-sum option.

group purchasing power, as group annuities tend to be priced more favorably than individual annuity contracts.[30] The downside, however, is that the group annuity may not be as portable when individuals change jobs. The importance of this factor should not be discounted, as median job tenure in the United States is 4.1 years (7.2 years for government jobs and 3.6 years in the private sector).[31] This means that an individual could very likely work for seven different employers in a 30-year career.

Whether an in-plan or out-of-plan annuity is preferable also depends on individual participant circumstances. For example, gender may play a role in whether an in-plan annuity option would be beneficial. Compared to an out-of-plan annuity, an in-plan annuity may be more advantageous to women than for men. Annuities purchased outside a plan are priced separately for men and women, while annuities offered under employer-sponsored retirement plans must be provided on a gender-neutral basis. All else being equal, a unisex annuity will be more expensive (i.e., provide lower regular payments) to men because they are placed in an insurance pool with women, who have higher life expectancies. Conversely, all else being equal, a unisex annuity will be less expensive (i.e., provide higher regular payments) to women. Thus, in-plan annuities, both because they are unisex and because they are group, are typically less expensive for women than out-of-plan annuities. In contrast, in-plan annuities, because they are unisex and despite being group, may be more expensive for men than out-of-plan annuities.

For annuities and other lifetime income products or draw-down strategies, whether and to what extent a participant has other assets outside an individual's last 401(k) plan also can affect whether an in-plan option would be advantageous. Sometimes it will make sense for an individual to roll over a plan account from a previous job into the 401(k) plan at a new job, but other times, the individual may prefer to stay in the prior employer's plan or may not be permitted to roll over the entire balance from a prior employer's plan. In addition to having multiple plan accounts, some individuals also will have other assets intended for retirement not sitting in employer plans. Therefore, it makes little sense to place emphasis exclusively on the distribution forms available within a plan, particularly the plan at the worker's final job. For many people seeking a lifetime stream of income, the best course of action may be to take some portion of their combined assets and look for an annuity or other product outside of the plan.

---

[30] As discussed in note 18, sales and administrative expenses and adverse selection both affect annuity pricing. Group annuities may have lower sales and administrative expenses than an individual annuity, but will still be subject to adverse selection.

[31] Data on job tenure in the United States is collected every two years by the Bureau of Labor Statistics; the most recent values are for January 2008, published online September 26, 2008. The *Employee Tenure Summary* report is available at www.bls.gov/news.release/tenure.nr0.htm.

For this reason, IRAs play an important role for many retirement income seekers. IRAs are crucial in helping Americans accumulate retirement savings and in managing those savings over a lifetime and hold a significant portion of the retirement savings of American workers. They were created in 1974 under ERISA for the purpose of allowing workers without access to workplace retirement plans to save for retirement and as a vehicle for holding retirement assets after leaving employment. ICI data shows that IRA assets were $4.2 trillion at the end of 2009, accounting for about 25 percent of all retirement wealth and about 8 percent of all household financial assets.[32] Most of the money flowing into IRAs consists of rollovers of lump-sum distributions from employer-sponsored retirement plans.[33]

IRAs are used both to accumulate retirement savings and to manage assets in retirement. An IRA investor generally has access to the same strategies for obtaining lifetime income as a 401(k) plan participant—sometimes more. An IRA holder generally can purchase an annuity, arrange for systematic withdrawals, or purchase any other product or service designed to enable retirees to generate regular income streams from their retirement accounts. With an IRA, an individual can easily consolidate assets into a single vehicle and make use of a wide variety of income products or strategies.

VII. <u>What Information Do Participants Need to Make Informed Decisions About Lifetime Income?</u>

Government and industry have a shared responsibility to raise awareness of retirement income options and help plan sponsors and participants understand and evaluate their choices. Because there is no one-size-fits-all solution in the distribution phase, information, education and advice are of paramount importance. An individual must consider his or her own needs in retirement and understand what tools can help meet those needs. It is important to understand the objectives of the various distribution options available (both in and outside the plan) and how those options address an individual's needs, appreciate the limitations of each option, and understand product fees and expenses. As explained above, all of the options involve tradeoffs. In our response to the RFI, we recommended that the Departments of Labor and Treasury should update their regulatory guidance to deal with spend-down decisions and should play leadership roles in new initiatives to equip participants to make informed decisions about lifetime income. We repeat these recommendations below.

[32] *See* Investment Company Institute, *2010 Investment Company Fact Book*, available at www.ici.org/pdf/2010_factbook.pdf.

[33] *See* Sabelhaus and Schrass, "The Evolving Role of IRAs in U.S. Retirement Planning," *ICI Perspective*, vol. 15, no. 3 (Nov. 2009), available at www.ici.org/pdf/per15-03.pdf.

Guidance relating to education and advice. The regulators should tailor their policies to encourage education and advice programs in the distribution phase. The Department of Labor should extend Interpretive Bulletin 96-1 or provide other guidance that makes clear that sponsors and service providers may convey the general advantages and disadvantages of various distribution forms without triggering fiduciary liability. The Department also should complete its project to implement the PPA's investment advice exemption, which is designed to expand opportunities to provide advice within 401(k) plans and IRAs.

The Department also could provide guidance on the appropriate use of plan assets to pay for educational efforts to help participants make informed decisions about lifetime income and other distribution options, including options available outside of the plan. In PSCA's most recent survey, only roughly 35 percent of plans provided some sort of education to participants taking a retirement distribution.[34] This number could increase with clearer guidance and encouragement from regulators.

Leadership in equipping participants to make informed decisions. Most importantly, the regulators should serve as catalysts for public- and private-sector initiatives to develop educational materials to help participants with distribution decisions at retirement. The private sector, non-profits, and the government should partner to develop curriculum and publicize an educational campaign. This type of public/private partnerships might be modeled after the "Educate to Innovate" campaign, announced by the Obama Administration in late 2009 in which the government will partner with industry to promote advancement of American students in the science, math, engineering and technology fields.[35] This initiative involves (1) public-private sector partnerships to harness the power of the media and develop innovative approaches to spark the interest of students to pursue careers in science, technology, engineering and mathematics and (2) private-sector financial commitments to support state of the art educational programs in these fields.

For example, public- and private-sector stakeholders could work together to develop educational tools that meet the needs of those entering retirement and that deliver information in an effective manner. These materials will be most useful if they are made prominent and easily accessible through use of technology and new media, including YouTube videos, computer courses that employers could offer, or social networking sites. Materials should be developed with research in mind that shows that people like clear and concise information presented in graphic form and, for computer-based

[34] *See* Profit Sharing/401k Council of America (PSCA), *52nd Annual Survey of Profit Sharing and 401(k) Plans (Reflecting 2008 Plan Experience)* (2009).

[35] *See* www.whitehouse.gov/the-press-office/president-obama-launches-educate-innovate-campaign-excellence-science-technology-en.

information, want to be able to click through easily to additional relevant information.[36] Regulators and other interested public- and private-sector parties also may want to build a financial education curriculum based on these same principles. Policymakers may want to consider offering individuals and employers incentives to participate in or offer the financial education curriculum. They may also want to consider efforts to make Americans aware of the potential advantages – in terms of monthly income – of delaying the date at which they begin taking Social Security.

The Departments of Labor and Treasury also should work with other regulatory agencies with an interest in assisting and protecting retirement savers. In an effort to improve services to older investors, the Securities and Exchange Commission, the North American Securities Administrators Association, and the Financial Industry Regulatory Authority announced in 2008 that they will seek to identify effective practices used by financial services firms in dealing with senior investors.[37] Each of these regulators has developed extensive websites devoted to addressing the problem of senior fraud.[38] It would be a natural progression for the retirement plan regulators to join forces to expand these tools to protect retirement investors. The regulators should not only facilitate education but should maintain robust enforcement of investor protection rules in connection with senior fraud.

Disclosure that translates an account balance into a projected monthly income is useful and many plans have begun to provide this information. We commend Chairman Kohl for recognizing the value of this type of disclosure by cosponsoring the Lifetime Income Disclosure Act (S. 2832). It would be premature, however, to codify a single approach to providing the information. It generally is important for participants to think about their account balances in terms of the income they reasonably could generate in retirement. Many plans and plan providers have begun to provide this information to help participants understand whether their retirement saving is on track. For example, some providers offer participants online calculators, which calculate a participant's projected income stream in retirement based on various assumptions and allow the participant to see how the

[36] For survey results summarizing mutual fund–owning households' views on information presentation, *see, e.g.*, Sabelhaus, *Investor Views on the U.S. Securities and Exchange Commission's Proposed Summary Prospectus*, Investment Company Institute (March 14, 2008), available at www.ici.org/pdf/ppr_08_summary_prospectus.pdf; and West and Leonard-Chambers, *Understanding Investor Preferences for Mutual Fund Information*, Investment Company Institute (2006), available at www.ici.org/pdf/rpt_06_inv_prefs_full.pdf.

[37] *See SEC, NASAA and FINRA Announce New Steps to Help Protect Senior Investors* (press release issued Feb. 8, 2008), available on the SEC's website at www.sec.gov/news/press/2008/2008-16.htm. The initiative was to seek input in the following areas: marketing and advertising to seniors; account opening; product and account review; ongoing review of the relationship and appropriateness of products; discerning and meeting the changing needs of customers as they age; surveillance and compliance reviews; and training for firm employees.

[38] *See* www.sec.gov/investor/seniors.shtml; www.saveandinvest.org/55Plus/index.htm; www.nasaa.org/investor_education/Senior_Investor_Resource_Center/.

projected income stream would change if, for example, the participant reduced or increased contributions to the plan. In addition to offering these interactive tools on plan websites, some providers include information on account statements projecting the monthly income a participant might receive at age 65. These calculations assume the participant continues to participate at the same rate and typically assume historical rates of inflation and account performance in projecting an account balance at age 65.

Although we believe it would be premature to codify a single approach or methodology for this disclosure, we recommend encouraging plans to provide this information by developing and publishing guidelines for its use. For example, plans and providers should make clear that the information is an estimate and should disclose the key assumptions underlying the calculations. Because the market for retirement plan services is highly competitive and providers compete based on the quality of the information and services they provide to plans and participants, we are confident that we shortly will see the disclosure of this information throughout the plan market and that more and more effective ways of presenting the information will develop. Letting this competitive market evolve will better serve the interests of plan participants – the users of this information – than trying to codify a single approach at this time.

If, despite our recommendation, the government is determined to mandate a methodology for lifetime income disclosure on benefit statements, we strongly oppose using as the basis for disclosure what *today's account value* would buy in terms of lifetime income in the future when the participant reaches age 65, as some have proposed.[39] This disclosure would provide meaningful information only to those close to retirement whose accounts are near the end of the accumulation stage. The information would be meaningless or confusing to younger participants because their account balances likely will be small and generate very small annuity equivalents. This, in turn, could cause an employee to cash out the retirement account when he or she changes jobs rather than rolling it over to a new employer's plan.

The principal goal of lifetime income stream disclosure should be to allow participants to see if their retirement saving is on track. To provide meaningful information to all participants, lifetime income disclosure should take into account and project future contributions. This is the approach Social Security uses in the benefit statement notices it provides to American workers and the regulators should encourage its use in retirement plan benefit statement disclosure as well.

If a methodology for disclosure is in fact mandated, we also would oppose requiring lifetime income payments to be expressed in the form of annuity payments. A stream of income expressed as annuity payments would necessitate complex judgments by regulators and prescribing complex

[39] *See* "Lifetime Income Disclosure Act" S. 2832, 111th Congress (2009).

assumptions for the disclosure. A simpler approach for translating a projected final account balance into an income stream would be to divide the projected account balance by the life expectancy stated on IRS tables at a certain age, such as age 65.[40] Another approach would be to use 3 percent or 4 percent of the projected final account balance at age 65, the approach some financial planners use.

VIII. Impact of Shift from Defined Benefit Pensions to Defined Contribution Plans

To a large extent the increased public policy interest in annuitization has been motivated by the shift of private-sector employers toward defined contribution plans and away from traditional defined benefit pensions. Concerns by some that lack of availability and take up of annuities in defined contribution plans will put American retirement security at risk – a concern reflected in the Administration's RFI – appears to come from the belief that, in the past, private-sector defined benefit plans generated a substantial amount of retirement income for a large segment of the population. Defined benefit plans have many positive features but the reality is that they never provided significant benefits to a large proportion of the American workforce because of the vesting and accrual rules. The end result is that few workers received regular income from private-sector defined benefit pension plans in retirement.

For example, in 1981, the year that 401(k) plans were introduced, fewer than 20 percent of individuals age 65 and older who did not work reported regular income from a private-sector pension plan (including both defined benefit and defined contribution plans), and the median benefit was less than $6,000 a year in constant 2007 dollars.[41] Since 1981, the percentage of individuals age 65 and older who did not work who reported regular pension income has increased, so that by 2007 approximately 25 percent individuals age 65 and older who did not work received regular income from a private-sector pension plan and the median amount was just over $7,000.[42]

A recent Congressional Research Service report found that in 2007 the median value of all retirement accounts owned by households headed by persons between the ages of 55 and 64 was $100,000.[43] The report calculates that this would produce annual annuity income of approximately

---

[40] *See* IRS Publication 590, Appendix (Jan. 7, 2010). The single life expectancy (Table I) at age 65 is 21 years.

[41] ICI tabulations from the March *Current Population Survey*. For a more detailed discussion of this issue and the statistics discussed here, see Submission from Paul Schott Stevens, President and CEO, Investment Company Institute, to Honorable George Miller, Chairman, Committee on Education and Labor, U.S. House of Representatives (March 10, 2009), for the record in connection with Education and Labor Committee Hearing on February 24, 2009.

[42] Another 11 percent of individuals age 65 and older who did not work received regular payments from a government pension.

[43] *See* Purcell and Topoleski, "Retirement Savings and Household Wealth in 2007," *Congressional Research Service* Report RL30922, April 2009.

$8,400 for a man and $7,800 for a woman.[44] The report suggests that this amount of income is inadequate. Even though many workers have not had a defined contribution plan their entire career, this amount of annuity income is on par with the median amount of benefits generated by pension plans historically. In short, we do not agree that the shift from defined benefit to defined contribution plans has left Americans less prepared for retirement.

IX. Ensuring Assets are Available for Retirement

A worker will face the decision of how to convert retirement assets into a stream of income only if the worker arrives at retirement with retirement assets of significance. This raises a public policy concern the Committee has previously examined: ensuring that retirement savings are preserved as much as possible for retirement.[45] The rules that govern distributions, in-service withdrawals, and loans from defined contribution plans and distributions from IRAs reflect a balance between preventing unlimited access to tax-favored savings vehicles while encouraging workers to contribute to these vehicles by offering limited access, in some cases without penalty, for unexpected needs.

For example, section 72(t) of the Internal Revenue Code imposes a 10 percent penalty on certain early distributions from defined contribution plans and IRAs, but provides exceptions for various hardship situations like the need to pay medical expenses. Similarly, section 72(p) allows participants to take a loan from their 401(k) plan without adverse tax consequence, but restricts the amount of the loan and the repayment period.

Research shows that the presence of a loan provision increases 401(k) participants' contribution rates.[46] Loan activity by participants, however, even during economic downturns, is very modest. Over the thirteen years (1996 to 2008) that EBRI and ICI have tracked loan activity of 401(k) plan participants, fewer than one in five participants in 401(k) plans that offer loans have had loans

[44] Women receive less in annuity payments because women live longer than men, on average.

[45] Hearing on "Saving Smartly for Retirement: Are Americans Being Encouraged to Break Open the Piggy Bank?" before Senate Special Committee on Aging (July 16, 2008).

[46] Utkus, "401(k) Plan Design: Match, Loan, and Investment Menu Effects," *The Vanguard Center for Retirement Research* (Dec. 2005), available at https://institutional.vanguard.com/iip/pdf/VCRRPD.pdf; Holden and VanDerhei, "Contribution Behavior of 401(k) Plan Participants," *ICI Perspective*, vol. 7, no. 4, and *EBRI Issue Brief*, No. 238, (Oct. 2001), available at www.ici.org/pdf/per07-04.pdf; Munnell, Sundén, and Taylor, "What Determines 401(k) Participation and Contributions?" *CRR Working Paper*, No. 2000-12, (Dec. 2000), available at crr.bc.edu/images/stories/Working_Papers/wp_2000-12.pdf?phpMyAdmin=43ac483c4de9t51d9eb41; U.S. Government Accountability Office,"401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some" (Oct. 1997), available at www.gao.gov/archive/1998/he98005.pdf.

outstanding at any given year-end.[47] The Department of Labor's latest available data show participant loans represent less than 2 percent of the assets of defined contribution plans.[48]

ICI has recently focused its research to get a sense of retirement savers' activity and sentiment in light of the extraordinary financial market volatility of the past two years. Contrary to what some believe, defined contribution plan participants have not tapped their accounts any more than in the past. Only 3.1 percent of defined contribution plan participants took withdrawals in 2009, with only 1.6 percent taking hardship withdrawals.[49]

Similarly, IRA withdrawals are infrequent and mostly retirement related. As reported in ICI's most recent research on IRA-owning households, 19 percent of traditional IRA–owning households took a withdrawal in tax year 2008.[50] Eighty-four percent of households that made traditional IRA withdrawals were retired. Only 5 percent of traditional IRA–owning households in 2009 headed by individuals younger than 59 took withdrawals. In fact, research demonstrates that IRA owners tend to preserve their IRA balances until the government *forces* a distribution at age 70½.

Although the data suggest that workers by and large preserve their retirement savings for use in retirement, we support the focus of Chairman Kohl and the Special Committee on Aging in examining whether the rules that govern distributions, in-service withdrawals, and loans strike the right balance.

X. Conclusion

Helping Americans take informed and sensible steps to translate their defined contribution account balances into income streams in retirement is important. Plan participants and IRA holders

---

[47] Holden, Sabelhaus, and Reid, *Enduring Confidence in the 401(k) System: Investor Attitudes and Actions,* Washington, DC: Investment Company Institute (Jan. 2010), available at www.ici.org/pdf/ppr_10_ret_saving.pdf. In addition, among participants with loans, the loans tend to be a small percentage of the remaining account balance. For the most recent update of the EBRI/ICI 401(k) database, see Holden, VanDerhei, and Alonso, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008," *ICI Perspective*, vol. 15, no. 2, and *EBRI Issue Brief*, No. 335 (Oct. 2009), available at www.ici.org/pdf/per15-02.pdf.

[48] See Department of Labor, *Private Pension Plan Bulletin, Abstract of 2007 Form 5500 Annual Reports* (June 2010), Table A3, page 7, available at www.dol.gov/ebsa/PDF/2007pensionplanbulletin.PDF.

[49] Investment Company Institute, "Americans Committed to Saving for Retirement: ICI Year-End Data," *News Release*, April 26, 2010, available at: www.ici.org/pressroom/news/10_news_trow_am_saves.

[50] Holden and Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2009," *ICI Fundamentals*, vol. 19, no. 1 (Jan. 2010), available at www.ici.org/pdf/fm-v19n1.pdf.

today have choices and effective strategies to do so, including annuity and non-annuity approaches. Research shows retirees are careful stewards of their retirement assets and that they seek input from various sources in making distribution decisions. Raising awareness of retirement income options and helping plan sponsors, employees and retirees understand and evaluate their choices should be the first priority. Meeting participants' needs for quality information that is delivered effectively should be a shared responsibility of government and the private sector.

The various products and services that are designed to provide lifetime income involve tradeoffs and participants themselves have different needs and circumstances. In addition, most retirees already hold most of their lifetime wealth in annuity-equivalent form. No single retirement income solution is suitable for all or even most Americans who are deciding how to take distributions from their defined contribution plan accounts or IRAs. For this reason, government policy should recognize that both annuity and non-annuity approaches are valid and should not seek to mandate or incentivize one approach over the other. Research shows that Americans are overwhelmingly against being required to annuitize some portion of their retirement plan accounts. The focus of government policy should be on helping Americans make decisions – decisions we believe they clearly want to make on their own – about how to manage their assets in retirement.

The Institute is committed to efforts to meet the needs of Americans for a secure retirement and looks forward to working with the Committee, Congress and regulators on these important issues.

Retirement Solutions, LLC
235 Main St. #158
Madison, N.J. 07940
Phone: 973-796-4230
Fax: 973-236-1584
E-mail: jane@retirement-solutions.us

Don't Let the Annuity Industry Raid Empty Nest Eggs

The Retirement Security for Life Act would amend the Internal Revenue Code so that annuity buyers could get a 50% tax deduction on annuity income reaching $40,000 annually. For the average retiree, the tax break could approximate $5,000.

The tax deduction, however would be totally offset by the fees and illegal sales practices of one of the most poorly regulated investment products in the country—not to mention one whose existence is unnecessary. The misdoings by annuity salespeople include misleading potential buyers about investment returns and how soon they can access their savings along with generating commissions by convincing the customer to buy a new annuity.

Annuities are a "sucker's game dressed up to look like a free lunch," says John Gay, a financial planner in Frisco, TX, who like many of his colleagues believes that retirees would be better off buying zero-coupon T bonds and index funds.

While in the past annuity sellers concentrated on the already-retired market, they are now setting their sites on the Boomers who are about to retire and can't afford to. Some examples:

- In 2006 the National Association of Securities Dealers (now the Financial Industry Regulatory Authority) issued an investor alert regarding annuity sales people conducting workplace seminars in which they convinced employees to retire early, cash out of their 401(k)--in which they could occur tax consequences if they're under 59 ½--and open an IRA which consists of a variable annuity. In one disciplinary case that NASD prosecuted, the broker told the employees, "you can make as much in retirement as you can at work," saying that he could generate annual returns of 18%.

- A similar pitch was made to employees at Exxon Mobil workers in 1997: 32 of them bought the broker's line and lost most of their money. In May of 2006 an NASD arbitration panel awarded the workers $22 million—one of the largest such awards, including $3.5 million in damages.

- In May of 2006 Attorney General Eliot Spitzer announced an agreement in which the Hartford Financial Services Group would pay $20 million in restitution and fines as a result of insurance brokers recommending group annuities to pension plans. A similar agreement was reached with Connecticut Attorney General Richard Blumenthal.

This practice would be shameful enough if annuity sellers were taking an adequate nest egg and putting it into a bad investment; unfortunately currently the average American has saved only one-fifth of what they need—a dilemma no investment product can fix. To retire from a 401(k) account, participants need to have an account balance that's at least 10 times their salary right before retirement, the formula often used by pension actuaries to calculate the benefit for defined benefit pension plans.

Currently, the average American head of household between age 62 and 65 only has about $110,000, if you add the median 401(k) account balance to the median rollover IRA balance—or less than twice the median salary of $61,600 for that age group. The only solution for this shortfall is for Boomers to stay in the "accumulation phase" of investing by continuing to work—and banking most of their paycheck—until they can afford to be in the distribution phase.

The tack taken by annuity sellers targeting retirees is to profit by selling multiple annuities to the same buyer, impose surrender charges on a sale and target people who don't need them because they are unlikely to outlive their savings. What follows are a sampling of actions taken against annuity sellers targeting the already-retired in a variety of states.

- In July of this year Florida Governor Charlie Christ signed a law increasing penalties on annuity salespeople who pressure elderly clients to buy annuities they don't need or want. The law increases fines from $100,000 to as much as $150,000 for certain "unfair or deceptive annuity sales activities," including "twisting," in which a salesman lies about the benefits of his annuity to get you to sell your current annuity from a different company, or "churning," which is replacing the annuity you have with a new product from the same company. The law also bans the use of professional designations that mislead consumers into thinking the broker has special expertise.
- In 2005 New Jersey launched its Senior Citizen Investment Protection Act, which limits how long annuity sellers can impose surrender charges in the event the annuity owner wants to sell the product. Along with Utah and Washington, New Jersey limits to no more than 10 years the length of time insurers can impose surrender charges.
- That same year the Massachusetts Securities Division convinced Bank of America to let thousands of elderly investors withdraw money from a variable annuity without penalty. In addition, the division issued subpoenas to 15 firms seeking information about the sales to clients age 75 or older.
- In 2004 California passed a law that increased jail time to one year and set a mandatory penalty of $25,000 or three times the amount lost on an annuity sale when a salesperson convinces an annuity holder to switch.

How did an industry with such a shameful track record manage to convince Congress to increase the sales of its product? Unfortunately the annuity industry gained credibility by convincing advocacy organizations representing women and minorities that annuities would keep these groups out of poverty. In addition, the annuitization option puts a spotlight on one of the more unfortunate feature of 401(k) plans, which is that unlike most defined benefit pensions, retirees can and often do take their payments as a lump sum—even before they've reached age 59 ½, when they incur taxes and penalties. With no good advice, they might spend it foolishly rather than banking it and taking payments that will last a lifetime. Unfortunately, neither the advocacy organizations nor the bill's sponsors appear to have researched the track record of the industry before buying into the idea that an annuity is the solution to the problem.

For one thing, for the tiny percentage of 401(k) participants who have saved enough, there are other options besides annuities for providing income streams for life. For example, the mutual fund industry offers "managed payout" or "target distribution" funds. Along with featuring lower fees than their annuity counterparts, these funds permit investors to pass on the value of the annuity to heirs in the event the investor dies unexpectedly—as opposed to the annuity industry, which gets to keep the money in that scenario (unless the heir is a spouse.)

Bottom line, however is that there is no investment that can turn a nearly empty nest egg into a full one. My solution to the retirement crisis to for America to adopt the Australian system of mandatory 9% employer contributions, three times the current rate. If that's not feasible, at a minimum, we are obliged to tell 401(k) participants the "inconvenient truth" that they will probably need to work until age 75 to afford to retire because the 401(k) arrangement is currently not set up to provide a pension. We also need to tell them how much to save based on their investment time horizon, which the mutual funds managing 401(k) assets can't be bothered to do.

At the invitation of the U.S. Department of Labor, I offered recommended contribution rates for 401(k) participants based on the age when they join the plan to the ERISA Advisory Council in the fall of 2007. As a result of my testimony, the Working Group on Financial Literacy recommended that the DOL encourage communicating to participants how big a nest egg they need as a multiple of their salary at retirement.

Urgent reform is needed at a time when prospective retirees face higher costs than their parents, given the increased life expectancies —20 years versus 13 years when Social Security was established, along with increased healthcare costs due to growing obesity rates. At the same time, Americans are unlikely to meet these costs by relying on stock market performance alone, given that the S&P 500 has performed almost as poorly during the first eight years of the 21^{st} century than during the eight years following the Great Depression, with an average annual return of 1.1 percent compared to .9% from 1929 to 1936.

If the world's wealthiest nation is unwilling to make its defined contribution system act like a real pension unlike Denmark, Hungry, Poland, Slovak Republic and Mexico (yes, you read it right), at a minimum its leaders should communicate to their citizens the inconvenient truth that they will have to keep working until they can afford to retire.

Retirement Solutions, LLC

About Jane White: Jane White is the founder and president of Retirement Solutions, LLC., which promotes 401(k) reform as well as providing investment education. White is also the author of the recently-released book, "America, Welcome to the Poorhouse," which describes the 401(k) savings crisis and was favorably reviewed by the *New York Times*, *Washington Post* and others. At the invitation of the U.S. Department of Labor, White offered recommended contribution rates for 401(k) participants based on the age when they join the plan to the ERISA Advisory Council in the fall of 2007. As a result of White's testimony, the Working Group on Financial Literacy recommended that the DOL encourage communicating to participants how big a nest egg they need to as a multiple of their salary at retirement.

White, who writes a column on the retirement crisis for *Employee Benefit News*, first observed the crisis in 1993 as an editor at Standard & Poor's Your Financial Future, distributed to half a million 401(k) participants at Fortune 500 firms. She also anticipated the housing bubble driven by the adjustable rate mortgage with her 1991 book, "The Cost-Conscious Homebuyer's Guide."

Previously White was a syndicated personal finance columnist for Gannett News Service and her articles have appeared in *The New York Times*, *Barron's, Investment News*, *Working Woman*, and *Newsday* and she has been interviewed on NN, CNBC and Fox Business News. White is also the author of "Employee Benefits for Small Business" (Simon & Schuster, 1991), and "A Few Good Women; Breaking the Barriers to Management" (Prentice Hall, 1990).

AMERICAN BENEFITS COUNCIL

STATEMENT FOR THE HEARING RECORD

FOR THE

SENATE SPECIAL COMMITTEE ON AGING

HEARING ON

"THE RETIREMENT CHALLENGE: MAKING SAVINGS LAST A LIFETIME"

Hearing Date: June 16, 2010

Submission Date: June 30, 2010

The American Benefits Council appreciates the opportunity to provide this written statement for the record of your committee's June 16 hearing entitled "The Retirement Challenge: Making Savings Last a Lifetime." The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The Council would like to commend you and the Senate Special Committee on Aging for holding this hearing on the critical issue of retirement security. The Council agrees that the retirement security of millions of baby boomers and future generations depends not only on their ability to accumulate sufficient assets/resources for retirement but also on how those resources are utilized to provide retirement income.

The Council's testimony consists of this letter and the attached copy of our May 3 comment letter filed in response to the joint Department of the Treasury and Department of Labor "Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans" (RFI). The Council believes this issue is so important that we held a benefits briefing conference call attended by nearly 200 of our members to obtain input for our May 3 comment letter.

While the Council believes that sufficient lifetime income to support retirees is a very important issue, we recognize that current policies regarding fiduciary responsibilities and administrative requirements discourage employers from providing access to lifetime income in defined contribution plans and current attitudes and beliefs of many participants trigger rejection of lifetime income options when they are offered. For employers, the Council recommends that any policy changes address fiduciary and administrative concerns. For employees, the key is education. Many employees view lifetime income options as costly investment products rather than insuring longevity.

The impact of potential fiduciary litigation cannot be underestimated and the Council would urge that any change in policy include clear guidance that includes safe harbors. Under current guidance, electronic administration of distributions (through Internet or telephone centers) becomes extremely difficult when lifetime income options are included and requiring paper for distributions is more costly for employers and less popular with employees.

Another reason employers are concerned about new, more costly requirements associated with offering lifetime income is that employees generally reject these options when a lump sum is available. To address this issue, policy makers should analyze why employees reject annuities and other lifetime income. Some reasons for this rejection may include:

- Cost – perception of high cost as an investment versus insurance

- Poor returns – perception of poor returns as an investment versus insurance
- Cowboy philosophy – I can beat the market
- Wealth illusion – perception of amount saved versus how much can be spent
- Longevity error – underestimating how long they will live and concern about not living long enough to recover "investment"
- Default danger – concern about putting all eggs in one basket
- Peer examples – what neighbors are doing

The Council strongly believes that education and encouraging (but not requiring) employers to provide illustrations of lifetime payments at age 65 are the first steps toward increasing the availability and use of lifetime income products. Any changes in policy should provide flexibility for employers and employees as the lifetime income product offerings continue to evolve, but also ease employer's administrative and fiduciary concerns.

Again, we appreciate the opportunity to submit this written statement and would be happy to discuss the matter further with you or your staff.

ATTACHMENT:
Council Comment Letter to DOL/EBSA Responding to Request for Information on Lifetime Income Options

AMERICAN BENEFITS
COUNCIL

May 3, 2010

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210
Attention: Lifetime Income RFI

Re: Request for Information – Lifetime Income (RIN 1210-AB33)

Dear Sir or Madam:

The American Benefits Council (Council) appreciates the opportunity to provide information and comment to the Department of Labor (DOL) and Department of Treasury (Treasury) on their Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans (RFI). The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

First and foremost we would like to thank Treasury and the DOL for initiating this project, which we understand will be the first phase of a new regulatory focus on the distribution phase of retirement planning. The Council agrees that the retirement security of millions of baby boomers and future generations depends not only on their ability to accumulate sufficient assets/resources for retirement but also on how those resources are utilized to provide retirement income.

In fact, the Council believes this issue is so important that we held a benefits briefing conference call attended by nearly 200 of our members and this letter represents the preliminary input from Council members during and after the briefing. We also plan to hold a roundtable discussion for plan sponsor members in the near future, but we were unable to schedule the roundtable in time to include resulting observations/insights in this letter. We will be happy to share the results with you following the roundtable.

Background

The increasing number of baby boomers approaching retirement, along with the recent turmoil in the financial markets, has understandably resulted in a sharpened focus on the need to ensure that retirement plan assets and other retirement resources last over the lifetime of the retiring employee. The decline in defined benefit plans and increase in defined contribution plans over the last 25 years means many baby boomers and future generations will face the decision on whether and how to create some form of lasting income (whether guaranteed or not) from accumulated retirement plan assets in order to supplement Social Security.

Although many lifetime income options are currently available – lifetime annuities, guaranteed minimum withdrawal products, systematic withdrawals, longevity insurance – employees generally do not select these options when retiring. Some policymakers appear to believe increased access to these options in plans will result in higher usage but the Council is not convinced this would be the case. When annuities are offered, for example, few elect them. This is especially telling in defined benefit plans with lump-sum options where the annuity form of payment is the default distribution option and the participant (and his/her spouse if married) must make a significant effort to elect another form of distribution but yet the vast majority do. Even if "you build it", they won't necessarily come.

Although the focus of this project is on defined contribution plans, the Council encourages the agencies to consider potential ramifications for defined benefit plans. Even though plan participants generally take the lump-sum payment when given a choice, all defined benefit plans offer life annuities and many defined benefit plans do not offer lump sums, at least with respect to the full benefit. They should be encouraged to continue or even extend that tradition. In particular, any incentives offered to participants to choose lifetime income should apply to people retiring under defined benefit plans as well as defined contribution plans. The Council firmly believes in the value of defined benefit plans and urges the agencies to make policy decisions that will provide helpful guidance and encouragement to defined benefit plan sponsors and resist decisions that will result in further decline of these plans (both within and outside this project).

While participants generally do not elect lifetime income options when taking distributions from employer-sponsored plans, Council members have noted that many roll over their distributions to IRAs. Thus, DOL and Treasury also need to focus on IRA distribution patterns and product availability.

One of the questions raised by the RFI is why employees who have annuities available to them fail to elect them. Council members and most other entities commenting for the RFI will only have anecdotal information from conversations with participants such as: the perceived high cost of annuities (due, in part, to adverse selection); perception of poor or negative returns (the insurance company gets to keep my money if I die tomorrow); unsupported belief in their own investment prowess (I can do better); wealth versus annual income deception (today I am a millionaire, tomorrow I have an annual income); fear of losing investment diversification (annuity backed by just one company although state insurance guarantees can partially mitigate this concern); the desire to bequeath assets to heirs; and the perception that a regular income in addition to Social Security checks will not be needed. In other words, participants want to retain access to their funds, they want the possibility of participating in asset growth, and they do not want to transfer all of their retirement assets to an insurance company.

The DOL and Treasury might find it helpful to conduct behavioral economic studies to provide insights beyond anecdotal information. Behavioral economics has been applied to health care and selective retirement plan issues (automatic enrollment). In fact, one limited study would seem to support the premise that how the choice is framed for the participant (consumption versus investment) strongly influences the outcome of their decision (perhaps indicating that appropriate educational material published by the agencies could have a significant effect).[1]

To put this in perspective, a 65-year-old who has accumulated $1 million and retires might be advised that the most he should withdraw from his account for the first year is 4 percent, and then adjust it for inflation in future years, in order to have a reasonable prospect of the money lasting for his lifetime. That would be $40,000 in the first year. By contrast, the same $1 million applied to an indexed-for-inflation (CPI-U) straight life annuity would currently produce an income of approximately $55,000 for a male and $50,000 for a female for the first year (according to quotes from one of our service provider members). Of course additional features such as a guaranteed payout in the event of premature death or a survivor annuity would reduce the annuity payment to some degree.

The Council commends DOL and Treasury for beginning this process through the publication of the RFI and collecting comments. There is significant work to be done by the agencies to encourage increased access to (and use by) retirees of annuity and other forms of lifetime income during their retirement years. An educational effort, backed by behavioral economic studies, would appear to be a good next step.

Our recent experience indicates that inertia can be a powerful tool such that automatic enrollment and automatic increases can be very useful in expanding employee

[1] "Why Don't People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle," by J.R. Brown, J.R. Kling, S. Mullianathan, and M.V. Wrobel, American Economic Review Papers and Proceedings 98:2 (2008).

participation in retirement plans. However, the Council does not believe an attempt to mandate annuities as the default option (or a partial default option) for defined contribution plans will share a similar success pattern. Where lump-sum payments are available (as clearly illustrated in defined benefit plans that default to annuity payments but offer lump-sum payments) plan participants tend to use whatever process is required in order to obtain the lump sum. In addition, it would be impossible to design a default option to account for the spectrum of financial situations of individual plan participants. The better focus should be education.

The Council is aware of new products addressing some of these participant concerns and we would urge the agencies to avoid inhibiting product innovation in crafting any new guidance, clarifications or educational materials that are generated. For example, some products now allow participants to purchase future streams of income ("pieces" of an annuity) with each investment under an in-plan retirement income accumulation plan. In addition, Mutual fund offerings now include funds that provide for appropriate investment diversification to support distributions through an individual's retirement years or for a specified period of years.

As another example, several insurance companies are currently offering products called Guaranteed Minimum Withdrawal Benefits (GMWB). The products differ, but basically the insurance company issues a guarantee, in exchange for a fee, that so long as the participant meets certain conditions, the insurance company will make payments to the participant at a specified rate even if the participant exhausts his/her entire retirement plan balance. The guaranteed payments are based on a "benefit base" that may be the highest balance in the participant's account during his/her working years or, in some products, the highest covered balance during his/her working or retirement years.

Fiduciary and Other Concerns

The RFI appears to assume most defined contribution plans do not offer periodic distributions and asks why. The Council understands that some of these plans do offer types of periodic payments, some of which are intended to stretch over the life of the participant and his or her beneficiary. Nevertheless, few defined contribution plans offer distributions in the form of an annuity. Council members indicate plan sponsor disinterest boils down to three issues: (1) fiduciary liability, (2) administrative challenges, and (3) lack of participant demand.

To rectify this, plan sponsors need clear, simple fiduciary guidance allowing them to provide lifetime income options to plan participants without risking a significant increase in potential fiduciary liability. Under current law, the selection of an annuity provider is fraught with potential missteps that could result in continued liability for the plan sponsor well into the future. As you know, the DOL issued guidance (in response to a directive in the Pension Protection Act) that the "safest available annuity" standard in Interpretive Bulletin 95-1 does not apply to the selection of an annuity contract provider for distributions from a defined contribution plan. The same guidance, however, indicated significant due diligence is necessary. This includes an assessment of the provider's continued ability to fulfill its contractual obligations, such that a clear "safe harbor" has not been established. Plan sponsors are understandably concerned that courts will make this assessment in hindsight, resulting in potential litigation liability years later.

In addition, recent lifetime income products allow plan participants to roll over their plan benefits into an IRA with an annuity platform which allows them to obtain multiple bids from different insurance companies selling annuity products. The plan sponsor may want to inform participants about the availability of the annuity platform to rollover IRAs, but would want to avoid any endorsement that could imply fiduciary responsibility. Clear guidance indicating due diligence steps (including what types of information should be provided to plan participants) that could be taken by plan sponsors to avoid future liability would be very helpful. For example, plan sponsors should be encouraged to make such "referrals" without becoming subject to fiduciary liability.

Another challenge for plan sponsors interested in providing access to lifetime income products prior to distribution (in-plan products) is ERISA Section 404(c). The regulations issued by the DOL under 404(c) provide the conditions necessary to relieve plan fiduciaries from liability for plan participant investment decisions. Among the requirements for core options are rules relating to transferability and liquidity. The 404(c) regulations do not currently address the plan sponsor's fiduciary obligations when offering an in-plan lifetime income options (including the GMWB described above). The Council encourages the agencies to provide clarifying solutions to the portability concerns that may deter plan sponsor interest in innovative lifetime income solutions because of the potential loss of a plan participant's guarantee should the plan sponsor change service providers.

Also, the current rules make it very difficult for plan sponsors to offer electronic elections and annuity options within the same defined contribution plan. With the development of electronic technology, plan sponsors face complaints from participants forced to obtain a distribution using paper forms. As you know, generally plan participants in plans that provide for annuity distributions must obtain spousal consent for any distribution method other than a joint and survivor annuity distribution. Although Treasury guidance allows an electronic signature from the spouse, the spouse must be in the presence of a notary or plan representative. The Council understands that plan service providers have been unable to devise a system accommodating electronic spousal consent. Guidance allowing other safeguards (such as a separate PIN for the spouse) could facilitate use of electronic technology in distributions from defined contribution plans that include annuity options and thus eliminate this administrative roadblock. Guidance is also needed to clarify whether GMWBs and in-plan options (including a GMWB) discussed above are considered lifetime periodic payments or annuities for purposes of these rules.

In addition, current rules make it difficult if not impossible for plan sponsors to offer another recent market innovation commonly called "longevity insurance". Longevity insurance involves purchase, generally at retirement, of a deferred fixed annuity which does not begin to make payments until a later time, typically around the average life expectancy. A 65-year-old retiree, for example, could purchase a deferred annuity that begins payment at age 85. The longevity insurance allows the retiree to budget the remainder of the retirement plan assets to last over a specified period (20 years in this example), thus eliminating the worry of outliving his or her income.

In this product, the time value of money and mortality premium (participants dying prior to the average life expectancy subsidize the payments to those living beyond average life expectancy) results in significant annuity benefits at lower cost than an immediate annuity may provide. Current minimum required distribution rules that require minimum distributions to begin by age 70-1/2 do not contemplate this type of arrangement. The participant would be forced to include the value of the annuity in the calculation of the minimum distribution resulting in larger required distributions. In extreme cases, the required distribution could be more than the remaining benefit. Until this is addressed, few plan sponsors will add longevity insurance to their plans. The Council recommends that assets used to purchase longevity insurance (without a death benefit) be excluded from the minimum distribution calculation.

As you can see in these issues, the key to any guidance relating to lifetime income will be flexibility. New product innovations may generate more support for lifetime income by participants and should be encouraged, not discouraged.

Disclosure and Education

The Council strongly believes disclosure and education are the first steps toward increasing the availability and use of lifetime income products. The agencies should encourage but not require plan sponsors to provide illustrations of lifetime payments at age 65. In fact, the Council would encourage the DOL to provide these examples in their guidance. Similar to the fee examples provided in the prospectus of a registered security, the DOL disclosure could illustrate that a lump sum of X could create an income stream of Y at age 65 and provide the relevant interest rate and mortality assumptions (and perhaps show the variance based on different interest rates).

Requiring plan sponsors to provide illustrations based on actual account balances could backfire. The Council is aware of one large member who currently provides such illustrations and is faced with employee relations problems whenever interest rates decline and future illustrations show lower payments.

Plan sponsors who want to educate employees on the benefits of lifetime income may be deterred by the lack of guidance on appropriate education in this area. The Council recommends that the DOL expand Interpretive Bulletin 96-1 and the DOL Advisory Opinion commonly known as "SunAmerica" to address allocation of assets in retirement.

It is also important that any educational efforts include information on the risks of lifetime income products – references to inflation adjustments, claims paying ability of the provider, disbursing risks, and state guarantees are all information of use to plan participants. Additionally, education about the risks associated with not electing any type of lifetime income product would also assist participants.

Finally, the Council would note that lifetime income products alone will not lead to a healthy retirement income. It would be difficult to live off the proceeds of an annuity purchased with, for example, $5,000. The DOL and Treasury should continue efforts to support increases in plan participation and rates of contribution among plan participants.

Again, we appreciate the opportunity to provide information and comment on the subject of lifetime income during retirement. We will follow up with you after we hold our plan sponsor roundtable. In the meantime, if you have any questions or would like to discuss these comments further, please contact me at 202-289-6700.

Sincerely,

Jan Jacobson

Jan Jacobson
Senior Counsel, Retirement Policy

Hearing Held by U.S. Senate Special Committee on Aging
The Retirement Challenge: Making Savings Last a Lifetime
June 16, 2010

Testimony of Jessica R. Flores, Managing Partner
Fiduciary Compliance Center, LLC

Fiduciary
Compliance Center

My name is Jessica Flores. I am the Managing Partner of Fiduciary Compliance Center, LLC. Fiduciary Compliance Center is a boutique consulting firm that brings together industry leading subject matter experts to deliver solutions to the plan sponsor community that improve employer-sponsored retirement plans for the participants and their beneficiaries. We do this by digging deep into the practices of service providers, investment managers and benefit consultants. From our work in this area, we have grown increasingly alarmed by the new Lifetime Income Solutions and the affects these products will have on the future of our aging population.

I would like to first state that I agree we need a solution to help ensure that retirement savings lasts through retirement and is not taken out and spent in the first couple years. I think that is an obvious fact that we can all agree on regardless of who we represent in this process.

That said however, is about all I agree on with the other industry experts on this subject. While in theory, just like most initiatives of the Department of Labor and Legislators, this sounds like it is in the best interest of the majority of American workers, the application of this solution will be where the problems hide. Let's not forget who is lobbying for this solution and who will ultimately manufacture such a product.

This is a great idea if it were structured in the sole interests of participants, which most products, especially the bundled ones offered by the very providers who have lobbied for this effort are not and are not required to be managed in the interests of participants.

My concerns about a mandatory or any sort of default Lifetime Income Scheme is as follows:

Steps absolutely must be taken to protect participants from spending up their retirement, but the products should be manufactured independently in the sole interests of participants and should impose fiduciary status on those who manufacture them.

Let's hope that the industry is not successful in defaulting employer contributions into these products. The litigation backlash would be enormous and if lawmakers protect fiduciaries from that backlash they will do so by selling out the interests of the participants.

We cannot become such a controlling government that we decide how folks spend their money, that thought is absurd. I think enforcing that some percentage is paid out over a de-cumulation phase and not in a lump sum makes sense, just do not define what vehicle that payout phase is invested in. By doing so you give all of the control to the industry powerhouses and accomplish exactly what they desire, guaranteed investments for the long term in their poorly managed products.

The industry powerhouses and the lobbying industry associations who claim to represent the interests of 10's of millions of participants while in reality voice the desires of the folks that profit from the participants are the key drivers behind this initiative. They have sophisticated studies and reports to offer that have undoubtedly been prepared by incredibly bright people to swindle lawmakers into buying into this whole thing just like they did during the efforts to get the target date funds into the QDIA regulations. These companies that claim to save participants from themselves will do all they can, as they have, and continue to do to distract lawmakers from the obvious – they are self-serving organizations that use the money of hard-working Americans to make profits with no regard as to the affect on the participant's accounts. This is true now, has always been true, and will always be true with the standards and protections we have blessed these organizations with receiving.

I ask you to spend 2 minutes considering the obvious do you really think this scheme is going to be the answer?

1. Didn't these same financial and investment experts manage the pension assets all of this time? And how is that working? They could not or arguably did not manage those assets to meet actuarial assumptions.

2. Didn't these same organizations manufacture, manage, make discretionary decisions for and then coerce lawmakers into a creative default scheme for a cute little product called "target date funds"? Were those funds not supposed to be "THE" answer for retirement accumulation? Did we assign any liability to those manufacturers who behaved as discretionary functional fiduciaries yet escaped the liability and were permitted to self-deal? And how did that work out? Well, being that most hid extremely aggressive fixed income strategies into an allocation that appeared conservative to most fiduciaries and participants with no repercussions for their inappropriate allocations leading to massive losses in 2008, I would say it didn't go so well.

3. And, let's not forget that this scheme has indeed already been created. What about fixed annuities? Why is this going to be any different than a fixed annuity? The insurance company earns a return in the market, credits the minimum amount they can get by with to contract holders and then keeps an undisclosed ridiculously excessive spread for themselves. This vehicle has obviously failed to adequately get savers where they need to be, so why are we now turning over this creative power to the same entities?

This effort is simply another scheme that will provide billions of dollars in revenue to the financial industry while providing minimal growth to investors. There will undeniably be conflicts of interest, self-dealing and minimal liability associated with the management of these vehicles.

If lawmakers continue to offer liability exemptions and relaxed fiduciary standards to the industry players as they have always done in the past, you can count on another major catastrophe like that of the target date funds. The good news is that this one will not be as evident nor as concentrated. Instead this one will occur over time when retirees are not experiencing reasonable growth in their accounts and therefore do not receive the same benefits they would if their accounts were invested solely in the interests of the retirees. Meanwhile, the financial institutions will earn billions over the course of these deals. Now throw in a mandatory arrangement and you have guaranteed their future earnings, great news for the shareholders of these institutions, bad news for investors in the products.

When will the day arrive when our government stops the bleeding of investor savings and regulates the institutions that manage this money? Why are institutions set up to profit from investor savings in their own interests with no accountability for ignoring the investors' interests? We have relaxed courts that have permitted self-dealing and discredited any fiduciary duties that were owed to investors by failing to hold the industry accountable.

I must hand it to the industry, this is a good sham. Default everyone into a target date scheme that makes billions of dollars for the industry, then when they are done sucking that dry, roll the accounts into an income scheme that will ensure they make billions more with no regard for the investor. If this becomes mandatory, I would expect to see an outcry from the American public and they may just stop funding their 401k plans altogether as their money would do better under their mattresses.

This is a scheme being sold to the Obama administration and nothing at all more than that! This is not the first one or the last and by allowing this you are selling out the retirement savings of the very people you are trying to protect. The industry regulation efforts must change and change drastically before this should be even be considered. Do not be fooled by the studies and reports, just chase the buck and you will always find the motive behind such a scheme like this lifetime income product.

Questions have been posed as to the best disclosure methods for these lifetime products. While lawmakers seem to always come back to improving disclosures as the best way to protect investors, the fact is that in most cases this additional paperwork has no value to the readers. No matter what you provide to participants, they will always be the underdog in this scheme. The industry knows how to overcomplicate disclosures and distract investors away from critical information so they can continue with business as usual. Fiduciaries routinely fail to disseminate the information overload to make good decisions for their plans. You cannot expect participants to be able to do this either.

No instead, we should be focused on proper regulations, liability assignment and standards of care and loyalty which should be enforced and monitored at the regulatory level and not be passed off to fiduciaries and participants who are always behind the curve on the industry's games. More disclosure only protects those who issue the disclosures and never protects the investor. In fact it more accurately removes the rights of investors by reducing the viability of their legal claims.

We bury this stuff in the fine print, the industry admits to self-dealing practices and even touts they are permitted to self-deal in these 300 page documents. Meanwhile the commercials they air every day to market to our aging population show a much different story of wealth protection and expert investment services. When things go bad for the investor and they file a claim, the lawyers practically abuse the investor in depositions to the point they wonder why they bothered filing a claim at all after losing ½ of their life's savings. We have got to start protecting the investors and stop protecting those who only desire to profit from the investors.

Disclosures and education is not the answer, you will get no where and only lead to more confusion and continue to give the power to the industry. It's time for the regulatory agencies that are funded by taxpayers and fines to do their jobs and regulate. They need to hire industry insiders and experts in the areas of fraud and willful omissions. Forget trying to educate the common man on how to make sure he's not being fed misrepresented information. And that does not mean, like the Department was convinced in the QDIA scheme, that the industry should take over without liability as they have allowed. Instead, it means service providers manufacturing these schemes should carry the most extensive liability far beyond that assigned to fiduciaries who have no idea about how the business actually works. Assign the liability to those who are the experts and hold the power and discretion. I guess I continually fail to see why lawmakers have yet to acknowledge this very basic idea.

Please tread slowly and please do not continue to be distracted by impressive charts and studies. And do not for one minute believe that some industry association in any way represents the American workers because those are not the voices lobbying behind the scenes. The biggest contributors and most active members of any industry association is very simply the industry powerhouses and those voices are very talented in the art of selling what is best for participants to our legislators and regulators, meanwhile acting always in their own interests. Put the interests of the participants first and stop putting up with these conflicts of interest and self-dealing arrangements.

Thank you for your time and interest in protecting the wealth and economic stability of our nation and its people.

Written Testimony Provided by:
American Agriculture Movement, Federation of Southern Cooperatives,
National Latino Farmers and Ranchers Trade Association, National Association of Farmer Elected Committees and Women Involved in Farm Economics

Senate Special Committee on Aging
Hearing on 'Turning Retirement Savings into Lifetime Income'
June 16, 2010

Mr. Chairman and distinguished members of the committee, as members of the Americans for Secure Retirement coalition, we welcome the opportunity to submit for the record our statement on policy recommendations to help farmers, ranchers and others working in agriculture ("farmers") plan and save for their retirement years. Americans for Secure Retirement (ASR) is a broad-based coalition of 70 member and affiliate organizations representing women, farmers, Hispanic-Americans and small businesses, among others.

America's rural and farming communities are influenced by factors that make obtaining a secure retirement uniquely difficult. At a time when Social Security on average covers only two-thirds of retirement needs, farmers are less likely to be covered by traditional pensions, forcing them to rely on Social Security at a much greater rate than those in other sectors. In addition, there is extreme variability in farm income due to largely uncontrollable fluctuations in commodity prices, weather, and macroeconomic policies, making it more difficult for farmers to adequately plan and save for retirement.

We – American Agriculture Movement, Federation of Southern Cooperatives, National Latino Farmers and Ranchers Trade Association, National Association of Farmer Elected Committees and Women Involved in Farm Economics - are united to advocate for greater attention around efforts that would ensure that farmers and other agricultural workers, as well as Americans at large, have access to guaranteed streams of retirement income that cannot be outlived. We are pleased that this committee recognizes the scope of the challenges facing those working in agriculture as they plan for retirement, and the importance of examining the full range of potential approaches that can be tapped to improve their retirement security.

Farm Workers Face Unique Challenges in Retirement

Farm and ranch operators and their workers face significant and unique obstacles in planning and providing for their retirement. They are less likely to be covered by traditional pensions, which make income payments for life, as well as other employer-sponsored retirement plans, as compared to workers in general. Extreme variability in farm income – due to fluctuations in commodity prices, weather, and macroeconomic policies, among other things – also makes it difficult for farmers to plan and save for retirement effectively.

For these reasons, many farmers today suffer the consequences of living long lives without adequate retirement income. Farm wives are particularly vulnerable to declining standards of living in retirement, because women tend to outlive men. Many have experienced this significant decline and a large number live only on monthly Social Security payments.

For too many farmers, there is little that is golden about their Golden Years. The average farmer faces very tough and unique obstacles to having a comfortable standard of living throughout his or her retirement. Considering increases in the average life expectancy, retired farmers are often faced with stretching their savings and investments to finance their housing, medical needs and way of life for 20 to 30 years beyond the age of 65.

Farmers' diminished independence and income ultimately affect the economic vitality of their communities, many some of the poorest in the nation, and strain already under-funded local governments. Indeed, the greatest concentrations of elderly Americans living below the federal poverty level are in rural America. Farmers, and their families and communities, would benefit greatly from having better access to retirement vehicles, such as annuities, that make it easier to convert and manage their farm assets and personal savings so they last a lifetime.

Agriculture Workers Are Less Likely To Have Employer Sponsored Retirement Plans

Most farmers are self-employed, and operate or work for farms that are basically small businesses, which generally do not offer traditional pensions (or, for that matter, defined contribution plans). Other than Social Security, these farmers have no other sources of guaranteed retirement income no matter how long they should live.

Only 30 percent of the agricultural workers in the United States work for an employer that sponsors some form of retirement plan; either a traditional pension, which makes regular income payments for life (i.e., a defined benefit plan), a defined contribution plan such as a 401(k) plan, or both. To put this in perspective, 60 percent of the American workface at large work for an employer that sponsors some form of plan. Similarly, less than one quarter (23.6 percent) of all farm workers participate in <u>any</u> retirement plan – again, half as much as the percentage for all workers. This means that for a majority of farmers, it is up to individuals to plan and save for retirement and then manage these savings to provide an adequate standard of living for the rest of their lives. [1]

Protecting Farmers and Their Income in Retirement

As the Obama Administration and Congress consider issues within the nation's retirement systems and offer changes, it is imperative to the nation's farm and ranch families that they address all of the elements of retirement security. For the nation's rural and agricultural communities, true retirement security will only come when we address both the savings accumulation side of the equation and the management of savings that would help individuals secure retirement income that lasts a lifetime.

Without addressing the latter, farmers and other rural constituencies who have limited options for generating regular retirement income will be left out in the cold. Retirement reform must include supporting policies that make annuitization, the only retirement vehicle that provides a steady stream of income for life, more accessible. For example, Americans for Secure Retirement supports the Retirement Security for Life Act, S. 1297, introduced by Sen. Kent Conrad (D-ND) and Sen. Pat Roberts (R-KS), and similarly, the Retirement Security Needs for Life Act, H.R. 2748, introduced by Representatives Earl Pomeroy (D-ND) and Ginny Brown-Waite (R-FL). Both of these measures would encourage Americans to invest a portion of their savings in lifetime annuities to secure a guaranteed source of income in retirement, an important first step toward reaching this goal.

---

[1] Lifetime Income Crucial to Farmer's Retirement Security," American Corn Growers Association and Americans for Secure Retirement, (http://paycheckforlife.org/uploads/Ag_Issue_Brief_FINAL.PDF)

Farmers represent the best of America. Their commitment to cultivating our land through hard work and dedication not only feeds, clothes, shelters and helps fuel our country, but supports an important part of our economy. It is a moral imperative to make sure farmers have the ability to have a secure retirement. It also makes for good public policy, as the inability of retired farmers to fend for themselves will have an impact on the budgets of local communities and the federal government.

The aforementioned legislation takes a sensible approach to encouraging Americans, especially Hispanics, to plan for the long-term. It should be among our top priorities to make sure that members of America's farming and agriculture industry have tools to help them adequately prepare for retirement and manage those savings so they last a lifetime. We are encouraged by this committee's demonstrated interest in helping American secure lifetime income for their retirement. We look forward to helping you in these efforts. Thank you.

Larry W. Matlack
President
American Agriculture Movement

Rudy Arredondo
President/CEO
National Latino Farmers and Ranchers
Trade Association

Ralph Paige
Executive Director
Federation of Southern
Cooperatives

Craig Turner
President
National Association of Farmer
Elected Committees

Tammy Basel
President
Women Involved in Farm Economics

ACLI
Financial Security. For Life.

The American Council of Life Insurers

Written Statement for the Record

for

**"The Retirement Challenge:
Making Savings Last a Lifetime"**

Before the

United States Senate Special Committee on Aging

**June 16, 2010
2:00 p.m.
Dirksen Senate Office Building, Room 562**

American Council of Life Insurers (ACLI) Statement for the Record
"Managing Retirement Assets: Ensuring Seniors Don't Outlive Their Savings."
Senate Special Committee on Aging
United States Congress
June 16, 2010

The American Council of Life Insurers (ACLI) commends this Committee for holding a hearing about the challenges workers and retirees face when managing retirement savings for their lifetime. We applaud Chairman Kohl (D-WI) and Ranking Member Corker (R-TN) for drawing attention to this vital matter and hope our recommendations will contribute to meaningful deliberations about solutions to the imminent retirement income security crisis.

The American Council of Life Insurers represents more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies represent more than 90% of the assets and premiums of the U.S. life insurance and annuity industry. ACLI member companies offer insurance contracts and investment products and services to qualified retirement plans, including defined benefit pension, 401(k), 403(b) and 457 arrangements. ACLI member companies also are employer sponsors of retirement plans for their employees. As service and product providers, as well as employers, we believe that saving for retirement and managing assets throughout retirement are critical economic issues facing individuals and our Nation.

As the first wave of the baby boom generation reaches retirement age next year, policymakers are looking at the current retirement plan system's ability to provide sufficient retirement income for these and future retirees. Many current retirees are fortunate in that they are receiving both a Social Security benefit as well as an employer-provided pension. That situation is rapidly changing. Today, we are seeing an increasing number of workers retiring with only Social Security and their own savings. This change in retirement financing leads to the question of how they might manage these savings to last throughout their lifetime. These workers should consider augmenting Social Security with additional amounts of guaranteed lifetime income, so that anticipated monthly expenses can be covered by a guaranteed lifetime income stream, thereby shifting the risk of outliving one's savings to a life insurer. ACLI believes that, given information about guaranteeing some level of savings, workers will have the knowledge to make informed decisions about their lifetime income options and therefore make decisions that enable them to maximize their guaranteed lifetime income. ACLI does not support a requirement that workers annuitize their savings.

This statement summarizes ACLI's submission to the Departments of Labor and Treasury's ("Departments") Request for Information regarding lifetime annuities and similar lifetime income options available to defined contribution plans. It describes the:

- role of life insurers in providing guaranteed lifetime income and other risk protection products to employer plans (in-plan) and directly to individuals (out-of-plan);

- important role employers have played in helping employees protect against risks by providing information about and access to life insurance, disability insurance, annuities and other risk protection products;
- variety of annuities and other guaranteed lifetime income options that are available today; and
- legislative and regulatory recommendations to enhance the retirement income security of participants and individuals by facilitating the use of guaranteed lifetime income options.

This statement also outlines consumer protections for purchasers of guaranteed lifetime income products.

When the ACLI and its members describe lifetime income, we are describing payments guaranteed for the life of an individual or individuals. In our financial system, such guarantees are only available from life insurers who are regulated under a system of insurance laws and regulations that are focused on the protection of policyholders. In the case of annuities and other risk protection products, those laws and regulations address rules governing reserves and capital necessary to meet the long-term commitments made by life insurers.

Life Insurers

The life insurance industry provides protection for individuals and families against the risk of adverse financial consequences due to premature death, long-term care needs, disability, and outliving one's financial assets or living at a substantially reduced standard of living. Financial protection provided by the life insurance industry to American households reaches across all ages and income levels. For example, in 2009, life, disability, long-term care, and annuity products provided over $142 billion in benefits to contract beneficiaries.[1] This protection is offered both directly to individuals and through employers.

Employers

Employers are key stakeholders in helping individuals obtain financial protection provided by life insurers. Employers offer financial protection to employees on a group basis which enables the employer to pass cost savings along to their employees. Half (51 percent) of all employees report obtaining the majority of their financial protection products, such as life, disability income, and long-term care insurance, as well as annuities and retirement savings plans, through the workplace.[2] This commitment by employers helps to increase employee awareness and understanding of the nature and benefits of these products. Whether employers pay for all or part of these products or permit employees to pay for them through payroll deduction, by making these products available at the workplace employers encourage employees to take action to protect themselves and their families.

ACLI members provide these financial protection products through employers (in-plan), directly to individuals (out-of-plan), or on a combination in-plan and out-of plan basis. Employer engagement has helped Americans understand the importance of life insurance and disability insurance. The financial protection that can be provided by guaranteed lifetime income may be less understood than the benefits of life and disability insurance and other insurance products.

---

[1] ACLI calculations based on preliminary data release of 2009 NAIC annual statement data.

[2] 7th Annual Study of Employee Benefits Trends, MetLife (2009).

This difference may be partly attributed to the prevalence in the past of defined benefit plans which provided lifetime income without the need for the employee to make a decision to obtain the benefit. As more and more employers choose to offer defined contribution plans rather than defined benefit plans, we believe that employers should play a key role in helping employees understand the benefits of, and gain access to, the protection provided by guaranteed lifetime income.

Guaranteed Lifetime Income Products

Guaranteed lifetime income products have evolved significantly over the past decade. The industry has responded to both individuals' interests and concerns with traditional annuities. The lifetime income products that exist today are significantly different from those that were being sold even six years ago. As we sometimes say, "This isn't your father's annuity." Today, there is an array of guaranteed lifetime income options that are generally available through ERISA and non-ERISA employer-sponsored plans, as well as on an individual basis.[3] The new products include more traditional payout or "income" annuities that provide periodic payments, typically for life, commencing "immediately" after purchase as well as new products that provide for payment on a "delayed" or "deferred" date past retirement, e.g., at age 85 (a "longevity annuity" or "longevity insurance,"). Newer payout (income) annuities can be purchased with a single premium or incrementally on a periodic basis, e.g., by monthly payroll deductions.

Annuities offer many additional features that enable the purchaser to customize the income stream to meet their particular needs, thereby enabling the purchaser to only pay for the protection that is needed. Annuities can include a variety of optional features to address needs such as survivor benefits, liquidity for emergencies, and inflation. Deferred accumulation annuities may include optional guaranteed living benefits that provide protection during the life of the owner against investment risk by guaranteeing a level of annuity payments and/or withdrawal amounts prior to annuitization. Annuities may include features that insure against premature death such as annuities based on joint lives, annuities that refund the remaining premium, or annuities with minimum payment period guarantees. Annuities may include some form of adjustment for inflation. Life insurers offer a variety of lifetime income protection products to address a variety of needs.

Recommendations to Enhance the Use of Guaranteed Lifetime Income

Academics write of the "annuity puzzle," i.e., why so few retirees annuitize defined contribution benefits when annuities provide much needed income protection. ACLI believes that efforts to educate employers and employees about the value of guaranteed lifetime income and to reframe individuals' thinking of defined contribution plan savings as a source of guaranteed lifetime income will help to solve the annuity puzzle. From a recent survey, employees are interested in guaranteed lifetime income options and find it valuable to see how much guaranteed lifetime income they could obtain by using their retirement plan savings.[4] It is important to note that ACLI believes that most workers should annuitize **some** of their retirement savings to support their monthly expenses and that annuitizing all of one's savings is not appropriate for most people.

---

[3] The Employee Retirement Income Security Act of 1974 ("ERISA") covers private employer sponsored qualified retirement plans. Governmental plans and many not-for-profit plans are exempt from ERISA.

[4] ACLI Study on Retirement Choice, Mathew Greenwald & Associates 2010 (see Appendix 2).

New laws and regulations can help employers assist their employees in obtaining guaranteed lifetime income in the same way they have assisted employees in obtaining life insurance, disability insurance, and other financial protection products. New laws and regulations can also create an incentive to use guaranteed lifetime income as part of an employee's overall retirement income plan.

Recommendations to Encourage Employers to Offer Annuities

1. Provide Employers with Guidance on Lifetime Income and Education. In our RFI submission, we urged the DOL to revise and extend Interpretive Bulletin 96-1 beyond guidance on investment education to include guidance on the provision of education regarding lifetime income and other distribution options, both "in-plan" and outside the plan, to assist participants and beneficiaries in making informed decisions regarding their distribution choices.

2. Help Employers Select an Annuity Provider. The DOL took an important step by changing the so-called "safest annuity standard" in Interpretive Bulletin 95-1 by adopting a safe harbor for the selection of annuity providers for individual account plans. While this regulation provided some helpful guideposts, it contains a requirement that the fiduciary "conclude that the annuity provider is financially able to make all future payments." This standard is difficult to meet, in part because it is hard to know how to draw this conclusion. While it is part of a "safe harbor," this prong makes it difficult to use the safe harbor and thus is an impediment to the offer of annuities in defined contribution plans. ACLLI believes that changes can be made to these rules which will make it easier for employers to meet their duties while at the same time ensuring a prudent selection. We plan to work with the Department of Labor to simplify this requirement so that an employer can more easily and objectively evaluate the financial stability of the annuity provider.

3. Annuity Administration. Employers take on a number of duties in administering a retirement plan, and the administration of an annuity option would increase those duties. The qualified joint and survivor annuity ("QJSA") rules provide important spousal protections. The notice and consent requirements provide spouses with an opportunity to consider the survivor benefits available under a joint and survivor annuity. However, these rules add an additional layer of administrative complexity as well as technical compliance issues that most plan sponsors choose to avoid by excluding annuities from their plans.

   There are a number of ways that the rules can be modified to make it easier for employers to administer this important requirement while protecting survivors, including:

   - model plan amendments for employers to add guaranteed lifetime income options;
   - simplify QJSA notice requirements; and
   - the use of electronic signatures, widely accepted in financial transactions today.

   ACLI proposes allowing those employers who choose to do so to transfer the duties and liabilities of administering qualified joint and survivor annuity rules to an annuity administrator. Also, employers need guidance that confirms that a participant's purchase of incremental deferred payout annuities should not be subject to the QJSA rules until the participant has elected to take the annuity payout.

4. Partial Annuitization Option. Some employers view annuitization as an "all-or-nothing" distribution offering. In our RFI submission, we asked the Departments to provide guidance making clear that plans may provide retirees with the option to use a portion of the account value to purchase guaranteed lifetime income, including model amendments to simplify the adoption of such provision.

Recommendations to Encourage Workers to Elect Annuities

1. Illustration. To reframe retirement savings as a source of lifetime income, ACLI supports legislative proposals to include an illustration of participant accumulations as monthly guaranteed lifetime income on defined contribution plan benefit statements. ACLI thanks Chairman Kohl, and Senators Bingaman and Isakson for their bi-partisan sponsorship of S. 2832, the Lifetime Income Disclosure Act, which will help workers understand how their retirement savings might translate into guaranteed lifetime income.

2. Information. In our RFI submission, we asked the Treasury Department to modify the 402(f) rollover notice requirements and the safe harbor notice to include information on guaranteed lifetime income, including the importance of income protections and the availability of lifetime income plan distribution options, if any, as well as lifetime income options available outside the plan.

3. Using a Portion of a Retirement Account to Purchase Guaranteed Lifetime Income. ACLI supports efforts to facilitate a retiree's election to use a portion of his or her defined contribution account to obtain guaranteed income for life. All of the following provisions can be found in H.R. 2748, the "Retirement Security Needs Lifetime Pay Act," that ACLI fully supports and encourages this Committee to support.

   - "Longevity Insurance" in Employer Plans and IRAs. The current required minimum distribution rules discourage the use of longevity insurance, i.e., deferred payout income annuities with an annuity start date later in retirement, such as age 85. H.R. 2748 includes a provision that would facilitate the use of longevity insurance in qualified plans and IRAs by excluding the longevity insurance premium amount when calculating an individual's required minimum distributions.

   - Partial Annuitization. ACLI supports efforts to facilitate a retiree's election to use a portion of his or her account to obtain guaranteed income for life. The Administration's budget and H.R. 2748 would permit the partial annuitization of an individual's annuity savings.

   - Tax Incentive for Guaranteed Lifetime Income. Current tax policy provides equal tax treatment to payments in any form made from defined contribution plans. Guaranteed lifetime income is treated the same as a single sum distribution (i.e., taxable at ordinary rates). H.R. 2748 includes a limited tax incentive to encourage individuals to take all or a portion of their retirement savings as an annuity that guarantees lifetime income.

Consumer Protections

Each state has comprehensive laws and regulations governing, but not limited to, licensing requirements, sales practices, and market conduct regulation, as well as product approvals. Companies routinely offer a free-look period following an individual annuity purchase. During this period (usually 10 days), the individual purchaser has the right to review the contract and return it for a full refund of the purchase price. The company then will cancel the contract and, depending on the state, will refund the initial contribution (purchase price) or the account value.

State regulators have endorsed a comprehensive package of sales practice regulations aimed at protecting consumers, with a focus on seniors, during the annuity sales process. The NAIC model regulations governing the use of senior-specific designations, annuity disclosure, and annuity suitability provide states with a robust regulatory scheme to assure that consumers receive the information and protection they deserve. Senator Kohl's Senior Investment Protection provision in the financial services reform legislation encourages state adoption of both the NAIC suitability and designations model regulations. Consistent with Senator Kohl's goals, the ACLI has actively supported the NAIC designations, disclosure and suitability models. ACLI will continue to work with the states as they adopt the new NAIC suitability model.

State insurance departments oversee life insurance companies to ensure their solvency by adopting NAIC uniform rules for the establishment of reserves, the valuation of assets and liabilities, risk-based capital requirements, required capital as well as financial condition examinations. Finally, consumers are protected from the unlikely event of an insurer insolvency. Each insurer is required by law to be a member of that state's guaranty association. Guaranty associations are financial safety nets –much like the FDIC -- established for each line of insurance (life/health and property/casualty, respectively). In the rare instance where an insurer fails and an insurance commissioner obtains court approval to liquidate the company, state guaranty associations become involved so that coverage and benefits continue to resident policyholders.

Conclusion

Workers need better tools to plan for retirement. A lifetime income illustration will help workers visualize how their savings will address their basic month-to-month living expenses after retirement. With this information, workers can better decide whether they need to increase their savings, adjust their 401(k) investments or reconsider their retirement date, if necessary, to assure the quality of life they expect when their working days are over.

Similarly, workers need more information on guaranteed lifetime income options and the risks of outliving their savings. Long-term retirement planning can be a daunting task for workers. Guaranteed lifetime income options can help ease that burden by providing workers with a "paycheck for life" they can count on no matter how long they live.

Encouraging workers to consider guaranteed lifetime income options, such as by facilitating the availability of longevity insurance and partial annuitization, represents sound public policy as the baby boom generation reaches retirement age.

While employers are understandably concerned about increased fiduciary responsibilities, we believe any added burdens can be eased through adjustments in existing regulations. These include making it easier for employers to meet their fiduciary duties in selecting annuity providers and allowing insurers to assume the duties of administering the QJSA rules.

Taking these important steps today can help address tomorrow's retirement income security crisis.

Attachments:

"ACLI Retirement Choices Study," by Mathew Greenwald & Associates, Inc, April 2010

"Encourage Annuity Options for Defined Contribution Plans," ACLI proposal, February 2009

General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, p. 74

ACLI Retirement Choices Study

Online Survey with

Near-Retiree Defined Contribution Plan Participants

Report of Findings

Prepared for:

ACLI

Financial Security. For Life.

by:

Mathew Greenwald & Associaties, Inc.

April 2010

Table of Contents

Introduction and Methodology

In an effort to gauge retirement plan participants' interest in (1) having their employers offer additional options for what they can do with their retirement plan accumulations after they retire and (2) being able to see an illustration of how much guaranteed lifetime income they may be able to get using the money in the plan, the American Council of Life Insurers (ACLI) commissioned independent research firm, Mathew Greenwald & Associates, to conduct a study of plan participants nearing retirement.

An online survey was conducted with 750 workers ages 45 to 65, who are participating in a defined contribution plan available through their current employer. Respondents were also screened to ensure that they had a minimum retirement plan account balance of at least $40,000 and were not expecting any retirement income from a defined benefit pension plan.

- Potential respondents for this study were selected from among members of eRewards Consumer Research Panel.
- The survey fielded between March 26 and March 31, 2010.

The survey data were weighted by gender, age, and education to reflect the composition of retirement plan participants ages 45 to 65 with account balances of at least $40,000. Population statistics were based on data from the 2007 Survey of Income and Program Participation (SIPP).

A similarly-sized random sample of 750 respondents would have a margin of error at the 95% confidence level of plus or minus 3.7 percentage points.

Key findings and a detailed discussion follow this section.*

*Percentages in the tables and charts may not total to 100 due to rounding and/or missing categories.

Key Findings

Seeing an illustration of how much guaranteed monthly income they could get for life may prompt many plan participants to save more.

- Just over nine in ten respondents say that it would be valuable to have their employer show them an illustration of how much monthly income they could get guaranteed for life based on the value of their retirement plan account, including more than half who feel that it would be very valuable.
- Three out of five say that if this illustration showed that the monthly income that could be generated would not be enough to meet their needs, they would start saving more immediately. Another one-third say that, after seeing this illustration, they would monitor how their savings affected the illustration and consider saving more later.
- Eighty-five percent express an interest in having this information available in their regular retirement statement or on a secure website hosted by either their employer or their plan provider.

An overwhelming majority support the idea of having employers offer an option in their retirement plans that would use some of their retirement plan savings to provide employees with guaranteed monthly income for the rest of their lives once they retire.

- Nearly nine out of ten plan participants surveyed report that they favor a proposal to have employers offer an option that would use their plan savings to generate a guaranteed stream of income for life.
- A similar share – fully 90% – say they favor the idea of their employer offering them this type of option, and would be interested in learning more about it, if it were available.

Given the overall favorable impression of this option, it's not surprising that positive statements about why such an option should be made available resonate more than arguments against it.

- More than nine in ten agree that employers should be encouraged to offer choices to help employees attain financial security, and nearly all agree that an option that offers to guarantee income for life can help accomplish this.
- Although a large majority of respondents say they feel at least somewhat confident about their ability to personally manage their finances after they retire, this confidence may be an overstatement, since more than nine in ten agree that it is difficult for "many workers" to know how to manage their money after they retire, and feel it would be helpful if employers offered an option to help with this.

- Likewise, seven in ten disagree that employees know how to use their savings to generate a retirement income for themselves and don't need an option from their employer to do it for them.
- Half disagree with the statement that "employers have no responsibility for helping employees determine what to do with their retirement plan savings after they retire."

Respondents' confidence in being able to manage savings and investments after retirement is lower than their confidence about managing money prior to retirement.

- Currently, eight in ten plan participants feel at least somewhat knowledgeable when it comes to selecting the savings and investment options within their plan that are best for them.
- Yet, fewer seem as optimistic about their ability to manage their assets after they retire – including being able to pick the appropriate savings and investment products, determine the right withdrawal amounts, and making their money last for the rest of their lives. While about one-quarter strongly agree that they are knowledgeable about selecting their investments right now, half as many describe themselves as being very confident in their ability to manage their money after they retire.
- Moreover, just 7% feel very confident in their ability to make savings and investment decisions once they reach their 80s or 90s.
- Perhaps as a result, three out of four plan participants indicate that they are concerned about not having enough money in retirement to meet their needs.

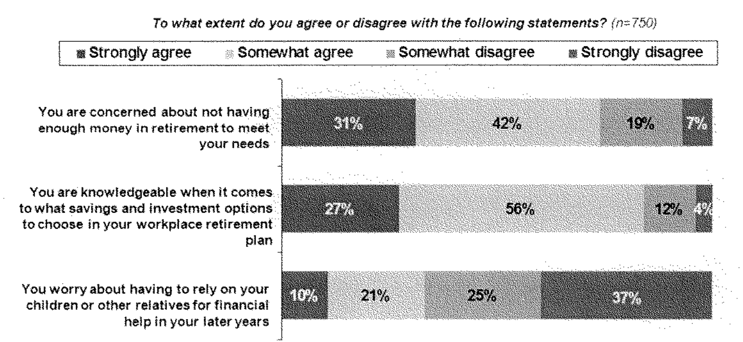
Detailed Findings

Retirement Outlook

Eight in ten plan participants say they are knowledgeable when it comes to selecting investment options inside their workplace retirement plan.

- Most plan participants (83%) describe themselves as knowledgeable when it comes to selecting savings and investment options within their employer-sponsored retirement plan, though just one-quarter strongly agree that they are knowledgeable in this area (27%).
  - Men are more likely to feel knowledgeable about selecting retirement plan investment options (86% v. 78% women).
- At the same time, nearly one-third (31%) strongly agree that not having enough money in retirement is a concern, and another four in ten (42%) suggest they are at least somewhat concerned about running out of money.
- In fact, one out of three (31%) agree that they are worried about having to rely on their children or other relatives for financial help in their later years. Women are especially likely to worry about this (38% v. 27% men).

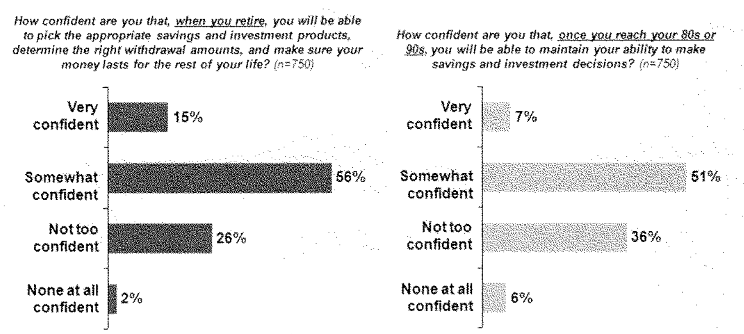
Retirement Outlook



Fewer feel confident that they will be able to pick the appropriate products, determine withdrawal amounts, and make their money last after they retire.

- Although 27% strongly agree that they are knowledgeable about selecting current retirement plan options, only 15% of plan participants feel very confident that – when they retire – they will be able to pick the appropriate savings and investment products, determine the right withdrawal amounts, and be able to make their money last for the rest of their of lives.
- A far larger share (56%) feel somewhat confident, and one-quarter (28%) say they are not too or not at all confident in their ability to manage their money in retirement.
- Even fewer feel very confident (7%) that they will maintain their financial decision-making ability into their 80s or 90s, though most (51%) remain at least somewhat confident that they will be able to make sound savings and investment decisions in their later years.

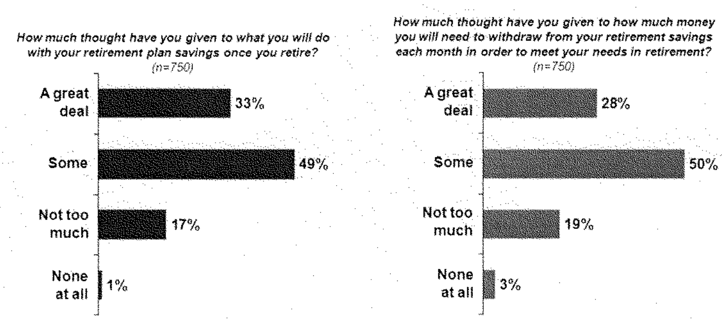
Confidence in Managing Retirement Finances



A majority have given at least some thought to what they will do with their retirement plan assets when they retire and how much they can withdraw each month.

- More than eight in ten retirement plan participants (82%) say they have given at least some thought to what they will do with their retirement plan assets once they retire. Still, only one-third have given this a great deal of thought, and two in ten (18%) indicate that they haven't given it too much thought at all.
  - Not too surprisingly, the likelihood of having thought this issue through increases with age (and proximity to retirement), such that 92% of those ages 60 to 65 say they have given at least some thought to what they will do with their plan assets, compared to 73% of those ages 45 to 49.
- Nearly as many say they have given at least some thought to how much they will need to withdraw each month from their retirement savings in order to meet their financial needs, though half (50%) say they have given this just some thought.
  - Those who are older (and closer to retirement) (88% of those age 60-65) are more likely than younger plan participants (72% of those age 45-49) to say they have thought about this to at least some extent.

Thought Given to Retirement Plan Assets and Withdrawals

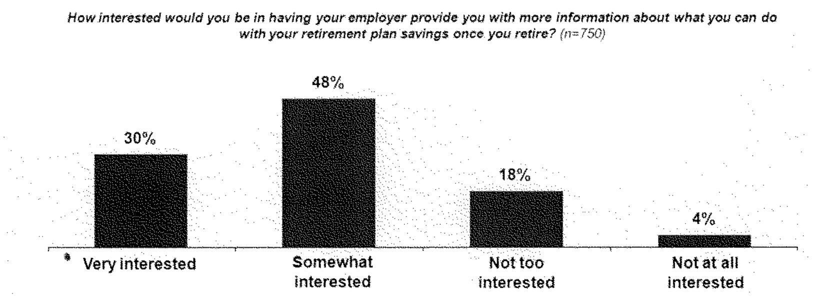


Interest in Information On and Options for Guaranteed Lifetime Income

Almost eight in ten would be interested in having their employer tell them more about what they can do with their retirement plan assets once they retire.

- Nearly eight out of ten (78%) express an interest in having their employer provide them with more information about what they can do with their retirement plan savings once they retire, including three in ten (30%) who would be very interested.

Interest in Information On Options for Retirement Plan Assets

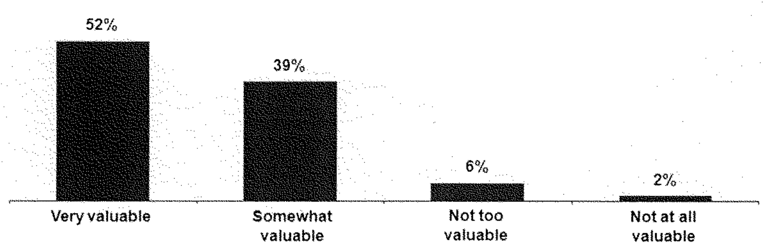


An overwhelming majority feel it would be valuable to see how much guaranteed lifetime income they could get using their retirement plan savings.

- Just over nine out of ten plan participants (91%) suggest that it would be valuable to have their employer show them an illustration of how much guaranteed monthly income they could get for life, starting at age 65, based on the current value of their retirement plan account. This includes more than half (52%) who feel such an illustration would be very valuable.
  - Plan participants who presumably still have more time to plan for retirement (92% of 45-59 year olds) are more likely than those who are older (86% of 60-65 year olds) to feel that this illustration would be at least somewhat valuable.
  - Those with incomes under $100,000 (95%) are also more likely than their counterparts (89% of those with $100k+) to feel an illustration of how much guaranteed monthly income they could get would be valuable.
  - Interestingly, those who have not given a lot of thought to what they will do with their retirement plan savings after retirement (96%) are especially apt to say this type of illustration would be valuable, compared to those who have already thought about what they will do (90%). This suggests that showing plan participants this type of illustration may help some begin thinking about how to use their retirement savings who haven't previously given it much thought.

Value of Guaranteed Monthly Income Illustrations

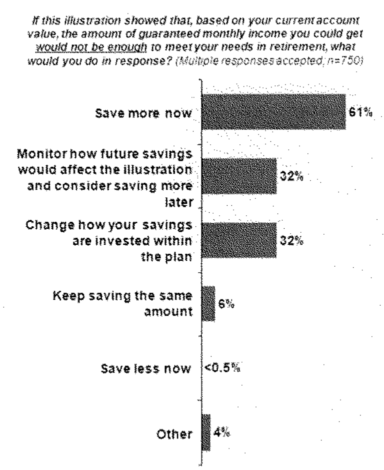
How valuable would it be to have your employer show you an illustration of how much monthly income you could get, guaranteed for life, starting at age 65, based on the current value of your retirement plan account? (n=750)



An illustration of how much guaranteed monthly income could be generated would prompt many to save more, if the current amount seemed insufficient.

- Six in ten plan participants (61%) say that if they saw an illustration that suggested the amount of guaranteed monthly income that could be generated by their retirement plan account would not be enough to meet their needs, it would prompt them to start saving more.
  - Plan participants between the ages of 45 and 49 (68%) are particularly likely to suggest they would start saving more (v. 58% of those ages 50-65).
  - Those with incomes of $100,000 or more (69%) are more apt than those with lower household incomes (55%) to react by saving more.
- One-third (32%) say they would continue to monitor how their savings affected the illustration and would consider saving more later.
- Others (32%) indicate that seeing an illustration like this would cause them to re-evaluate and change their asset allocation.
- Only 6% say they would continue saving the same amount and less than 1% would save less as a result of seeing the illustration.

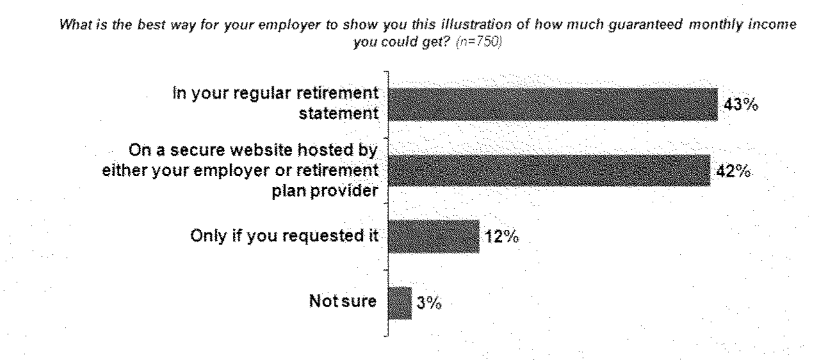
Response to Inadequate Income Illustration



Five in six (85%) want to see an illustration of how much guaranteed monthly income they could get on a regular basis, only 12% want it available only on their request.

- Eighty-five percent of plan participants indicate that the best way for them to see an illustration of how much guaranteed monthly income they could get is either in their regular retirement statements or on a secure website hosted by either their employer or their retirement plan provider.

Showing Illustration of Guaranteed Monthly Income



Nearly nine in ten plan participants favor a proposal to have employers offer an option of receiving guaranteed income for life.

- Eighty-six percent of plan participants surveyed favor a proposal that would have employers offer their employees an option in their retirement plan that would use some of the participants' assets to generate a guaranteed stream of income for life.
  - Women (92%) are significantly more likely than men (83%) to favor this proposal.
  - This proposal is viewed especially positively by plan participants nearing retirement, as 48% of those ages 55 to 59 say they strongly favor the proposal, which is significantly higher than those older (32% of 62-65 year olds) and those younger (36% of those age 45-54).
  - Those with incomes under $100,000 (91%) are more likely than higher earners (82%) to express their support.

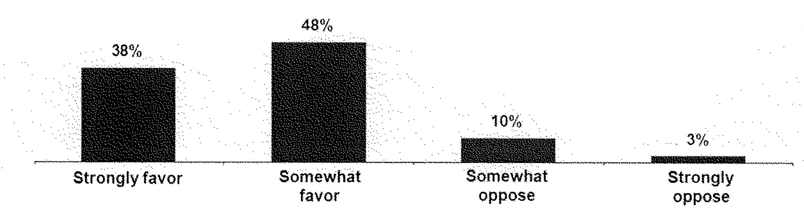
Attitude Toward Employers Offering Guaranteed Income for Life Option

Some financial planning experts believe that employers should offer an option in their retirement plans that would provide employees with guaranteed monthly income for the rest of their lives once they retire.

Employees would be able to choose whether or not to select this option. If they did choose it, they could put in any amount of money from their retirement plan that they wanted to.

The monthly income payments would never go down and it would be paid as long as the employee lives. Married employees could also have the option to have the payments last as long as either they or their spouses are alive.

How strongly do you favor or oppose having employers offer their employees the option of getting guaranteed income for life, if they want it? *(n=750)*

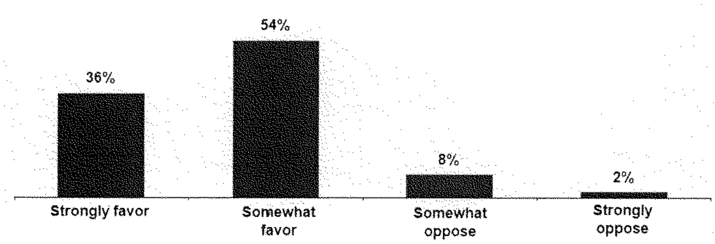


Nine in ten favor the idea of their own employer offering them an option for guaranteed lifetime income.

- Fully ninety percent say they strongly (36%) or somewhat (54%) favor the idea of their employer offering an option that, once they retire, they could use some of their retirement plan savings to produce a guaranteed monthly income for the rest of their lives.
  - Again, women (94%) and those with household incomes under $100,000 (93%) are more inclined than their counterparts to say they favor the idea of their employer providing this option (88% of men, 87% of those earning $100,000 or more).
  - Plan participants who say they tend to be investment risk averse (52%) are more likely than those who are willing to take average to above average investment risk (35%) to strongly favor having their employer offer this option.

Desire for Own Employer Offering Guaranteed Income for Life Option

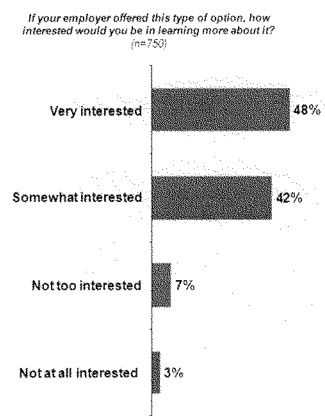
To what extent would you favor or oppose your current employer offering you an option that, once you retire, could use some of your retirement plan savings to produce a guaranteed monthly income for the rest of your life? (n=750)



Given these positive reactions, it's not surprising that nine in ten also say they'd be interested in learning more about this option, if it were available.

- Nearly half of plan participants (48%) say they would be very interested in learning more about this option, if their employer offered it. And another four in ten (42%) say they would be somewhat interested in learning more.
  - Those who favor the proposal overall (96%) are more likely than those who oppose it (56%) to say they would be interested in learning more.
  - However, plan participants who have not previously given much thought to what they will do with their retirement plan assets (97%) are especially likely to say they would want to learn more about a guaranteed lifetime income option (v. 89% of those who have already given some thought), suggesting that the very offer of this option might prompt some to think through these issues in more detail.
  - Those with retirement plan account balances between $40,000 and $75,000 (96%) are more apt than those with higher balances (87%) to express an interest in more information on this option.

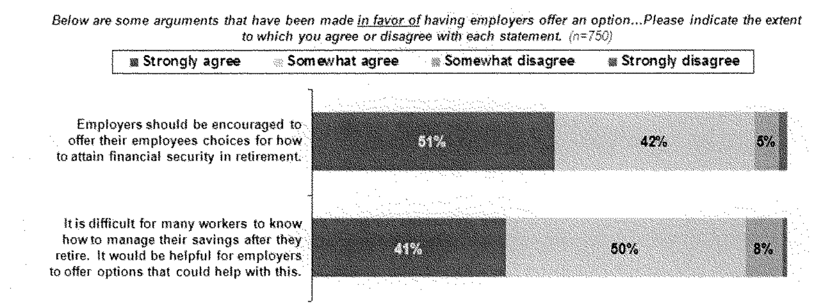
Interest in Learning More About Guaranteed Income for Life Option



Nine in ten believe that employers should offer choices to help employees attain financial security in retirement; many feel it may be difficult to do this on their own.

- Half of plan participants (51%) strongly agree, and more than four in ten somewhat agree (42%), that employers should be encouraged to offer their employees choices for how to attain financial security in retirement.
- Moreover, 91% of plan participants strongly or somewhat agree that it is difficult for many workers to know how to manage their assets after they retire and it would be helpful if employers offered options to help with this.

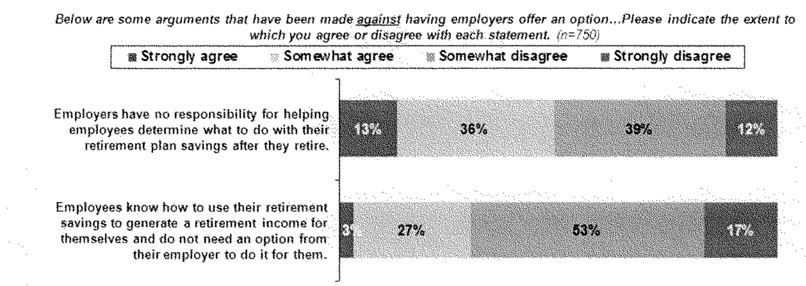
Agreement with Statements in Favor of Employers Offering Guaranteed Income Option



Seven in ten disagree that employees know how to use their income to generate income in retirement and do not need the help of employers.

- Half (51%) disagree with the statement that employers have no responsibility for helping employees manage their retirement plan savings after they retire.
- Still, the vast majority – seven in ten (70%) – disagree that employees know how to use their retirement savings to generate retirement income for themselves and therefore do not need an option from their employer to do this.

Agreement with Statements Against Employers Offering Guaranteed Income Option



February 2009

Encourage Annuity Options for Defined Contribution Plans

Problem: Currently, about one-half of employees' retirement savings is in defined contribution plans. Most defined contribution plans do not contain guaranteed lifetime income (annuity) distribution options notwithstanding that annuitization of account balances on retirement is the best way of assuring that retirement funds will not be exhausted during the participant's life. Early exhaustion of account balances may also adversely affect surviving spouses.

A major reason that defined contribution plans do not provide guaranteed lifetime income options is that, if they do so, the plan must then comply with burdensome statutory requirements relating to joint and survivor annuities. The J & S rules impose costly and burdensome administrative requirements involving notifications to spouses, waivers by spouses, and prescribe the form and amount of spousal benefits. A major reason for the shift to defined contribution plans is a desire by employers to avoid the administrative cost and complexity associated with defined benefit plans, including compliance with joint and survivor annuity requirements.

A potential solution to this problem would be for the plan sponsor to outsource the administration of the joint and survivor annuity rules to the annuity provider. However, in the event of a failure of the annuity provider to properly administer the rules, the plan and plan sponsor would still be liable for a claim for benefits under Section 502 of ERISA.

Solution: Where the plan sponsor and the annuity provider have agreed that the annuity provider will be responsible for administration of the joint and survivor annuity rules, provide that enforcement actions for failure to comply with the joint and survivor annuity rules may only be maintained against the annuity provider, provided that the plan sponsor or administrator has prudently selected and retained selection of the annuity provider. Make this provision applicable only to administration of the joint and survivor annuity rules under defined contribution plans. The electronic delivery rules should be modified to allow greater use of electronic means for administration of the J & S rules.

Rationale: The ability to shift responsibility for the administration of the joint and survivor annuity rules would make guaranteed lifetime income (annuity) options more attractive to plan sponsors and could result in significantly wider availability of such annuity payment options under defined contribution plans. While this approach would retain the cost and complexity of the annuity rules, it would preserve spousal protections and would permit the plan and plan sponsor to shift responsibility to an experienced third party annuity provider. This provider would be an insurance company with experience in annuity administration and a secure financial ability to pay annuities. These factors makes shifting responsibility to annuity issuers more beneficial to and protective of plan participants, beneficiaries (including surviving spouses) and the plan sponsor than leaving responsibility with the plan and plan sponsor.

Electronic administration is more cost efficient and has become more widely used. DOL has indicated that they are modifying their regulation on electronic delivery, although it is not known whether the modification will cover the QJSA rules.

Encourage Annuity Options for Defined Contribution Plans

SECTION __

(a) AMENDMENTS TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974.---

(1) IN GENERAL --- Section 402(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1102(c)) is amended ---

(A) in paragraph (2) by striking "or" at the end;

(B) in paragraph (3) by striking the period at the end and inserting "; or"; and

(C) by adding at the end the following new paragraph:

"(4) that a named fiduciary, or a fiduciary designated by a named fiduciary pursuant to a plan procedure described in section 405(e), may appoint an annuity administrator or administrators with responsibility for administration of an individual account plan in accordance with the requirements of Section 205 and payment of any annuity required thereunder."

(2) Section 405 (29 U.S.C. 1105) is amended by adding at the end the following new subsection:

"(e) Annuity Administrator

If an annuity administrator or administrators have been appointed under section 402(c)(4), then neither the named fiduciary nor any appointing fiduciary shall be liable for any act or omission of the annuity administrator except to the extent that ---

(1) the fiduciary violated section 404(a)(1) ---

(i) with respect to such allocation or designation, or

(ii) in continuing the allocation or designation; or

(2) the fiduciary would otherwise be liable in accordance with subsection (a). "

(3) Section 205(b) (29 U.S.C. 1055) is amended by adding at the end the following new sentence:

"Clause (ii) of subparagraph (C) shall not apply if an annuity administrator or administrators have been appointed under section 402(c)(4)."

(b) AMENDMENTS TO THE INTERNAL REVENUE CODE OF 1986 ---

(1) IN GENERAL ---Section 401(a)(11) of the Internal Revenue Code of 1986 (relating to requirements of joint and survivor annuities and preretirement survivor annuities) is amended by adding at the end the following new sentence:

"Clause (iii) (II) shall not apply if an annuity administrator or administrators have been appointed under section 402(c)(4) of the Employee Retirement Income Security Act of 1974."

(c) ELECTRONIC DELIVERY

(1) IN GENERAL --- The Secretary of the Department of Labor shall modify the regulations under section 104 or section 205 of the Employee Retirement Income Security Act of 1974 to provide a broad ability to administer the requirements of section 205 of the Employee Retirement Income Security Act of 1974 by electronic means.

General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals

Department of the Treasury
February 2010

PERMIT PARTIAL ANNUITIZATION OF A NONQUALIFIED ANNUITY CONTRACT

Current Law

If a taxpayer receives an amount as an annuity under a nonqualified, deferred annuity contract, a proportionate part of the amount received is excluded from gross income because it is considered to represent a return of premiums or other consideration paid for the annuity. The proportionate part that is excluded from gross income is determined by an exclusion ratio, which equals the investment in the contract as of the annuity starting date divided by the expected return under the contract as of that date.

If, on the other hand, an amount is received under an annuity contract but not as an annuity, the amount either is included in gross income (if received on or after the annuity starting date) or is included in gross income to the extent allocable to income on the contract (if received before the annuity starting date).

The annuity starting date is the first day of the first period for which an amount is received as an annuity. This date is generally the later of the date on which the obligations under the contract became fixed, or the first day of the period that ends on the date of the first annuity payment.

Reasons for Change

Under current law, a taxpayer may exchange a portion of an existing annuity contract for a second annuity contract and, under certain circumstances, annuitize one of the contracts involved in the exchange. An exclusion ratio then applies to determine the extent to which amounts received as an annuity under the annuitized contracts are included in gross income. Current law does not, however, address the treatment of a transaction (sometimes known as a partial annuitization) in which the holder of an annuity contract irrevocably elects to apply only a portion of the contract to purchase a stream of annuity payments under the contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis. It is appropriate that these transactions be treated consistently.

Moreover, the possibility that a partial annuitization could be taxed on an income-first basis rather than on a proportionate basis discourages some taxpayers from annuitizing existing deferred annuity contracts at a time when annuity payments are needed to fund their retirement.

Proposal

An exclusion ratio would apply to each amount received as an annuity with regard to a portion of a nonqualified deferred annuity contract that is partially annuitized. This treatment would be available only if: (1) the taxpayer irrevocably elects to apply a portion of the contract to purchase a stream of annuity payments; (2) the stream of annuity payments is either for at least ten years or for the life of one or more individuals; and (3) the exclusion ratio is computed based on the expected return and investment in the contract with regard to the portion of the contract that is annuitized.

The proposal would be effective for partial annuitizations that are effected after December 31, 2010.

RETIREMENT INCOME INDUSTRY ASSOCIATION

FOUNDING MEMBERS

AMERICAN CENTURY
Gary Gregg

BANK OF AMERICA
Keith Piken

ING
Randall Ciccati

MASSMUTUAL
Judy Zaiken

MERRILL LYNCH
Aimee Decamillo

MORNINGSTAR / IBBOTSON
Peng Chen

NATIONWIDE FINANCIAL
Daniel Amodeo

OPPENHEIMERFUNDS, INC.
Kathleen Beichert

PEPE&HAZARD LLP
Al Turco

PLANSPONSOR
Charlie Ruffel

RUSSELL INVESTMENT GROUP
Richard Fullmer

SYMETRA FINANCIAL
Kim Sheridan

WACHOVIA
Donna Peterson

WEALTH2K, INC.
David Macchia

June 14, 2010

Electronic Delivery to:
Jeff_Cruz@aging.senate.gov
Jennifer_Brody@aging.senate.gov

Mr. Jeff Cruz
Senior Policy Advisor
Democratic Staff
Senate Special Committee on Aging
G31 Dirksen Senate Office Building

Attention: June 16, 2010, Written Testimony

Ladies and Gentlemen:

This is the written testimony submitted by the Retirement Income Industry Association (RIIA). We appreciate the opportunity to comment on this important topic.

Set forth below is a description of RIIA, a brief comment summary and an attachment including RIIA's response to the Department of Labor's Request for Information on Life Income Options with its appendix as submitted to the Department - the current curriculum book for RIIA's Retirement Management Analyst designation (RIIA's RSM(SM) designation), "*The Body Of Knowledge of RIIA Retirement Management Analyst Designation: How to benefit from the* View Across the Silos".

The Retirement Income Industry Association (RIIA)
RIIA was started in February of 2006 at the request of about 30 Founding Members. These Founding Members came together to create a new retirement-focused association that would function as "Switzerland" by welcoming members from all business silos in the industry. Based in Boston and drawing members from all segments of the financial services industry, RIIA (www.riia-usa.org) provides "the View Across the Silos". The association serves both as a think tank to analyze retirement income issues and as an incubator to facilitate the exchange of new ideas, concepts and knowledge between institutions interested in building retirement income businesses.

RIIA's mission as a national, not-for-profit organization is to define the future of retirement income in America. RIIA does this by bringing the retirement income industry together with a "View Across the Silos" to develop the products, processes and advisory services Americans need to create a secure retirement.

101 Federal Street, Ste 1900 | Boston, MA 02110
Tel: 617.342.7390 | www.RIIA-USA.org

Senate Special Committee on Aging
June 16, 2010 Written Testimony
June14, 2010

RIIA members span the entire industry, including: banks, insurers, mutual fund companies, brokerage houses, financial advisors, distributors, record keepers, transaction settlers, plan sponsors, researchers, technology companies, marketers, authors, academics, media and regulators. This unique view provides RIIA members, investors and financial advisors with unbiased perspectives on key retirement income issues. Interestingly, this "View Across the Silos" naturally extends to the individual households, the clients of the financial industry. This broad household perspective helps RIIA analyze and document the fundamental shifts happening at the household level and their impact on the business models of financial institutions. RIIA provides "The View Across The Silos" at the industry, academic and client levels.

The Retirement Income Toolbox

This written testimony is based on Version 2.0 of RIIA's RMA(SM) curriculum book. We are continuously adding to this version as we prepare to release Version 3.0. in 2011.

To summarize this testimony, we will use the analogy of a toolbox. This will help us highlight in step-by-step fashion the key differences between the investment management/accumulation body of knowledge and the retirement income/retirement management body of knowledge.

Financial advisors ask, why it is so hard to do retirement income with what we have and what we know about investment management? The answer is: You are bringing the wrong toolbox to the retirement income job. It is a bit like bringing a plumber's toolbox to a electrical job. Both jobs deal with flows (water vs. electrons) but we all know that wet plumbing tools will bring unwanted results when electrons flow freely. The same idea applies when you bring your accumulation toolbox to a retirement income job.

We will use the matrix below to summarize the differences between the accumulation toolbox and the retirement income toolbox. For this purpose, we will use eight "tools" to compare the Accumulation toolbox and the Retirement Income toolbox as shown below. The items identified in the Retirement Income Tool Box are some of the components of RIIA's RMA(SM) designation.

The Toolbox Matrix

Tools	**Accumulation Tool Box**	**Retirement Income Tool Box**
Place of Work		
Segmentation Tool		
Work Medium		
Risk Metrics		
Work Objective		
Implementation Tools		
Academic Justification		
Performance Metric		

We will now describe the "place of work" tool for both the accumulation and the retirement toolboxes. The key "place of work" differentiating observation is that retirement is not an individual client event. Retirement is a household event.

Senate Special Committee on Aging
June 16, 2010 Written Testimony
June14, 2010

The matrix below contrasts the usual client "place of work" in the accumulation toolbox (The account or the client level) vs. the necessary household level "place of work" in retirement income toolbox. While accumulation level work can sometimes involve the entire household rather than just the account or the client, this is not necessary nor is it prevalent. For retirement income work, the household is the place to start. This seemingly small semantic difference matters because it is one of the many reflections of the shift in the mentality of the investor from the traditional "make me rich" to "pay me a smooth monthly income" business propositions.

The Tool Box Matrix: Place of Work

Tools	**Accumulation Tool Box**	**Retirement Income Tool Box**
Place of Work	Usually at the Client level	Always at the Household level
Segmentation Tool		
Work Medium		
Risk Metrics		
Work Objective		
Implementation Tools		
Academic Justification		
Performance Metric		

This different "place of work" means that the retirement advice relationship is likely to be deeper than the traditional investment advice relationship.

There are a few implications that immediately come to mind:

- The focus on household helps explain why the leading wave of retirement income innovation is happening in the $9+Trillion Retail and nearly $5Trilllion IRA channels rather than in the $4Trillion Defined Contribution channels. Aside from the accumulation focused regulatory constraints of DC, it is harder to get the household view in the employer-sponsored channels than in the retail channels.
- The focus on household also helps explain why retirement income management may be more process oriented than accumulation investing. The added complexity may not be easily answered with straight product sales.

In the interest of brevity, the table below shows the rest of the matrix. This matrix and its individual observations are explained in greater details in our attached response to the Department of Labor's Request for Information on Lifetime Income Options, including in appendix the current curriculum book for RIIA's Retirement Management Analyst designation (RIIA's RSM(SM) designation), *"The Body Of Knowledge of RIIA Retirement Management Analyst Designation: How to benefit from the* View Across the Silos"

Senate Special Committee on Aging
June 16, 2010 Written Testimony
June14, 2010

The Tool Box Matrix: Eight Points Comparison

Tools	**Accumulation Tool Box**	**Retirement Income Tool Box**
Place of Work	Usually at the Client level	Always at the Household level
Segmentation Tool	Assets Under Management (AUMs)	Ratio of Annual Consumption divided by Financial Capital
Work Medium	Work primarily with Financial Assets	Always work with Human Capital, Social Capital and Financial Capital
Risk Metrics	Traditional range of Public Policy and Business Risks	Larger range of Public, Policy and Client Risks
Work Objective	Expose Assets to Upside subject to Client's Risk Profile	First Build a Floor, Then Expose to Upside
Implementation Tools	Asset Allocation among risky assets (Diversification)	Allocations among risk management techniques, including: Diversification, Risk Pooling, Risk Transfer and retirement-focused Risk Free Assets
Academic Justification	Modern Portfolio Theory (MPT)	Theories that encompass and extend MPT
Performance Metric	Investment returns	Payment of a smooth monthly income

As we bring this written testimony to a close, note in particular the crucial difference in the "Work Objective" tool: In retirement the goal changes dramatically from the traditional "Expose [the client's] Assets to Upside subject to the Client's Risk Profile" to "First Build a Floor, Then Expose to Upside".

RIIA appreciates the opportunity to testify on this important topic and would welcome the opportunity to continue our dialogue in the near future. In the meantime, please feel free to contact us if you have any questions on the information and recommendations provided by RIIA.

Sincerely,

François Gadenne

Executive Director

RETIREMENT INCOME INDUSTRY ASSOCIATION

FOUNDING MEMBERS

AMERICAN CENTURY
Gary Gregg

BANK OF AMERICA
Keith Piken

ING
Randall Ciccati

MASSMUTUAL
Judy Zaiken

MERRILL LYNCH
Aimee Decamillo

MORNINGSTAR
Peng Chen

NATIONWIDE
Daniel Amodeo

OPPENHEIMERFUNDS, INC.
Kathleen Beichert

PEPE&HAZARD LLP
Al Turco

PLANSPONSOR
Charlie Ruffel

RUSSELL INVESTMENT GROUP
Richard Fullmer

SYMETRA FINANCIAL
Kim Sheridan

WACHOVIA
Donna Peterson

WEALTH2K, INC.
David Macchia

May 3, 2010

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
Room N-5655
200 Constitution Avenue, N.W.
Washington, D.C. 20210
Attention: Lifetime Income RFI (RIN 12210-AB33)

Ladies and Gentlemen:

This is a comment submitted by the Retirement Income Industry Association (RIIA). We appreciate the opportunity to comment on this important retirement income initiative and we commend the Department of Labor and Department of Treasury on the work performed in preparing the "Request for Information (RFI) regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans." Set forth below is a description of RIIA, as well as a discussion of why a lifetime income option makes good sense for American workers, a legal safe harbor and possible default options. This comment letter was a collaborative effort of a RIIA committee chaired by Steve Saxon of Groom Law Group and co-chaired by Fred Reish of Reish and Reicher.

RIIA recognizes that the RFI is in one sense merely a first step in a process of collecting, evaluating and deciding upon what steps should be taken by the federal government to facilitate access to lifetime income options in the defined contribution plan and IRA marketplace. That said, it is an important step and RIIA has pulled together the observations and analyses of numerous experts in the employee benefits community to address the issues raised in the Departments' RFI. RIIA would welcome the opportunity to discuss these issues with Department representatives at your convenience.

As discussed below, RIIA has reviewed the questions in the RFI and offers several recommendations for the Departments' consideration. First, RIIA recommends that lifetime income options become mandated options for defined contribution plans. Importantly, RIIA is not advocating that such lifetime income options become mandated elections for all participants, but only that participants be given the opportunity to select a lifetime income option. Secondly, RIIA suggests that, at a minimum, the Department of Labor ("DOL") create a safe harbor detailing the circumstances under which information and assistance can be given to participants without the risk of fiduciary liability for plan sponsors. As set forth in the attached "The Body Of Knowledge of RIIA Retirement Management Analyst Designation: How to benefit from the View Across the Silos", DOL should promote the dissemination of education

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

materials to participants that focuses on the process of retirement income planning (flooring and upside) and retirement income distribution (investment vehicle and product selection), including the consideration of their human, social and financial sources of capital. Thirdly and recognizing the difference between lifetime income products and secure products, RIIA suggests that the Department of Labor consider the following lifetime income options within the context of a decumulation QDIA:

- One or more annuities, providing income for life or to a covered life and survivor on a joint and survivor basis.
- One or more stable value funds where the fund is an investment option available to participants within the plan. Such stable value fund options should be extended to IRA accounts.
- One or more products that combine lifetime income and risk premium applicable to insuring certain catastrophic risks (e.g. long term care) that serve to deplete accumulated assets.
- One or more products or funds that are principal protected (e.g. laddered maturities), issued or managed by the U.S. Government or an instrumentality thereof or by a state or federal regulated creditworthy financial institution.
- One of more products or funds that combine (i) items 1 through 4 above and (ii) a money market fund.

Again, RIIA recognizes that the RFI and the responses to it are just a first step, but we hope that this initiative will set the stage for real progress in helping American workers build for a secure retirement.

The Retirement Income Industry Association (RIIA)

RIIA was started in February of 2006 at the request of about 30 Founding Members. These Founding Members came together to create a new retirement-focused association that would function as "Switzerland" by welcoming members from all business silos in the industry. Based in Boston and drawing members from all segments of the financial services industry, RIIA (www.riia-usa.org) provides "the View Across the Silos". The association serves both as a think tank to analyze retirement income issues and as an incubator to facilitate the exchange of new ideas, concepts and knowledge between institutions interested in building retirement income businesses.

RIIA's mission as a national, not-for-profit organization is to define the future of retirement income in America. RIIA does this by bringing the retirement income industry together with a "View Across the Silos" to develop the products, processes and advisory services Americans need to create a secure retirement. RIIA members span the entire industry, including: banks, insurers, mutual fund companies, brokerage houses, financial advisors, distributors, record keepers, transaction settlers, plan sponsors, researchers, technology companies, marketers, authors, academics, media and regulators. This unique view provides RIIA members, investors and financial advisors with unbiased perspectives on key retirement income issues. Interestingly, this "View Across the Silos" naturally extends to the individual households, the clients of the financial industry. This broad

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

household perspective helps RIIA analyze and document the fundamental shifts happening at the household level and their impact on the business models of financial institutions.

The following comments reflect RIIA's "View Across the Silos" as applied to the RFI:

1- RIIA prefers the promotion of a large and even playing field rather than a narrow and tilted playing field. RIIA has an evolutionary view of business and favors broad and diverse financial ecosystems so that all investor needs can be serviced, not just the average investor needs.

2- RIIA also prefers a wide range of private solutions rather than a narrow set of mandated solutions. RIIA's evolutionary view favors a large number of solutions that can be tested with room for affordable experiments or successful adaptation to changing circumstances as any action begets unexpected reactions by the other participants in the economy.

3- As a non-profit organization, RIIA can add value to the investment industry at the level of process – as contrasted to the level of products - through its *Retirement Management Analyst (RMA) Industry Designation. (See attachment: "The Body Of Knowledge of RIIA Retirement Management Analyst Designation: How to benefit from the* View Across the Silos"*).*

4- Facilitating a response to the recently issued RFI, RIIA acts as an independent, objective, educational partner to help inform this industry and public dialogue on Lifetime Income Solutions. This "View Across the Silos" response was shared with all RIIA members to help them prepare their own response and detailed examination of specific questions that may pertain to their specific business/industry silo.

RIIA's many Committees provide information, education, research and benchmarks to its institutional, financial advisor and other members.

As an example of its bottom-up, Committee-driven organization and in order to facilitate the industry dialogue and response for the recent Request for Information issued by the U.S. Departments of Labor and Treasury on February 2, 2010, RIIA has established a separate standing committee: **The Institutional Lifetime Income Committee.**

The purpose of the Committee is to encourage and support the provision of lifetime income for retirees from Retirement Plans and IRAs. It will support that purpose primarily by educating the investment industry and the public sector (including specifically the Department of Treasury, the Department of Labor and the United States Congress) about the need for lifetime income to ensure that retired American workers can preserve their life style and live in comfort and dignity.

The Committee has made the following preliminary observations:

1- The marketplace for Lifetime Income is diverse and one-size-fits-all product solutions are likely to create unintended and negative second-order consequences. RIIA would ask the industry to take a view across the traditional industry silos. In particular and in order to properly solve the diverse needs of retirees, the industry may want to emphasize the importance of the retirement income advisory process over the practice of stand-alone product sales.

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

2- Retirement Plans and IRAs have historically been managed and invested as asset accumulation vehicles rather than retirement income distribution vehicles.

3- While a Lifetime Income option is not the panacea for all of the problems facing the U.S. retirement system it is more than "yet another feature in Retirement Plan and IRA features race". Propelled by fundamental changes at the individual household level, it represents a fundamental shift in the business model for many industry participants (from "collecting assets under management" to "paying a monthly check").

4- Encouraging funded, private and freely elected Lifetime Income options is preferable to enforcing mandatory conversion/enrollment in government programs or generational transfer programs. Such freely elected Life Income Options at the participant level could certainly be mandatory options for inclusion at the Plan level.

5- Encouraging both institutional and retail options are preferable to enforcing a mandate of one vs. the other.

6- Encouraging plan sponsors and participants to think about Retirement Plans as lifetime income generators will help the industry begin to develop tools to translate accumulation values into lifetime income values.

7- Plan sponsors will need workable and reliable safe harbor provisions in the law in order to make the decisions necessary to adapt to the on-going retail paradigm shift from investment accumulation to retirement income..

8- Helping plan sponsors and participants understand the trade-offs will lay the foundation for informed decisions.

9- Making it easy to acquire lifetime income on a timed purchase basis will encourage participants to start thinking about lifetime income sooner rather than later.

10- Rules and regulations should be written in ways that keep the burden of cost and compliance to a level that ensures optimum results for all.

Lifetime Income Options

American workers have seen that, during epic market downturns, equity sub-classes tend to march to the same dismal drumbeat. How do we protect American workers against these infrequent but highly destructive events similar, but not exclusively, to those that occurred in 2000 and 2008?

Diversification alone is not enough. Diversification among *risk management techniques* must accompany the traditional diversification among risky assets. The American worker has two objectives: (1) first *to build" an income" floor* and (2) then *to create "accumulation" upside* from financial capital

A retirement plan participant's definition of "building an income floor" or "flooring" will depend on many factors and the objective will range from meeting basic necessities to maintaining a certain subjective level

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

of comfort. All American worker want to achieve the latter, but many will be constrained and only be able to meet their basic needs and a modest cushion.

The most reliable type of floor in a Defined Contribution Plan is a funded floor as opposed to an intergenerational promise.

The "floor" provides security. It has to "be there" when needed—without exception. When building the floor, although it is acceptable to take judicious and measured amounts of the diversifiable type of credit risk associated with insurance contracts or corporate bonds, it is not acceptable to take unprotected market risk as this would entail the possibility of breaking through the floor. Flooring must be resilient and even redundant.

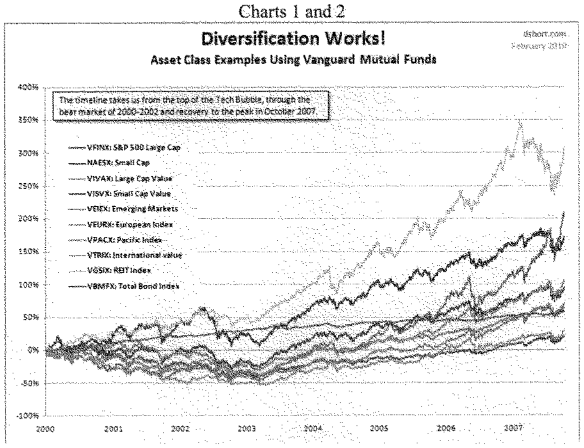
It is in this context of "building a floor" that *a lifetime income option* becomes critically important. The traditional financial framework is about creating expectations. The retirement framework is about creating outcomes. A *lifetime income option* during the saving phase as well at retirement in Defined Contribution plans can help create this much needed outcome.

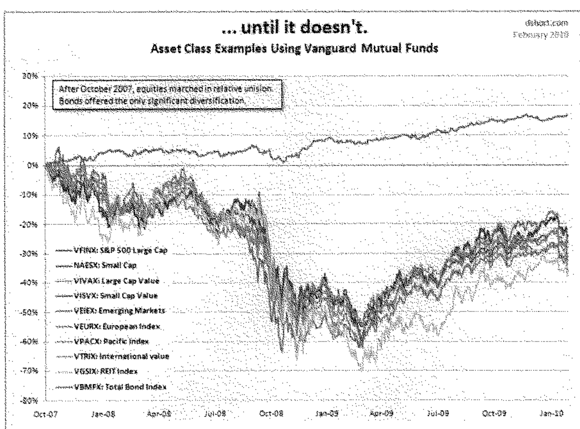
For decades and as the industry focused mostly on accumulation, diversification among risky assets seemed to be a reasonable investment strategy for anyone with a long enough investment horizon. It is, after all, the essence of the most common industry understanding of Modern Portfolio Theory (MPT). Followers of MPT will naturally seek to balance risky assets with an appropriate, age-adjusted ratio of fixed-income assets in their portfolios. Or they would reduce equity holdings whenever the market appears significantly overvalued or trends downward.

However, in March 2000 and again after September 2008, many historical "truths" about diversification have been contradicted, raising questions about over-reliance on its broad validity for investors, particularly those with finite horizons. Diversification, by itself, is not sufficient to protect investors. As evidence of that, consider the two Charts below, created by Doug Short (www.dshort.com) a Special Advisor to the Board of RIIA, track the performance of the components of a diversified stock/bond portfolio during strong bull and strong bear markets, respectively. But, while bonds and rebalancing will help mitigate market risk, they won't mitigate all of the risks to income that retirees can expect to encounter.

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

Charts 1 and 2





A lifetime income option will allow American workers to protect a portion of their retirement assets from both the possible sequence-of-return erosion based on expected market volatility and from the prospect of another *"Black Swan"* event. In the long run, a ***lifetime income option*** will create a better more secure outcome for American workers and their families.

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

The marketplace for ***lifetime income options*** is diverse and one-size-fits-all product solutions are likely to create unintended risks and consequences. We would urge the Departments to take a view across the traditional investment industry silos and to recognize that multiple ***lifetime income*** solutions for funded floors are available. While a ***lifetime income option*** is not the panacea for all of the problems facing American workers and the U.S. retirement system, it is much more than "yet another feature in Retirement Plan and IRA features race". It represents a fundamental shift in retirement income protection.

RIIA's "View Across the Silos" suggests that such lifetime income options become mandated options for all Defined Contribution plans, but, as noted above, RIIA is not advocating that such lifetime options become mandated elections for all participants.

Legal Safe Harbor

The Departments are well aware that the 401(k) plan has become the predominant retirement savings vehicle for American workers. As more Americans rely upon 401(k) and other defined contribution plans for their retirement income security, the ability to manage limited assets to provide adequate income throughout their retirement is increasingly important. Hence, the need for a lifetime income option.

ERISA initially required that defined contribution plans offer an annuity option, which would provide participants with a monthly payment similar to a defined benefit plan's monthly payment. Following changes to the tax code in the early 1980s and subsequent regulatory changes, most defined contribution plans were changed to offer only one distribution option at retirement: a lump sum payment.

Plan sponsors made this move for several reasons, including:

- Lump sumps were most popular with participants
- Where annuity options had been offered, they had little take up by participants

However, times are changing again and increasingly, the retirement industry, including plan sponsors and fiduciaries as well as financial and investment services companies, have recognized the value of offering participants a distribution option which provides them with income payments.

The primary legal obstacles to inclusion of a lifetime income option in a defined contribution plan are threefold: (1) plan sponsor fear of fiduciary status, particularly regarding uncertainty as to when a plan sponsor will be acting as a fiduciary; (2) the expenditure of time and resources needed to satisfy regulatory and other legal requirements; and (3) the risk of fiduciary liability for the failure of meeting participant expectations.

Fiduciary Liability

Faced with the risk of fiduciary liability or litigation, the safest path for a plan sponsor or fiduciary is to do nothing, and force participants to take a lump-sum as their sole distribution option. In the long run, this hurts participants, particularly those retirees for whom periodic retirement benefits would be preferable. These risks arise in several contexts, and the Labor Department can reduce the risk faced by plan sponsors and other fiduciaries in each of these contexts as RIIA discusses below.

Deciding to Provide a Lifetime Income Option

Like all decisions regarding creation, amendment and termination of an employee benefit plan, the decision to include a lifetime income option is a plan sponsor decision not subject to ERISA's fiduciary standards. Written guidance confirming that adding a lifetime income option to a plan does not implicate fiduciary duties and would reassure plan sponsors and encourage them to consider the value of a lifetime income option.

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

Selection/Monitoring of the Provider

The Department of Labor has long held that the selection of an investment manager (or other plan service provider for that matter) is a fiduciary act, and further that the fiduciary is obligated to periodically monitor the performance of that provider. Presumably, the Department would make the same finding for a provider of lifetime income benefits.

In 1995, the Department of Labor issued Interpretive Bulletin 95-1, instructing plan fiduciaries to select the safest available annuity. The presence of IB 95-1 created a great deal of uncertainty and confusion in conjunction with the selection of annuity distribution options for defined contribution plans. In responding to this problem, Congress clarified in section 625 of the Pension Protection Act that the safest available standard applied only to the selection of an annuity provider for terminal annuities for a defined benefit plan, and instructed the Department to issue regulations clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan to a participant or beneficiary is not subject to IB 95-1, but is subject to all otherwise applicable fiduciary standards.

In September, 2007, the Department issued a proposed regulation for the selection of a provider for an annuity distribution option in a defined contribution plan. Prop. 29 CFR § 2550.404a-4 72 Fed. Reg. 52021, (Sept. 12, 2007). The regulation as proposed mandated 14, separate items a fiduciary must consider to make a prudent selection of an annuity provider within the meaning of ERISA section 404. At that time, many RIIA members and others argued strenuously that the selection of an annuity provider should be no more burdensome than the selection of any other investment or plan service provider. If it is, fiduciaries will be discouraged from ever considering an annuity distribution option. RIIA members think of it in terms of a level playing field. If plan sponsors are advised by their attorneys that the selection of an annuity provider is a fiduciary act and that, because of the myriad of conditions that must be satisfied, they could be subject to an increased risk of fiduciary liability, plan sponsors will look elsewhere.

Fortunately, the Department of Labor made significant changes to the final regulation streamlining the proposal in issuing the final regulation. The final regulation is a significant improvement over the version proposed last year. 29 CFR § 2550.404a-4, 73 Fed. Reg. 5847 (Oct. 7, 2008) (Annuity Provider Regulation). As finalized, the Annuity Provider Regulation provides a safe harbor for fiduciaries, providing that they will have fulfilled the prudence requirements of ERISA section 404(a)(1)(B) if they meet certain requirements. The Regulation also expressly states that the regulation does not constitute the exclusive means to satisfy those fiduciary responsibilities. This is an improvement over the proposed regulation, which did not explicitly provide safe harbor relief but rather suggested that it prescribed the only method of fulfilling a fiduciary's duties with respect to the selection of an annuity provider.

The annuity provider regulation identifies a number of steps a fiduciary must take to gain the safe harbor's protection:

- the fiduciary must engage in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;

- the fiduciary must appropriately consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;

- the fiduciary must appropriately consider the cost of the contract in relation to the benefits and administrative services provided (the final regulations add a parenthetical describing costs as

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

"including fees and commissions;" the preamble states the addition was to "emphasize their importance to the fiduciary's decision making process"); and

- the fiduciary appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the contract is reasonable in relation to the benefits and administrative services to be provided under the contract.

In addition, the Regulation states that the fiduciary must "if necessary, consult with an appropriate expert for purposes of compliance with the safe harbor." This is a significant improvement over the proposed regulation, which, like IB 95-1, required a fiduciary to either determine that he had the appropriate expertise to evaluate the selection or that the advice of a "qualified, independent expert was necessary. RIIA strongly urges the Department to adopt a similar regulatory safe harbor for the selection of a lifetime income option protection consistent with the protection under section 404(c) of ERISA or, at a minimum, clarify that the safe harbor in the Annuity Provider Regulation applies the selection of a provider of lifetime income benefits.

Investment Advice to Participants

It is well established that plan sponsors have long been nervous about providing fiduciary advice to participants. Frankly, the issuance of the section 404(c) regulations and Interpretive Bulletin 96-1 has not done a whole lot to change this problem. It is the view of RIIA that once a plan includes a lifetime income option, participants will demand assistance in deciding what type of distribution option will benefit them. Plan fiduciaries will understandably be concerned about their potential fiduciary liability in this context. The Department should provide appropriate guidance to permit plan fiduciaries to provide the information and advice participants need without undue fiduciary risk.

For example, Interpretive Bulletin (IB) 96-1 clarified the information that fiduciaries could provide to plan participants about their investment options without facing fiduciary liability for providing "investment advice" within the meaning of ERISA section 3(21). Under the interpretive bulletin, permitted information includes information about: general financial and investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investments; historic differences in rates of return between the different asset classes; effects of inflation; estimating future retirement income needs; determining investment time horizons; and assessing risk tolerance. Even asset allocation modeling is permitted.

The Department should clarify and extend Interpretive Bulletin 96-1 to permit plan fiduciaries to provide participants with information on issues relating to the decumulation stage of retirement, including estimating the amount of money needed for a secure retirement, and calculating the best method to ensure that retirement savings provide income throughout retirement. More specifically, DOL should provide guidance clarifying that advice to participants regarding the possible use of a lifetime income distribution option is non-fiduciary. RIIA's "View Across the Silos" suggests that at a minimum, DOL needs to create a safe harbor detailing the circumstances under which information and assistance can be given to participants without the risk of fiduciary liability to plan sponsors.

Further and as set forth in the attached "*The Body Of Knowledge of RIIA Retirement Management Analyst Designation: How to benefit from the* View Across the Silos", DOL may want to promote the dissemination of education materials, to participants, that focus on the process of retirement income planning (flooring and upside) and retirement income distribution (investment vehicle and product selection), including the consideration of their human, social and financial sources of capital.

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

Default Options

The need to provide American workers with lifetime income options is becoming acute. Coinciding with the demographic driven shift from capital accumulation to decumulation, is the erosion of the lifetime income scheme in place for the post World War II generation. Please consider the following data compiled by The Profit Sharing/401k Council of America:

The System: The Money				
Retirement Assets (Federal Reserve, PSCA)				
	1994	2007	2008	2009
Private DC	$1.16T	$3.73T	$2.67T	$3.34T
403(b), 457	$0.24T	$0.81T	$0.72T	$0.78T
IRA/KEO	$1.06T	$4.78T	$3.58T	$4.28T
Private DB	$1.28T	$2.67T	$1.93T	$2.12T
State & Local	$1.11T	$3.30T	$2.33T	$2.67T
Federal	$0.51T	$1.20T	$1.22T	$1.32T
Annuities	$0.52T	$1.60T	$1.40T	$1.53T
Total	$5.91T	$18.09T	$13.85T	$16.04T

While the data demonstrates a significant growth in retirement assets during the past 15 years, it also confirms a risk related shift from participant income protection to investment risk that has occurred within the United States retirement system (excluding Social Security) since 1994:

1. The percentage retirement system assets attributable to plans that provide lifetime income (e.g. defined benefit plans) decreased from 58% to 48%. Conversely, the percentage of assets attributable to accumulation based plans (e.g. 401(k), 403(b), IRA) increased from 42% to 52%.

2. Assets in the retirement system attributable to accumulation based plans increased from $2.46 trillion to $8.40 trillion (341%), while assets attributable to lifetime income plans increased at a significantly slower pace, from $3.42 trillion to $7.64 trillion (223%).

The shift away from lifetime income places the "baby boom" generation at financial risk as its members exit the labor market.

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

RIIA has commented above on the value of providing a legal safe harbor to plan sponsors in the context of the sponsor providing a lifetime income option for participants. RIIA believes that the Department of Labor should also make provision for a plan sponsor to include one or more lifetime income default options within the plan. Plan sponsors should have a choice of lifetime income options.

Today nearly half of accumulation plan sponsors provide for automatic enrollment for workers in order to increase plan participation. Many, if not most, accumulation plans also include a default investment option.

The increase by plan sponsors in the design and use of a plan default investment option followed the Department of Labor's publication of the final regulation addressing default investment alternatives under participant directed individual account plans ("QDIA"). Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60452 (Oct. 24, 2007) (to be codified at 29 C.F.R. pt. 2550).

The regulation provides a fiduciary safe harbor so long as a plan default investment option is provided by the plan from among the QDIA options set forth in the regulation. The three primary types of QDIAs are set forth in the regulation are:

1. A product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund),

2. An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (an example of such a service could be a professionally-managed account), or

3. A product with a mix of investment that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund).

Each of the primary QDIAs set forth in the regulation were identified by the Department of Labor as an appropriate investment for long-term retirement savings – an accumulation objective. RIIA recommends the provision of a fiduciary safe harbor for appropriate decumulation default investment options, as a natural extension of the QDIA accumulation based investment options set forth in the regulation.

For the decumulation phase of the retirement system, plan sponsors should be incentivized to provide lifetime income options and participants who do not elect away from these options, should have the protection afforded by lifetime income.

RIIA's "View Across the Silos", recognizing the difference between lifetime income products and secure products, suggests that the Department of Labor consider the following options within the context of a decumulation QDIA:

1. One or more annuities, providing income for life or to a covered life and survivor on a joint and survivor basis.

2. One or more stable value funds where the fund is an investment option available to participants within the plan. Such stable value fund options should be extended to IRA accounts, subject to the development of sophisticated criteria applicable to the trustee or custodian.

Office of Regulations and Interpretations
U.S. Department of Labor
April 28, 2010

3. One or more products that combine lifetime income and risk premium applicable to insuring certain catastrophic risks (e.g. long term care) that serve to deplete accumulated assets.

4. One or more products or funds that are principal protected (e.g. laddered maturities), issued or managed by the U.S. Government or an instrumentality thereof or by a state or federal regulated creditworthy financial institution.

5. One of more products or funds that combine (i) items 1 through 4 above and (ii) a money market fund.

* * * *

RIIA appreciates the opportunity to comment on the RFI and would welcome the opportunity to continue our dialogue with Department representatives in the near future. In the meantime, please feel free to contact us if you have any questions on the information and recommendations provided by RIIA.

Sincerely,

François Gadenne
Executive Director

Front Cover

RIIA's RETIREMENT MANAGEMENT ANALYST

rma ©

Body of Knowledge for RIIA's Retirement Management Analyst (RMA) Designation

How To Benefit From "The View Across the Silos":

From Investment Management to Retirement Income and Retirement Management

François Gadenne and Michael Zwecher

Body of Knowledge for RIIA's Retirement Management Analyst (RMA) Designation
How to Benefit from "The View Across The Silos":
From Investment Management to Retirement Income and Retirement Management

RIIA Publishing
101 Federal Street
Suite 1900
Boston, MA 02110
Orders@riia-usa.org

Preface

The RIIA Advisory Process

We who come from the world of investment management sometimes need a reminder that we do not create financial portfolios for their own sake. Our clients save a portion of their income for a purpose other than to let us grow the money under management. As clients age, their purpose is increasingly to provide retirement income.

This book is designed to provide a *classification system* for retirement management in general and for specific topics, products, processes and solutions related to retirement income. Based on the ongoing work of RIIA's Education Committee, the book's primary goal is to clarify the role that financial advisors and their clients play in the creation of retirement income.

In the accumulation framework, the advisor's role is to place bets and create *expectations* that the market may or may not fulfill. In the retirement framework that we propose, the advisor pursues *outcomes*—an income floor, for example—while placing bets to achieve growth and to reduce the client's longevity risk, market risk, inflation risk, health risk, interest rate risk and so forth.

An advisor once told us, "My inventory is my time." We have developed this curriculum, matching software programs, classes and examinations with his comment in mind. Also, if you study this curriculum and practice with the customized software programs, we hope that you will agree with us that this advisory process should help you increase wallet share, close new business and save you time by helping fix "sick" clients.

Who This Book Is For

Financial professionals, including asset managers, licensed agents and representatives of broker/dealers, registered investment advisors and certified financial advisors of all kinds (see Appendices B and C for a complete list of practitioners) can expect this book to help them:

- Organize their thoughts about their clients' financial situations.
- Reach conclusions about their clients' retirement income needs.
- Recommend appropriate retirement income plans.
- Explain why the plans make sense.
- Implement the plans by changing the clients' asset allocations or enabling them to purchase new products.
- Seek to take the examination for RIIA's Retirement Management Analyst designation.

The Retirement Management Analyst

Thousands of conversations with RIIA members have enriched the information in this book. Our members come from virtually every "silo" in the financial industry, including the insurance, investment, advisory, public policy, and academic worlds. The diversity of their perspectives enables RIIA to create a "View Across the Silos" that benefits all.

Those conversations have led to the conception of a new professional designation, the Retirement Management Analyst (RMA). RIIA plans to develop additional designations over time. The unique skills required for this designation are rooted in RIIA's Body of Knowledge, a systematized compilation of existing and evolving retirement planning practices.

This book and future editions of this book will provide an overview of the Body of Knowledge covered by the RMA Examination and its annual updates. RIIA's exam workbooks use the Spoke/Section/Learning Objective structure to organize the examination questions and answers. Study programs, provided by approved institutions, help candidates better prepare for the exam.

Candidates for the RMA must:

- Have, at a minimum, a Basic Individual Membership with RIIA.
- Pay the Application Fee to cover the registration costs and the required texts that RIIA provides to candidates.
- Pay the Examination fee to cover the costs of administering the exam.
- Upgrade, for those who pass the exam, to Full Individual Membership level.

A number of RIIA members are developing their Institutional Training Programs to match this body of knowledge so that their trainees may receive partial credits towards the RMA designation.

A number of RIIA's Affiliated Associations are sharing the content of their investment-focused curriculum/designations so that their charter holders may qualify for partial credits towards the RIIA designations.

In contrast to an investment management professional, a Retirement Management Professional demonstrates competence and serves clients by:

- Understanding and helping plan their Human Capital.
- Understanding and helping plan their Social Capital.
- Understanding and helping plan their Financial Capital using Life-Cycle management and risk management techniques, not just asset allocation and other investment management techniques.
- Having a clearly stated guiding principle and goal of "First Build a Floor, Then Expose to Upside."

Candidates for the Examination are accepted on the basis of prior education, experience and ethics requirements. RIIA considers both the education and the experience of a candidate so that the college degree requirement can be traded off against three or more years of relevant experience.

What You Need To Know In Advance To Read This Book

The authors assume that readers of this book already understand:

- The concepts of present value, future value, compound interest and valuation of assets by discounting future cash flows.
- The risky asset classes, including stocks and bonds.
- The principles (but not necessarily the mathematics) of Markowitz Optimization, the Efficient Frontier and Modern Portfolio Theory.
- The major types of investment and retirement accounts (e.g., defined benefit, defined contribution, IRAs, taxable accounts, etc.), products (e.g., mutual funds, annuities, CDs, etc.), and the regulations or laws that govern them.

We do not assume that all readers will be familiar with:

- The Consumption to Financial Capital ratio.
- Household asset/liability matching.
- Risk aversion as opposed to risk tolerance.
- Consumption Smoothing.
- Selecting the appropriate mix between flooring and upside portfolios.
- Risk pooling techniques, including mortality credits.
- Risk transference techniques.
- Selecting the appropriate mix or risk management techniques for both the flooring and the upside portfolios.
- Building client specific Flooring Portfolios.

How To Read This Book

Interested clients and practitioners can read this book from front to back or dip into the text at any point. The **One-Minute Summary** is a good place to start. Readers can also skip to the chapter that matches the stage that they're at with their clients.

RMA Candidates must also read the book *Retirement Portfolios: Theory, Construction and Management*, by Michael Zwecher. We wrote both books concurrently and in coordination. Mike's book focuses on the "Engineering Approach" to building retirement portfolios as introduced in Chapter 5/Spoke 4 of this book.

As part of this content coordination, Chapter 13 of Mike's book, **Case Studies**, follows the customer segmentation mapping presented in Chapter 1 of this book and Chapter 12 of Mike's book. This gives the reader a single, consistent set of real-world examples of retirement income problems and solutions.

Table of Contents

Acknowledgments

Writing a book is a lonely endeavor, even for co-authors. Fortunately, RIIA is a bottom-up organization whose output includes contributions from its entire member base. Many RIIA members participated in the discussions, research and presentations that led to this book.

In addition to the editorial support that we received from Kerry Pechter, publisher of Retirement Income Journal.com, we want to recognize the contributions of the following members:

RIIA's current and former Board members including:
Al Turco, Pepe & Hazard, Counsel
David Macchia, Wealth2k, Inc., Secretary
Sri Reddy, USAA, Treasurer
Nevin Adams, PLANSPONSOR
Joan Boros, Jorden Burt, LLP
Peng Chen, Morningstar/Ibbotson
Tom Johnson, MassMutual
Steve Langlois, LPL
Ron Mastrogiovanni, HealthView Services
Steve Mitchell, RIIA
Rick Nersesian
Keith Piken, Bank of America
Elvin Turner, Turner Consulting
Bruce Wolfe, Allianz

Our Academic Special Advisors to the Board:
David Babbel, Wharton School
Somnath Basu, California Lutheran
Shlomo Benartzi, UCLA
Jeff Brown, University of Illinois
Zvi Bodie, Boston University
Larry Kotlikoff, Boston University
David Laibson, Harvard University
Annamaria Lusardi, Dartmouth College
Moshe Arye Milevsky, York University
Doug Short (retired) North Carolina State University
Meir Statman, Santa Clara University
Pirooz Vakili, Boston University
Jack VanDerhei, Temple University and EBRI Fellow
Stephen Zeldes, Columbia University

Our Executive Special Advisors to the Board:
Mitch Anthony
Howard Bloom
Hans Carstensen, retired President of AVIA
Farrell Dolan

Keith B. Jarrett, Chairman, Rockport Funding
Jerry Kenney, Merrill Lynch
Mike Mayhew, Integrity Research Associates
Anna Rappaport, FSA, MAAA, Anna Rappaport Consulting
Chuck Robinson, Northwestern Mutual Wealth Management Company
Don Trone

The Chairs, Co-Chairs and Members of RIIA's Standing Committees including:

Membership Committee
Chair: David Macchia, Weatlh2k, Inc.
Co-Chair: Rick Nersesian
Co-Chair: Will Prest, Transamerica
Co-Chair: Carol Hartman
Co-Chair: Ron Mastrogiovanni, HealthView Services

Employment Survey Committee
Chair: Laura DiFraia
Co-Chair: Gail Palubiak

Marketing (Communications and Programs) Committee
Chair: Marcia Mantell, Mantell Retirement Consulting, Inc.
Co-Chair: Kazi Ariff, Bank of America
Co-Chair: Keith Piken, Bank of America

RIIA's Advertising Award Committee
Chair: Sean Hanna, *Investment Wires*
Co-chair: Armie Lee, *Investment Wires*

RIIA's Achievement in Applied Retirement Research Award Committee
Chair: Bob Tyndall, *Research* magazine
Co-Chair: Gil Weinreich, *Research* magazine

RIIA's D.C. Communications Award Committee
Chair: Nick Platt, PLANSPONSOR
Co-Chair: Charlie Ruffel, PLANSPONSOR

RIIA's Retail Communications Award Committee
Chair: Suzanne Fitzpatrick-Siracuse, Crain's *InvestmentNews*
Co-Chair: Evan Cooper, Crain's *InvestmentNews*

RIIA's Retirement Income Client Education Award Committee
Chair: Marion Asnes, Source Media
Co-Chair: Bruce Morris, Source Media

Noted Authors Committee

Chair: Jerry Bramlett, BenefitsStreet
Co-Chair: Greg Cherry

Education Committee
Chair: Chuck Robinson, Northwestern Mutual Wealth Management Company
Former Chair: Ron DeCicco, RBC Insurance/ Royal Bank of Canada
RMA Body of Knowledge Book Editor: Kerry Petcher
Examination Workbook Editor: Bob Powell

Academic Research Peer Review Selection Committee
Chair: Mike Zwecher
Co-Chair: Rick Miller, Sensible Financial

Research Committee
Chair: Greg Cherry
Co-Chair: Elvin Turner, Turner Consulting LLC

Research Projects Sub-Committee
Chair: Jeffrey Cohen, Taos Advisors, LLC

Resources Exchange Committee
Chair: Judy Zaiken, MassMutual
Co-Chair: Bob Powell

Methodologies Committee
Chair: Richard Fullmer, Russell Investments
Co-Chair: Phil Edwards

Self-Help/Social Network for Retirement Committee
Chair: Anand Rao

The Retirement Plan and IRA Committee on Lifetime Income
Chair: Steve Saxon, Groom Law Group
Co-Chair: Fred Reish, Reish & Reicher

We want to recognize Dan Amodeo and Greg Watson of Nationwide for their insights and leadership in working with the Education Committee and for their commitment to RIIA.

We gratefully acknowledge the insights of George Wilbanks (Russell Reynolds) for his efforts in creating the Retirement Management Professional job description.

Finally, we want to recognize RIIA's staff, including Steve Mitchell, Deb Burkholder, Sue Chanley, Karen Snow, Tom McDonough and Bob Powell for their patience and their many contributions.

The 'One-Minute' Summary of the Book

Build a Floor and Create Upside Potential

Most investment professionals specialize in managing client assets, with an eye toward maximizing accumulation during the clients' working lives. The duties of *retirement income professionals,* however, are broader. These advisors need to manage their clients' assets, liabilities and cash flows, with an eye toward minimizing risk during their clients' retirements.

We developed a hub-and-spoke framework to present retirement income approaches. The framework has seven aspects—a hub, five spokes and an integrative process. The client is the hub, and the spokes are the steps in a process of integration and monitoring. We call them "spokes" rather than "steps" for two reasons. First, they represent a cyclical process of interaction with the client that has no specific beginning or end. Secondly, each one strengthens the relationship between advisor and client.

The objective: *To build a floor and create upside potential.* We assume that, during retirement, clients need a sufficient level of income ("a floor") from guaranteed or low-risk sources, as well as the potential for growth through exposure to risky assets (the "upside").

Building a portfolio for retirement income isn't necessarily harder than building a portfolio for asset accumulation, but it does require a deeper assessment of the client's needs. The investment of more time at the beginning of the relationship can pay off, however, in the creation of satisfied clients whose assets will be "stickier" and who will bring additional advisory opportunities.

The Hub and Spoke Model

The Hub at the Center of the Advisory Process: The Client

Intuitively enough, the client stands at the center or "hub" of the process. However, the retirement client segmentation is not based on Assets Under Management (AUMs) only but on a ratio of the client's annual consumption in retirement to their Financial Capital.

The primary quantitative objective of Chapter 1 is to calculate a "first-order" estimate of the client's consumption /portfolio yield. Inputs for this calculation include an estimate of the client's current Financial Capital and his or her expected annual consumption level in retirement. Outputs from this calculation categorize the client as underfunded, constrained or overfunded. This first-order estimate will be revised as we move through the spokes. This core level of analysis focuses on averages and can be also refined with an advanced level analysis including a specific year-by-year simulation.

Spoke 1: "The Household Balance Sheet" Is the Start of a "Life-Cycle" Plan
Focusing first on the household's balance sheet, analyze the client's *income statement* (current income versus current expenses), *balance sheet* (assets versus liabilities), and *cash flow statement* (a snapshot of cash inflows and outflows). This is the first step towards creating a *Life-Cycle Plan*. This can take place before, at or after retirement, but the earlier, the better.

The primary quantitative objective of Chapter 2/Spoke 1 is to calculate a "first-order" estimate of the client's household balance sheet. Inputs for this calculation include asset balances (e.g., financial assets and bank balances) as well as expected cash flows (e.g., social security and pensions). Inputs also include liabilities, such as mortgage balances, expected annual consumption in retirement, desire for a bequest, etc. Finally inputs for this calculation include discount rates/expected returns. Outputs from this calculation are shown as a household balance sheet with projected and discounted values as of the client's retirement date.

Spoke 2: "Cash Flows" and the Completion of the Life-Cycle Plan
Match the client's anticipated *social capital* (e.g., Social Security, pension income), *human capital* (e.g., income from work in retirement) and *financial capital* (investments) with his or her income statement, balance sheet and cash flows. The advisor determines the portion of the client's minimum income or "floor" that social and human capital can provide, and how much will need to come from financial capital. This step completes the creation of a Life-Cycle Plan.

The primary quantitative objective of Chapter 3/Spoke 2 is to refine the cash flow inputs that go into the client's household balance sheet. Inputs include personal income/earnings as well as taxes, fixed expenses and discretionary expenses. Outputs are shown on both the client's household Income Statement and Balance Sheet.

Spoke 3: "The Retirement Risk Profile" and the Retirement Income Plan
Turn the Life-Cycle Plan into a *retirement income plan* that matches the income from the client's three sources of capital to the potential costs associated with the client's identifiable *retirement income risk factors* (e.g., health risk, inflation risk, longevity risk, etc.).

The primary quantitative objectives of Chapter 4/Spoke 3 are to determine the client's risk tolerance (e.g., Conservative, Moderate, Aggressive) and to calculate the portion (percent and dollar) of his or her financial portfolio that should be dedicated to flooring. In addition to the risk profile questionnaire, inputs include the client's current age, desired retirement age, life expectancy and various inflation and discount factors. Outputs are the client's risk tolerance and the portion of his or her financial portfolio that should be dedicated to flooring.

Spoke 4: Risk Management Allocations to Design "A Floor with Upside"
Using the client's financial capital, create an income floor through the *allocation of risk management techniques* that are compatible with the client's risk profile. Then, with any remaining assets, create an upside. In making the allocation, advisors will choose a mix of risk management techniques including *risky assets* (stocks, bonds, mutual funds, ETFs), *insured products* (annuities), *hedged* or *financially engineered products* (e.g., structured notes), and *risk-free assets* (government securities).

Chapter 5/Spoke 4 describes various risk management approaches (Engineering Practices, Economic Models and RIIA's Empirical Validation Framework) that make it possible to determine if the client is best served with primarily capital markets products portfolios, insurance portfolios or hybrid portfolios. The primary quantitative objectives of Chapter 5/Spoke 4 are to determine the portions of the flooring portfolio and the upside portfolio that should go to investments, hedging, insurance and risk-free assets. Inputs were developed in prior spokes. Outputs are the percent and dollar portions of the flooring and upside portfolios that should go in some or all of the risk management techniques.

Spoke Five: Specific Products to Implement the Plan and Allocations

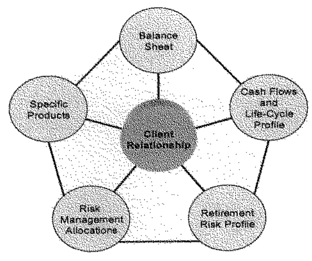
Chapter 6/Spoke 5 provides a high-level, asset-class like mapping of available products for each of the four risk management techniques. This provides guidance to the financial advisor who – within the constraints of his or her chosen risk management approach - can then exercise his or her best professional judgment to implement and manage the flooring and upside portfolios.

Putting It Together: Presenting and Monitoring the Plan

Using a variety of software platforms, the advisor can integrate findings and recommendations into a plan that can easily be presented to and understood by the client. The software can be used during the annual review to monitor results against plan and to create a new plan as client circumstances warrant.

Chapter 1: The Hub At The Center Of The Advisory Process – The Client

RIIA's Retirement Management and Retirement
Income Advisory Process



1.1 The Hub of the Advisory Process: The Client

Learning Objectives

LO 1.1.1. List client objectives in the period prior to October 2008.
LO 1.1.2. List client objectives in the period after October 2008.
LO 1.1.3. Describe what clients want advisors to deliver in the period after October 2008.
LO 1.1.4. Describe why knowing your client's emotions is important in the period after October 2008.

The Bernie Madoff episode of 2008-2009 highlighted both the importance and the fragility of trustworthiness in advisor-client relations. Clearly, Madoff's victims trusted him. But consider how few people expressed disbelief that such a betrayal could happen. Instead, their disbelief focused on the scale of the crime and on Madoff's apparent callousness in defrauding so many charities and friends. Trust is hard to build, easy to destroy.

But even skeptical clients want and need to trust their advisors. They want advisors to invest their money safely and wisely, to design an appropriate portfolio and to execute the right trades. Clients become loyal to advisors who earn their trust and confidence under all market conditions.

Security is not merely a synonym for a financial asset. The client-advisor relationship is based as much on emotions—peace of mind, trust, fear, greed, friendship, etc.—as it is on gains or losses. Firms may try to stake a claim on clients, but the client's most important relationship is with the advisor.

Each client invests a different set of emotions in the relationship. And he or she expects the advisor to deliver a satisfactory emotional outcome in addition to a satisfactory financial one. An advisor addresses human needs that are more fundamental than the mere need for wealth.

In what we will call the "old normal"—the period before October 2008—many clients were driven by the search for control, novelty, status and attention. In the "new normal" that lies ahead, we think clients will seek security, validation, belonging, meaning and warmth.

As an advisor, are your emotions tuned to the emotional frequency of the clients you want to serve? What are their unspoken pains and fears? Can you name your clients' emotions? Instead of choosing investments for your clients, can you create desired outcomes? Can you answer the question: "What do aging clients want?" This question is raised in Howard Bloom's book, *The Genius of the Beast* (Prometheus Books, 2009).

1.2 Core Topic: The Accumulation Perspective

Learning Objectives

LO 1.2.1. Describe the typical client types in the accumulation model.
LO 1.2.2. Describe why many firms cater to the High-Net-Worth (HNW) and ultra-HNW client segments.
LO 1.2.3. List the major client wealth categories in the accumulation model.
LO 1.2.4. List the major risk tolerance categories in the accumulation model.

Every client's needs are unique. But turning your clients' limitless individual differences into a scalable business model requires a method for classifying them into a manageable number of types. Retirement management clients shouldn't be classified the way accumulation-phase clients are, however.

The typical accumulation-phase model identifies clients by wealth and risk tolerance levels using five risk tolerance categories and four wealth categories. In such an approach, a matrix such as the one shown in Table 1.2.1 is often used to categorize or "to grade" a client and suggest an "off the shelf" portfolio for him or her. Opinions will vary on the grading as shown in the table below.

Table 1.2.1: The Traditional Investment Client Segmentation Model

Wealth level/ Risk tolerance	Mass Market	Mass Affluent	High Net Worth (HNW)	Ultra HNW (UHNW)
Conservative	D- level Value Potential for Accumulation FAs	B- level Value Potential for Accumulation FAs	A- level Value Potential for Accumulation FAs	AAA level Value Potential for Accumulation FAs
Moderately Conservative	D- level Value Potential for Accumulation FAs	B- level Value Potential for Accumulation FAs	A-level Value Potential for Accumulation FAs	AAA level Value Potential for Accumulation FAs
Moderate	D level Value Potential for Accumulation FAs	B level Value Potential for Accumulation FAs	A level Value Potential for Accumulation FAs	AAA level Value Potential for Accumulation FAs
Moderately Aggressive	D+ level Value Potential for Accumulation FAs	B+ level Value Potential for Accumulation FAs	A+ level Value Potential for Accumulation FAs	AAA level Value Potential for Accumulation FAs
Aggressive	D+ level Value Potential for Accumulation FAs	B+ level Value Potential for Accumulation FAs	A+ level Value Potential for Accumulation FAs	AAA level Value Potential for Accumulation FAs

*Financial advisors.

Since product offerings for the wealthy are generally more profitable or bring more assets under management, many firms cater to the HNW and UNHW segments. As shown in Appendix G: Typology of Financial Professionals, the field has become highly segmented. Advice business models have differentiated over time to match the distinctive characteristics of these accumulation client types.

The "follow the money" approach may make sense for investment management, but it doesn't necessarily make sense in retirement management, where clients face more or less similar hazards and harbor similar fears.

1.3 Core Topic: The Retirement Perspective

Learning Objectives

LO 1.3.1. Describe how planning for retirement income is different from planning for accumulation.
LO 1.3.2. Discuss the difference between the volatility of annualized returns and the volatility of compounded returns.
LO 1.3.3. Define the minimum amount of income that a client will need.
LO 1.3.4. Explain why the shift in emphasis from wealth to Consumption demands a shift in approaches to clients and market segmentation.
LO 1.3.5. Describe how risk tolerance is relevant to the accumulation model (risk profile) and risk aversion is relevant to the retirement income decumulation model.

Planning for *income* is fundamentally different from planning for *accumulation*. In the typical model of accumulation, future investment returns follow a normal distribution. For any time horizon, their volatility increases at roughly the square root of time.

When trying to measure portfolio risk, accumulation-oriented financial advisors tend to focus on the volatility of annualized returns, which decreases over time. In doing so, they often neglect the volatility of *cumulative* returns, which increases over time. For a retirement-minded advisor, cumulative returns—what a retiree can use to put bread on the table and pay his condo fees—matter by far the most.

This is a crucial distinction. The market as a whole may or may not tend to revert to its long-term average returns. But for any single retirement savings portfolio, planning based on an expectation of average performance is unwise. The distribution of possible endpoints for any particular portfolio of diversified risky assets will *expand* over time. As advisors, we always hope we can overcome short-term disappointments in the long run. But it is a hope, not a certainty. The odds of beating a cumulative, risk-free return are still odds and not certainties, regardless of the time horizon.

When clients have a defined financial objective, such as a predictable retirement income, advisors don't have the luxury of waiting indefinitely for portfolios to recover. As our client's emphasis shifts from maximizing wealth on some far-off date to ensuring income (i.e., consumption) on a specific date, achieving out-performance becomes much less urgent than avoiding under-performance.

We call the minimum amount of income that the client will need on each date, the *consumption floor*.

This shift in emphasis demands a shift in our approach to client and market segmentation. For instance, traditional measures of client risk aversion are based on levels of assets under management (AUMs). But those measures lose their relevance when we move to a discussion of the client's income expectations. It is no longer enough to consider AUM in isolation. AUM must be seen in terms of its ability to generate income.

Open-ended and speculative strategies will feel more appropriate and comfortable to advisors as long as they orient their planning toward growth. But with practice, advisors can become just as comfortable with strategies aimed at creating income floors and risk-resilient portfolios.

1.4 Core Topic: Three Kinds of Retirement Clients

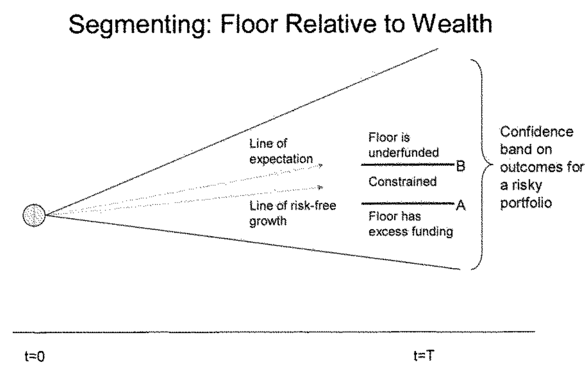
Learning Objectives

LO 1.4.1 List the three basic types of retirement income clients.
LO 1.4.2 Describe the dimensions of risk aversion vs. risk tolerance.
LO 1.4.3 List the benchmark distribution draw rates for the three basic types of retirement clients.
LO 1.4.4 Learn to elicit a "first-order approximation" of the consumption yield ratio.

Charles Dickens famously wrote, "Annual income £20, annual expenditure £19, six shillings, result: Happiness. Annual income £20, annual expenditure £20, 6 shillings, result: Misery." We can assume Dickens knew a third kind of bloke, not happy or miserable but constantly worried, whose income exactly equaled his expenses.

At the time of retirement, retirees fall into three analogous categories: those whose floor or minimum income is sufficiently funded by their risk-free assets, those whose floor is likely to be underfunded by their risk-free assets, and those in the middle, who feel "constrained" in their spending choices (see Chart 1.4.1).

Chart 1.4.1



Flooring needs below line A have excess funding. Flooring needs above line B are Under Funded. Between lines A and B choices are constrained.

Note that the client's risk aversion is not yet part of our formal considerations. The primary issue at this point is whether the client has enough money to fund the floor amounts. Only after the flooring is secure does the client's risk aversion become relevant. This sentence is worth repeating because it is an important distinction between traditional investing for accumulation and our proposed method of investing for retirement income. Only after the income floor is secure does the client's risk aversion become relevant. Risk aversion only matters when you're managing the part of the portfolio that's devoted to creating upside potential above the floor.

Many advisors will find it easier to frame retirement planning in terms of the portfolio yield (or consumption yield ratio) that's required to maintain an expected lifestyle or consumption rate. For them, the different segments in Chart 1.4.1 might translate into the following distribution or draw rates. (Note that higher assets or a lower floor require a lower draw rate, and vice-versa.)

- Excess funding ≈ draw rate ≤ 3.5%
- Constraint ≈ 3.5% < draw rate ≤ 7%
- Under funding ≈ draw rate >7%

Table 1.4.2, below, brings these concepts together to present a simple segmentation of retirement income clients. It applies the three floor-related segments to the four wealth segments to produce 12 segments instead of the 20 in Table 1.1. This categorization method clarifies the targeting of product sets that make up the solutions to the client's retirement income portfolios. Again, using a grading method, we show one – of many – opinions about the value of each segment for financial advisors (FAs).

Table 1.4.2: The Retirement Income Market Segmentation

	Mass Market	Mass Affluent	High Net Worth	Ultra High Net Worth
Under-funded	D- level Value Potential for Retirement FAs	B level Value Potential for Retirement FAs	B level Value Potential for Retirement FAs	Retirement income considerations may not be relevant
Constrained	D level Value Potential for Retirement FAs	A level Value Potential for Retirement FAs	A level Value Potential for Retirement FAs	Retirement income considerations may not be relevant
Excess Funding	D+ level Value Potential for Retirement FAs	A+ Level Value Potential for Retirement FAs	A+ level Value Potential for Retirement FAs	Retirement income considerations may not be relevant

In this approach, greater wealth doesn't necessarily mean greater income adequacy. HNW clients with lifestyles that require distribution rates higher than 5% or 7% belong to the *underfunded floor* category as much as a Mass Market (MM) client in the same relative situation. Nor does financial capital alone determine draw rates in retirement. Human and social capital are also important considerations before we calculate the actionable consumption yield /portfolio yield ratio.

1.5 Core Topic: Consider the Client's Entire Household

Learning Objectives

LO 1.5.1 Discuss why retirement advisors must consider the household view as opposed to the account view of the client, which is sufficient for investment advisors.

A consideration of the entire household is critical for comprehensive retirement planning and management. An advisor may usually meet "across the table" with an individual or a couple during the accumulation phase, but their wealth will most likely have to meet the long-term needs of a constellation of family members.

As financial entities, households may be simple or complex. The family unit may encompass one or several generations and one or more earners. The advisor who understands the entire household is less likely to waste time on solutions that later prove unworkable. It's useful to know, for instance, that households with multiple earners in different age brackets are not likely purchasers of life annuities.

1.6 Advanced Topic: Helping Clients Leave Their "Comfort Zones"

Learning Objectives

LO 1.6.1 Describe the characteristics of clients making basic financial decisions.
LO 1.6.2 Explain why investing takes clients outside of their comfort zone.
LO 1.6.3 Explain why advisors can help clients make better decisions outside of their comfort zone.
LO 1.6.4 Understand the role of the advisor in managing clients' emotions and fears.

Most people are rational, capable and effective when making minor financial decisions within the "comfort zone" of their daily lives, as economist Tim Harford and others have pointed out. Most adults can easily juggle budgets, determine fair prices, and negotiate financial trade offs.

In this comfort zone, people show sensible preferences (i.e., motive), recognize their level of negotiating power (i.e., ability) and match their behavior to the available market supply (i.e., opportunity). They understand the consequences of their actions (i.e., budget impact) in light of their own view of the world.

Investing takes most people outside of their comfort zones, however, where they often behave less rationally. Few people possess the successful investor's instinct to "zig when others zag," to buy low and sell high. Investing is a complex business with its own vocabulary. This is why a trusted relationship with a good advisor is so important.

Advisors can help clients make better decisions outside of their comfort zone. As we will see in the following chapters, this does not always mean that advisors need to create permanent, comprehensive, multi-year plans. For many clients, having a general strategy and making frequent course corrections will bring more comfort—and more success—than fixed long-term plans.

1.7 Recapitulating Where We Are In the Process

RIIA's Retirement Management and Retirement Income Advisory Process has two goals:

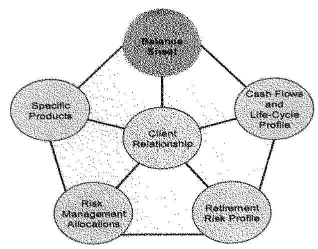
- Goal 1: Build a Floor
- Goal 2: Create Upside

The primary quantitative objective of Chapter 1 is to calculate a "first-order" estimate of the client's consumption /portfolio yield. Inputs for this calculation include an estimate of the client's current Financial Capital and his or her expected annual consumption level in retirement. Outputs from this calculation categorize the client as underfunded, constrained or overfunded. This first-order estimate will be revised as we move through the spokes. This core level of analysis focuses on averages and can be also refined with an advanced level analysis including a specific year-by-year simulation.

The remaining chapters will present the remaining five spokes.

Chapter 2: "The Household Balance Sheet" Is the Start of the "Life-Cycle" Plan

RIIA's Retirement Management and Retirement Income Advisory Process – 1st Spoke



2.1 Spoke One: Life-Cycle Plan, Part I–The Balance Sheet

Learning Objectives

LO 2.1.1 Describe why retirement advisors should start with the client household's balance sheet.
LO 2.1.2 Describe the theoretical importance of starting with the balance sheet.

Like a player in a game of Texas hold'em, a client may have a couple of financial "hole cards" that he or she chooses not to reveal to an advisor at the beginning of their relationship. But eventually there must come a "showdown" where the client flips over all the cards.

In Spoke One of our process, we'll review all of the cards in what we call the "household balance sheet."

A household balance sheet is distinct from an individual account or balance sheet. Accumulation-oriented advisors can afford to take an individual view, but retirement-oriented advisors must consider the finances of the entire family or household. It's no accident that retirement vehicles typically require beneficiary designations.

2.2 Core Topic: Benefits of Focusing on the Household

Learning Objectives

LO 2.2.1 Explain the two major benefits of looking at the household level rather than the individual level to create a retirement plan.

When you invest for growth, you tend to focus on the client's financial wealth. When you plan for retirement income, you focus on the link between the client's current wealth and his or her household's expected future consumption. In a later Spoke, we'll show readers how to tie household balance sheet items to the cash flows in the household income statement.

Two major benefits accrue from focusing on the income and expense needs as well as the wealth on the balance sheet:

The client's portfolio is more than simply a pool of money. It is tethered to the client's life plan. He or she created it to finance consumption. As retirement approaches, the advisor and client should frequently discuss the goals of the portfolio in order to clarify the range of opportunities and strengthen the relationship.

The sooner the advisor can encourage clients to think about how their existing assets will support their future consumption, the easier it will be to make sure their expectations are reasonable. No advisor should wait until clients retire to tell them that they expect too much and that their dreams are bigger than their means.

2.3 Core Topic: Assets Minus Liabilities Equals Owner's Equity

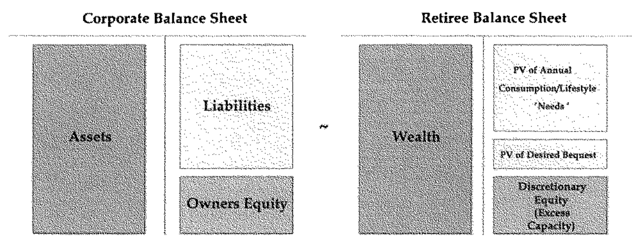
Learning Objectives:

LO 2.3.1 List the components of the household balance sheet.
LO 2.3.2 Describe the difference between a household's balance sheet and a corporate balance sheet.
LO 2.3.3 Discuss why a client's consumption plans are summarized in the form of a present value on the balance sheet.
LO 2.3.4 Explain why the present value of a client's consumption plans is shown as a liability on the balance sheet.
LO 2.3.5 Contrast how an accumulation-minded advisor focuses on a client's balance sheet vs. a retirement-minded advisor.
LO 2.3.6 List five key questions a retirement-minded advisor would ask clients about their assets.
LO 2.3.7 List five key questions a retirement-minded advisor would ask clients about their liabilities.
LO 2.3.8 Calculate the present value of consumption cash flows as well as the present value of income and gains.

Like a corporate balance sheet and as shown on Figure 2.3.1 below, a household balance sheet displays assets on the left and liabilities (consumption needs, bequest desires) plus owners' equity (discretionary wealth) on the right.

Figure 2.3.1

Retirement Balance Sheets



The difference between a corporate and a household balance sheet is most apparent on the liabilities side. The clients' consumption needs, derived from their budget/income statements, can be expressed in the form of a Present Value (PV). That PV becomes a liability that the advisor can match against existing assets.

Similarly, the advisor can calculate the PV of a future bequest or charitable gift and post it as a liability. When the sum of the present values is smaller than total assets, the difference represents the equivalent of owner's equity.

To emphasize what we said earlier, accumulation-focused advisors focus on enhancing the left side of the balance sheet. Retirement management and retirement income advisors focus on matching the assets on the left side of the balance sheet with the client's liabilities (including the present value of future consumption) on the right.

2.4 Core Topic: A Household's Three Sources of Capital

Learning Objectives

LO 2.4.1 List the household's three sources for cash flows.
LO 2.4.2 Define the key components of a client's Human Capital.
LO 2.4.3 Define the key components of a client's Social Capital.
LO 2.4.4 Define the key components of a client's Financial Capital.
LO 2.4.5 Describe the importance of the Consumption to Financial Capital ratio.
LO 2.4.6 Understand the importance of netting Human Capital and Social Capital income out of Consumption before calculating the ratio to Financial Capital.

Households have three major capital sources of cash flows, including:

- Human capital
- Social capital
- Financial capital

Each of these three sources of capital creates cash flows that we can measure and track through the household budget/ income statement and balance sheet.

The client's *human capital* represents his or her earning power. Some clients will have multiple income streams. The amount they earn will vary, depending on their education levels, experience and entrepreneurial abilities.

The client's *social capital* represents claims on the human capital of others. Rich uncles, Social Security payments, and various kinds of support from religious or civic organizations all qualify as social capital. Defined benefit plans can also be included in social capital although some analysts and software providers categorize defined benefit plans as human capital, calling them deferred compensation or a personal annuity.

The client's *financial capital*, or investable assets, is the portion of wealth that advisors are most familiar with. But a retirement advisor is more interested in the ratio of those assets to the client's annual consumption needs than in the value of those assets alone, expressed as account balances or AUM.

A high financial-capital-to-consumption ratio (say, 30:1) tells the advisor that the client may be able to live on income from financial capital alone. A low ratio means that the client may have to rely on social or human capital or tap illiquid assets such as real estate in order to meet consumption needs.*

*Home equity will be an important component of net worth for some clients. It tends to be more important for the lower quintiles of wealth (see Chapter Six). Depending upon your type of clients, reverse mortgages and other housing strategies may or may not be relevant.

2.5 Core Topic: Helping Clients Understand Household Finance

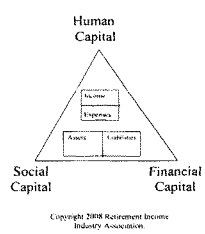
Learning Objectives

LO 2.5.1 Explain the effects of financial illiteracy on clients.
LO 2.5.2 List the components of a client household's balance sheet.
LO 2.5.3 List the components of a client household's budget/income statement.
LO 2.5.4 Identify the flows between the household's balance sheet and budget/income statement.

As researchers such as Annamaria Lusardi and others have shown, financial illiteracy is prevalent in America. Many people can't grasp the arithmetic of household income and expense budgeting, let alone the higher math of annuity fair value and bond duration. Ignorance leads people—rich and poor alike—to spend more than they earn, to borrow more than they can pay back and to put money in instruments they don't understand. Yawning gaps in basic knowledge often hide behind apparent sophistication.

Advisors can use the client's household income statement, balance sheet and cash flow statement as a primer for teaching financial literacy. The two main components of cash flow, income and expenses, are fairly self-evident. Similarly, the two main components, assets (which generate positive cash flows) and liabilities (which generate negative cash flows), can easily be explained. Figure 2.5.1, for instance, shows that the household budget/income statement lies in the context of the investor's three capital sources of positive cash flows.

Figure 2.5.1
Current Income Statement and Balance Sheet



2.6 Core Topic: Types of Financial Capital

Learning Objectives

LO 2.6.1 List the three goal categories of Financial Capital.
LO 2.6.2 Explain how the categories correspond to building a floor and creating upside.

Some practitioners divide financial capital into three goal categories:

- Assets for necessities
- Assets for emergencies
- Assets for discretionary use

These classifications correspond to building a floor (assets for necessities), bracing the floor (assets for emergencies), and creating upside (assets for discretionary use). In the way that pilots use a pre-flight safety checklist before take off, advisors can use this type of functions-based classification system when preparing to interview clients.

2.7 Core Topic: Data-Gathering Methodologies for Household Statements

Learning Objectives

LO 2.7.1 List the three goal categories for client income/positive cash flow.
LO 2.7.2 Describe the process of building a household balance sheet.
LO 2.7.3 Describe the two approaches to estimating cash flows.
LO 2.7.4 List five key questions to ask clients about Human Capital.
LO 2.7.5 List five key questions to ask clients about Social Capital.
LO 2.7.6 List five key questions to ask clients about Financial Capital.

We saw earlier (Figure 2.5.1) that the household income statement and balance sheet can be placed in the context of the investor's three capital sources of cash flows. Table 2.7.1, below, provides general questions to elicit the necessary data from the client.

We've also seen that the cash flow statement and the balance sheet each have a positive and a negative component. The advisor can classify the investor's income or positive cash flows as:

- Income expensed for current consumption, such as paying for groceries.
- Income partially-expensed for financing future income or consumption, such as putting money aside in a Christmas club account or a 529 Education account.
- Income expensed for assets that can generate future positive cash flows, such as investments in a business.

To build a household balance sheet, you can start with the financial capital. It represents current stocks of wealth. You don't necessarily have to consider human and social capital yet. In most client situations, those values would equal the present value of the cash flows over an expected time horizon. The next question is: How do we estimate the cash flows? There are two approaches: *bottom up* and *top-down* estimation. For either, the level of detail may be finer or grainier depending on the client and the relationship. If done properly, either approach should bring you to roughly the same place.

Table 2.7.1

Questions to Ask the Client about Sources of Capital

About social capital:

- Can you provide a copy of a recent Social Security statement?
- Are you a veteran and/or entitled to VA benefits?
- Any you entitled to benefits from any other governmental programs?
- Are you covered by any defined benefit plans?
- Will you receive employee insurance benefits in retirement?

About human capital:

- Are you self-employed or an employee?
- Do you ever earn money outside of your regular employment?
- Do you have outside interests that can be turned into an employment opportunity?
- Have you considered starting your own business?

About financial capital:

- What is the value of your retirement accounts, if any (401(k), 403(b), IRA, Keogh, etc.)?
- What other financial assets do you own?
- Do you own any real assets?
- Do you own any other assets that could be monetized?

2.8 Core Topic: Top-Down Estimates

Learning Objectives

LO 2.8.1 Explain how to create a top-down estimate of a client household's income and expense cash flows.
LO 2.8.2. List the documents used to create a top-down estimate of a client household's income and expense cash flows.

For top-down estimates of cash flows, current lifestyle is a good place to start. The client's income can be found on his or her Form 1040. The extent of the client's savings can usually be found on the monthly statements of his or her 401(k), IRA or savings accounts. Top-down estimates allow you to create a big picture view of consumption needs using easily accessible information.

Using the equation, "consumption = income - saving," you can calculate the client's current consumption by subtracting annual savings from annual income. This level of consumption provides a basis for predicting consumption in retirement. You can adjust it by subtracting expenditures that may vanish (e.g., college tuition, mortgage payments, commuting costs) and adding ones that may crop up in retirement (e.g., health care expenses, a new car, weddings).

2.9 Core Topic: Bottom-Up Estimates

Learning Objectives

LO 2.9.1 Describe the process to build a client household's bottom–up estimate of income and expense cash flows.

For bottom-up estimates of cash flows, start with a blank sheet of paper (or a budgeting software package, if you're technologically advanced) and build the expected cash in-flows and out-flows from scratch. These cash flows can be turned into present values in order to build the bottom-up estimate of the client's balance sheet.

2.10 Core Topic: Detailed Household Balance Sheets

Learning Objectives

LO 2.10.1 List the categories and sub-categories of assets in the client household balance sheet.
LO 2.10.2 List the categories and sub-categories of liabilities in the client household balance sheet.

As shown on Table 2.10.1 below, more comprehensive categories of assets and liabilities could include:

Table 2.10.1
The Personal Balance Sheet

Assets	Liabilities
- Human Capital	- Financial Debt
- Social Capital	-- Mortgage
- Financial Capital	-- Education
-- Tax-Deferred	-- Auto Loans
-- Taxable	- Future Consumption Needs
-- Liability Matched	- Future Bequest Desires
-- Marketable Non-Financial Assets	- Discretionary Equity (Uncommitted funds allowing for liability expansion)

These analyses are maps of the client's underlying lifestyle and financial reality. Such maps represent much-simplified views of the clients' situations. It is up to advisors to decide how much detail they need before they can make confident recommendations to their clients. In trying to prepare for the future, the advisor will have to balance precision and accuracy. As economist John Maynard Keynes put it long ago, "I'd rather be approximately correct than precisely wrong."

Some clients' personal balance sheets will be more complex than others. For instance, the value of closely held businesses and executive deferred compensation packages constitutes a major portion of the assets of the wealthiest five percent of Americans. The advisor will want to ask about this source of wealth in order to add it to the client's balance sheet where applicable.

2.11 Advanced Topic: The Life-Cycle View of the Household Balance Sheet

Learning Objectives

LO 2.11.1 Understand the difference between a static view and a Life-Cycle view of the client household financial statements.

In Spoke One, our analysis was necessarily static because the household balance sheet reflects only a single point in time. In Spoke Two, we'll expand from this static balance sheet view to include an analysis of the investor's dynamic spending patterns and cash flows. That will enable us to create the investor's *Life-Cycle Profile*. Later, we will see that income flows from human capital and social capital will be critical for clients whose financial capital-to-consumption ratio is too low to finance their retirement.

2.12 Advanced Topic: Dynamic Stochastic Optimization or Present Values on the Balance Sheet?

Learning Objectives

LO 2.12.1 Describe the distinction between the dynamic stochastic optimization method and the asset/liability matching method.

Planning for retirement might be compared to filling and emptying a balloon. We accumulate assets and later decumulate them. However, planning the draw-down segment of the process is subject to the problems of path dependency. What methods are available to us and how do we know when one method is better than another for our clients?

Many financial tools are forward-looking tools. They project income and expenses forward into the future. This method complicates the retirement income problem by approaching it as an exercise in dynamic stochastic programming. It works best when we know our objective and understand all the possible factors that could send us off course. If we choose the wrong objective, or if the objective changes, then the solutions that we've created will be aimed widely off of the mark.

But is it truly useful to guess the value of the client's portfolio at some distant point and try to align it with the client's needs at that point? Does that add information or does it just add noise to your decision-making process? Clients and advisors like projecting anticipated returns because the assumption of risk creates an impression of rising wealth. But favorable outcomes may represent just a handful of the ever-widening range of possible outcomes.

Are there planning methods that introduce less noise in the process? Yes. Consider a method that compares the present values (PV) of assets and liabilities. Annual matching of the PVs of assets and liabilities makes it possible to lock in a "floor." The disposition of the remaining upside, if any, can be handled flexibly each year.

Academics will point out that under the PV method, if we know the objective and the states of the economy before we start planning, failure to produce a complete plan over the entire planning horizon may impose a cost. The PV method is flexible because it is incremental. It builds the plan one year at a time. We would point out that under real life assumptions (e.g., where objectives may change and we have imperfect information about the current and future states of the economy) the potential cost of this flexibility must be compared with the real cost of getting a complete plan wrong.

Again, as an academic note, if there is no investment alpha in the projection of the assets then projecting assets and liabilities forward should not create new information (except money illusion) that the current, present-valued balance sheet does not already show.

Under the stochastic method, the key question is: Will my assets grow enough to meet my future needs? Under the second method, the key question becomes: Do my assets match the PV of my future needs? By discounting on the basis of observed prices, present values can be quite precisely measured and compared to observed wealth. If a client's assets are insufficient, the advisor can posit the "what ifs" and recommend actions using human, social and financial capital. The PV process benefits from iteration since observed prices will change.

Starting with the client's balance sheet, the advisor can calculate the present values of various future consumption needs. The advisor can then compare and allocate assets against these present values of liabilities. If necessary, the advisor can also project the balance sheet forward and match the present values of liabilities against the projected assets.

2.13 Advanced Topic: Pensions: Social Capital or Financial Capital?

Learning Objectives
LO 2.13.1 Explain why income from defined benefit (DB) plans can be classified as either Social Capital or Financial Capital.

For most retirees, the largest constituent of social capital will be Social Security. This "pay-as-you-go" program uses payroll taxes from active workers to provide benefits to those over 62 and to the disabled and their dependents. Veteran benefits and a variety of grant programs also provide social capital. Private sources of social capital include civic groups, religious organizations, and family members who provide cash and non-cash support.

Should income from public and private DB plans be classified as social capital or financial capital? Table 2.13.1 below uses overlapping boxes to represent the different ways of categorizing DB plans. Advisors can choose either, depending on personal preferences and the technical tools they use.

Table 2.13.1

Three Sources of Income: Age 65 to 69

Income from human capital
Wages: $15,000

Income from social capital
Social Security: $10,399
Public defined benefit plans: $15,600
Private defined benefit plans: $6,720

Income from financial capital
Annual income: $952

November 7, 2005, Table 1, page CRS-4, Topics in Aging: Income and Poverty Among Older Americans in 2004, Debra Whitman and Patrick Purcell

2.14 Recapitulating Where We Are in the Process

The Goals
Remember what we are trying to do:
RIIA's Retirement Management and Retirement Income Advisory Process has two goals:

- Goal 1: Build a Floor
- Goal 2: Create Upside

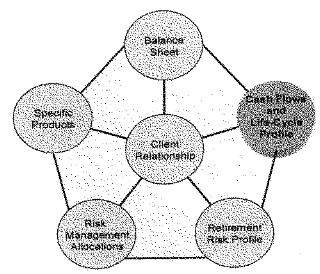
The primary quantitative objective of Chapter 1 is to calculate a "first-order" estimate of the client's consumption /portfolio yield. Inputs for this calculation include an estimate of the client's current Financial Capital and his or her expected annual consumption level in retirement. Outputs from this calculation categorize the client as under-funded, constrained or over-funded. This first-order estimate will be revised as we move through the spokes. This core level of analysis focuses on averages and can be also refined with an advanced level analysis including a specific year-by-year simulation. The remaining chapters will present the remaining 5 spokes.

Spoke #1
The Advisor starts the creation of a Life-Cycle plan based on an understanding of the client's Balance Sheet as illustrated below.

The primary quantitative objective of Chapter 2/Spoke 1 is to calculate a "first-order" estimate of the client's household balance sheet. Inputs for this calculation include asset balances (e.g., financial assets and bank balances) as well as expected cash flows (e.g., social security and pensions). Inputs also include liabilities including mortgage balances, expected annual consumption in retirement, desire for a bequest, etc. Finally, inputs for this calculation include discount rates/expected returns. Outputs from this calculation are shown as a household balance sheet with projected and discounted values as of the client's retirement date.

Chapter 3: The Second Spoke – Cash Flows and the Completion of the Life-Cycle Profile

RIIA's Retirement Management and Retirement Income Advisory Process – 2nd Spoke



3.1 Spoke Two: Life-Cycle Plan, Part II–Cash Flows

Learning Objectives
LO 3.1.1 Describe the differences between the Boomer blended retirement life plan and the traditional retirement plan.
LO 3.1.2 Describe the differences between the old normal and the new normal.

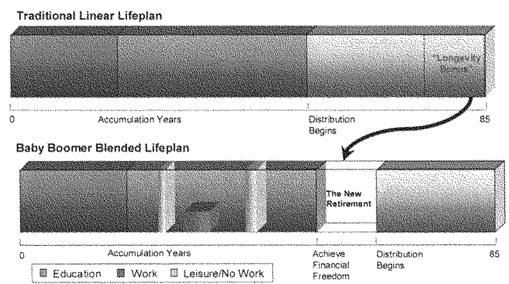
By today's standards, the traditional retirement party, where a white-haired, 65-year-old employee receives a gold pocket watch after a lifetime with "the firm," seems like the quaint ritual of a bygone era. And that's exactly what it is: a cultural memory of the days when our transitions from school to career to retirement were predictable, formal and few.

We call that the *old normal.* Serial employment and flexible or reversible retirement dates characterize the new normal. Many people's careers are now punctuated by extended breaks (voluntary or otherwise) for education, re-training or some other kind of mental refresher. We call that the *new normal.*

RIIA chief operating officer Steve Mitchell, a senior-level executive in the retirement planning industry for more than 30 years, has described the new retirement as a "boomer blended life plan." To illustrate the new paradigm, Steve uses the following chart (Figure 3.1.1) from a 2005 Merrill Lynch study. It depicts some of the differences in expectations between yesterday's workers and today's. The key idea is that retirement is a process, not an event.

Figure 3.1.1

Comparing the Traditional Investor Lifeplan to the Boomer Blended Lifeplan



Source: The 2005 Merrill Lynch New Retirement Study: A Perspective From The Baby Boomer Generation

In light of this revolution in the way many clients will perceive their lives, the advisor may sometimes need to create a portfolio that allows the client with the option of a mid-life career change or "time out."

Post-2008, the bursting of the housing bubble and the collapse of the bull market will probably delay many clients' plans for self-actualization (e.g., summers in Tuscany) and bring more prosaic worries and needs (the cost of re-shingling the roof) to the fore. Some clients will have lost enough money in the crash to warrant a wholesale reorientation of their priorities. Frugality will become a bigger component of retirement plans under the New Normal.

3.2 Core Topic: What Portion of Annual Consumption Must Come from Financial Capital?

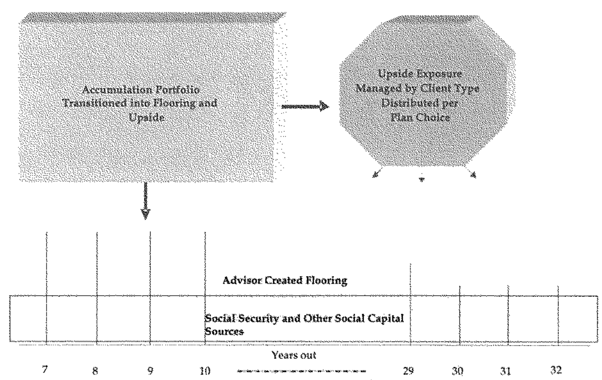
Learning Objectives

LO 3.2.1 Describe the practice of finding a flooring level by matching the estimates of a client household's consumption cash flows to the estimates of its income and gains cash flows from Human Capital, Social Capital and Financial Capital.
LO 3.2.2 Describe the importance of calculating the Consumption to Financial Capital ratio.
LO 3.2.3 Describe the importance of calculating the ration net of the estimated and projected impact of income from Human and Social Capital.

Accumulation-focused advisors dwell on the asset side of the client's household balance sheet. Retirement income-focused advisors watch both sides of the balance sheet and pay equal attention to the household budget/income statement. The twin goal of "building a floor" and "creating upside" for the client demands this broader, more inclusive view. Figure 3.2.1 illustrates the dual objective.

Figure 3.2.1

The Transition from Accumulation to



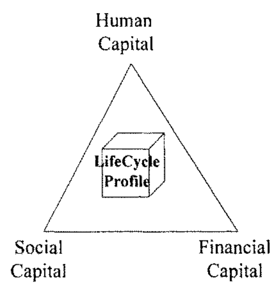
The advisor can start this more dynamic analysis by examining the investor's sources of social capital, which by definition accrues from the work of others. Social capital, or the lack of it, often plays an important role in a retirement plan. A retired couple with supportive adult children obviously wouldn't need the same plan that a single investor with no close family members would.

Using the asset side of the household balance sheet, the advisor can identify the client's other sources of capital and determine which of them can create the various income flows that appear on the household income statement. From the household income statements, the advisor can estimate future expenses, calculate their present value, and add that amount to the liability side of the household balance sheet.

With repeated efforts, the advisor and the client can start to match future consumption with income flows. The exact method is up to you. Depending on the size and complexity of the client's portfolio, you can perform this exercise on the back of an envelope or with specialized financial planning software.

As shown in Figure 3.2.2 below, the discussion and collection of the investor's three capital sources of income forms the basis of the investor's Life-Cycle profile.

Figure 3.2.2
Create a Life-Cycle Profile, the Basis for a Retirement Management Plan



The income flows from the client's social and human capital appear in the Household Income Statement and Household Balance Sheet. Ideally, they should provide a minimum level of income that doesn't depend on Financial Capital. This non-financial income floor can be expressed as a range and may vary over time.

The Life-Cycle profile presents the balance – over the time horizon - between the investor's capital sources of income, namely social capital, human capital and financial capital.

Chapter 1 introduced and showed the importance of the concept of the client's annual consumption to Financial Capital ratio. This introduction allowed the advisor and the client to create a "first-order" estimate of the ratio to start the conversation in the right direction. This section introduces the idea that we can increase the precision of the estimates that went into the initial calculation.

If the Annual Consumption to Wealth ratio is high (above 7%), the investor can't expect to consume at that level for very long. If the ratio is low (below 3.5%), the investor is less likely to run out of money over the long run.

Note that the Annual Consumption to Financial Capital ratio (a form of yield) can also be expressed as a Financial Capital to Annual Consumption ratio (a capitalization multiple). Since advisors and clients discuss yield and returns in many of their conversations, we prefer to use the yield ratio rather than the capitalization ratio.

We can increase the precision and actionable relevance of the ratio by evaluating the impact of Human Capital and Social Capital on the variables that go into the ratio. Some clients will also have employment—participation on corporate boards, consulting or even hobbies—that can generate human capital during retirement. This will cover some of the Annual Consumption needs instead of relying 100% on income from Financial Capital. Likewise, all retired clients who are eligible for Social Security benefits will have social capital (a source of income based on the efforts of others) that will provide a consumption floor.

However, many clients will rely primarily on their financial capital—savings, investments, assets that they can converted to income—as the workhorse that will generate their income above the minimum that social capital provides. For constrained clients (those with a ratio between 3.5% and 7%), the solution won't be as cut-and-dried as saying, "If you want to spend $80,000 in retirement, you'll need $2 million in assets." Creativity will be called for. The client may have to tap non-investment sources of above-average returns, such as the "survivorship credits" that arise from mortality risk pooling, and/or distribution of principal. In Spoke Three and Spoke Four, we'll take a closer look at this issue.

3.3 Core Topic: The Basic Household Budget

Learning Objectives

LO 3.3.1 Describe the key elements of a client household's budget/income statement.

As shown in Table 3.3.1 below, the client budget/income statement can be mapped top/down, with income on top and expenses below, to distinguish it visually from the side-by-side mapping of the balance sheet.

Table 3.3.1
The Basic Household Budget/Income Statement

Income
Earnings
Expenses
Taxes Household Expenses

There are two kinds of people in the world: those who like to plan ahead by creating a budget—and the rest of us. There may once have been a national passion to budget (see "When Private Budgets Were A Public Matter," below) but it has clearly fallen out of favor.

Why? Perhaps because Baby Boomers are uncomfortable with any suggestion of rationing, of "making do" or accepting limits. It's also possible that budgeting was abandoned because circumstances can change fast, making new budgets obsolete overnight. But retirement planning is hard to do without some kind of spending analysis.

Table 3.3.2
When Private Budgets Were A Public Matter

For the sake of historical perspective, here's a quote from "An Overview of Recent Work on Standard Budgets in the United States and Other Anglophone Countries," Gordon M. Fisher, U.S. Department of Health and Human Services, 2007.

"In the U.S., a 33-item standard budget was published as early as 1891, and dozens of standard budgets at various standards of living were developed between about 1902 and 1920, during the Progressive Era. These budgets were generally for individual cities and were generally developed by social workers or other private investigators, although a few isolated budgets were developed by employees of federal government agencies. The developers of these budgets were generally working to improve the living conditions of urban industrial workers and their families.

"Standard budgets continued to be developed during the 1920s and 1930s, but on a somewhat more routine basis. After World War II, the U.S. Bureau of Labor Statistics developed and updated standard budgets—all at standards of living higher than poverty—between the late 1940s and the early 1980s; these included the City Worker's Family Budget at a "modest but adequate" standard of living, published in 1948 and updated until the early 1950s, and three budgets at "lower," "moderate" or "intermediate," and "higher" standards of living, published in 1969 and updated until the early 1980s.

"In general, however, the standard budget methodology fell into disfavor in the United States during the 1960s, 1970s, and 1980s. It is not entirely clear why this methodology fell into disfavor, but two contributing factors appear to have been a turnover of generations among analysts and a change in intellectual trends or paradigms."

The advisor will also need to map the expense items on the standard budget to the income cash flows from human, social and financial capital. Differentiating expense items between fixed and discretionary will help with the mapping.

3.4 Core Topic: Expenses: Fixed vs. Discretionary

Learning Objectives

LO 3.4.1 List two major types of expenses.
LO 3.4.2 Explain the differences between fixed and discretionary expense types.
LO 3.4.3 Explain retirement advisors' map expenses against assets.
LO 3.4.4 Describe best practices for mapping expenses against assets.

On the income statement, expenses are either *fixed* or *discretionary*. The precise difference between the two will be different for each client. Clients who aim for austere seclusion will probably have different needs and wants from those who aspire to live life "to the fullest." But most people probably define fixed and discretionary in the same general way.

Table 3.4.1

Fixed vs. Discretionary Expenses

Fixed
-Food
-Shelter
-Clothing
-Heath-Care
-Utilities
-Insurance
-Taxes

Discretionary
-Vacations
-Entertainment
-Hobbies
-Gifts

After the advisor and the client agree on the specifics of the budget/income statement, they can map the expenses against the assets in the balance sheet. Ideally, the client's risky assets will cover his discretionary expenses and his fixed income (e.g., bonds) and guaranteed assets (e.g., annuities) will match up with his fixed expenses. If not, you might look for ways to close a shortfall in one area with a surplus from another.

3.5 Core Topic: Detailed Household Income Statement/Budget

Learning Objectives

LO 3.5.1 Explain when and why a comprehensive analysis of a client household's finances may be needed.
LO 3.5.2 Describe the key components of a comprehensive budget/income statement.
LO 3.5.3 Practice building the client household's budget/income statement starting with your own.

When the clients' tastes or ambitions clearly don't match the standard budget, a more comprehensive analysis of household finances might be needed. This can be done with paper and pencil, a homegrown spreadsheet or the type of specialized process-compliant software that RIIA encourages vendors to create for advisors.

Income and expenses can take many forms. As Table 3.5.1 shows, earned income, passive income from real estate, interest, dividends and capital gains are some of the most common kinds of income. General household expenses, education expenses for children and taxes are common expenses.

Table 3.5.1

The Household Income Statement

Income -Earned Income -Passive Income -Active Portfolio Income -Gifts	
	Expenses -Household Expenses -Education Expenses -Taxes -Business Expenses

Knowing how to create a budget, explicitly or implicitly, is an important element of financial literacy. Budgeting involves more than controlling expenditures. It also means:

- Employing all sources of income
- Managing current expenses
- Creating practical spending limits
- Curbing excess spending
- Anticipating emergencies
- Using debt wisely

Advisors should avoid the shortcut of using average expenditures instead of collecting specific spending data from each client. Just as the average of several coin tosses won't help you predict the next toss, "average behavior" won't necessarily describe any particular client's future needs. The use of rules-of-thumb like "replacement ratios" has therefore been replaced by more individualized expense-forecasting methods.

Taxes, either as an expense or a reduction of income, must also be accounted for. Because of their high marginal tax rate, taxes from all sources are a large, if not the largest, expense for high net worth clients.

At this point in the process, we can recognize two essential concepts. First, clients possess stored wealth (financial capital), potential wealth (human capital) and wealth derived from membership in a social compact (social capital). Second, retirement advisors need to match these sources of wealth against the clients' current and planned expenditures.

3.6 Advanced Topic: The Life-Cycle View of Distribution Curves and Life Events

Learning Objectives

LO 3.6.1 List five key aspirations that clients may have for retirement
LO 3.6.1 List five discretionary milestones that may exist in a client's Life-Cycle plan
LO 3.6.2 List the regulatory milestones that may apply in a client's Life-Cycle plan

It's easier to understand clients when you see them through the lens of their aspirations rather than their account balances. To paraphrase from a training program based on Mitch Anthony's "The New Retirementality" and presented by Greg Heffington from Van Kampen Consulting, clients may have set their hearts on a retirement that includes:

- A longer career
- A second career
- Play (golf, fishing, sailing, flying, etc.)
- Pursuit of unfulfilled dreams
- Spiritual growth
- Home improvement

- Landscaping and gardening
- New challenges, such as competing in a marathon
- Travel
- Volunteer work, charity or philanthropy

In addition to the traits or circumstances that make each client unique, many clients will experience similar milestones. Again, paraphrasing from Van Kampen Consulting's brochure on "The New Retirementality" these may include:

- Graduation from school or university
- Marriage
- Employment
- Parenthood
- Children's graduations
- Children's weddings
- Children's careers
- Grandparent-hood
- Retirement

In addition to these milestones that derive from personal lifestyle choices, members of American society share regulatory Life-Cycle markers including:

- The earliest age of eligibility for Social Security benefits (62)
- The earliest age of eligibility for Medicare (65)
- The ages when we are eligible for penalty-free distributions from certain tax-deferred retirement savings vehicles (59½, with exceptions)
- The final year before distributions from certain tax-deferred retirement vehicles must begin (the year after the year the participant reaches 70½)

3.7 Recapitulating Where We Are in the Process

The Goals
Remember what we are trying to do:
RIIA's Retirement Management and Retirement Income Advisory Process has two goals:

- Goal 1: Build a Floor
- Goal 2: Create Upside

The primary quantitative objective of Chapter 1 is to calculate a "first-order" estimate of the client's consumption /portfolio yield. Inputs for this calculation include an estimate of the client's current Financial Capital and his or her expected annual consumption level in retirement. Outputs from this calculation categorize the client as under-funded, constrained or over-funded. This first-order estimate will be revised as we move through the spokes. This core level of analysis focuses on averages and can be also refined with an advanced level analysis, including a specific year-by-year simulation. The remaining chapters will present the remaining 5 spokes.

Spoke #1
The Advisor starts the creation of a Life-Cycle plan based on an understanding of the client's Balance Sheet as illustrated below.

The primary quantitative objective of Chapter 2/Spoke 1 is to calculate a "first-order" estimate of the client's household balance sheet. Inputs for this calculation include asset balances (e.g., financial assets and bank balances) as well as expected cash flows (e.g., social security and pensions). Inputs also include liabilities including mortgage balances, expected annual consumption in retirement, desire for a bequest, etc. Finally, inputs for this calculation include discount rates/expected returns. Outputs from this calculation are shown as a household balance sheet with projected and discounted values as of the client's retirement date.

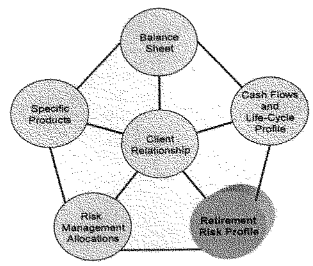
Spoke #2
The Advisor completes the creation of a Life-Cycle plan by matching the client's Social Capital, Human Capital and Financial Capital sources of income with the Income Statement, Balance Sheet and matching Cash Flows.

The goal of this Life-Cycle plan is to understand how much of the client's retirement income floor can come either from Social or Human Capital and how much needs to come from Financial Capital.

The primary quantitative objective of Chapter 3/Spoke 2 is to refine the cash flow inputs that go into the client's household balance sheet. Inputs include personal income/earnings as well as taxes, fixed and discretionary expenses. Outputs are shown on both the client's household Income Statement and Balance Sheet.

Chapter 4: The Third Spoke – The Retirement Risk Profile and the Retirement Income Plan

RIIA's Retirement Management and Retirement Income Advisory Process – 3rd Spoke



4.1 Spoke Three: Assessing Retirement Risks

Learning Objectives

LO 4.1.1 Understand the limits of Modern Portfolio Theory (MPT) in the context of retirement income planning.
LO 4.1.2. Understand that MPT is a special case of a broader class of investment models because it assumes away the Consumption variable.
LO 4.1.3 Understand the difference between risk aversion and risk tolerance.

In a 2007 article in *Research* magazine, York University's Moshe Milevsky warned that traditional approaches to the management of investment risk, such as Harry Markowitz's Modern Portfolio Theory, may not adequately apply to the management of longevity risk—the risk of running out of money during retirement.

That shouldn't be surprising. Conventional finance uses a static, utility-based model of human behavior. In the Markowitz model, life doesn't evolve or end. Instead, an investor's needs, risks and uncertainties are fixed, and today merely repeats itself, as in the 1993 Bill Murray movie, "Groundhog Day."

Markowitz planned it that way. In his famous 1952 paper in the *Journal of Finance,* he assumed that investors would put a conceptual firewall between their at-risk assets and the funds they needed for current consumption. While this assumption allowed him to focus on the value of diversification and the risk/return tradeoff, it ignored the eventual need to use the portfolio to fund future consumption.

This framework in which most investment advisors operate treats the client portfolio as separable from desired future consumption. This assumption is understandable when the client's wealth vastly exceeds his or her annual consumption. However, HNW and ultra-HNW clients are a minority of clients. Most clients facing retirement face constrained or under-funded situations, and the traditional framework assumptions create more problems than they solve.

The traditional framework's assumptions make mean-variance optimization a special case in a larger class of financial models that we will explore in greater detail. When the client has an interest in lifestyle maintenance, portfolio construction separates between lifestyle flooring and investing for potential upside. A floor is a statement by the client that there are outcomes where fear overwhelms the desire for upside gains.

As you most likely know, MPT posits that a risk-averse investor will want the highest expected return for a given level of portfolio risk and, conversely, will prefer the least risky portfolio for an anticipated level of return. Since efficient markets offer few low risk/high return investments, investors almost always face a tradeoff between risk and return. But how much expected returns will your client forego for a given unit of risk reduction? And how much added risk would your client assume for additional return? The answer depends on the investor's degree of risk aversion. Risk-prone investors will sacrifice very little return. Risk-averse investors will give up a lot. A good retirement advisor helps each client assemble a mix of risk-free and risky assets that matches the client's appetite for risk.

In the traditional framework as practiced by many advisors, it would appear that risk aversion has been simplified into risk tolerance. Risk aversion includes several dimensions, including the client's:

- Habit for a certain lifestyle
- Preference for a level of flooring
- Level of impatience as reflected by a discount factor
- Time horizon.

Risk tolerance for the purpose of sorting clients into conservative/moderate/aggressive categories focuses primarily on time horizon, assuming into near or total irrelevance most of the other dimensions.

Assembling the right portfolio mix for retirement income will not be a once-and-done exercise. As the client and their advisor progress from investment management to retirement management, they will need to abandon the narrow approaches associated with long-term optimization among risky assets. Instead, they will have to allow for more dimensions and accommodate repeated mid-course adjustments. For instance, introducing risk aversion and lifestyle flooring creates a need for portfolios with asymmetric payoffs. While very rich clients may buy mean/variance optimal portfolios, most retirement income clients will seek portfolios that have less downside than if normally distributed. Retirement portfolios must create outcomes, not just expectations.

Outcome-focused risk profiling is performed in two steps that will be detailed in this chapter:

- First, identify the Life-Cycle risk factors that drive the portion of the portfolio that will be allocated to flooring.
- Second, identify the shape of risk aversion curve to determine if the client is a conservative, moderate or aggressive investor for the upside portfolio.

4.2 Core Topic: Managing A Wider Range of Risks to Establish the Floor

Learning Objectives

LO 4.2.1 Understand the wider set of risks that the client faces during retirement.
LO 4.2.2 List the three categories of risks as identified by RIIA.
LO4.2.3 Understand how these categories of risk map against the client's Human, Social and Financial sources of capital.

Retirement income-focused risk profiles are, by definition, more comprehensive than accumulation-focused risk profiles. Both are sensitive to inflation risk, market risk and longevity risk. But income-focused profiles also address issuer risk, spending risk, health care expense risk and tax policy risk. Given the dramatic changes in American governance and financial markets in 2008, those last two risks should be increasingly relevant to retirees.

As shown on Figure 4.2.1 below, Spoke Three in the retirement income advisory process matches the corners of the client's Life-Cycle profile to the corresponding corners of the client's retirement risk factors. This process retains some aspects of accumulation-focused investor risk profiling while introducing new features.

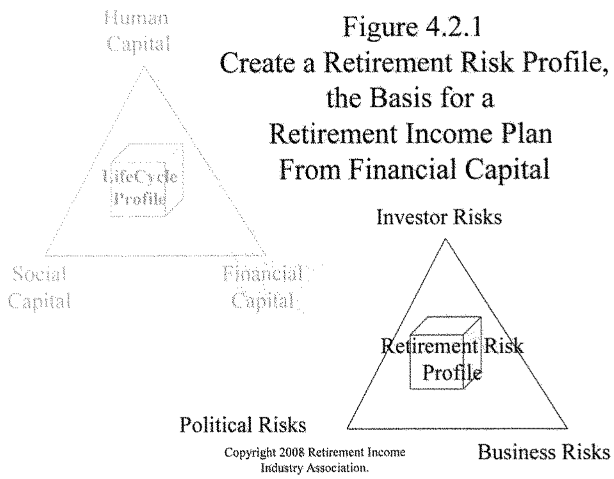


Figure 4.2.1
Create a Retirement Risk Profile, the Basis for a Retirement Income Plan From Financial Capital

4.3 Core Topic: The Retirement Risk Profile

Learning Objectives

LO 4.3.1 List the specific risks faced by retirement income clients.
LO 4.3.2 Map the specific risks into the three risk categories (Political, Business and Investor Risks).
LO 4.3.3 Understand the various risk mappings that are possible and choose one that you prefer given the nature of your practice.

In order to find actionable clarity about the investors' income potential from their financial capital, Spoke 3 starts with a list of the major retirement risks. This list of retirement risks builds on and extends the traditional lists of accumulation-focused investment risks, including:

Market risk. The client's portfolio experiences downside fluctuations in market prices and asset values that are larger than expected or downside moves that persist longer than anticipated.

Issuer and credit risk. The client's portfolio is negatively affected by unexpected changes in credit conditions of the issuers of the assets, including liquidation, bankruptcy, default, changes in terms, changes in control or unexpected downgrades in credit rating.

Inflation and deflation risk. Inflation: The purchasing power of the client's assets is negatively impacted over time. Deflation: The real value of levered assets may decrease. Correspondingly, the real value of liabilities may increase, adversely affecting the client's balance sheet.

Household shock risk. The client experiences unfortunate events (e.g., death of a spouse, divorce, unemployment, etc.) with the potential to force unexpected changes in portfolio composition. This includes the potential need to unwind hard-to-reverse decisions.

Spending risk. The client spends more than the planned income and may have to trade the future for the present by invading his or her capital.

Income risk. The client's investments experience unexpected or un-manageable reductions in income generation either because of changes in market conditions, issuer default or changes in public policies.

Health care expense risk. The client experiences unexpected and expensive changes in the cost of maintaining his or her health, requiring spending above budget and the need to dip into capital. Ironically, it is those who are healthiest at the time of retirement that tend to live long enough to require a care facility.

Longevity risk. The client lives longer than planned or expected, increasing the likelihood of not maintaining the desired standard of living.

Public policy risk. Government legislation and regulation changes affect retirement and income planning leading to earlier-than-expected portfolio depletion or the invalidation of previously sound recommendations.

By rearranging these risks into generic types and putting them in a table format as shown on Table 4.3.1 below, we can see the beginning of a risk matrix with nine risks arrayed across three categories of risk.

Table 4.3.1

Political risks	**Business risks**	**Investor risks**
• Public policy risk • Inflation risk	• Market risk • Issuer risk • Income risk	• Spending risk • Household Shock risk • Health Care risk • Longevity risk

Doug Short, a special advisor to RIIA's Board of Directors and former professor of North Carolina State University, suggested an alternate view of the risk matrix. He takes a broader view of Income Risk, as shown in table 4.3.2 below, seeing it as the fundamental risk to which the other eight contribute. He further subdivides the eight contributory risks into two categories:

systematic risks that have broad impact on all households and unsystematic risks that can vary widely across households.

Table 4.3.2

INCOME RISK			
Systematic Risks		**Unsystematic Risks**	
Political risks	**Business risks**	**Behavioral**	**Chance**
• Public Policy • Inflation	• Market • Issuer	• Spending	• Household Shock • Health Care • Longevity

Risk metrics in accumulation have been researched for many years if not many decades. Risk metrics in retirement need considerable more research attention. We expect risk classifications to evolve over time.

4.4 Core Topic: A Stressful Transition Due to Changing Priorities

Learning Objectives

LO 4.4.1 Describe the effect of stress on a client's ability to plan for retirement.
LO 4.4.2 Describe the psychology of change and how to present recommendations to clients, especially when the reality is much lower than the previous expectations.
LO 4.4.3 Describe the importance of mapping and prioritizing risks in each of the three risk categories.
LO 4.4.4 Describe the process of mapping and prioritizing risk for the clients.

At this point, the client may have to make an emotional or psychological adjustment. Planning for retirement income can dash a person's hopes. If they don't have enough wealth to retire as planned or to maintain a certain lifestyle in retirement, the discovery of it may be painful.

A retirement plan might fail simply because it doesn't help the client adapt to the sudden appreciation of new risks and the stress that goes it. In *Why Most Things Fail: Evolution, Extinction & Economics* (Pantheon, 2006), Paul Ormerod describes a stress threshold above which a person or system fails. When the external stress is below the investor's stress tolerance level, the investor does well. But if the external stress level surpasses that threshold, even by a little, failure occurs. The transition from doing well to failing can be quite abrupt. A retirement advisor needs to be aware of this danger. Creating a floor goes a long way towards avoiding systemic failure.

To construct an investment portfolio with the client's financial capital, it's important to prioritize risks by their importance to the client. This will help the advisor determine the level of flooring that should apply to the client. Advisors will find it useful to rank sub-risks within the major risk categories. For instance, a traditional mapping of client risk—inflation risk, market risk and longevity risk—is illustrated in Figure 4.4.1 below.

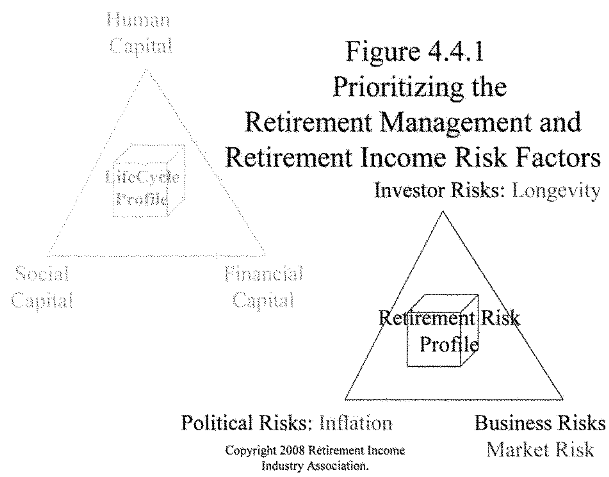


Figure 4.4.1
Prioritizing the
Retirement Management and
Retirement Income Risk Factors

Although future changes may lie ahead, the financial and political reversals of 2008 may have elevated the priority of tax risk above inflation risk, credit risk above market risk, and health care expense risk over longevity risk.

This mapping of risk will help the advisor move from measuring risk tolerance and towards measuring risk aversion.

4.5 Core Topic: Taxes Are A Major Retirement Risk

Learning Objectives

LO 4.5.1 Describe the importance of taxes as a retirement income risk.
LO 4.5.2 Describe the broad strategies that clients can use to mitigate the impact of taxes in retirement.
LO 4.5.3 Describe the state and local geographical variation of taxes in the client household's retirement budget.
LO 4.5.4 Understand the risk that clients who live on fixed incomes face because of the unfunded liabilities at the Federal, State and Local levels.
LO 4.5.5 Explain the importance of building retirement plans for changing tax rates.

LO 4.5.6 Describe the impact of future tax changes on your retirement portfolio recommendations.
LO 4.5.7 Describe the importance of revisiting retirement income plans on an annual basis.
LO 4.5.8 Describe the risk that tax uncertainty brings to over-optimized or long-term optimized retirement plans.

In the future, taxes may become a bigger expense for wage earners in general and retirement investors in particular. Many analysts still seem to suffer from "tax myopia" and underestimate the impact of taxes. On the contrary, taxes are the "elephant in the room."

Taxes come in a wider variety of forms than ever, including but not limited to income taxes, Social Security taxes, Medicare taxes, state income and sales taxes, real estate and property taxes, city wage taxes and excise taxes. Taxes are levied on realized capital gains as well as unrealized capital gains (e.g., certain real estate taxes). Income taxes have even been levied retroactively.

The impact of taxes on income and investment returns is likely to be felt more painfully by retirees who have less ability to adjust sources of income than by those still working and saving. Older investors generally don't tolerate stress as well as young investors. Retirees are more likely to live on fixed incomes and have less capacity to recover from losses. They can hedge their inflation risk with TIPS or products that contain COLA provisions, but tax risk is hard to hedge.

A recent report, "Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison", showed that total tax burden can vary from state to state by a factor as great as six. In 2005, the average annual state tax burden for a household earning $150,000 ranged from as little as $4,000 in Alaska to as much as $24,000 in Connecticut.

Ben Williams, co-founder of Rational Investors and Retirement Engineering, points out that the tax departments of local governments and municipalities may represent an even larger retirement planning risk than the federal government. Municipalities have limited flexibility in managing budget shortfalls and debt. A tax hike becomes the default action.

The cost of unfunded liabilities, such as pension and health benefits for public employees, may eventually have even greater impact on individuals than the cost of federal entitlements, Social Security and Medicare. Local tax increases can affect discretionary income and home values.

Every election cycle ushers in a new tax regime. Along with death and taxes a third certainty is that future tax rates and regulations will differ from the rates and regulations prevailing today. One's views of political climates may influence optimism or pessimism with regard to future tax rates and regulations, but the tax regime will certainly be different.

The actions that are appropriate for tax rates that are rising differ from the actions that are appropriate for falling future tax rates. Understanding how to position a portfolio for a view on future tax rates and against adverse changes is of added importance for retirees relying on their portfolios as the primary source of funding.

The risk that tax rates may go up can bring great uncertainty to retirement planning. Planning in the face of a fixed tax regime is much simpler. Comprehensive retirement plans that cannot anticipate the true behavior of tax rates, and tax payments over the planning horizon are likely to cause stress for the retiree.

To prevent problems, the advisor should revisit each client's plan at least once a year. Together, they should make sure that the plan's use of risk management approaches (i.e., diversified risky assets, insurance guarantees, exposure transforming options and hedges), account types (taxable, tax-deferred, tax-free), and asset types (human and social capital) are still appropriate. If the plan is flexible, it will be relatively easy to adjust.

4.6 Core Topic: Credit Risk Is A Major Retirement Risk

Learning Objectives

LO 4.6.1 Explain the importance of credit risk in building retirement income portfolios.

The possibility that bond issuers or borrowers will not repay their debts—credit risk—can seriously disrupt a retirement plan. Retirement income that's based on debt instruments other than government securities will entail credit risk.

While institutions can manage and diversify their credit risk and require collateral, credit risk is harder to manage for individual clients. Bonds can be laddered using different issuers, but it requires great resources to be able to diversify at each point in time. Annuities can be diversified, but that also requires resources and many separate contractual arrangements. The notion of a client receiving collateral is unrealistic and even humorous to contemplate.

Many contractual arrangements can mitigate market risk. Some products offer guaranteed returns. Guarantees such as options embedded into contracts, if they are not properly hedged by the issuer, may simply transform what was market risk into issuer credit risk. At that point, things can get especially complicated.

Ratings are snapshots in time. They don't predict the ultimate soundness of a particular debt. As we've all seen, ratings can remain stable for years before a fast plummet to oblivion. Enron, Worldcom, and Lehman Brothers maintained high ratings right up until their bankruptcy filings.

It boggles the mind to recall that between 2003 and 2007 the debt ratings of established financial firms remained stable while their leverage ratios rocketed to the high 30s from the low teens. To be sure, an examination of the actual credit spreads of issuers can be useful for short-term horizons. But for the long-term horizon of retirement income planning, prudent diversification may prove to be more reliable than the letters and symbols provided by the ratings agencies.

4.7 Core Topic: Health Care Cost Uncertainty Is a Major Retirement Risk

Learning Objectives

LO 4.7.1 Explain the importance of health care risk for retirement income clients.
LO 4.7.2 Describe the importance of matching potential health care liabilities with Human, Social or Financial Capital sources of income.
LO 4.7.3 Describe methods to mitigate, insure or transfer healthcare risk.

Illness hits retirees in a lottery-like fashion. Some people "square the curve" and remain healthy until the end, while others require expensive care along the way. The probabilities can be estimated and the risk can be reduced through insurance. Long-term care insurance and primary care options that supplement Medicare are widely available.

Ironically, those who are healthiest at retirement often face the greatest risk. The longer one expects to live, the more likely one will need assistance at some point. Moreover the healthy often forego insurance, discounting the consequences of super-longevity. Harvard's Amy Finkelstein and others have documented this somewhat counterintuitive result.

Many clients seem to worry a lot about health insurance but, oddly, don't take advantage of options for long-term care soon enough. They may base their predictions for future health on current health, or discount the future at a high rate, or retain the option of a self-directed exit.

RIIA's teaching software platform for the RMA includes a health cost calculator. This calculator, developed by HealthView Services (HVS), helps clients and their advisors estimate their customized cost of health care in retirement. More information on the RMA teaching software platform and HVS's relationship to RIIA can be found in Chapter 7, Section 10.

4.8 Core Topic: Moving from Risk Profiling to Setting Flooring / Upside

Learning Objectives

LO 4.8.1 Create a first-order estimate of the flooring portfolio as a percent of the total portfolio.
LO 4.8.2 Modify the first-order estimate of the flooring portfolio with the client's risk profile.

Using the following formula,

$$A\% = \left(\frac{Consumption}{Financial\ Capital}\right)\left(\frac{1 + interest}{interest - inflation}\right)\left[1 - \left(\left(\frac{1 + inflation}{1 + interest}\right)^{\substack{years\\ in\\ retirement}}\right)\right]\left(\frac{1 + inflation}{1 + interest}\right)^{\substack{years\\ before\\ Retirement}}$$

with client data that we have gathered earlier, including current age, desired retirement age and expected longevity, we can create a first-order estimate of the level of flooring as a percent of the total portfolio.

Note that the Consumption number is the revised consumption level net of what will be supported by Human Capital and Social Capital. This number is the consumption that will be provided from Financial Capital only.

Financial Advisors can also adjust this first-order estimate with their standard risk profiling processes and questionnaires to categorize the clients by risk levels, most commonly labeled "Conservative," "Moderate" and "Aggressive."

Our illustrative guidelines, as shown and used in the teaching software platform, are to add 10% to the flooring estimate of Conservative clients and 5% to the flooring estimate of Moderate clients.

4.9 Advanced Topic: RIIA's Retirement Income Risk Framework

Learning Objectives

LO 4.9.1 Describe why and when risk becomes relevant to clients.
LO 4.9.2 List the four dimensions of risk that determine the relevance of a specific risk to a specific client.

Risks are often expressed in the form of probabilities. But for the investor, probabilities are less important than consequences. For instance, how does one's perception of an acceptable level of probability change if the possible outcomes include losing one's life?

From our investor's point of view, a risk is relevant:

- If the risk involves an *identifiable* hazard
- If the investor has *exposure* to the hazard
- If the *consequences* are too severe for investor to ignore
- If the *probability* of negative consequences is high enough to make the combination relevant[1]

---

[1] Based on personal reading notes from Ropeik/Gray (2002) Harvard Center for Risk Analysis – Harvard School of Public Health.

Adding these dimensions to our previous list of risks produces RIIA's Retirement Management and Retirement Income Risk Matrix as shown in Table 4.9.1 below:

Table 4.9.1
RIIA's Retirement Income Risk Matrix

	Political		Business			Client			
Retirement Income Risk Matrix	Public Policy Risk	Inflation Risk	Market Risk	Issuer Risk	Income Risk	Spending Risk	Household Shock Risk	Health Care Risk	Longevity Risk
Hazard									
Exposure									
Consequences									
Probabilities									

Note that it is the level of exposure that creates the positive or negative consequences, not the probability. No exposure, no consequences. This is a good thing because we do not observe probabilities directly. We observe events, and we fit these event observations with the probability distributions that we know or that seem to work best. Many probability distributions can fit the observed events. This should create a healthy level of skepticism with regard to probabilities. It is best to develop a strong understanding of exposure and its consequences before playing the odds.

Retirement income-focused advisors can take the risk profile analysis one level deeper by looking at the risk dimensions on the y-axis of RIIA's Retirement Management and Retirement Income Risk Matrix and asking:

- Do I see new threats to retirement income that weren't present in the accumulation phase?
- Am I, or are my clients, exposed to these new hazards?
- Have the negative consequences of any hazards increased or decreased?
- Has the likelihood of these negative consequences increased or decreased?

These retirement risk profiles help the advisor translate the household balance sheet and income statement needs into appropriate risk management allocations in Spoke Four.

Many clients in their 50s realize that market risk, which was perhaps the biggest hazard of the accumulation stage, is now just one of several equally dangerous risks. It's not that the new risks didn't exist before. But only at a certain age does the investor become meaningfully exposed to them and unable to ignore them.

4.10 Advanced Topic: Risk Aversion Profiles Affect the Shape of the Distribution Curve

Learning Objectives

LO 4.10.1 Understand the concept of risk tolerance.
LO 4.10.2 Understand the concept of risk aversion.
LO 4.10.3 Describe the two basis curves of risk aversion.
LO 4.10.4 Describe the Constant Relative Risk Aversion (CRRA) model.
LO 4.10.5 Describe the Decreasing Relative Risk Aversion (DRRA) economic model.

In the traditional framework as practiced by many advisors, it would appear that risk aversion has been simplified into risk tolerance. Risk aversion includes several dimensions including:

- The client's habit for a certain lifestyle
- The client's preference for a level of flooring
- The client's level of impatience as reflected by a discount factor
- The client's time horizon

To delve a little deeper into the notion of risk aversion, how it evolves for different client types and the fundamental link to diminishing returns, we'll use the concepts of walking up a linear ramp, walking up a round-top hill and the effect of walking up slippery slope versions of each.

When walking up a linear ramp each step forward also brings you further up the ramp. If it's a linear ramp then each step forward also brings you to a higher altitude. Assuming that your steps are all of the same length, each step raises your altitude by the same amount as the previous step. If the ramp metaphor describes a utility function, then each additional unit of consumption provides the same increment to happiness as the previous additional unit of consumption. If the ramp were slippery such that the next step has an equal chance of ending up as one step forward or one step back, since the ramp is linear the expected up/down movement of the next step would be zero and the expected gain or loss to utility of the next step would also be zero. A risk-neutral individual would be indifferent to the risk.

If walking up a rounded-top hill the story is a little different. On this hill, the hill is steepest at the bottom and each step forward raises our altitude by less than the previous step. Reverting to utility, our utility functions would be said to exhibit diminishing marginal utility; each incremental unit of consumption brings less additional happiness than the previous incremental unit. If the hill is slippery so that the next step has equal likelihood of ending up as one step forward or one step back then although the expected forward movement is zero, the expected vertical movement is negative. A step forward is likely to lead to a net loss in height. The risk isn't worth it.

So, using the concept of a ramp versus a hill, we can distinguish between risk aversion and risk neutrality. For a risk-neutral client, the increase in happiness from a step forward is unchanging. For a risk-averse client, a step forward brings greater happiness but at a slowing rate; utility is increasing at a decreasing rate with each increment to consumption. Exactly how risk averse a risk-averse client will be depends on how quickly marginal utility slows.

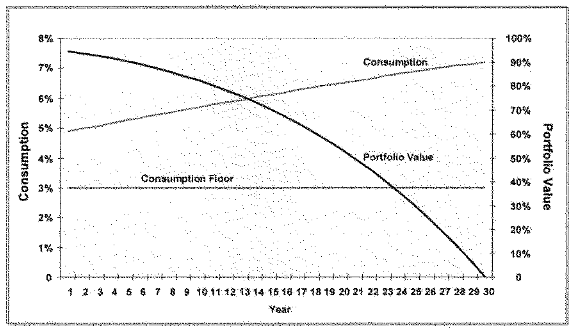
At the risk of switching metaphors, it might be easier for a moment to think of distance vs. speed vs. deceleration. In this metaphor, distance is the equivalent to the utility function, speed (change in distance per unit of time) is equivalent to marginal utility (change in utility per unit added consumption) and deceleration (the change in speed per unit time) is the equivalent to change in marginal utility (per unit added consumption). Formally, to the economist, the absolute level of risk aversion is measured by the ratio of deceleration to speed, i.e., the rate at which marginal utility is decreasing divided by the level of marginal utility at that point. Relative risk aversion can be found by multiplying the absolute number by the level of wealth. For those of you comfortable with the jargon of calculus, absolute risk aversion is measured by taking the negative of the second derivative divided by the first derivative.

There is an intimate link between risk aversion and the type of smoothing that will be optimal for a particular client. To see this, we consider two clients. The first client faces risk the same way no matter what their wealth level. We call this Constant Relative Risk Aversion – CRRA. The second client becomes more fearful of sliding back the closer they are to the bottom of the hill and more willing to risk near the top. We call this Decreasing Relative risk Aversion – DRRA.

For a person with CRRA preferences, retirement's risks are faced with no greater or lesser fear as assets are depleted. For this type of client, the portfolio's profile will remain steady and *planned* consumption will only differ through time based on the rate of impatience which determines whether planned consumption is exactly equal across periods (no impatience) or whether putting off consumption today needs to be bought off with the expectation of slightly more tomorrow.

Chart 4.10.1

Wealth Drawdown and Consumption For Individual Exhibiting Constant Relative Risk Aversion

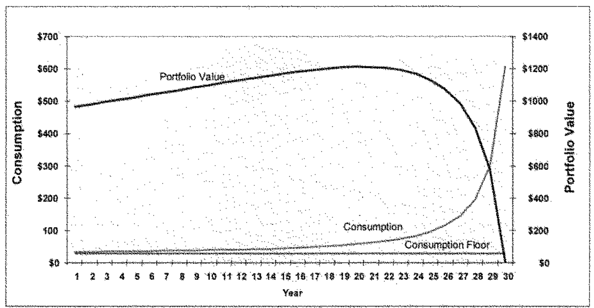


This individual remains equally tolerant of risk regardless of wealth. Consumption is planned to rise only because the individual wants to get as much incremental happiness from consuming tomorrow as today. Since the planned consumption tomorrow is worth less than today (impatience) constant incremental happiness requires planning for more consumption tomorrow.

For a person with DRRA preferences, the realization that assets will be depleted leads to a plan that will initially eat into wealth more slowly and conservatively than the CRRA example. In addition, the desired risk level of the "upside" portfolio will decrease as wealth depletes. For this type of client, planned consumption will hold back more of seed corn until it is clear that the goal can be obtained. This type of client may also be impatient, but impatience will be held at bay by fear until near the end of life.

Chart 4.10.2

Wealth Drawdown and Consumption For Individual Exhibiting <u>Decreasing</u> Relative Risk Aversion



This individual is less tolerant of risk as wealth declines. Consumption is deferred and the portfolio husbanded as impatience gives way to fear - until very late in life. Near the end of life as there is a shorter future to worry about, fear recedes, and impatience roars back.

Most firms have established a set of questions for establishing a client's risk aversion or tolerance of risk as it relates to where the client stands on the hill today. What kind of hill the client is on is usually ignored. However, for Life-Cycle portfolios, it is important to know whether the client's preferences are shaped more like the ramp, the rounded hill or something else entirely.

Quantifying how the client's attitudes will change through time requires more subtle questions:

- Which planning path looks most appealing to you?
- Suppose that your wealth rises and your portfolio scales proportionately. As your wealth rises, would you be willing take more, less or equal risk than today?
- Do you worry more about losing out on happiness today or about your money running out too soon?
- Over the last 20 years, have you desired to increase, decrease or keep the risk of your portfolio about the same?

For the engineering approach, we know that we will never know what makes a particular client tick, but we can create choices and portfolios for the client among paths that appear preferable. We can also design enough flexibility into the solution so that as more information about the client becomes available we can adapt the portfolio. We can also seek to retain flexibility in order to adapt to events that will surprise, for good or ill, the client.

Risk and uncertainty are not the same, and the distinction is important for anyone who hopes to optimize investment portfolios. Risks can be measured. Uncertainties are too diffuse or unforeseeable to allow for the assignment of meaningful probabilities.

4.11 Transitioning From Risk Profiles To Allocations Among Risk Management Techniques

Learning Objectives

LO 4.11.1 Explain the difference between risk and uncertainty.
LO 4.11.2 Explain the difference between severity and frequency when it comes to risk.
LO 4.11.3 Understand how the severity/frequency matrix leads to generic risk avoidance strategies including: risk retention, risk pooling, risk avoidance, and risk control.
LO 4.11.4 Describe the technique to manage risks with high severity and low frequency (risk pooling).
LO 4.11.5 Describe the technique to manage risks with high severity and high frequency (risk avoidance).
LO 4.11.6 Describe the technique to manage risks with low severity and high frequency (risk control).
LO 4.11.7 Describe the technique to manage risks with low severity and low frequency (risk retention).

When their probabilities are measurable, risks can be pooled, hedged or insured against using widely available financial products. Uncertainties, on the other hand, are random events. Often, the only defense against them is to hold excess assets—precautionary assets.

Conventional wisdom says that one should insure oneself against risks with high severity and low frequency, avoid risks with high severity and high frequency, self-insure (risk retention) for risk with low severity and low frequency, and establish prevention (risk control) programs for risks with low severity and high frequency.

The insurance industry has a traditional framework that corresponds to these beliefs and maps the severity of the risk by its frequency. This creates four blocks where one can show that risk (hazards) to which one has exposure can have high or low severity (i.e., consequences) as well as high or low frequency (i.e., probabilities). This matrix logically links us to the next chapter, where we'll talk about using risk pooling (insurance), hedging (risk avoidance), diversification, (risk retention) and reserves (risk control).

This framework helps us make the transition from the traditional approach to asset allocation to RIIA's approach to risk management technique allocation. This will be explored in detailed in the next chapter.

4.12 Recapitulating Where We Are in the Process

The Goals
Remember what we are trying to do:
RIIA's Retirement Management and Retirement Income Advisory Process has two goals:

- Goal 1: Build a Floor
- Goal 2: Create Upside

The primary quantitative objective of Chapter 1 is to calculate a "first-order" estimate of the client's consumption /portfolio yield. Inputs for this calculation include an estimate of the client's current Financial Capital and their expected annual consumption level in retirement. Outputs from this calculation categorize the client as under-funded, constrained or over-funded. This first-order estimate will be revised as we move through the spokes. This core level of analysis focuses on averages and can be also refined with an advanced level analysis including a specific year-by-year simulation. The remaining chapters will present the remaining 5 spokes.

Spoke #1
The Advisor starts the creation of a Life-Cycle plan based on an understanding of the client's Balance Sheet.

The primary quantitative objective of Chapter 2/Spoke 1 is to calculate a "first-order" estimate of the client's household balance sheet. Inputs for this calculation include asset balances (e.g., financial assets and bank balances) as well as expected cash flows (e.g., social security and pensions). Inputs also include liabilities including mortgage balances, expected annual consumption in retirement, desire for a bequest, etc. Finally, inputs for this calculation include discount rates/expected returns. Outputs from this calculation are shown as a household balance sheet with projected and discounted values as of the client's retirement date.

Spoke #2
The Advisor completes the creation of a Life-Cycle plan by matching the client's Social Capital, Human Capital and Financial Capital sources of income with the Income Statement, Balance Sheet and matching Cash Flows.

The goal of this Life-Cycle plan is to understand how much of the client's retirement income floor can come either from Social or Human Capital, and how much needs to come from Financial Capital.

The primary quantitative objective of Chapter 3/Spoke 2 is to refine the cash-flow inputs that go into the client's household balance sheet. Inputs include personal income/earnings as well as taxes, fixed and discretionary expenses. Outputs are shown on both the client's household Income Statement and Balance Sheet.

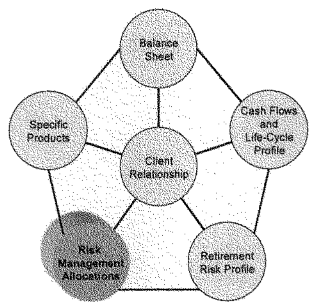
Spoke #3

The Advisor translates this Life-Cycle plan into a Retirement Income plan by matching the Investor's Capital Sources of Income to his or her prioritized Retirement Income Risk Factors.

The primary quantitative objectives of Chapter 4/Spoke 3 are to determine the client's risk tolerance (e.g., Conservative, Moderate, Aggressive) and to calculate the portion (percent and dollar) of his or her financial portfolio that should be dedicated to flooring. In addition to the risk profile questionnaire, inputs include the client's current age, desired retirement age, life expectancy and various inflation and discount factors. Outputs are the client's risk tolerance and the portion of his or her financial portfolio that should be dedicated to flooring.

Chapter 5: The Fourth Spoke – Risk Management Allocations to Design "A Floor with Upside"

RIIA's Retirement Management and Retirement Income Advisory Process – 4th Spoke



5.1 Spoke Four: Managing Retirement Risks

Learning Objectives

LO 5.1.1 Describe the limits of asset allocation among risky assets for retirement income portfolios.
LO 5.1.2 Explain why retirement portfolios must diversify among risk management techniques before they diversify among risky assets.

For decades, diversification among risky assets seemed to be a reasonable investment strategy for anyone with a long enough investment horizon. It is, after all, the essence of the time-honored and widely followed Modern Portfolio Theory.

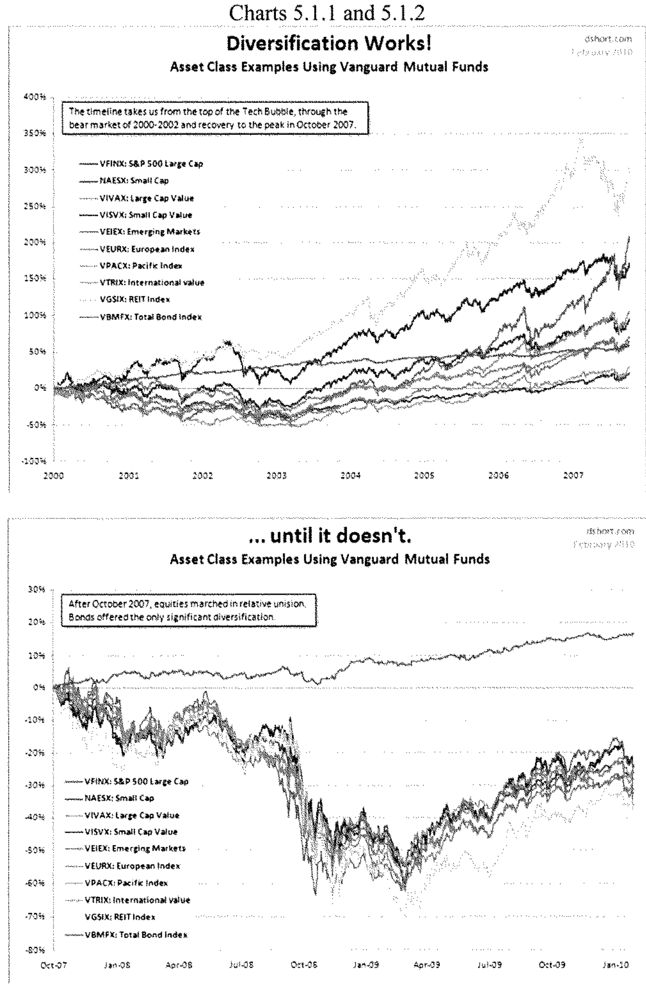
Followers of MPT will naturally seek to balance risky assets with an appropriate, age-adjusted ratio of fixed-income assets in their portfolios. Or they would reduce equity holdings whenever the market appears significantly overvalued or trends downward.

Since March 2000 and again after September 2008, many historical "truths" about diversification have been contradicted, raising questions about over-reliance on its broad validity for investors, particularly those with finite horizons. Diversification, by itself, is not sufficient to protect investors.

As evidence of that, consider Charts 5.1.1 and 5.1.2 below, created by Doug Short. The two charts track the performance of the components of a diversified stock/bond portfolio during strong bull and strong bear markets, respectively.

But, while bonds and rebalancing will help mitigate market risk, they won't mitigate all of the risks to income that retirees can expect to encounter.

Charts 5.1.1 and 5.1.2



You can see that, during epic market downturns, equity sub-classes tend to march to the same dismal drumbeat. How do we protect against these infrequent but destructive events? First we need to accept the fact that they do happen — as they did in 2000 and 2008.

In retirement planning, diversification among *risk management techniques* must accompany diversification among risky assets. To *build a floor* and *create upside* from financial capital (using the client's Life-Cycle profile and their retirement risk profile as a guide) the advisor needs to know how to allocate among these risk management techniques:

- Diversification (Investments in partially uncorrelated risky assets, i.e., risk retention)
- Transference (Hedging strategies, i.e., risk avoidance)
- Pooling (Health and longevity insurance, i.e., risk pooling)
- Reserves (Risk-free precautionary balances, i.e., risk control)

In fact, the retirement advisor needs to know how to allocate among these techniques two ways: one when building floors and another when creating upside.

Remember that a client's definition of "building a floor" or "flooring" will depend on the results of the analysis performed in Spokes 1, 2 and 3. On the liabilities side, the definitions will range from meeting basic necessities to maintaining a certain subjective level of comfort. All clients want to achieve the latter, but many will only be able to meet their basic needs and a modest cushion. On the asset side, the matching mix of human, social and financial capital will vary widely from client to client.

The floor provides security. It has to "be there" when needed—without exception. When building the floor, it's acceptable to take judicious and measured amounts of the diversifiable type of credit risk associated with insurance contracts or corporate bonds, but not unhedged market risk. Flooring must be resilient and even redundant.

"Creating Upside" means using the remaining financial capital to enhance the standard of living above the floor. Upside is closer to traditional optimization of risky assets.

The traditional financial framework is about creating expectations. The retirement framework is about creating outcomes. You'll find that outcomes resonate better with retirement clients. Outcomes are the theme around which retirement management professionals need to build portfolios.

5.2 Core Topic: RIIA's "First Build a Floor, then Expose to Upside" Goal is Compatible with MPT

Learning Objectives

LO 5.2.1 Describe the characteristics of Life-Cycle portfolio selection models.

LO 5.2.2 Describe the advisor's task in building a floor and exposing the rest of the portfolio to upside.
LO 5.2.3 Understand how diversification among risk management techniques is compatible with MPT.
LO 5.2.4 Understand how MPT is a special case of diversification among risk management techniques.

The phrase "First Build a Floor, then Expose to Upside" may sound unfamiliar, especially to advisors who have only studied conventional finance "laws" such as "risk and return," "diversify and rebalance," and "reversion to the mean."

However, "First Build a Floor, then Expose to Upside" is related to MPT. Indeed, the Markowitz model is only a special case of a wider class of the lifetime-portfolio selection models pioneered by Franco Modigliani, Paul Samuelson and Robert Merton[2].

Most of the lifetime-portfolio selection models imply the notion of a minimum level of consumption required for each period. They express the optimal level of consumption in two parts: a minimum requirement (the floor) and a fraction of the excess (upside) that remains after locking in future floors:

$$C_{\text{optimal}} = C_{\text{Floor}} + x\% \text{ (Wealth} - PV_{\text{future floors}})$$

Where C_{optimal} denotes the optimal level of consumption derived from an economic model, C_{Floor} denotes the minimum consumption level that the client subjectively feels is necessary, x% is the fraction of discretionary equity that the client wishes to consume in a particular time period and (Wealth - $PV_{\text{future floors}}$) is the measure of discretionary equity.

In other words, all of these models decompose into a floor plus upside. They differ mainly in the fraction of discretionary equity (x%) that can optimally be consumed in a given period. In other words, all the models share the concept of building a floor. They differ only in the way that the "upside" is drawn down.

In still other words, your client's portfolio contains two sub-portfolios, one for flooring and the other for upside. The upside portfolio is familiar; the flooring portfolio is the wrinkle that Markowitz ignored while he focused on demonstrating the value of diversification.

In Spokes 1 to 3, the advisor seeks to establish the client's optimal consumption level and the client's risk profile as well as the residual level of flooring that must come from Financial Assets. To the extent the essence of this consumption and risk behavior is captured by the above equation, the advisor's task in building a floor and creating upside becomes clearer. He or she needs to gauge:

---

[2] All have received Nobel prizes, with Samuelson being the first American recipient and clearly one of the greatest economists of the twentieth century.

- The right amount of floor
- The risks to which the floor is exposed
- The right technique or portfolio for creating upside

5.3 Core Topic: Three Basic Approaches to Creating Optimal Floor and Upside Portfolios

Learning Objectives

LO 5.3.1 List the three basic approaches to creating retirement portfolios with flooring and upside.

RIIA has identified three generic approaches to building retirement portfolios. There are called the Engineering, the Economic and the Empirical Approaches. The following sound-bites summarize the key differences between these approaches:

- "Here's what *I* can do for you" (Engineering Approach)
- "Here's what you *ought* to do" (Economic Approach)
- "Here's the *professional consensus* on what to do" (Empirical Approach)

5.4 Core Topic: The "Engineering Approach"

Learning Objectives

LO 5.4.1 Describe the Engineering Approach.
LO 5.4.2 Describe Mike Zwecher's approach as a specific Engineering Approach.

Advisors who use the Engineering Approach create alternative solutions that are feasible, given current asset prices and each client's preferences. This approach relies heavily on the advisor's creativity and imagination, and there's no limit to the number of potential solutions. In essence, engineering is a "Here's what *I* can do for you" approach, with an emphasis on the advisor's skills.

For example, using Mike Zwecher's Engineering Approach, the client's funding status (the ratio of the expected annual consumption to be funded from financial assets divided by total financial assets) determines the generic type of portfolio that would apply: capital market solutions for funded clients, hybrid solutions for constrained clients and mortality monetization solutions for under-funded clients.

There are other ways to engineer portfolios for retirement income including "time segmentation," "buckets and ladders," etc. Working with its Financial Advisor members in general and the Education Committee in particular, RIIA is actively documenting and classifying engineering approaches so that we can present them in this curriculum.

5.5 Core Topic: The Economic Approach

Learning Objectives

LO 5.5.1 Describe the Economic Approach.

The Economic Approach starts with a particular economic model and then plugs in the client-specific values to find the optimal allocations for that client. Consider someone who wants the same floor income as the client described above. In the Economic Approach, the client's optimal allocations would depend on his or her risk tolerance, age and life expectancy.

Earlier in this chapter we presented a simplified exposition of economic models of Life-Cycle behavior:

$$C_{\text{optimal}} = C_{\text{Floor}} + x\%(\text{Wealth} - PV_{\text{future floors}})$$

Where C_{optimal} denotes the optimal level of consumption derived from an economic model, C_{Floor} denotes the minimum consumption level that the client subjectively feels is necessary, x% is the fraction of discretionary equity that the client wishes to consume in a particular time period and (Wealth - $PV_{\text{future floors}}$) is the measure of discretionary equity.

The Economic Approach uses advanced mathematics, particularly dynamic programming, to internally find spending targets for clients - both pre-retirement and post-retirement - that lead to smooth living standards per household member. Software programs and simulations based on this approach can help households raise their living standards and estimate the living standard impact of early retirement, downsizing one's home, living to a different state, etc.

For example, Section 5.8 presents Consumption Smoothing, the Economic Approach developed by Laurence J. Kotlikoff of Boston University.

There are other Economic Approaches for retirement income. Working with its Academic Special Advisors to the Board in general and the Peer Review Selection Committee in particular, RIIA is actively documenting and classifying Economic Approaches so that we can present them in this curriculum.

5.6 Core Topic: The Empirical Approach

Learning Objectives

LO 5.6.1 Describe the nature of RIIA's Empirical Valuation Framework (EVF) program.

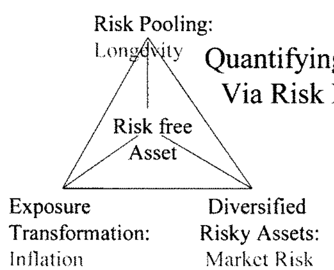
LO 5.6.2 Describe the basic elements of RIIA's Empirical Approach.
LO 5.6.3 Understand the limit of simulation and optimization.

The Empirical Approach is the ultimate stage in the quest for *best practices*. The empirical approach is more descriptive than prescriptive; it describes what professionals engaged in providing solutions are actually implementing on their client's behalf. Best practices may change over time but they are important windows on the underlying framework.

RIIA is currently researching and developing an "empirical validation framework" (EVF) for retirement income portfolios. Analogous to the "60/30/10" ratio that has come to define a prudent mix of stocks, bonds and cash in an MPT-driven accumulation portfolio, EVF will help guide advisors in dividing retirement assets among various risk management techniques.

It is too early for RIIA to endorse benchmark EVF allocations (there may be one for flooring and another for upside), but they will likely include the four risk management techniques shown in Figure 5.6.1.

Figure 5.6.1
Quantifying the Strategic Allocations
Via Risk Management Techniques



Allocation of Financial Capital to Risk Management Techniques

Inv.	Hed	Ins.	Rf.
?%	?%	?%	?%

RIIA's Research Committee and other standing committees are currently managing and funding research programs to develop and promote an EVF. These research programs, which address the EVF's academic, commercial, and regulatory implications, seek to refine:

- The definitions of the necessary risk management techniques
- The applications of those techniques to various investor types
- The guidelines for making investor-specific adjustments in the techniques

Fortunately, advisors won't have to wait for RIIA to finish its empirical research before they can start building portfolios that will "First Create a Floor" and "Then Expose to Upside." Existing engineering approaches and economic models will suffice until then.

To highlight the importance of building an empirical approach, advisors should remember that over-reliance on optimizations and simulations can bring brittleness in the face of unexpected shocks. The incidence of life shocks is higher than commonly believed. According to the Health and Retirement Study (HRS) conducted by the University of Michigan and sponsored by the National Institute on Aging (1992-2002), incidence rates of shocks for individuals in the age 51–age 61 cohort were:

- Major medical condition 41.3%
- Medical work limitation 33.7%
- Laid-off from work 18.7%
- Widowed 7.3%
- Severe disability 6.9%
- Nursing home 3.4%
- Divorce 2.3%

5.7 Core Topic: Deciding When to Focus on Flooring with Mike Zwecher's Engineering Approach

Learning Objectives

LO 5.7.1 Explain why the cost of the floor rises with the client's age during the accumulation period.

LO 5.7.2 Describe when advisors should have the flooring discussion with clients.

Richard Fullmer, a RIIA member with Russell Investments, points out that Financial Advisors must remember that the present value of flooring rises with age during the accumulation phase. The later you start, the higher the present value, the greater the change in the client's portfolio and the more resistance that the required change will engender. The essence of a seamless transition from accumulation to retirement income is to pitch the switch in focus when the flooring allocation of a retirement income portfolio approximately equals the fixed income allocation of an accumulation portfolio.

The engineering approach that Mike Zwecher uses is a program of techniques and tools that have the following features:

- The look and feel of the portfolio retains familiarity with accumulation portfolios.
- The products and approaches are scalable across a wide variety of client types.
- The client chooses the desired lifestyle and the advisor delivers, or explains why the delivery is probable but risky, or explains that the delivery is improbable.

- The mechanics of both static and dynamic management approaches are designed to allow the advisor to diffuse suitability risk.

In this section, we'll start with the cost of flooring and develop the engineered flooring concept. We'll see how, for any desired lifestyle, the longer the transition is deferred, the higher the cost of flooring and the required flooring allocation will be. Flooring represents lifestyle security. It provides a base from which we can build a full portfolio with allocations that are intuitive and explainable because they serve the needs for lifestyle security, longevity protection, precautionary measures and potential for upside.

To illustrate the rise in present values with the clients' age during the accumulation phase, we provide the following example. Table 5.7.1 shows the cost of securing $10,000 per year in floor income when purchased at the ages that are shown in the far left column (30 through 65). In every case, the client receives the floor income from age 65 until age 100.

Three columns labeled 5%, 6%, and 7% are presented. For each age-at-purchase, they roughly estimate the initial cost of the floor income when Treasury Strips (appreciating at 5% per year), corporate bonds (6% per year) and insurance-based annuities (7% per year) are purchased.

One can read these as the cost of risk-free flooring (Treasury bonds), the cost of flooring with issuer credit-risk (corporate bonds), and the cost of flooring with issuer credit risk + purchaser mortality risk (annuity).

Table 5.7.1: Cost of Flooring by Age of Client at Purchase

Cost per $10 K annual payment; stream from age 65 – 100			
Nominal Values 0% Anticipated Inflation			
Age at Purchase	5%	6%	7%
30	$ 31,169	$ 19,995	$ 12,976
35	$ 39,781	$ 26,757	$ 18,200
40	$ 50,771	$ 35,808	$ 25,526
45	$ 64,798	$ 47,919	$ 35,801
50	$ 82,701	$ 64,126	$ 50,213
55	$ 105,550	$ 85,815	$ 70,427
60	$ 134,711	$ 114,840	$ 98,777
65	$ 171,929	$ 153,681	$ 138,540

So, exactly when and how should advisors re-direct their clients' focus from accumulation to retirement income?

To the client, the change should feel like a natural transition in the portfolio management process—no more than a gradual reshaping of the portfolio. Advisors should avoid abrupt, significant changes in the portfolio.

Here's how an advisor using this approach might handle it. Suppose that his or her client is concerned only with flooring, longevity risk, and the need to keep some cash as a precaution. Suppose also that the yield curve is flat at 5% and the client has a 40% chance of reaching age 85 and a 20% chance of living to age 90. The client retires at age 65.

Key Step: Our advisor will build a floor portfolio of cash, bond strips, and longevity insurance (in the form of a deferred annuity).

The remainder can be invested at risk to generate potential upside. On the green half of Table 5.7.2, allocations are designed to support an annual draw of five percent of current wealth from age 65 to age 85. On the purple half of Table 5.7.2, the allocations are designed to support a four percent annual draw from current wealth from age 65 to age 90.

As Table 5.7.2 shows, the nominal flooring allocations for a 50-year-old client are either 31% or 28%, depending on whether they want a 5% or 4% draw rate. For this example, let's assume the client's allocation is 30%. Note that scaling the allocations to higher or lower draw rates is possible with the caveat that the At Risk column (upside) will need to be adjusted to keep the property that each of the rows add up to one.

For an advisor using a 60/30/10 allocation for accumulation, age 50 would be a natural point to begin re-allocating the client's fixed income assets from a typical constant-duration bond fund to a planned maturity schedule. In this way, the 30% fixed income allocation becomes flooring. The earlier that the transition is begun in the 30 year window before retirement, or the pre-positioning of assets for the transition, the less strain on the overall portfolio and the more the transition will feel like a natural progression rather than a change in course.

Table 5.7.2 Two Examples of Allocation Tables with Allocations differing by draw rates (4% and 5%) and time horizon (age 85 and age 90)

Allocations For Flooring to 85				
Nominal Values, 0% Anticipated Inflation				
Age	Flooring	Longevity	Cash	At Risk
30	12%	1%	10%	77%
35	15%	1%	10%	74%
40	19%	2%	10%	69%
45	25%	2%	10%	63%
50	31%	3%	10%	56%
55	40%	3%	10%	47%
60	51%	4%	10%	35%
65	65%	5%	5%	25%
70	73%	7%	5%	15%
75	*81%*	*9%*	*10%*	*0%*

Allocations For Flooring to 90				
Nominal Values, 0% Anticipated Inflation				
Age	Flooring	Longevity	Cash	At Risk
30	11%	0%	10%	79%
35	14%	0%	10%	76%
40	17%	1%	10%	72%
45	22%	1%	10%	67%
50	28%	1%	10%	61%
55	36%	1%	10%	53%
60	46%	2%	10%	42%
65	59%	2%	5%	34%
70	65%	3%	5%	27%
75	73%	3%	5%	19%

This table shows the allocations required for each category by age of the client under the assumption that the client will retire at 65, the yield curve is a flat 5% and there is a 40% chance of survival to 85, 20% chance of surviving until 90 and no chance of living past 110. Entries highlighted in red are cases where capital-markets solutions are infeasible and monetizing mortality via an annuity goes from being an option to being a necessity. Table is produced in greater detail in Zwecher (2009)[3].

Note on column headings in Table 5.7.1: Flooring + Longevity = Flooring Portfolio as defined in Spoke 3. Cash + At Risk = Upside Portfolio as defined in Spoke 3.

Note on Longevity: This is not exclusively the province of insurance products. It can also be achieved, generally at a higher cost than insurance, with capital markets products.

As a rule, *the point of smoothest transition will be the age (or date) when the proposed flooring allocation for securing retirement income is closest to the fixed-income allocation for accumulation.*

Different allocation schedules can be easily constructed to accommodate changing prices, expectations of inflation, and coverage windows. As the allocation schedules change, the point of smoothest transition will naturally change.

These important issues and more are discussed in detail in Mike Zwecher's book, *Retirement Portfolios.*

5.8 Advanced Topic: What Does Consumption Smoothing Add To Creating Optimal Portfolios?

Learning Objectives

LO 5.8.1 Understand the concept of consumption smoothing.
LO 5.8.2 Understand the limits of the replacement ratio approach.
LO 5.8.3 Learn how to calculate a "certainty equivalent," smoothed consumption level.
LO 5.8.4 Understand the generalized formula that ties Consumption to Wealth.
LO 5.8.5 Understand the limits of optimization and how to integrate it in daily practice.

Economists generally accept the proposition that, all else being equal, most people will try to assure themselves a consistent living standard—a "smooth consumption path"—that avoids downside surprises. Many economic models take consumption smoothing as a primary motivator for an individual's foregoing of consumption today, saving the money and having it available to fund future consumption. But as we've discussed the risks to retirement lifestyles in this section, we can see that creating a portfolio that helps clients smooth consumption is not an easy task. As an example, focus on longevity risk and inflation risk.

In a perfect world without credit risk, asymmetric information or other "frictions and imperfections," an actuarially fair, real annuity would be able to provide smooth consumption and it would also be an attractive alternative to taking portfolio risk. Since actuarially fair, real annuities are hard to find, the question becomes one of finding a smooth path for clients that best meets their desires for a sustainable lifestyle using the products and tools available.

---

[3] Retirement Portfolios: Theory, Construction and Management, John Wiley & Sons, 2010.

To get there, we need to review a few theoretical highlights, including widely adopted formalizations of the problem as provided by the late Paul Samuelson (1969) and Robert Merton (1969). Economists are using collations of the theories seen in texts like that of Ingersoll (1987) that have sections based largely on the results of the 1969 papers mentioned above and a paper Robert Merton wrote in 1971. Ingersoll shows that if we put aside the fact that the optimal draw-down percentage out of excess wealth (see "x" in the formula below) can be a complex function of such things as impatience, risk aversion and remaining life, we can simplify the optimal smooth path as the following:

$$C[\text{optimal}] = C[\text{floor}] + x\% \,(\text{Wealth} - PV[\text{future floors}])$$

$C_{optimal}$ denotes the optimal level of consumption derived from an economic model, C_{Floor} denotes the minimum consumption level that the client subjectively feels is necessary, x% is the fraction of discretionary equity that the client wishes to consume in a particular time period and (Wealth - $PV_{future\ floors}$) is the measure of discretionary equity.

The solution shows that optimal consumption for each period equals the minimum consumption needed plus a fraction of the discretionary wealth in excess of future and planned lifestyle needs. The fraction "x" may be gauged by understanding the client's potential time horizon, the client's attitudes towards risk today, the client's likely attitude towards risk as wealth is drawn down and the appropriate risk-free rates.

The economic models that derive from this generalized formula focus on:

- The importance of wealth rather than annual income in determining Life-Cycle consumption
- The importance of consumption smoothing (x is a smooth function across time)
- The fact that risk averse clients will be willing to pay to ensure a reliable and smooth consumption plan
- How dissimilar clients can be when it comes to setting up their unique Life-Cycle goals

Finally, more elaborate versions of the models, such as those presented by Constantinides (1990) and Lax (2002), endogenize the consumption floors and provide the following insight:

- The importance of habit formation and the matching minimum lifestyle preferences

To summarize theory back to the practical, economists believe that the desire for a smooth/stable living standard over one's Life-Cycle motivates people to:

- Save for retirement
- Buy insurance products
- Save for uninsurable events, such as losing your job (i.e., to save for the proverbial rainy day)
- Diversify one's economic resources

Laurence Kotlikoff, the Boston University economist mentioned earlier, and Scott Burns, a nationally syndicated financial columnist, discuss this "consumption smoothing" in *Spend 'til the End* (Simon & Schuster, 2008). Zvi Bodie, a Boston University economist, also focuses on clients' desire to achieve a stable living standard over time in *Worry-Free Investing* (Prentice-Hall, 2003, co-authored with Michael Clowes).

"Consumption," in this context, refers to total spending. Consumption smoothing refers to establishing a stable living standard. The theory of consumption smoothing, whose more recent formalizations were discussed above, dates back to seminal work in the 1920s by Irving Fisher. The assumption that people want a smooth ride is grounded in human physiology. In economists' terminology, our marginal utility from consuming more at a given point in time declines the more we consume. This *diminishing returns* feature of our happiness leads us to want to spread our spending power over time and forms the basis of the theory of saving. This same desire to smooth consumption underlies economists' recommendations concerning insurance and portfolio diversification. The goal is to smooth consumption not just over time, but also over *times* – good times and bad times.

For instance, property insurance permits us to stabilize (smooth) our consumption across times when we experience accidental losses. If our house burns down and we are insured, then we experience no losses. Buying insurance (paying insurance premiums) transfers spending power from situations of no loss (when we have less to spend because of the premium payments) to situations of loss (when we collect on the insurance policy we purchased).

On the other hand, the act of saving transfers spending power from the present to the future.

Investment diversification also redistributes spending power from good to bad times. If we only invest financial assets in a specific stock and it does poorly, we are disrupting, not smoothing, our living standard compared to the alternative, i.e., carefully diversifying our assets. By diversifying, we end up with less spending power in good states (when some of the assets boom), but more spending power in the bad states (when these same assets tank).

Let's start thinking about consumption smoothing with a model in which clients live for two periods – they are young and then they are old, and there is no uncertainty of any kind. This simplification will keep the math approachable with pen and paper.

Let's call their consumption when young C_y, and their consumption when old, C_o. Let's also use S_y to reference the saving the young clients do. For simplicity, we assume no saving when clients are old. Finally, let's call E_y the amount the client earns when young and E_o the amount the person earns when old. Finally, to keep making the model simple, assume that all these variables (C_y, C_o, S_y, E_y, and E_o) are measured in today's dollars.

Note: Remember that we are looking at discretionary spending only. If there are taxes, E_y and E_o can be viewed as net of these payments. If there are Social Security or other government benefits, E_o and E_o should be viewed as net of these payments. Let's also do the same with other items that can be viewed as non-discretionary spending. For some clients, this could include college expenses, mortgage payments, or alimony. In all such cases, then E_y and E_o will be smaller as we net out the non-discretionary spending.

When young, E_y is either spent or saved, so:

$$C_y + S_y = E_y$$

When old, consumption is financed (paid for) by E_o as well as the principal of one's saving S_y plus the income earned on one's saving:

$$C_o = S_y\,(1+r) + E_o,$$

Note: "r" stands for the return on one's saving.

These two equations can be combined into one equation by substituting out for S_y. The result is what economists call the *lifetime budget constraint.*

$$C_y + C_o/(1+r) = E_y + E_o/(1+r)$$

The equation says that the present value of lifetime consumption has to equal the present value of lifetime, spendable resources. Or in simple terms, you can't spend more than you make over your lifetime.

If the person wants to make consumption when young equal to consumption when old, i.e., if she wants C_y to equal C_o, the person just sets $C_y = C_o$ and replaces C_o in the above equation by C_y and then solves for C_y.

$$C_y = C_o = [E_y + E_o/(1+r)]\,(1+r)/(2+r)$$

This is the consumption-smoothing solution if the person wants consumption in both periods to be exactly equal. In general, stable preferences coupled with the diminishing returns property of their preferences will lead them to try to smooth consumption over adjacent periods. There may be a preference for consumption to evolve, but the economic theory of consumption smoothing suggests that people would want to plan for consumption to evolve smoothly.

There is, even in this simple model in which there is no uncertainty, one major potential impediment to consumption smoothing that needs to be considered. There are conditions when the client is unlikely to be able to borrow (to make S_y negative) in order to smooth consumption. Some young clients with a large mortgage to pay and a growing salary may not be able to borrow against future income. If E_y is small compared with E_o, the client may want to make C_y bigger than E_y, in order to make C_y equal to C_o. This borrowing when young to increase consumption beyond earnings may not be possible.

With people living not for two periods, but many years, such *borrowing constraints* (also called *cash constraints* or *liquidity constraints*) make solving the consumption smoothing equations very difficult. Formal solution of consumption smoothing optimization problems may be difficult, if not impossible, without the aid of computers and efficient computer algorithms.

A popular algorithm that is both exhaustive in considering all possibilities and computationally efficient is called *dynamic programming.* Dynamic programming was developed in the early 1950s by a mathematician named Richard Bellman. Dynamic programming is a tool to optimize a goal subject to constraints.

Given the lifetime budget constraint and the borrowing limitations discussed earlier, the client household will try to make its "lifetime happiness meter" as big as possible. This is what economists call the lifetime *utility function*. In this two-period model, economists would express the utility function, U, as:

$$U = U(\mathrm{C_y}, C_o)$$

This equation indicates that lifetime happiness depends both on the client's consumption when young, C_y, and consumption when old, C_o. This utility function captures the diminishing returns arising from satiation. Mathematically, this translates into saying that for a given value of C_y (C_o), raising C_o (C_y) by more and more will add less and less to the person's happiness (U) if the amount of C_y (C_o) is held constant.

Intuitively, if you have just eaten a meal, eating a second meal does not double your total pleasure, and eating a third is even less additional fun than eating the second. If you can preserve that third meal for tomorrow or some other future date when you'd otherwise not have any food to eat, you'll seek to do so. Thus, consumption smoothing is simply an economic aspect of human nature. Mathematically speaking, the name of the game is choosing the consumption plan that makes U as large a possible without violating the lifetime budget or borrowing constraints. Specifically, the model maker tries to find values of C_y and C_o that maximize U subject to these two restrictions.

It is at this point that theory gives way to assumptions about functional form for implementation from which an "optimal" plan can be derived. With uncertainty about the value of E_o that one will experience or the "r" that one will earn, one is forced to choose C_y without knowing precisely what this choice will mean for the value of C_o, which one will experience when one is old. In this setting, economists assume that the person will try to maximize her *expected or average utility* – the level of U that will arise, on average, once the value not just of C_y but also of C_o is determined.

Note: Go back to the example of steady consumption and the equation for $C_y = C_o$, which shows that the value of C_o will depend on S_y set when young as well as what E_o and "r" turn out to be.

The diminishing returns imbedded in an individual's utility function, which naturally leads clients to want to save, also influences their concern about risk – their risk aversion. Indeed, the standard mathematical formula used by economists to quantify the degree of risk aversion, called the degree of relative risk aversion, is determined by how fast diminishing returns set in and how quickly the diminishment is changing. So diminishing returns and risk aversion are not two sides of the same coin. They are the same side.

The more risk-averse clients (the more diminishing returns affects their happiness) will be concerned about making E_o and "r" safer. Buying homeowners insurance, auto insurance, taking a safer job, taking out a fixed rate mortgage – these are ways or ensuring that E_o, which again is labor income net of taxes, net of "off-the-top" expenses, but including Social Security and other government benefits, is less variable. Investing in a diversified manner is a way to ensure that "r" is safer.

To help people understand the living standard risks they are facing and their ability to limit these risks, it's important to show them as precisely as possible the range of C_o outcomes they might experience for different choices of C_y and decisions about insurance and diversification.

To economists, financial planning comes down to one thing—your living standard, because it is these values of C_y and C_o that enter into your happiness meter, i.e., your utility function.

In addition to smoothing and protecting your living standard through time (trying to make sure that C_o doesn't end up very low relative to C_y), economics is focused on making the household's living standard (the combined values of C_y and C_o) as high as possible. There is a range of decisions that don't involve taking on more risk that can raise our lifetime resources (the right-hand-side of the lifetime budget constraint). For example, taking Social Security benefits at age 70, rather than age 62, may make E_o larger, without making it riskier. A second example is taking an equally safe job in another city, where the housing costs are lower, and the job pays more. This will raise E_y and E_o and, therefore, lifetime resources.

The final focus of economics-based financial planning, beyond smoothing, protecting, and raising your living standard, is pricing your living standard. This refers to knowing how much certain lifestyle decisions, such as retiring early and thus lowering E_o, will cost in terms of its impact on C_y and C_o. Another example is buying a larger home. Since this raises your non-discretionary spending (including the down-payment, higher mortgage payments, higher property taxes, and higher homeowners' insurance), it comes at the price of less discretionary spending – lower values of C_y and C_o. To decide if retiring early or buying the larger house is worth it, economists believe you need to understand precisely what it may mean for your C_y and C_o.

There are several extensions to this standard framework. These extensions focus on a number of issues that can be understood within our simple two-period framework. Some economists posit that people become habituated to their living standard and don't like to see it decline. This comes down to a statement of the precise form of the utility function U. With such *habit formation*, the mathematical expression of U is such that diminishing returns to having more and more C_o, for a given amount of C_y, sets in very powerfully and asymmetrically the closer C_o is to C_y. At the extreme, the person would get no extra utility from consuming more when old than C_y and be completely miserable (have infinitely negative utility) if consumption when old falls below C_y.

People with such preferences tend to be very concerned with the downside to their future living standard and will seek to set a floor on their future living standard.

Consumption Smoothing boils down to the simple notion that people prefer smooth rather than jumpy patterns of consumption. It also accommodates the fact that households will revise their spending plans each year in light of their market gains, their wages, and other unexpected changes to their remaining lifetime resources.

This approach argues against workers putting their saving on autopilot. Doing so would smooth their savings but disrupt their living standards. It also argues against retirees spending a fixed amount of assets each year without regard to earnings. This doesn't imply an absolute preference for a completely flat level of discretionary spending consumption, only that optimal plans will tend to be smooth. This approach also makes it clear that the optimal planning horizon is your maximum age of life, not your expected age of life. The reason is simple: You can't count on dying on schedule. You need to plan on having the capacity to spend until your 100th year or more, because you might see it.

5.9 Advanced Topic: What Does Behavioral Finance Add To Creating Optimal Portfolios?

Learning Objectives

LO 5.9.1 Understand the relationship between Consumption Smoothing and Behavioral Finance.

In 1966 an economist named Kelvin Lancaster demonstrated that it is not goods per se but the characteristics of goods that provide utility. We near the limits of monetary smoothing when we ask: What are the characteristics of a smooth living standard? For people who are contemplating their latter life, smoothing may mean maintaining a sense of independence. This can help determine the composition of assets that they will use to finance their lifestyles. As they see their world shrinking, home ownership may be the last redoubt of independence. Do not be surprised if a client would rather own a modest home than sell it and rent a luxury apartment.

The simple models that we use in economic analyses often ignore facts that a non-economist would take for granted. Most models enforce a clean split between financial assets and consumption. Wealth becomes a fungible commodity, and consumption decisions split from portfolio decisions. This ignores the fact that some assets like art, gold, stamps and coins may be purchased for their aesthetic pleasures as well as for the potential for price appreciation. In the housing boom of the last decade, people didn't necessarily buy more houses, but they tended to buy bigger houses, as the asset was sold to them as not just a place to live but an "investment." For assets that provide both consumption and investment returns, the models will be silent. But if you ignore their dual nature, your clients may be quite vocal.

Related aspects of economics-based planning go under the heading of *behavioral finance*. One area of research in behavioral finance concerns changes in preferences over time. Such changes are often referred to as *dynamic time inconsistency.* In a setting with more than two periods, a person who knows that her preference for utility (*U*) may change—indeed, change in ways she doesn't want—has, in effect, a current self that contends with a range of future selves. Each self has its own *U* function and will try to allocate its remaining consumption the way it sees fit. Since the current self doesn't share the future self's preferences, the current self will try to lock in the future self into certain behaviors. For instance, a person might put money into a retirement account to keep future selves from spending it before retirement and incurring a tax penalty.

Another strand of the economics literature on behavioral finance questions whether people understand either their preferences or their lifetime budget constraints. Research in the emerging field of neurological economics shows, for example, that savings and spending decisions are processed in different parts of the brain. In reality, these questions are two sides of the same coin. But if you pose a saving question using language about spending, you'll get a different answer than if you pose the economically equivalent question using the word saving.

Going back to our discussion of risk aversion in Spoke 4, we can now show how the "x" in the formula ($C_{optimal} = C_{Floor} + x\%\ (Wealth - PV_{future\ floors})$) will differ for clients with different types of risk aversion. If a person's willingness to risk a given percentage of wealth is independent of their level of wealth, it is called Constant Relative Risk Aversion (CRRA). The optimal draw-down behavior for that person will be nearly linear.

For an individual with CRRA preferences, consumption will be set at a fraction that depends primarily on the number of years remaining. The degree of impatience provides the upward tilt in the consumption path shown here and yields positive interest rates as a corollary. By valuing consumption now over consumption later, the point of indifference is reached only when deferred consumption is high enough to compensate for foregoing higher consumption today. In the example above, wealth is consumed and consumption rises at a constant rate.

However, most people exhibit Decreasing Relative Risk Aversion (DRRA). When their wealth is growing, they can tolerate more risk. During retirement, if their wealth is shrinking, they tolerate less risk. This restraint persists until late in life, when the discipline of "saving for a rainy day" finally yields to acceptance that "You can't take it with you." Anecdotally, it's not unusual for the very elderly to reverse years of frugality and decide to redecorate the house or go on a cruise. This isn't a health-related phenomenon or an attempt to avoid estate taxes; it occurs regardless of health or wealth status. It's impatience, and it eventually overtakes frugality. Since their risk aversion rises as their wealth declines, their fear of running short of funds suppresses their consumption rate until very late in life. In other words, risk aversion holds impatience at bay.

In addition to suggesting optimal draw-down paths, these models can be used to create optimal portfolios. The difficulty with this approach lies not with finding ideal solutions, but with finding solutions for specific people. To put it another way, the models don't yet account for the richness of human behavior.

5.10 Advanced Topic: What Do Monte Carlo Simulations Add to Creating Optimal Portfolios and Why Is "60/30/10" Too Risky for Retirement?

Learning Objectives

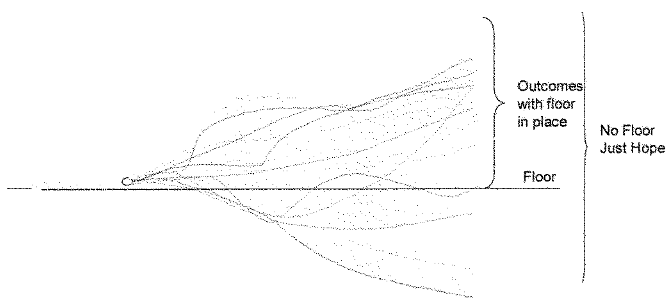
LO 5.10.1 Describe the limits of the 60/30/10 approach for retirement portfolios.
LO 5.10.2 Describe the use and the limits of Monte Carlo analysis.

In *Why Most Things Fail,* Ormerod observed something relevant to those who think about retirement planning. "To have the intention of securing a particular outcome is usually no guarantee at all that it will be achieved," he wrote. "Intent is not the same as outcome."

Planning for retirement is about creating outcomes rather than hopeful expectations. It should first focus on creating a floor under the investor's income risk. The change in focus from expectations to outcomes helps us deal with the structural fragility of planning. As shown on Monte-Carlo simulation based Chart 5.10.1, the use of targets, floors and guarantees can make financial plans less brittle—that is, less vulnerable to failure.

Chart 5.10.1

Simulating Paths for Accumulation



Planning is more definitive when outcomes are bounded. Unbounded outcomes make planning more difficult.

Monte Carlo simulation is a tool that is frequently used to study complex processes that are not amenable to direct methods. A large sampling of paths through a difficult-to-disentangle process can be simulated to create a picture of and evaluate the outcome of the process. In financial applications, for instance, it can simulate the array of outcomes arising from the use of exotic options, structured products and whole portfolios. For our purposes, it is useful for understanding differences between portfolios that may behave similarly in most cases but deviate substantially in the tails. Where one portfolio may be prone to frequent but mild failures, the other may tend toward rare but severe failures. It should always be remembered that Monte Carlo techniques provide a tool for analysis that mechanically renders results for a previously designed parameterized process. It's an estimation tool whose simulations are based on preconceived models. It provides deductive results that can rule out models, but it does not validate models in a scientific sense.

Accumulation planning focuses on the investor's exposure to risky assets and modifies it according to the investor's risk tolerance. Its approach to asset allocation, summarized as 60/30/10, dictates that average investors with a sufficiently long time horizon should put 60% in investable assets in stocks, 30% in bonds and 10% in cash.

While 60/30/10 has long served as an empirical validation of the asset allocation practices of investment management professionals, can it also function as a dominant empirical valuation framework, or EVF, of the retirement management industry during the distribution era? No, because it leaves out the need for reducing downside risk and creating an income floor.

A retirement plan—as well as the economic science of retirement and the matching retirement education—should act like a good map that helps us navigate unfamiliar terrain. In contrast to accumulation planning, retirement income planning involves more than allocating an investor's financial capital among risky assets. It should also include such risk management techniques as:

- Creating income guarantees
- Creating exposure transformations for asymmetric outcomes
- Protecting real values

This suggests that 60/30/10 is not likely to provide the complete EVF for retirement income planning. One can see that while asset allocation is part of the picture, it is only one of at least four useful risk management techniques.

For retirement income planning to blossom, it may need an EVF summary all of its own. Instead of 60/30/10, a retirement planning EVF may have different components that further differ by age. These four components would include allocations of the investor's financial capital to include:

- Diversification of risky assets
- Mitigation of personal risks via insurance
- Mitigation of market risks via hedges
- Creation of reserves of risk-free assets

5.11 Advanced Topic: Beware the Black Swans (and the Dragon-Kings!)

Learning Objectives

LO 5.11.1 Understand Power Curves and their relationship to Black Swans and Dragon-Kings.

Nassim Taleb, in his books, *Fooled by Randomness* (Random House, 2005) and *The Black Swan* (Random House, 2007), demonstrated that life confronts us with larger and more frequent catastrophes than our preconceived notions of risk usually lead us to expect. Taleb calls these large events "Black Swans." Didier Sornette, in his paper, *Dragon-Kings, Black Swans and the Prediction of Crises* (International Journal of Terraspace Science and Engineering, 2009), makes the point that we can identify even larger catastrophes than Black Swans. He calls them "Dragon-Kings."

Taleb and others make the point that natural, self-organizing systems, including social and business systems, are, more often than commonly perceived, punctuated by large and rare events. Mathematically, a power law probability distribution of outcomes as a variable of event or artifact size (in contrast to a normal distribution for instance) is often seen as a statistical signature of such natural, self-organizing systems.

When a market remains stable for a while, for instance, we become complacent. The crisis that began in 2007 when a global bank, HSBC, suddenly wrote-down its mortgage book, spreading collateralized debt obligations (CDOs), Asset Backed Commercial Paper, and leading eventually to a full-blown panic, is one reminder of the age-old error of mistaking models, which describe probabilities, for descriptions of reality.

Wall Street, for instance, treated CDOs and other credit instruments as fully hedgeable securities. Why? Because it's easier to mark to a pricing model and hedge to the factors that drive that model, recognizing P&L along the way, than to value the inherent (and very real) non-hedgeable risk. But the Street acquired a false sense of control. Imbibing its own Kool-Aid, it believed that it could successfully model the market's behavior. Then—wham! The market reminded us that we are its playthings and not the reverse.

Sornette makes the point that Black Swans cannot be predicted with the common statistical tools since nothing in the mathematics distinguishes them, a priori, from their smaller siblings. On the others the even larger events are akin to phase-transitions (a physical example would be the change from ice to water) in order to become true catastrophes. The mathematics of phase transitions, unlike the mathematics of Black Swans, allow for predictions if one learns how to recognize the warning signs of a Dragon-King.

Dragon-Kings are revolutions with a clear before and after. They emerge from the existence of positive feedback loops that amplify the power of certain events or certain persons. They are the result of amplification. While we tend not to see Dragon-Kings in the distribution of most investment returns (depending upon the data and time frames, we tend to see normal distributions, log-normal distributions and power laws), the presence of amplifying mechanisms, such as portfolio insurance, option hedging and momentum trading, does create the emergence of Dragon-Kings (e.g., the crash of the tech bubble in April 2000 or the stock market crash of October 1987.) These events are not standard statistical events, they are true phase transitions: ruptures, bifurcations, tipping points, catastrophes, and revolutions. They happen because the market is based on imitation herding, self-organized cooperation and positive feedback loops, leading to internally generated instabilities. Some of those instabilities, the larger ones, may be more predictable than we know.

5.12 Recapitulating Where We Are in the Process

The Goals
Remember what we are trying to do:
RIIA's Retirement Management and Retirement Income Advisory Process has two goals:

- Goal 1: Build a Floor
- Goal 2: Create Upside

The primary quantitative objective of Chapter 1 is to calculate a "first-order" estimate of the client's consumption /portfolio yield. Inputs for this calculation include an estimate of the client's current Financial Capital and their expected annual consumption level in retirement. Outputs from this calculation categorize the client as under-funded, constrained or over-funded.

This first-order estimate will be revised as we move through the spokes. This core level of analysis focuses on averages and can be also refined with an advanced level analysis including a specific year-by-year simulation. The remaining chapters will present the remaining 5 spokes.

Spoke #1
The Advisor starts the creation of a Life-Cycle plan based on an understanding of the client's Balance Sheet.

The primary quantitative objective of Chapter 2/Spoke 1 is to calculate a "first-order" estimate of the client's household balance sheet. Inputs for this calculation include asset balances (e.g., financial assets and bank balances) as well as expected cash flows (e.g., social security and pensions). Inputs also include liabilities including mortgage balances, expected annual consumption in retirement, desire for a bequest, etc. Finally, inputs for this calculation include discount rates/expected returns. Outputs from this calculation are shown as a household balance sheet with projected and discounted values as of the client's retirement date.

Spoke #2
The Advisor completes the creation of a Life-Cycle plan by matching the client's Social Capital, Human Capital and Financial Capital sources of income with the Income Statement, Balance Sheet and matching Cash Flows.

The goal of this Life-Cycle plan is to understand how much of the client's retirement income floor can come either from Social or Human Capital, and how much needs to come from Financial Capital.

The primary quantitative objective of Chapter 3/Spoke 2 is to refine the cash-flow inputs that go into the client's household balance sheet. Inputs include personal income/earnings as well as taxes, fixed and discretionary expenses. Outputs are shown on both the client's household Income Statement and Balance Sheet.

Spoke #3
The Advisor translates this Life-Cycle plan into a Retirement Income plan by matching the Investor's Capital Sources of Income to his or her prioritized Retirement Income Risk Factors.

The primary quantitative objectives of Chapter 4/Spoke 3 are to determine the client's risk tolerance (e.g., Conservative, Moderate, Aggressive) and to calculate the portion (percent and dollar) of their financial portfolio that should be dedicated to flooring. In addition to the risk profile questionnaire, inputs include the client's current age, desired retirement age, life expectancy and various inflation and discount factors. Outputs are the client's risk tolerance and the portion of their financial portfolio that should be dedicated to flooring.

Spoke #4

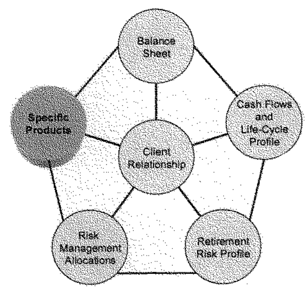
To build a floor and to create upside from Financial Capital according to the client's retirement risk profile, advisors must know how to allocate among four risk management techniques:

• Diversification among risky assets – Investments
• Risk Transference – Hedging
• Pooling Risks for health and mortality – Insurance
• Advice/Reserve – Risk-free precautionary balances

Chapter 5/Spoke 4 describes various risk management approaches (Engineering Practices, Economic Models and RIIA's Empirical Validation Framework) that make it possible to determine if the client is best served with primarily capital markets products portfolios, insurance portfolios or hybrid portfolios. The primary quantitative objectives of Chapter 5/Spoke 4 are to determine the portions of the flooring portfolio and the upside portfolio that should go to investments, hedging, insurance and risk-free assets. Inputs were developed in prior spokes. Outputs are the percent and dollar portions of the flooring and upside portfolios that should go in some or all of the risk management techniques.

Chapter 6: The Fifth Spoke – Specific Products to Implement the Plan and Allocations

RIIA's Retirement Management and Retirement
Income Advisory Process – 5th Spoke



6.1 Spoke Five: Choosing The Right Products

Learning Objectives

6.1.1 Describe the importance of choosing specific products to build a floor and to expose to upside.

To complete the process of building a floor and creating upside potential, we need to buy specific financial tools. In this chapter, we'll look at flooring and upside-generating products. Some products create only upside, some create flooring or upside and some try to create both at once. We'll also match products with the client profiles that we developed in Spokes 1, 2, 3, and 4.

Appendix A provides a definition of each of the most commonly used products. Here we focus on the products and their role in the management of risk in a retirement income portfolio.

6.2 Core Topic: Key Characteristics of Flooring Products

Learning Objectives

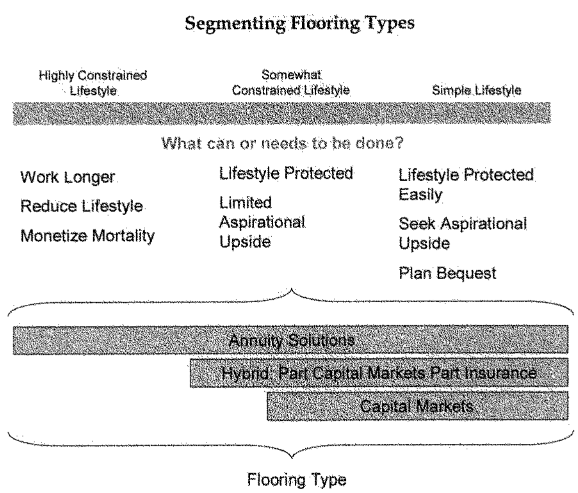
LO 6.2.1 Describe the characteristics of products for flooring.

Figure 6.2.1 illustrates the flooring choices that match up with the lifestyles we first talked about back in Chapter 1. (We're disregarding the client's age here.) The sooner clients are transitioned to retirement income, the more flooring options they'll have, regardless of lifestyle.

For a product to qualify as flooring it has to pay out a lower-bounded amount over a lower-bounded timeframe. To put it more succinctly: "It has to pay at least this much for at least that long." Some advisors may prefer to build flooring products in a modular fashion; others might prefer bundled products.

Products used primarily for flooring (e.g., Treasury Strips) sometimes have secondary roles in creating upside. But we'll try to categorize products by their primary uses. Flooring products should meet needs, mitigate risks and contain uncertainties. In contrast, the upside process deals with goals and aspirations above the currently defined floor.

Figure 6.2.1



6.3 Core Topic: Thematic View of Flooring and Upside Products

Learning Objectives

LO 6.3.1 List the types of products associated with flooring.
LO 6.3.2 List they types of products associated with upside.

Table 6.3.1 identifies the types of products that we feel are most useful for flooring and upside. Some products are bundled to provide both flooring and upside attributes (e.g., variable annuities with GMIB riders) and could fit in both groups.

Table 6.3.1 – The Thematic View

Motive	Diversification/Investments Risk Retention	Transference/Hedges/ Risk Avoidance	Pooling/Insurance	Reserves/Precautionary Balances/Risk Control
Flooring	Non-Callable Corporate Debt	Securities that use derivatives to protect otherwise unprotected flooring	Life-contingent annuities, survivor products P&C, health, or business insurance	Government- issued debt and Federally- insured funds "Near cash"
Upside	Assets without principal protection or call protection	Structured securities that lock in upside or limit downside.	Actuarial upside	Stabilizers for upside portfolio

The advisor's first task is to identify the product sets useful for flooring and to determine their roles in a risk management framework. Annuities (insurance contracts) and certain capital markets products can furnish basic flooring.

Some products (variable deferred annuities with living benefit riders) address both flooring and upside needs. We should emphasize that *no* product is universally applicable or appropriate. The client's own desired outcomes should drive the choice of solutions, not the reverse[4,5].

[4] One could argue about the best level of detail for classification (e.g., whether an annuity bundles corporate debt and mortality credits), but we take the common approach of describing an annuity as a type of insurance product.

[5] It would certainly be possible to build floors in a mixed module format: e.g., floor out a few years with S&P SPDRs hedged with options, lengthen the floor with Treasury strips and finally lay on longevity and other insurance products to mitigate personal risks. However, such a detailed approach would be beyond the scope of this book.

6.4 Advanced Topic: The Universe of Flooring and Upside Products

Learning Objectives

LO 6.4.1 List the basic flooring products using Capital Markets products.
LO 6.4.2 List the basic products to secure the flooring using Insurance products.
LO 6.4.3 List the basic products that bundle flooring and upside features together.
LO 6.4.4 List the basic products that provide precautionary reserves.
LO 6.4.5 List the basic products used for upside.

Four product menus can be found below. These menus can help advisors choose the building blocks with which to construct their clients' retirement income portfolios. For convenience and flexibility, they feature both "a la carte" and "prix fixe" options.

- Table 6.4.1 shows basic flooring products using Capital Markets products.
- Table 6.4.2 shows products to secure the flooring using Insurance products.
- Table 6.4.3 shows products that bundle flooring and upside features together.
- Table 6.4.4 shows products that provide precautionary reserves.
- Table 6.4.5 shows the products used for upside.

Table 6.4.1 - Product Type View – Flooring with Capital Markets Products

RM Classification	Basic Flooring Products	Risks and Benefits
Investments	Non-callable corporate debt (corporate bonds and corporate zero-coupon bonds)	Corporate bonds contain credit risk, less costly than government issues
	Municipal debt	Municipal securities contain credit risk
	Principal-protected structured products	Risky asset + derivative have no basis risk
	Risky-asset +derivative	Structures may be used for flooring, but are generally short dated
Hedges	TIPS Risky-asset +derivative	TIPS are real risk-free flooring
Insurance	See Table 6.3	Contain credit risk and utilize mortality credits that reduce flooring cost
Risk-free	TIPS Savings bonds Treasuries Treasury Principal Strips	Savings bonds are sold retail, not traded Strips are the most solid but expensive nominal flooring

Table 6.4.2 - Product Type View – Flooring with Insurance Products

RM Classification	Flooring Protection	Description
Investments	Deferred annuities Income annuities	Longevity insurance that may be combined with capital markets floors
Hedges		
Insurance	Deferred annuities Income annuities Life insurance Health insurance Health-related insurance Homeowners/renters insurance Vehicle insurance Credit insurance Business insurance Longevity insurance	
Risk-free		

Table 6.4.3 - Product Type View – Bundle Products for Flooring and Upside

RM Classification	**Combined Flooring/Upside Products**
Investments	Variable annuities (with GMAB, GMIB, or GMWB riders) Insurance-wrapped portfolios
Hedges	
Insurance	
Risk-free	

Table 6.4.4 - Product Type View – Flooring with Precautionary Savings

RM Classification	**Precautionary Assets**
Investments	
Hedges	
Insurance	
Risk-free	Treasury Bills Insured Bank Deposits Insured Money Market Deposit Accounts

Table 6.4.5 - Product Type View – Products for Creating Upside

RM Classification	**Upside Assets**	
Investments	Stock and bond mutual funds UITs, ETFs Target Date Funds Managed Payout Funds Closed end funds Corporate Bonds Listed and Exempt Securities Options** Futures** Commodities Unregistered securities	REITs CMOs Limited partnerships Precious metals Equity in real estate Vehicles Business ownership Numismatic & Philatelic items Marketable art Gems Antiques
Hedges	Structured products and notes Insurance wrapped capital markets products Options Futures	
Insurance	Tontine types	
Risk-free	Money market mutual funds	

* Appropriateness for flooring depends upon content and obligation to pay minimum amounts on set dates.

As we see above, some of the products serve single purposes and some serve multiple purposes.

6.5 Advanced Topic: The Universe of Account and Regulatory Vehicles

Learning Objectives

LO 6.5.1 List the specific account/regulatory vehicles.

Location, location, location may be the traditional mantra of real estate agents. But the ability to determine the best location for retirement assets is also a crucial competency for the advisor and the key to effective management of retirement portfolios.

Table 6.5.1 – Account Vehicles

Account Types	Definition
Asset management accounts	**Asset management account**, sometimes called an investment management account, is an account that combines money market funds, stocks, bonds, mutual funds and other investments, check writing privileges, a credit card or debit card, and pre-authorized borrowing against a margin account or line of credit. There is usually a minimum deposit of cash and/or securities for these accounts. If there are any assets with investment risks in the account, the total amount in that account is included under this category.
Packaged account	**Packaged accounts**, sometimes called **relationship banking accounts**, are accounts that combine a household's checking, savings, certificates of deposit, and/or money market deposit accounts, usually at a bank, into a single package of services for which the household receives one consolidated statement each month. If there are any assets with investment risks in the account, the total amount in that account is included under this category.
Wrap accounts	**Wrap accounts** are accounts for which a financial professional is authorized to manage the assets in the household's account in one of two ways: 1) the professional buys or sells securities with the household's approval; or 2) the professional buys or sells securities without the household's approval. For both these types of management, the household pays in one of two ways: 1) a fee based on a percentage of the assets under management; or 2) a commission based on the number of trades.

Custodial accounts	**Custodial accounts** are accounts set up for, and managed on behalf of, minors. They contain securities, cash, and other property given to a minor under the Uniform Gift to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA).
Education savings accounts	**Education savings accounts** (also called **Education IRAs** or **Coverdell Education Savings Accounts**) are accounts that can be set up and contributed to on behalf of a child under the age of 18. Contributions are not tax deductible but withdrawals are not taxed if the funds are used to pay eligible education expenses (including elementary and secondary school expenses and tuition at private and parochial schools).
529 plans	**529 Plans (state-sponsored college savings plans)** are investment plans designed to encourage saving for future college costs while providing special tax benefits to the individual who established the plan. Upon withdrawal, the earnings are tax-free if used for qualified education expenses and they have much higher contribution limits than Education Savings Accounts.
Personal trusts	**Personal trusts (living trusts or testamentary trusts)** are established to provide income to someone. This income comes from assets administered and managed by a trustee. With a living trust, a person transfers ownership of assets to the trust during that person's lifetime. With a testamentary trust, the terms of a person's will place assets in trust when that person dies.
Private banking	**Private banking** is a special service offered by many banks for selected customers. Usually, the private banking office is in a different location from all other bank offices (e.g., on a different floor). There are usually requirements, such as a minimum balance in an account and assets or a minimum income, to be eligible for these services. If there are any assets with investment risks in the account, the total amount in that account is included under this category.

Confidential Draft

IRAs/SEPs	An **IRA/SEP** is an investment vehicle established by the taxpayer that allows individuals to contribute, transfer and grow their investments and earnings on a tax-deferred basis. If there are any assets with investment risks in the account, the total amount in that account is included under this category.
401k, 403b, 457	**Salary-reduction plans**, which include **401(k), 403(b), or 457** plans, allow employees of sponsoring companies to shelter part of their salary from current taxes. 401(k)s apply to employees of publicly- and privately-owned for-profit businesses; 403(b)s apply to employees of non-profit organizations such as educational or research institutions; 457s apply to employees of municipal or other government agencies. These are not defined benefit pension plans. Limits on the amount of salary an employee can shelter vary by type of plan and other factors such as employee income. Taxes on both contributions and earnings are deferred until withdrawal--usually after retirement or when an employee leaves the employer. In some cases, employers also contribute to the plan. If there are any assets with investment risks in the account, the total amount in that account is included under this category.
Keoghs	**Keoghs** are tax-deferred retirement plans for self-employed individuals.

6.6 Recapitulating Where We Are in the Process

The Goals
Remember what we are trying to do:
RIIA's Retirement Management and Retirement Income Advisory Process has two goals:

- Goal 1: Build a Floor
- Goal 2: Create Upside

The primary quantitative objective of Chapter 1 is to calculate a "first-order" estimate of the client's consumption yield/portfolio yield. Inputs for this calculation include an estimate of the client's current Financial Capital and their annual consumption level in retirement. Outputs from this calculation categorize the client as under-funded, constrained or over-funded. This first-order estimate will be revised as we move through the spokes. The remaining chapters will present the remaining 5 spokes.

Spoke #1
The Advisor starts the creation of a Life-Cycle plan based on an understanding of the client's Balance Sheet as illustrated below.

The primary quantitative objective of Chapter 2/Spoke 1 is to calculate a "first-order" estimate of the client's household balance sheet. Inputs for this calculation include asset balances (e.g., financial assets and bank balances) as well as expected cash flows (e.g., social security and pensions). Inputs also include liabilities including mortgage balances, expected annual consumption in retirement, desire for a bequest, etc. Finally, inputs for this calculation include discount rates/expected returns. Outputs from this calculation are shown as a household balance sheet with projected and discounted values as of the client's retirement date.

Spoke #2
The Advisor completes the creation of a Life-Cycle plan by matching the client's Social Capital, Human Capital and Financial Capital sources of income with the Income Statement, Balance Sheet and matching Cash Flows.

The goal of this Life-Cycle plan is to understand how much of the client's retirement income floor can come either from Social or Human Capital, and how much needs to come from Financial Capital.

The primary quantitative objective of Chapter 3/Spoke 2 is to refine the cash-flow inputs that go into the client's household balance sheet. Inputs include personal income/earnings as well as taxes, fixed and discretionary expenses. Outputs are shown on both the client's household Income Statement and Balance Sheet.

Spoke #3
The Advisor translates this Life-Cycle plan into a Retirement Income plan by matching the Investor's Capital Sources of Income to his or her prioritized Retirement Income Risk Factors.

The primary quantitative objectives of Chapter 4/Spoke 3 are to determine the client's risk tolerance (e.g., Conservative, Moderate, Aggressive) and to calculate the portion (percent and dollar) of their financial portfolio that should be dedicated to flooring. In addition to the risk profile questionnaire, inputs include the client's current age, desired retirement age, life expectancy and various inflation and discount factors. Outputs are the client's risk tolerance and the portion of their financial portfolio that should be dedicated to flooring.

Spoke #4
To build a floor and to create upside from Financial Capital according to the client's retirement risk profile, advisors must know how to allocate among four risk management techniques:

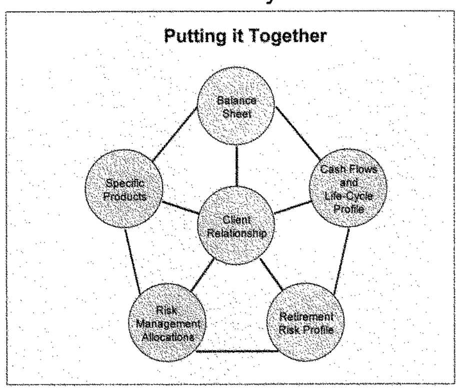
• Diversification among risky assets – Investments
• Risk Transference – Hedging
• Pooling Risks for health and mortality – Insurance
• Advice/Reserve – Risk-free precautionary balances

Chapter 5/Spoke 4 describes various risk management approaches (Engineering Practices, Economic Models and RIIA's Empirical Validation Framework) that make it possible to determine if the client is best served with primarily capital markets products portfolios, insurance portfolios or hybrid portfolios. The primary quantitative objectives of Chapter 5/Spoke 4 are to determine the portions of the flooring portfolio and the upside portfolio that should go to investments, hedging, insurance and risk-free assets. Inputs were developed in prior spokes. Outputs are the percent and dollar portions of the flooring and upside portfolios that should go in some or all of the risk management techniques.

Spoke #5
The 5th spoke provides a high-level, asset-class like mapping of available products for each of the four risk management techniques. This provides guidance to the financial advisor who—within the constraints of his or her chosen risk management approach—can then exercise his or her best professional judgment to implement and manage the flooring and upside portfolios.

Chapter 7: Putting It Together

RIIA's Retirement Management and Retirement Income Advisory Process



7.1 Bringing The Process To Closure

Learning Objectives

LO 7.1.1 Summarize the key Spokes, Charts and Tables that illustrate the process.

The process starts with the client relationship that we show at the center of the chart.

The first spoke is about the household balance sheet; namely, understanding the assets and the liabilities of the client.

The second spoke ties the household balance sheet to the household income statement in the context of the client's Life-Cycle expectations.

The third spoke explores the hazards, exposures, consequences and probabilities that the client may have.

The fourth spoke maps the household balance sheet, income statement, Life-Cycle expectations and risk profile into risk management techniques allocations.

The fifth spoke implements the risk management technique allocation with the available products, account and regulatory vehicles.

Finally, putting the process together means that the advisor manages and monitors the client's needs across the five spoke process with the ethics of the retirement income professional, including knowledge of the rules and regulations that apply.

7.2 Core Topic: Ethics

Learning Objectives
LO 7.2.1 Understand the importance of the Ethics of the Retirement Management Professional (RMP),

"Trust, but *verify*." This phrase, which has been attributed to Ronald Reagan, was a watchword of Cold War arms control policy. But it's just as applicable to the relationship between advisors and retirement clients.

When an advisor helps a client build a retirement income floor out of low-risk assets, and when the floor's construction is transparent and its safety is verifiable, then the advisor will have demonstrated good ethics and gone a long way toward gaining the client's trust.

A client's trust should never be taken for granted. Just one in four Americans believe bankers are honest and trustworthy, according to a June 2009 Harris Poll. Even fewer (13%) trust financial planning firms, and a mere four percent trust "Wall Street" or credit card companies.

7.3 Core Topic: What Is Trust?

Learning Objectives
LO 7.3.1 Understand the importance of trust as a key component of the Ethics of the RMP.
LO 7.3.2 List the three key elements of trust.

Trust is an abstract concept. Webster's Encyclopedic Unabridged Dictionary of the English Language defines "trust" primarily as:

1. Reliance on the integrity, strength, ability, surety, etc. of a person or thing; confidence.
2. Confident expectation of something, hope.

The Random House dictionary also includes these elements:

- A measure of honest and good intentions

- A measure of technical competence
- An expectation of specific outcomes

Trust is a mental state—perhaps a moral choice—that no one can observe or measure directly. Trustworthiness can only be measured after it is given and depends on whether expected outcomes materialize or not. It takes time to grant trust. It takes even more time to verify it.

Synonyms for trust include:

- Certainty
- Belief
- Faith
- Assurance
- Confidence
- Commitment
- Commission
- Credit

These synonyms—weighted heavily in the direction of personal honor—show why breaches of trust are easier to forgive if they stem from errors and not dishonesty. Because of the asymmetry of knowledge in many advisory relationships, only trust can provide the glue. Peers are usually bound by mutual respect. But where one person holds power or knowledge over another, trust is essential.

A structured and orderly environment fosters trust. Francis Fukuyama has written extensively about "High Trust" cultures and "Low Trust" cultures. France, for instance, is considered a "Low Trust" country while the U.S.A. is a regarded as a "High Trust" country. Trust grows best when the rules apply equally to all, when the playing field is reliably level. Within any group, any form of favoritism destroys trust.

7.4 Core Topic: The Saliency of Trust in The Current Crisis

Learning Objectives
LO 7.4.1 Explain the importance of creating "confident expectations" with clients.
LO 7.4.2 Understand the importance of creating portfolios that deliver reliable outcomes rather than creating high expectations in order to create confident expectations.

After spending money and credit for many years in ever-rising amounts, we are learning the hard way that the two are not the same. When you spend money, time is like a wind at your back. When you spend credit, time is like a wind in your face. According to one rule of thumb, it generally takes two dollars of future income to repay one dollar of credit.

Taxes only make the situation worse. According to another rule of thumb, taxes cut spending power in half. Combining taxes and the adverse impact of time on debtors, the case can be made that a person has to earn four dollars in the future to pay back every dollar of credit spent today.

Clients are increasingly aware that they may not have enough financial capital to fund their expected consumption in retirement. Reverse mortgages aside, they won't be able to borrow to fund consumption in retirement. Inter-generational transfers, such as Social Security, won't be able to close the gap. Household debt has grown beyond the ability of borrowers to pay it all back.

Under such conditions, trust—defined as "confident expectation"—is increasingly difficult to cultivate or sustain.

7.5 Core Topic: The Importance of Process Transparency

Learning Objectives

LO 7.5.1 Understand the value of process transparency in creating and maintaining trust with clients.
LO 7.5.2 Understand how the RMA Advisory Process can help with "sick" clients.

Anyone who uses an ATM machine, or who has transacted business with an investment company via a website or a telephone voice-recognition system, knows that most interactions with the financial industry don't require establishing a personal relationship.

Even when we work with accounting, tax, banking, lending, insurance and investment specialists, we don't necessarily need a trust relationship. These relationships are based on the technical competence of the specialist, and don't necessarily entail the emotional depth and personal knowledge of a trust relationship.

But if we want to establish trust with clients, what can we do?

Do we provide specific advice from a variety of disciplines including accounting, tax, legal, financial planning, investment management, insurance, etc.? Or do we provide an integration of all disciplines?

Do we focus on profitable practices aimed at the clients who can afford them? Or do we assume an obligation to reach beyond the most profitable clients?

Do we project complete emotional confidence and psychological tranquility? Or do we reveal the limits of our abilities and point out the client's own responsibilities?

When an advisor works from the accumulation mindset, the answers to these questions are always driven by the need to increase assets under management and to allocate assets among risky investment vehicles. But, as clients eventually learn, they can find this type of service in many places.

But when an advisor works from the retirement income mindset, the answers are driven by the same clear goal that RIIA teaches to professionals who train for the Retirement Management Analyst (RMA) designation: "First Build a Floor, Then Expose to Upside." RIIA believes that if we want to establish trust with clients, this is what we have to do.

Note that this process is not only useful to create trust with clients starting to focus on retirement income but also with "sick" clients—clients who have experienced the downside of the accumulation approach and who may no longer be advisable in the traditional ways.

7.6 Core Topic: Integrating Education, Experience and Ethics with Examples

Learning Objectives

LO 7.6.1 Understand the use of the retirement income client segmentation matrix.
LO 7.6.2 Understand the cases in Chapter 13 of Mike Zwecher's book "Retirement Portfolios."

Most advisors are familiar with the traditional four-bucket typology of clients: Mass Market, Mass Affluent, High Net Worth, and Ultra-High Net Worth. In retirement income planning, we also need to consider the ratio between consumption expenses and financial wealth.

In short, it's all relative. Retirees with simple needs don't necessarily have to be rich to feel secure. We would argue that if retirees can live on three percent of their wealth, the world is their oyster—regardless of their account balances. Their needs can be easily met by any number of available capital markets products and insurance products. We call them "unconstrained."

But many clients will need to tap seven percent or more of their wealth each year to meet expenses. Capital-market solutions alone can't solve their problem. They may need to buy life-contingent annuities, whose payouts combine a fixed-income return with the "mortality credit" (also known as "survivorship credit," in Jeffrey Dellinger's formulation) that comes from mortality-risk pooling.

As you may remember, we introduced these distinctions in Chapter One, Chart 1.1. Specifically, in Chart 1.1, we identify three consumption-to-financial wealth (C/FW) types:

- Unconstrained - Consumption / Financial Wealth < 3.5%
- Somewhat Constrained - Consumption / Financial Wealth 3.5% < C/FW < 7%
- Constrained - Consumption / Financial Wealth > 7%

Suppose that you have a long-time client who wants to get serious and specific about preparing for retirement. You can begin the process at any Spoke that you choose. To follow the pattern we've established so far, we'll run through the Spokes as if they were consecutive steps. But they are not. You may start at any Spoke that feels appropriate and refer to the others only when necessary.

As we said in Chapter One, you first need to understand your client. If you're already envisioning specific products that we don't mention until Spoke Five, that's fine. But to be a true retirement income professional you have to be able to do much more than merely sell product.

7.7 Core Topic: Case Studies

Learning Objectives

LO 7.7.1 Practice the lessons learned with cases covering all the cells in the retirement client matrix.
LO 7.7.2 Practice the lessons learned with cases focused on capital market solutions.
LO 7.7.3 Practice the lessons learned with cased focused on insurance solutions.

The cases in the required reading (Chapter 13 of Zwecher (2010)) are organized as shown in table 1.4.2 in the first chapter of this book and reproduced below.

Table 1.4.2: The Retirement Income Market Segmentation

	Mass Market	Mass Affluent	High Net Worth	Ultra High Net Worth
Under-funded	D- level Value Potential for Retirement FAs	B level Value Potential for Retirement FAs	B level Value Potential for Retirement FAs	Retirement income considerations may not be relevant
Constrained	D level Value Potential for Retirement FAs	A level Value Potential for Retirement FAs	A level Value Potential for Retirement FAs	Retirement income considerations may not be relevant
Excess Funding	D+ level Value Potential for Retirement FAs	A+ Level Value Potential for Retirement FAs	A+ level Value Potential for Retirement FAs	Retirement income considerations may not be relevant

The cases distinguish with separate examples of capital markets and insurance-based portfolios for those who are at the point of retirement from those who are still in the process of accumulating while planning for retirement.

To get the most out of these examples you will be best served if you read the neighbor cases rather than simply the exact match for the wealth and lifestyle of any particular client. Secondly, the goal in presenting these examples is to focus on the retirement income part of construction that differs from accumulation.

The reader should consider each case looking for the issue or issues that require discussion and the method/tool template to articulate and to document their conclusions, their reasons for these conclusions and finally their evidence. In other words, these cases are meant to provoke thought rather than provide a specific "optimal" portfolio solution.

7.8 Core Topic: Comparing the Accumulation and the Retirement Income Tool Boxes

Learning Objectives
LO 7.8.1 Provide candidates with the "tool box" checklist to implement RIIA's Advisory Process.

Many advisors ask: Why it is so hard to do retirement income with what we have and what we know? The answer is: You are bringing the wrong tool box to the job. It is a bit like bringing an electrician's tool box to a carpenter's job.

As RIIA develops its Body of Knowledge for Retirement Management and Retirement Income, it is helpful to use the analogy of a tool box to highlight the key differences with the investment management/accumulation body of knowledge. Table 7.8.1 below summarizes the differences between the tool boxes.

Table 7.8.1 Comparing the Accumulation and Retirement Income Tool Boxes

Accumulation Tool Box	**Retirement Income Tool Box**
Usually with a Client Focus	Always with a Household Focus
AUMs as key metric	Ratio of Consumption / Financial Capital as key metric
Work primarily with Financial Assets	Always work with Human Capital, Social Capital and Financial Capital
Traditional range of Public Policy and Business Risks	Larger range of Public, Policy and Client Risks
Goal is to Expose Assets to Upside subject to Client's Risk Profile	Goals are: First Build a Floor, Then Expose to Upside
Implement with Asset Allocation among risky assets (Diversification)	Implement with allocations among risk management techniques: Diversification, Risk Pooling, Risk Transfer and retirement-focused Risk Free Assets
Justified by Modern Portfolio Theory	Justified by theories that encompass and extend MPT
Performance metric is primarily investment returns	Performance metric is primarily smooth monthly income

7.9 Advanced Topic: Software Platforms for RMA Candidates and RMA Charter Holders

Learning Objectives

LO 7.9.1 Introduce candidate to the software platforms available to teach RIIA's Advisory process in general and the RMA designation in particular.
LO 7.9.2 Introduce candidates to the RIIA Advisory Process compliant software platforms that are available to advisors following graduation.

RIIA's members span the "View Across the Silos" including software vendors. Several of these members have developed or are developing software platforms to teach the RMA designation.

The same and/or other RIIA members are also developing software platforms to support the daily practice of RIIA's Advisory Process in general and the RMA Designation in particular.

7.10 Advanced Topic: Using HealthView/RIIA's Teaching Software Platform

Learning Objectives

LO 7.10.1 Introduce candidate to HealthView/RIIA software platform.

Ron Mastrogiovanni is the founder and President of HealthView Services (HVS). He is also a Board member of RIIA. HVS has developed an RMA teaching software platform with RIIA. HVS's business plans include the building of commercial software platforms that are based on this teaching software platform.

Key features include:

- Archive and present the current version of the RMA Body of Knowledge.
- Save and store the client cases from Chapter 13 in Mike Zwecher's book.
- Save and store the client cases that RMA candidates enter themselves.
- Provide the "Core Topic" calculations that implement the RMA process and Body of Knowledge.

The current version of the software platform covers all "Core Topics." The next version will include the "Advanced Topics."

The RMA teaching software platform complements the books. Registered RMA candidates can use it as a self-study guide. RMA faculty can use it instead of PowerPoint slides.

7.11 Advanced Topic: Using ESPlanner to Understand Consumption Smoothing

Learning Objectives

LO 4.10.1 Learn how ESPlanner can help to create a smooth consumption plan.
LO 4.10.2 Apply ESPlanner to solve curriculum cases.
LO 4.10.3 Contrast Consumption Smoothing case solutions to traditional solutions.
LO 4.10.4 Describe the dangers of over-optimization.

If people have trouble choosing what to order on a restaurant menu, imagine the greater complexity of doing consumption smoothing through your maximum age of life, taking into account all the complex interrelated tax and Social Security issues, not to mention borrowing constraints.

Fortunately, the well-known Boston University professor, author, academic advisor to RIIA, and recipient of the 2009 RIIA Lifetime Achievement Award, Larry Kotlikoff, has built and championed the use of a financial planning software program called ESPlanner, which stands for Economic Security Planner.

ESPlanner takes, as inputs, the regular and retirement account assets, labor income, and all other current and future resources of the household as well as its off-the-top (non-discretionary) spending obligations. It then uses an implicit default model of preferences and explicit model of returns to calculate how much the household should spend each year, on a discretionary basis, to achieve a living standard that is a stable as possible without going further into debt. In producing its discretionary spending recommendations, ESPlanner, in effect, finds the household's appropriate spending targets. In contrast, traditional retirement planning software requires the client or the planner to specify future spending targets to determine how achievable the targets are. These targets tend to be much higher than those generated by ESPlanner.

Note: Many of the traditional planning programs tout their ability to determine the risk of the client outliving their assets. A five percent chance of success may seem fine—unless you happen to be the 20th client. Furthermore, that five percent chance is misleading because it means that every client's program will fail in one out of every 20 years.

ESPlanner lets users specify the shape of their future living standard path, so if, for example, they want it to gradually fall after retirement, they are free to do so and the program will generate spending recommendations that are consistent with this preference.

Finally, ESPlanner is able to show the level and variability of a household's future living standards based on how it decides to allocate its portfolio of regular and retirement account assets through time. These Monte Carlo simulations take into account that households will adjust their spending each year in light of the high or low returns they receive on the market each year.

In running the ESPlanner in Monte Carlo mode, you can also specify whether the household will be spending aggressively, cautiously, or conservatively.

ESPlanner does not explicitly specify the form of the utility function, *U*, per se. But by specifying the desired age, living standard shape and, in the case of Monte Carlo analysis, whether the spending is to be aggressive, cautious, or conservative, users can, in effect, get the program to adopt a variety of preferences. This helps the client simulate when to allocate spending power through time and how much risk to take in spending when future investment returns are uncertain.

Professor Kotlikoff is working with RIIA to make ESPlannerPRO (ESPlanner for Professionals) available to RMA students so that it can be used to teach the classes and solve the client cases. This is one of several software packages that can be used to study the RMA and later on implement what was learned in one's own daily practice.

Rules of thumb for retirement tend to be inapplicable except for the client who lives on that particular razor's edge. Draw-down plans have been shown to be unreliable. The tools underpinning planning based on draw-down plans generally ignore borrowing constraints and other real world constraints. Targeting spending without a link to current lifestyle is of dubious value. The Consumption Smoothing approach focuses on ensuring that disaster is averted and consumption does not suffer an undesirable drop. ESPlanner is a tool that takes smooth consumption as an objective throughout life.

Of course, no planning tool is perfect and ESPlannerPRO has its limitations. Any optimum is only an optimum with respect to the specifics of the modeled objective and the specifics of the modeled dynamics; what may be optimal for one client may not be optimal for an otherwise identical client. Like all models, the output is subject to the limitations of the features and the accuracy of the input data. Yet, since the program uses information that you are already trying to collect from the client, it can be used to explore different assumptions about future earnings, inflation, healthcare costs, etc. It can be used to provide a *could* even if not used for a *should.*

This curriculum seeks to have you understand the technical aspects of the available tools as well as the practical constraints that daily client practice will impose on the trade off between precision and accuracy.

Finally, as new information, i.e., information that was unanticipated at the time of the original optimization, becomes available, then an optimized solution will need to be recalculated and the previously optimized portfolio will need to be flexible enough to accommodate updating. No matter what the optimized solutions are supposed to be, it is a good idea to keep a margin of flexibility in the portfolio, at a certain cost of inefficiency, just in case things change or our understanding of them changes.

Appendix A: Sources and Resources

This section provides, for each Chapter/Spoke, a list of materials for further study as follows:

Required Reading
Knowledge of these books, articles and presentations is essential for passing the RMA exam.

Suggested Reading
These books, articles and presentations are quoted in the curriculum but have not (yet) been developed or customized to support it. Though useful, they are not required for the RMA exam.

Optional Material
These are books, articles, presentations, videos and software products that have broad relevance for the well-rounded retirement advisor.

Chapter 1 - The Hub of the Advisory Process: The Client

Required Reading

Besides this book, there are no required readings for this Spoke at this time.

In addition to the material in this book, RIIA is working with its Academic Special Advisors to the Board and Committees to evaluate and/or develop material that may become required readings as the curriculum develops.

Suggested Reading

For identifying and naming the emotions that retirement income clients experience:

Bloom, Howard.
The Genius of the Beast (Prometheus Books, 2009).

Optional Material

For information on middle market resources and segments:

Abkemeier, Noel and Brent Hamann. 2009. Segmenting the Middle Market: Retirement Risks and Solutions Phase I Report, Society of Actuaries, Schaumburg, Il.

For information on issues affecting women:

Hounsell, Cindy. 2008. The Female Factor, WISER, Washington, D.C.

Rappaport, Anna M. 2008, "Living to 100, A Woman's Issue", 2008 Living to 100 Monograph, Society of Actuaries, Schaumburg, Il.

For insights on what the public knows about retirement security:

Mitchell, Olivia S, and Stephen P. Utkus. 2004., Pension Design and Structure: New Lessons from Behavioral Finance, Oxford University Press, Oxford, United Kingdom

Rappaport, Anna M and Steven Siegel. 2009. "Financial Literacy and the Challenges of the Post-Retirement Period", Employee Benefits Quarterly, International Foundation of Employee Benefit Plans, Brookfield, Wisconsin

Sondergeld, Eric T. and Mathew Greenwald. 2005. Public Misperceptions about Retirement Security. LIMRA, International, the Society of Actuaries, and Mathew Greenwald & Associates, Hartford, Ct., Schaumburg, Il and Washington, D.C.

<u>For more information about authors mentioned in the text:</u>

Bloom, Howard.

The Lucifer Principle: A Scientific Expedition Into the Forces of History (Atlantic Monthly Press, 1997).

Global Brain: The Evolution of Mass Mind from the Big Bang to the 21st Century (Wiley, 2001).

Harford, Tim.

The Logic of Life (Random House, 2008).

The Undercover Economist (Random House, 2007).

Chapter 2 – Spoke One: The Household Balance Sheet

Required Reading

Besides this book, there are no required readings for this Spoke at this time.

In addition to the material in this book, RIIA is working with its Academic Special Advisors to the Board and Committees to evaluate and/or develop material that may become required readings as the curriculum develops.

Suggested Reading

There are no suggested readings for this Spoke at this time.

Optional Material

For information on decisions throughout life:

Actuarial Foundation and WISER. 2004. *Seven Life Defining Decisions,* Actuarial Foundation, Schaumburg, Il and WISER, Washington, D.C.

For information on phased retirement and work during retirement:

Rappaport, Anna M. 2009. "Signals, Retirement Options, Phased Retirement and Retirement Decisions", *Retirement 2020 Monograph.* Society of Actuaries, Schaumburg, Il.

Rappaport, Anna M. and Mary B. Young. 2007. *Phased Retirement after The Pension Protection Act*, The Conference Board, New York, NY

For help in data gathering and identifying issues:

U.S. Department of Labor. *Taking the Mystery Out of Retirement Planning*, Department of Labor, Washington, DC

Chapter 3 - Spoke Two: Creating a Life-Cycle Profile

Required Reading

Besides this book, there are no required readings for this Spoke at this time.

In addition to the material in this book, RIIA is working with its Academic Special Advisors to the Board and Committees to evaluate and/or develop material that may become required readings as the curriculum develops.

Suggested Reading

For more information about authors mentioned in the text:

Milevsky, Moshe A. *Are You a Stock or a Bond? Create Your Own Pension Plan for a Secure Financial Future* (FT Press, 2009).

Ibbotson, Roger G., Moshe A. Milevsky, Peng Chen, and Kevin X. Zhu. *Lifetime Financial Advice: Human Capital, Asset Allocation and Insurance* (CFA Institute, 2007).

Optional Material

For views on the future of retirement:

Evensky, Harold and Deena B. Katz, eds. *Retirement Income Redesigned, Master Plans for Distribution: An Adviser's Guide for Funding Boomer's Best Years* (Bloomberg, 2006).

Rappaport, Anna M. 2008. "The Future of Retirement: An Exploration and Comparison of Different Scenarios", *Benefits Quarterly,* International Foundation of Employee Benefit Plans, Brookfield, Wisconsin

Chapter 4 - Spoke Three: Assessing Retirement Risks

Required Reading

Besides this book, there are no required readings for this Spoke at this time.

In addition to the material in this book, RIIA is working with its Academic Special Advisors to the Board and Committees to evaluate and/or develop material that may become required readings as the curriculum develops.

Suggested Reading

There are no suggested readings for this Spoke at this time.

Optional Material

<ins>For more information about authors mentioned in the text:</ins>

Ropeik, David, and George M. Gray. *Risk: A Practical Guide for Deciding What's Really Safe and What's Dangerous in the World Around You* (Houghton Mifflin Harcourt, 2002).

<ins>For general perspectives on retirement risk:</ins>

Blitzstein, David, Mitchell, Olivia S., and Utkus, Stephen P. 2006. *Restructuring Retirement Risks,* Oxford University Press, Oxford, United Kingdom

Society of Actuaries. 2008. *Managing Post-Retirement Risks: A Guide to Retirement Planning.* Society of Actuaries, Schaumburg, Il.

<ins>Surveys and focus groups on use of assets during retirement:</ins>

Bryck, Sally A., Betty Meredith, Anna Rappaport, and Stephen Siegel. 2009. *What A Difference a Year Makes,* Society of Actuaries, Schaumburg, Il and LIMRA, Hartford, Ct.

Greenwald, Mathew, Sally A. Bryck, and Eric T. Sondergeld. 2006. *Spending and Investing in Retirement: Is there a strategy?* LIMRA, International and the Society of Actuaries, Hartford, Ct. and Schaumburg, Il.

Society of Actuaries, LIMRA, and InFRE. 2009. *Will Retirement Assets Last a Lifetime?* Society of Actuaries, Schaumburg, Il. and LIMRA, Hartford, Ct.

Surveys on public knowledge and perceptions about post-retirement risk:

Cowell, Michael and Anna M. Rappaport. 2006. *Longevity: The Underlying Driver of Retirement Risk: 2005 Risks and Process of Retirement Survey Report,* Society of Actuaries, Schaumburg, Il.

Society of Actuaries. 2008. *Health and Long-term Care Risks in Retirement.* Society of Actuaries, Schaumburg, Il.

Society of Actuaries. 2008. *Understanding and Managing the Risks of Retirement: 2007 Risks and Process of Retirement Survey Report.* Society of Actuaries, Schaumburg, Il.

Report focusing on what changes during retirement, building on survey data:

Society of Actuaries. 2008. *Managing Post-Retirement Risks: The Phases of Retirement and Planning for the Unexpected*, Schaumburg, Il.

Distribution of benefits issues in defined contribution plans including communication issues:

Rappaport, Anna M. 2008. Testimony delivered to ERISA Advisory Council Working Group on Spend Down of Defined Contribution Assets in Retirement. Department of Labor, Washington, D.C.

Rappaport, Anna M. 2009(forthcoming). "Defaults for Distribution of Retirement Assets: What Are the Issues?", *Retirement 2020 Monograph.* Society of Actuaries, Schaumburg, Il.

Rappaport, Anna M. 2009 (forthcoming). "The Role of Information and Expectations in Retirement Planning: Communicating Income vs. Lump Sums", *Retirement 2020 Monograph.* Society of Actuaries, Schaumburg, Il.

Studies of how retirement planning software treats post-retirement risks:

Sondergeld, Eric T., Robert S. Chamerda, Matthew Drinkwater and Daniel G. Landsberg. 2002. *Retirement Planning Software.* LIMRA, International and the Society of Actuaries, Hartford, Ct. and Schaumburg, Il.

Turner, John A. and Hazel A. Witte. 2009. "Retirement Planning Software and Post-Retirement Risks." The Society of Actuaries and The Actuarial Foundation.

Chapter 5 - Spoke Four: Risk Management Allocations

Required Reading

Zwecher, Michael. *Retirement Portfolios: Theory, Construction and Management* (John Wiley & Sons, 2009)

Suggested Reading

For more information about the economics approach:

Bodie, Zvi, Robert Merton and David Cleeton. *Financial Economics 2/E* (Prentice Hall, 2009).

Optional Material

For more information about authors mentioned in the text:

Fullmer. Richard K.

Modern Portfolio Decumulation: A new strategy for managing retirement income Journal of Financial Planning, vol. 20 no. 8 (August): 40-51. 2007.

The Fundamental Differences in Accumulation and Decumulation. Journal of Investment Consulting, vol. 9 no. 1 (fall): 36-40. 2008.

A Framework for Portfolio Decumulation. Journal of Investment Consulting, vol. 9 no. 2 (Summer).

Kotlikoff, Laurence J., and Scott Burns. *Spend 'Til The End* (Simon & Schuster, 2008).

Sornette, Didier. *Dragon-Kings, Black Swans and the Prediction of Crises (International Journal of Terraspace Science and Engineering, 2009).*

Chapter 6 - Spoke Five: Choosing The Right Products

Required Reading

Besides this book, there are no required readings for this Spoke at this time.

In addition to the material in this book, RIIA is working with its Academic Special Advisors to the Board and Committees to evaluate and/or develop material that may become required readings as the curriculum develops.

Suggested Reading

There are no suggested readings for this Spoke at this time.

Optional Material

For more information about authors mentioned in the text:

Pechter, Kerry H. *Annuities for Dummies* (Wiley, 2008).

Chapter 7: Putting It Together

Required Readings

Besides this book, there are no required readings for this Spoke at this time.

In addition to the material in this book, RIIA is working with its Academic Special Advisors to the Board and Committees to evaluate and/or develop material that may become required readings as the curriculum develops.

Suggested Reading

There are no suggested readings for this Spoke at this time.

Optional Material

For more information on authors mentioned in the text:

Retirement Resource Guide: Essential ERISA Education & Best Practices for Financial Advisors (Retirement Learning Center, Brainerd, MN, 2009).

Appendix B: Client Segmentation

The Boomer Wealth Landscape

In the fall of 2008, the investments of millions of Americans lost up to a third of their value. Many Boomers, ages 45 to 62, had counted on those investments to finance their old age. Many of them still don't know exactly what to do next. Some will double their saving rate. Others will double-down into riskier assets like global equities or junk bonds. But should retirement-bound Boomers assume more risk—or off-load it?

That depends on their finances. In this chapter we'll look at America's balance sheet and see that:

- Financial wealth in 2001 was concentrated among only five percent of Americans.
- Debt was concentrated among the poorest 90% of Americans.
- Most Americans won't be able to replace their pre-retirement income merely by drawing down savings at a sustainable, inflation-adjusted rate.
- The market crash of 2008 worsened the household balance sheets of millions of Americans.
- Older investors shouldn't try to recover lost paper wealth by re-allocating to riskier assets.

By the end of the chapter, you'll have a better understanding of the market for retirement income planning. You'll be ready for the Case Studies of Chapter 7, where we'll look at practical responses to the challenges facing several hypothetical Boomers on the verge of retirement.

The Retail Investors' Balance Sheet

America's wealth is concentrated among a relatively few households. Data from the Federal Reserve Board's triennial Survey of Consumer Finance (SCF) bears this out. Although the latest data is from 2001, it has been analyzed in depth[6].

The survey uses wealth ownership (not income) to identify five demographic groups. As Table 7.1 shows, the bottom 50% class represents about 53 million American families, who hold about 2.5% of the nation's financial assets. The next 40% represents about 43 million families who own about 25% of the assets. These groups represent what are sometimes called the "mass" and "mass affluent" markets.

[6] "A Rolling Tide: Changes in the Distribution of Wealth in the U.S., 1989-2001," by Arthur B. Kennickell. Federal Reserve Board, September 2003.

The top 10% (divided among the wealthiest one percent, the next wealthiest four percent, and the next five percent) own almost 60% of the financial assets. Representing the ultra high net worth Americans, the top one percent owns about 32% of the assets, and the next four percent owns about 27% of the assets. Representing high net worth investors, the next five percent owns about 7% of the assets.

Average Assets

Table 7.1 displays the assets in the balance sheet with these percentile classes as columns:

Survey of Consumer Finances, 2001, U.S. Balance Sheet, Assets ($ billions)

Asset (2001 $ billion)	Bottom 50%	Next 40%	Next 5%	Next 4%	Top 1%	Total
Financial Assets	$512.1	$5,160.0	$2,860.5	$5,410.3	$6,401.8	
Cash Accounts	$142.6	$778.6	$316.1	$520.5	$622.9	$2,380.7
CDs, Saving Bonds, Bonds	$34.6	$434.2	$203.4	$356.6	$659.7	$1,688.5
Stocks, Ret. Accts.	$22.1	$498.4	$434.7	$1,106.0	$2,317.9	$4,379.1
Mutual Funds	$23.1	$507.4	$444.2	$807.6	$695.4	$2,477.7
Retirement Accounts	$187.4	$2,081.4	$1,005.5	$1,667.4	$778.6	$5,720.3
Cash Value of Life Ins.	$78.0	$501.5	$167.7	$193.7	$136.8	$1,077.7
Annuities, Trust, Mgd.Accts.	$7.3	$287.8	$267.1	$622.0	$1,024.0	$2,208.2
Other Fin. Accts.	$17.0	$70.7	$21.8	$136.5	$166.5	$412.5
Non Financial Assets	$2,170.7	$9,231.7	$2,780.8	$5,877.9	$7,799.5	
Vehicles	$462.6	$799.6	$156.9	$153.2	$83.9	$1,656.2
House	$1,602.6	$6,612.9	$1,587.8	$2,087.0	$1,173.2	$13,063.5
Other Residential Real Estate	$42.2	$605.5	$264.1	$689.1	$655.7	$2,256.6
Real Estate Investments	$13.2	$329.5	$206.4	$801.9	$929.3	$2,280.3
Closely Held Bus.	$29.2	$803.4	$534.8	$2,029.8	$4,751.2	$8,148.4
Antiques, Collectibles, etc.	$20.9	$80.8	$30.8	$116.9	$206.2	$455.6
Total Assets	$2,682.8	$14,391.7	$5,641.3	$11,288.2	$14,201.3	$48,205.3

Although the data is somewhat dated, it clearly indicates the disparity in asset levels across investor classes. While homeownership is common across the board, just 10% of families have stock and retirement account investments that exceed the value of their house.

Clearly, home ownership is the biggest source of wealth for all but the wealthiest 10% of Americans. Sellers of reverse mortgages may want to target the 40% members of the mass-affluent group. In contrast, investments (non-qualified and non-qualified) are the primary assets of the next 9% of families. Registered representatives of broker-dealers will lay claim to many of them. For the top 1%, the primary assets are closely held businesses, following by stock ownership. With their complex needs, the ultra high net worth individuals often require sophisticated financial planning services.

One could say that an American acquires wealth by getting a job, buying a house, opening a retirement account, investing in financial assets, and starting a successful business.

Average Liabilities

Turning our attention towards liabilities, Table 7.2 shows that the bottom 50% of families has the highest debt burden, with a 56% debt-to-asset ratio in 2001. Their collective debt outweighs their financial assets by about three-to-one. The wealthy have relatively little debt. As you go up the wealth ladder, the debt ratio falls rapidly until, for the top 1% of families, it almost disappears (2% ratio).

Table 7.2: CSF 2001 Data, U.S. Balance Sheet, Liabilities (2001 $ billion)

Liabilities (2001 $ billion)	Bottom 50%	Next 40%	Next 5%	Next 4%	Top 1%	Total
Debt	$1,507.1	$2,788.4	$501.4	$673.1	$346.0	$5,816.0
Net Worth	$1,175.7	$11,603.3	$5,139.9	$10,615.1	$13,855.3	$42,389.3
Total Liabilities	$2,682.8	$14,391.7	$5,641.3	$11,288.2	$14,201.3	$48,205.3

The data is not adjusted for age, however, as Ben Williams, chief technology officer at Retirement Engineering, has pointed out. Wealth tends to increase as clients approach retirement age, which is when net worth matters most. We would expect the debt-to-asset ratios to decrease over time as families pay down education loans, mortgages and similar forms of debt.

Note that company-level liabilities arising from ownership of closely held or public stock businesses are not included here. This is a form of indirect leverage for the higher brackets.

Average Net Worth

Dividing the net worth of each group by the number of households in the group, we can arrive at the average net worth of American families.

Table 7.3: CSF 2001 Data, U.S. Balance Sheet, Net Worth ($ billion)

Net Worth	Bottom 50%	Next 40%	Next 5%	Next 4%	Top 1%
Average Net Worth ($000)	$22	$272	$970	$2,469	$12,596
Families (mm)	53.2	42.6	5.3	4.3	1.1

Average Potential Retirement Income

Assuming that the table accurately reflects what families will have as net worth at retirement, and assuming a withdrawal rate of 4%, these numbers can be used to provide a rough estimate of retirement income. Although net worth includes homes and other non-financial or illiquid assets, it's still a useful gauge for estimating the amount of retirement income achievable from all sources, including reverse mortgages.

Comparing these results to the 2001 average income of these five percentile classes, Table 7.4 shows the following results:

Table 7.4: Retirement Income Estimates, 2001

Estimates	Bottom 50%	Next 40%	Next 5%	Next 4%	Top 1%
Average Annual Pre-retirement Income ($)	$31,868	$66,115	$128,377	$263,767	$976,636
4% of Net Worth ($)	$884	$10,895	$38,792	$98,745	$503,829
Replacement Ratio	3%	16%	30%	37%	52%

These numbers are startling, at least from the nation's perspective. All percentile classes, on average, would experience a drop in income if they tried to live on four percent of their assets per year, according to the data in Table 7.4. In every group, the replacement ratio is less than the 70-80% used in traditional financial planning.

Even if we assume that younger families are disproportionately represented in the lower wealth and income categories, the chart shows that only the high net worth group could obtain an adequate income in retirement by liquidating their net worth at the so-called sustainable rate.

Q4 2008: The Impact of a Crater

Wealth levels improved in the mid-2000s for many Americans. But Boomers saw their net worth fall by large percentages in the fall of 2008, according to a February 2009 report from the Center for Economic and Policy Research (CEPR) titled, "The Wealth of the Baby Boom Cohorts After the Collapse of the Housing Bubble."

Boomers are hurting more than most realize, according to the report. Because of the decline of housing and equity values, especially in the once-hottest real estate markets, some Boomers saw their net worth decline by as much as 50%. Homeowners, not surprisingly, tended to lose more wealth than renters.

The CEPR paper (not yet peer reviewed) makes separate projections for the losses of early Boomers (ages 55 to 64) and late Boomers (ages 45 to 54), using the 2004 Survey of Consumer Finance. The estimated net worth of the wealthiest 20% of the late Boomers was expected to decline from about $2.5 million in 2004 to $1.5 million for 2009.

The estimated average net worth of the wealthiest quintile of "early Boomers" was expected to drop from about $4 million to about $2.5 million. As a percent of net wealth, the losses were expected to be even greater for the lower 80% of Boomers because housing represented a larger share of their wealth and was more likely to be leveraged than stock investments.

Declines in housing wealth probably won't hurt those who bought their homes to live in as much as those who bought homes as speculative investments. Capital market losses may therefore be a better predictor than home equity losses of the financial difficulties that retired Boomers will face.

Some boomers may even benefit from the drop in housing prices, which was concentrated in the sun-belt states that are the traditional destinations for retirees. In economist-speak, Boomers who retire from snow-belt to sun-belt states may be able to "monetize a location differential."

Most Boomers won't have enough time before normal retirement age to make up their losses in the capital and housing markets, the paper's authors, David Rosnick and Dean Baker point out. As a result, they may have to rely more heavily on social insurance programs during retirement.

How Not To Dig Out of the Hole

If investors lack enough assets to meet their retirement income expectations, should they take bigger risks with their investments in order to catch up? Our answer is an unambiguous *no*.

Since not all advisors may agree with that position, let us explain. If Boomers switch to riskier assets with higher expected values, the discount rate for those assets will increase and their balance sheet will remain unchanged. There is no free lunch.

True: if you win you are better off. But other than "alpha," there are no economic rents for taking on more risk. As the balance sheet depicted in Chart 7.1 shows, exposing one's financial capital to more risk (higher discount rates) increases the volatility of the assets but does not reduce the discounted value of the liabilities.

Chart 7.1 – Exposure to Risky Assets vs. Discounting Liabilities

Assets	Liabilities
Exposing assets to more financial risks…	Does not reduce the Net Present Value of Liabilities…
… and may lead to a decrease in assets from adverse market conditions.	

It's widely known that when a corporation undertakes riskier ventures, its creditworthiness may decline and the market value of its liabilities may fall. The cash flows of the liabilities won't change, but the firm's probability of meeting them may be reduced.

But retirement-bound investors seldom understand this important concept, as Boston University's Zvi Bodie has noted. That's unfortunate, because for them the matter becomes much more personal. The present value of food won't change for the person who takes on more risk, but his or her ability to buy it will be less certain.

Looking at Chart 7.1 above, another question comes to mind: Would it be prudent for a retail investor to use the expected rate of return of their financial asset allocation to discount the liability? The answer is no.

Taking Added Risk Isn't A Viable "Catch-Up" Strategy

Who pays if the return expectations are not met? If a make-up payment is required when expectations aren't met, then there is an implied put. Is this a suitability put unknowingly written by the advisor, wherein investors who prevail in suitability suits can claw back some of their losses? We think so.

Professor Bodie has argued that when a liability, such as the need for retirement income, is perfectly matched with risk-free assets, no additional capital is needed to protect it from contingencies. But when liabilities and assets are not perfectly matched, additional capital is required.

Consider two cases:

An over-funded client with assets greater than his or her liabilities (i.e., discretionary equity as illustrated in Chapter 2 - Figure 2.1 is greater than zero) can put all of the assets at risk as long as there is either a hedge or a dynamic strategy to ensure that the assets can't fall below the present value—at the risk-free rate—of the flooring needs.

But an under-funded client with assets lower than his or her liabilities (i.e., negative discretionary equity) is technically insolvent. The client is, as they say, in a hole. It may be possible for such clients to gamble their way out of the hole. But gambling doesn't increase their chances of getting out. It will merely bring that chance into the realm of possibility.

Don't Sell an "Implied Put"

If an investor moves from a perfect match between assets and liabilities by placing, say, 50% of the assets in risky investments, then more capital—reserves—would be needed to match the liability. Such increased capital requirements are a function of the percentage risk of the shortfall from risky investments and the potential dollar consequences of the shortfall.

Insurance against such shortfall risk is effectively a put option. The put insures against earning less than the risk-free rate of interest. The cost of such an option *increases* with the time horizon—which contradicts the nostrum that stocks are good "for the long run" and that a reliable "equity premium" exists.

Professor Bodie first explained this in a paper called "On the Risk of Stocks in the Long Run" (*Financial Analysts Journal*, May-June 1995). He showed that if equity investments really become less risky over time, then the cost of insuring them against the risk of earning less than the risk-free rate of interest should decline as the investment horizon lengthens. Of course, it doesn't.

Appendix C: Product Definitions

Investment Vehicles

Asset	Definition
Treasuries	Treasury securities are debt obligations of the Federal government (or its agencies), which are traded on the open market and subject to credit risk. These include TIPS.
Treasury strips	Treasury securities that have been stripped by firms into principal and coupon. Strips are accorded unique CUSIPS, allowing them to be treated as treasury obligations. Strips allow construction of flexible floors.
Corporate bonds	A traded security, representing a debt obligation of a corporation.
Municipal securities	A traded security, exempt from all but the antifraud provisions of the Securities Exchange Act of 1934, representing a debt obligation of a public entity such as a city or town.
Zero coupon bonds	Zero coupon bonds are debt obligations that investors buy at a deep price discount, receiving back the full value of the bond plus imputed interest. Such obligations do not pay interest during the life of the bonds.
Fixed income annuities	A level stream of payments over a defined (capital markets, insurance) or open-ended (insurance) interval. Both capital markets and insurance firms issue these typically as level-payment bonds but only the insurance products utilize mortality credits.
Variable deferred annuities	Tax-deferred annuities with exposure to market risk via link to stock, bond or balanced fund investments held in separate accounts.
GMIBs, GMWBs, etc	Variable deferred annuity contract riders that provide downside protection through accumulation or income guarantees. These products attempt to bundle flooring and upside.
Unregistered debt	Unregistered debt obligations; direct lending agreements that are not in securitized form.
Stock and bond mutual funds	Mutual funds (stock or bond) are managed portfolios of stocks, bonds, or other securities. Shares are usually offered continuously and can be redeemed at any time based on the market value of the securities portfolio.

Limited partnerships	A limited partnership investment is a legal arrangement that entitles the household to have an ownership interest in a profit-making venture. The limited partnership structure is a very common way to own real estate, for example.
Precious metals	Investments in bullion, certificates, accounts, derivatives or shares of funds that directly own precious metals such as gold, silver or platinum.
Marketable art	Investments in paintings or other art that can be sold to others.
Gems	Investments in precious stones that have marketable value.
Numismatic & philatelic items	Investments in U.S. and other country's coinage or postage stamps, where such items have marketable value to collectors. These differ from other collectibles by the nature of their government issuance and the correspondingly stricter legal implications for counterfeiting vs. mere fakery.
Antiques	Investments in furniture and other old or rare articles that have marketable value.
Equity in real estate: primary home or other	Primary home is the place where household members live at least six months of the year. Other real estate may include second or third homes. Equity is the value of the real estate minus any mortgage obligations.
Vehicles	Automobiles, boats and other movable transportation equipment of the household. This may include transportation items that are held for reasons other than transportation, e.g., classic cars.
Listed and exempt securities	A security, representing a unit of ownership in a corporation, which is listed and traded on an exchange and subject minimally to the antifraud provisions of the SEC.
Unregistered securities	A security, representing ownership stake, debt obligation or derivative contract that is not listed and traded on an exchange. This would include hedge fund and private-equity shares, unregistered debt obligations trading or without a CUSIP, and OTC derivative contracts.
REITs	A traded security that represents ownership in a real estate investment trust.
UITs	**Unit investment trust** is a group of predetermined stocks or bonds that are packaged together and sold as a single security. Investors own shares (units) of the trust.
CMOs	Collateralized Mortgage Obligations are bonds that entitle holders to receive specific cash flows from large pools of home mortgages. Due to prepayment risk, we don't count these in flooring.

ETFs	**Exchange Traded Fund (ETF)** is a single security that represents a portfolio of stocks designed to track one specific index.
Closed end funds	**Closed-end funds** are mutual funds with a limited number of shares, usually listed on a major stock exchange.
Business ownership	Value of investment that household has in a business venture.
Options	An option to buy or sell a specific capital-market risk for speculative or hedging purposes. Options are useful for hedging the traditional market risks associated with most portfolios: equity, interest rate and currency.
Commodities, Futures	Commodities futures, or futures contracts, are agreements to buy or sell a specific commodity at a specific date in the future at a specific price. As with options, these may be used for speculative purposes.
Group life insurance	**Group life insurance** is obtained through your employer or through membership in organizations and associations rather than directly from a life insurance company or a life insurance sales person, agent, or broker.
Individual life insurance	**Individual life insurance** is obtained directly from a life insurance company or from a life insurance sales person, agent, or broker rather than through your employer or other organization. **Whole (straight) life insurance** provides fixed coverage for the life of the insured; cash value which is a "savings" portion that is guaranteed in advance; and premiums that usually do not increase. **Term life insurance** provides coverage for a specific term and is usually guaranteed renewable until age 60, 65, or 70; no cash value; and premiums that increase or coverage that decreases with age. **Universal, variable, and interest-sensitive life insurance** have coverage that can fluctuate based on the performance of underlying investments; cash value that fluctuates depending on current interest rates or the performance of underlying investments; and premiums that may be fixed or flexible.

Health insurance	**Comprehensive medical insurance** usually pays 75% - 80% of both routine medical expenses and expenses for a major illness or injury. It usually has a small deductible and a large maximum benefit level. **Major medical insurance** usually pays 75% - 80% of expenses for major illness or injury but nothing for routine medical expenses. It has a deductible. **Basic medical insurance** only covers expenses of routine medical services and minor hospitalization costs. It generally has no deductible and will pay up to a specified maximum amount or for a limited number of days for an illness. **Individual health insurance** is purchased directly from a health insurance company or a health insurance sales person, agent, or broker. **Group health insurance** is obtained through employment or through membership in other organizations.
Health-related insurance	**Disability insurance** is insurance that pays persons who become disabled due to an accident or illness (other than job-related injuries) an amount that is a percentage of their previous income. **Long-term care insurance** is insurance that is available to provide medical and other services to patients who need constant care in their own home or in an assisted living facility or nursing home. **Optional life or disability insurance** is coverage that pays off a household's primary home mortgage if the borrower dies or becomes disabled (mortgage life insurance). **Accidental death and dismemberment insurance** covers accidental loss of life or limb. **Dental insurance** pays part of the expenses of both routine dental care and the treatment of dental disease or injury. **Eye care insurance** pays part of the expenses of routine vision examinations and usually one pair of glasses every two years.
Homeowners and renters insurance	Insurance covering homes or other facilities where the purchaser of the insurance has either owns or rents the property.

Vehicle insurance	Insurance covering cars, trucks and other vehicles.
Credit insurance	**Credit life or credit disability insurance** pays off a loan, credit line, or lease in the event of death or disability.
Business insurance	**Professional and regular liability insurance** is insurance that covers the policyholder's legal liability resulting from injuries to other persons or damage to their property. **Travel and accident insurance** is insurance that covers only accidents that occur while an insured person is traveling, usually on a commercial carrier.
Longevity insurance	A pure play as a hedge against outliving one's assets.
Checking accounts	**Checking accounts** may or may not pay interest. Checking accounts that pay interest usually have minimum balance requirements and may earn interest at a rate similar to passbook savings accounts.
Savings accounts	**Regular or passbook savings accounts** pay a rate of interest and have no penalties for early withdrawal.
Money market deposit accounts	**Money market deposit accounts (MMDAs)** have an interest rate that changes according to money market trends; each month a limited number of checks can be written and a limited number of withdrawals can be made.
Money market mutual funds	**Money market mutual funds (MMMFs)** are usually offered by stockbrokerage firms, mutual fund companies, and insurance companies. The funds are invested in short-term, highly rated instruments such as U.S. Treasury notes or bank certificates (but not in stock). They usually have initial deposit requirements of at least $1,000 and usually offer check-writing privileges.
CDs	**Certificates of deposit** (also called **CDs, savings certificates,** or **time deposit accounts**) require that funds remain on deposit for specific terms. Minimum deposits and interest rates vary by institution.
Savings bonds	**U.S. Savings Bonds** are bonds issued by the U.S. government in face-value denominations ranging from $50 to $10,000. The most common types are Series EE and Series I bonds. Both accrue interest immediately and continue to accrue interest for up to 30 years. The Series EE bonds pay 90% of the average 5-year Treasury market yields for the preceding 6 months; Series I bonds pay an inflation-adjusted rate tied to the Consumer

	Price Index.

Appendix D: Account Vehicle Definitions

Account Types	Definition
Asset management accounts	**Asset management account**, sometimes called an investment management account, combines money market funds, stocks, bonds, mutual funds and other investments, check writing privileges, a credit card or debit card, and pre-authorized borrowing against a margin account or line of credit. There is usually a minimum deposit of cash and/or securities for these accounts. If there are any assets with investment risks in the account, the total amount in that account is included under this category.
Packaged account	**Packaged accounts**, sometimes called **relationship banking accounts**, combine a household's checking, savings, certificates of deposit, and/or money market deposit accounts, usually at a bank, into a single package of services for which the household receives one consolidated statement each month. If there are any assets with investment risks in the account, the total amount in that account is included under this category.
Wrap accounts	**Wrap accounts** are accounts for which a financial professional is authorized to manage the assets in the household's account in one of two ways: 1) the professional buys or sells securities with the household's approval, or 2) the professional buys or sells securities without the household's approval. For both these types of management, the household pays in one of two ways: 1) a fee based on a percentage of the assets under management; or 2) a commission based on the number of trades.
Custodial accounts	**Custodial accounts** are accounts set up for, and managed on behalf of, minors. They contain securities, cash, and other property given to a minor under the Uniform Gift to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA).

Education savings accounts	**Education savings accounts** (also called **Education IRAs** or **Coverdell Education Savings Accounts**) are accounts that can be set up and contributed to on behalf of a child under the age of 18. Contributions are not tax deductible but withdrawals are not taxed if the funds are used to pay eligible education expenses (including elementary and secondary school expenses and tuition at private and parochial schools).
529 plans	**529 Plans (state-sponsored college savings plans)** are investment plans designed to encourage saving for future college costs while providing special tax benefits to the individual who established the plan. Upon withdrawal, the earnings are tax-free if used for qualified education expenses and they have much higher contribution limits than Education Savings Accounts.
Personal trusts	**Personal trusts (living trusts or testamentary trusts)** are established to provide income to someone. This income comes from assets administered and managed by a trustee. With a living trust, a person transfers ownership of assets to the trust during that person's lifetime. With a testamentary trust, the terms of a person's will place assets in trust when that person dies.
Private Banking	**Private banking** is a special service offered by many banks for selected customers. Usually, the private banking office is in a different location from all other bank offices (e.g., on a different floor). There are usually requirements, such as a minimum balance in an account and assets or a minimum income, to be eligible for these services. If there are any assets with investment risks in the account, the total amount in that account is included under this category.

IRAs/SEPs	An investment vehicle established by the taxpayer that allow individuals to contribute, transfer and grow their investments and earnings on a tax-deferred basis. If there are any assets with investment risks in the account, the total amount in that account is included under this category.
401k, 403b, 457	**Salary-reduction plans**, which include **401(k), 403(b), or 457** plans, allow employees of sponsoring companies to shelter part of their salary from current taxes. 401(k)s apply to employees of publicly- and privately-owned for-profit businesses; 403(b)s apply to employees of non-profit organizations such as educational or research institutions; 457s apply to employees of municipal or other government agencies. These are not defined benefit pension plans. Limits on the amount of salary an employee can shelter vary by type of plan and other factors such as employee income. Taxes on both contributions and earnings are deferred until withdrawal—usually after retirement or when an employee leaves the employer. In some cases, employers also contribute to the plan. If there are any assets with investment risks in the account, the total amount in that account is included under this category.
Keoghs	**Keoghs** are tax-deferred retirement plans for self-employed individuals.

Appendix E: The Retirement Management Professional (RPM) Job Description

RMPs are Professionals

The value of RIIA's "View Across The Silos" is often reflected in the difficulty of the questions that members ask. During a conference call, the following question came up: Is retirement planning a profession? The question startled me because I wanted to answer, yes, but I could not articulate clearly why I felt that way. My first reaction was to ask: Compared to what? What is the name of the other category if one is not a professional? As you will see in the rest of this article, the name of this other category is: technician.

This startling question lead me to looking again at sources that I had not read since the mid-1980s, including academic memos from David Maister who was then an Assistant Professor of Business Administration at the Harvard Business School. He was then, and he is still now, the "go-to" source when it comes to the topic of professional services firms. In particular, I wanted to look again at memo No. 8, titled "Brains, Grey Hair and Procedure."

In this memo, David breaks the world of service work into three categories:

- Brains – where people operate at the creative edge of their practice, dealing with unique projects that require fundamentally different customization from client to client.
- Grey Hair – where people deal with issues that are not dissimilar to what they have seen before and in fact consciously work to leverage and to scale up their past experience.
- Procedural – where people work with well-defined and well-specified tasks and seek to deliver services in the most timely and most cost-efficient manner.

Where does retirement planning fall on this spectrum? The question is important because the nature of the work drives the organizational structure of the services firm. For instance, organizational structures for:

- "Brains" services are very narrow with few entry-level people supporting top-level people who do the professional work. Strategy consulting services are the typical example.
- "Grey hair" services are broader organizations with more entry-level people supporting the top-level people. Engineering services provide a good example.
- "Procedural" services are very broad with many entry-level people managed by mid-level people who support the top-level people. Examples include accounting and tax preparation services.

David also presents a useful tool to differentiate professional work from technical work: How much of the services work performed is in "diagnostic" vs. "execution" tasks? The more diagnostic work, the more professional the job becomes. The more execution work, the more technical the job really is. Likewise, the more diagnostic work performed, the more the job falls in the brains category. The more execution, the more the job falls in the procedural category. So, is retirement income planning a professional job or is it a technical job?

Let's compare investment planning to retirement planning in light of these categories and distinctions. Investment planning is about creating and managing expectations that the markets may deliver. How much of investment planning is in diagnostic work rather than execution work? Each one of us may have a different percent estimate. Similar to establishing liability in car accidents, at a minimum, which is 51%, which is 49%? What is your answer based on your own experience?

Retirement planning is different from investment planning because it is not as much about managing probabilistic expectation as it is about delivering specific outcomes. Retirement planning also means that the professional needs to learn about the client's human and social capital in addition to the client's financial capital. We can also expect that retirement planning will not be an exercise in presenting utopian perfection but instead an annual effort in discovering the most tolerable imperfections. How much of retirement planning is in diagnostic work rather than execution work? Again, each of us may have a different percent estimate. Would we not agree that everything else being equal, retirement planning is likely to involve more diagnostic work than investment planning?

Clearly, we will not resolve this question in this column. General answers are likely to be misleading. Specific answers require more analysis. Further analysis to determine the professional vs. technical nature of specific investment or retirement planning work would benefit from answers to the following questions:

- Who is the client?
- How long does the engagement last?
- What are the professional tasks involved?
- What are the deliverables?
- How much does each engagement cost?
- How do we bill and how often?
- Etc.

These are potentially uncomfortable ideas to contemplate. However, they are important ideas because another aspect of David's work is the creation of a mathematical formula to manage the professional or technical services firm.

Practice Management Guidelines for RMPs

Should we see retirement planning develop as a profession or a technique, we will also see the development of companies that focus on the management of both the professional (or technical) talent and the client relationships. Either way, successful retirement planning institutions will emerge because of their mastery of two key competences: the management of the talent and the management of client relationships.

This observation should be placed in the context of our prior column about financial business models. The core business model of investment management is "collection" (of AUMs). On the other hand, retirement management's core business model is "payment" of monthly checks. Developing customized, high-diagnostic retirement plans to create monthly payments will lead to new forms of professional services firms. On the other hand, if the nature of the work is low diagnostic and low customization, the winning firms will follow a technical services model rather than a professional services model.

Having the right ideas about the nature of retirement planning work can mean the difference between staying in business and going out of business. To continue this discussion, let's take a look at some of the key assumptions behind David's formula for the management of the professional (or technical) services firm, including:

- Services firms sell time.
- The conceptual nature of the work determines the structure of the firm.
- People are the real assets of services firms.
- Key indicators used to monitor financial performance are different from key indicators used in product driven businesses. (In particular, gross margin is not an indicator of performance in a services firm.)
- Financial success is measured by net income per partner (owner).

There are six key indicators of success that are necessary to make the formula work:

- Available Hours: This is the capacity of the firm. It is expressed as the total number of available hours.
- Leverage: This reflects the nature of the services rendered by tracking the number of entry-level people that are necessary to support the top-level people. It is expressed as a ratio of the number of entry-level people to the number of top-level people.
- Average Billing rate: This reflects both the nature of the services rendered and the weighted average of the prices paid to the top and entry-level people. It is expressed in dollars.
- Average Utilization rate of the talent: This reflects how much of the people's time is billable. It is expressed as a percent of billed hours to available hours.
- Realization Rate: This reflects what invoices are actually collected. It is expressed as a percent of collected revenues to billed revenues.
- Net Margin: This reflects how much cash is available for distribution to the top-level people (partners or owners) after all the operating costs have been paid. It is expressed as a percent of net income (before partner/owner distributions) to total revenues.

It is now time to look at the formula. It is expressed as an equation with net income available for distribution per partner/owner on the left and the six key indicators on the left. These key indicators are multiplied, one after the other.

Net income per partner = Available Hours x (1 + Leverage) x Average Billing Rate x Average Utilization x Realization Rate x Net Margin

In other words:

Net Income per top-level people (partners or owners) = Capacity of the firm x Structure of the Firm x Price Level for the talent x Workload of the talent x Market Pricing Factor x Efficiency of Operations

The formula is interesting to contemplate. Let's look at the two extremes of brains vs. procedural work.

If the nature of the work is high diagnostic and high customization, there will be few entry-level people to support the top-level people. Therefore, available hours will be low and leverage will be low. Average billing rates will be high because of the high relative proportion of top-level people but the market will drive average utilization and realization. Net margin will reflect the frugality or profligacy of the top-level people.

On the other hand, if the nature of the work is high execution and low customization, there can be more entry and mid-level people to support the top-level people. Therefore, available hours will be high and leverage will be high. Average billing will be low because of the high relative proportion of entry-level people. The market will drive average utilization and realization. Net margin will reflect the budgeting and management skills of the firm.

Retirement planning practices are likely to fall in between these two extremes. Some practices may provide services that are heavy on diagnostic and highly customized. These would look like brains practices with the economics of professional services firms.

Other retirement planning practices may provide services that are heavy on execution and mass-production. These would look like procedural practices with the economics of technical services firms.

RMPs Require a Professional Designation

So, the question remains: Is a retirement planner a professional or a technician? If we frame this question in light of what we have just learned, we can see that the answer must address the question on both the individual financial advisor level and the level of the financial institution. This is the case because teams and not just individuals will be required to solve the range and complexity of retirement planning. At the individual level, some members of the team will focus on the diagnostic aspects of the work, while others will focus on the execution aspects. At the institutional level, retirement planning firms may have more of a professional feel and than less of a technical feel because retirement planning requires a large amount of diagnostic work and client customization.

As delivered outcomes become more important than managed expectations, clients will seek thriving retirement planning institutions that are successful in managing the professional and technical talent as well as the client relationships. These firms will have a reputation for being able to customize the right retirement plans and to deliver reliable monthly checks.

What Is The Retirement Management Professional (RMP) Job Description?

Mission

A Retirement Management Analyst is responsible for helping investors plan, implement and manage every phase of their pre- and post-retirement life in a more holistic fashion to achieve and maintain their desired standard of living.

Responsibilities

Develop customized plans at the appropriate level of detail including:

Human Capital – Life-Cycle plans, longevity, personal lifestyle and extended family expectations

Social Capital – Existing corporate and governmental retirement benefit realities and trends, macroeconomic/inflation realities and expectations

Financial Capital – Collars around financial expectations, with potential for upside appreciation

Diversified Investments among risky assets – Risky Assets

Pooling Risks for health and mortality – Insurance

Risk Transference – Hedges

Advice/Reserve – Risk-free precautionary balances

Implement, monitor and adjust the financial capital plan as necessary during pre- and post-retirement phases, and assist the investor in a realistic self-assessment of all aspects of their plan during implementation.

Assist the investor in the managing toward the human capital lifestyle adjustments necessary to implement every phase of the plan, particularly given the realities of emerging social and financial capital environment during the life of the plan.

Qualifications

Achieve and maintain financial proficiency at least on par with the Certified Financial Planner.

Achieve and maintain proficiency in insurance product management and underwriting equivalent to the Chartered Life Underwriter.

Possess proficiency in demographic and psychographic theory through psychology and psychometric testing methodologies to facilitate client guidance on human capital decision making.

Possess proficiency in macroeconomic and capital markets theory in order to facilitate the use of sophisticated quantitative predictive investing decision theory in asset allocation processes and derivative driven structured products in risk management.

Have a minimum of three years career experience in the field implementing plans on behalf of clients in the field of retirement counseling.

Meet the highest ethical standards as both a financial fiduciary and life counselor.

Appendix F: RIIA's Body of Knowledge

RIIA's Body of Knowledge is organized as a database to capture the past, current and future knowledge that Retirement Management Professionals (RMPs) will need to know in order to serve their client well.

This database architecture makes it possible to:

- Articulate where prior knowledge from other designations fit
- Differentiate the unique value and contribution of the Retirement Management Analyst (RMA) curriculum
- Integrate future developments

The following slides describe the high-level structure of RIIA's Retirement Management and Retirement Income Body of Knowledge.

The Professional Skills of the Retirement Management Professional

The Body of Knowledge starts with the skill set identified in the RMP Job Description.

Professional Skills of the RMP

- **Professional and Practice Management Skills, Technical Knowledge, Ethics**
  - **(1) Form an Opinion:** Markets, Trends, Investors, Products, Processes
  - **(2) Build a Floor:** Create a Retirement Management Plan based on the Investor's LifeCycle Profile
  - **(3) Exposure to Upside:** Based on the Investor's Retirement Risk Profile, Create a Retirement Income Plan for the Investor's Financial Capital and Implement the Risk Management Approach Allocations for the Investor's Financial Capital
  - **(4) Understand the Relevant Regulations** in order to Implement the Retirement Management and the Retirement Income Plans
  - **(5) Know Specific Products and Processes** in order to Implement the Retirement Management and the Retirement Income Plans
  - **(6) Practice the Ethics of the Retirement Management Professional** and Understand the Range and Types of Business Models

riia

The Spokes of RIIA's Advisory Process

In order to classify the Learning Objectives, the skill set of the RMP is sub-divided by Lesson and Topics and matrixed by the Spokes in the RIIA Advisory Process.

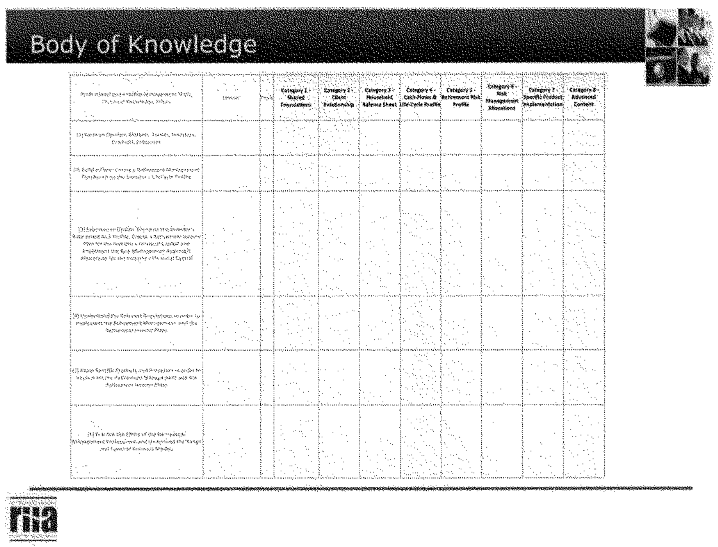
RIIA's Body of Knowledge

- **Learning Objectives Matrixed by:**
  - Rows of Professional Skills (6)
    - From RMP Job Description
      - » Form an Opinion, Build a Floor, Expose to Upside, Understand Regulations, Know Products and Processes, Practice Ethics of RMP
    - by Lesson and Topic
      - » Title, Summary, Key Terms, Sources, Detailed Content, Exam Questions & Answers
  - Columns of Curriculum Category (8)
      - » Shared Foundations, Client Relationship, Household Balance Sheet, Cash-Flows and Life-Cycle Profile, Retirement Risk Profile, Risk Management Allocations, Product Implementation, Advanced Content

riia

The Top Level View of the Body of Knowledge

Adding a "Shared Foundation" column and an "Advanced Content" column to the Spokes in RIIA's Advisory Process completes the matrix.



Appendix G: Typology Of Financial Professionals

During the February 2007 "Managing Retirement Income" conference, David McClellan presented the following segmentation[7] of financial professionals:

Brokers
Asset gatherers
Investment managers
Insurance planners
Financial planners
Wealth managers

Details including the behavioral "skews" of these financial advisor segments included the following descriptions:

Brokers

Brokers are transactional sales representatives. Their primary investment vehicles tend towards mutual funds, variable annuities, and individual equities. These vehicles are mostly Series 7 and Series 6 registered as well as insurance licensed. Their primary channels include banks, insurance broker/dealers and wirehouses. There are about 175,000 such product sellers and their average assets-under-management (AUMs) per investor client range from $50,000 to $200,000.

Asset Gatherers

Asset gatherers are relationship-driven salespersons who outsource the investment management function. The primary investment vehicles include mutual funds and separately managed accounts (SMAs). They tend to be Series 6 and 7 registered. Their primary channels include wirehouses and independent broker/dealers (IBDs). There are about 95,000 asset gatherers and their average AUMs per client range from $200,000 to $10 million.

Investment Managers

Investment managers are analytical portfolio managers who do not focus their practice on having high client skills. The primary investment vehicles they use include mutual funds, exchange traded funds (ETFs), SMAs, and individual equities. They often are Series 6, 65 and 7 registered. They also favor the "Chartered Financial Analyst" (CFA) designation. Their primary channels include IBDs, registered investment advisors (RIAs), and wirehouses. There are about 50,000 investment managers and their average AUMs per clients range from $200,000 to $10 million.

---

[7] **Source:** www.riia-usa.org, **2007 Annual Managing Retirement Income Conference February 2007**

Insurance Planners

Insurance planners are sophisticated insurance salesmen who sell life insurance solutions. The primary investment vehicles they favor include life insurance and variable annuities. They often hold specialized insurance designations. Their primary channels include IBDs, Insurance broker/dealers and wirehouses. There are about 37,000 insurance planners and their average AUMs per client range from $50,000 to $3 million.

Financial Planners

Financial planners offer comprehensive financial planning processes and are often fee-only. The primary investment vehicles they prefer include fee-based planning processes and software, mutual funds, ETFs and SMAs. Many are series 6 registered and they favor the CFP designation. Their primary channels include IBDs, RIAs, and wirehouses. There are about 18,000 financial planners and their average AUMs per client range from $50,000 to $3 million.

Wealth Managers

Wealth managers are members of high net-worth (HNW) teams who act as the investor's chief financial officer. The primary investment vehicles they use include SMAs, hedge funds and trusts. They hold various registrations, licenses and certifications. Their primary channels include wirehouses, IBDs, and bank broker/dealer or trust departments. There are about 24,000 wealth managers and their average AUMs per client are greater than $3million.

Glossary

Accumulation Portfolio: An accumulation portfolio is a portfolio that takes the portfolio objective as maximizing expected return for a given level of risk. This approach works best for those whose use of the portfolio for funding consumption is sufficiently far in the future that it is sensible to act as if the investor never expects to need to liquidate assets to fund consumption.

Annuity (nominal): A level stream of payments over either a fixed term or indefinite period of time. Most of the traditional annuities pay for the lifetime of the holder. In that regard, indefinite annuities combine mortality credits with a perpetual bond. The probabilities of your survival over future dates make annuities less costly than perpetual debt.

Annuity (real): An annuity where the stream of payments over either a fixed term or indefinite period of time rises or falls with some measure of prices. The annuity's flows adjust in order to provide cash flows that have the same purchasing power in all periods.

Balance Sheet (corporate): A corporate balance sheet is a double-entry design for displaying assets on one side and the sum of liabilities and owners equity on the other. Owner's equity plays the role of the balancing amount. When assets meet or exceed liabilities the firm is said to be solvent. There are strict accounting rules that govern construction of corporate balance sheets. Some of these rules are useful for standardizing the content. However, the accounting rules can obscure the true value of the entity.

Balance Sheet (economic): An economic balance sheet is a double-entry design for displaying assets on one side and the sum of liabilities and owners equity on the other. When trying to find a market value for an entity, an economic balance sheet is a valuable tool. This type of balance sheet attempts to value the entity as a portfolio of assets, some of which are not tangible or otherwise ineligible for corporate accounting. For example a physician's practice would show corporate assets of the historical cost of the building, examination table and the various examination doohickeys. In contrast, the economic balance sheet would display current market values of the same assets plus the discounted value of the patients expected to continue after a change in ownership. The economic balance sheet would show a different value of the firm than a corporate balance sheet.

Balance Sheet (retiree): The retiree balance sheet is an economic balance sheet that is designed to value assets and liabilities that are both tangible and intangible at proper market values.

Bottom-Up Estimates: A process of estimating amounts by beginning at the level of greatest detail; an attempt to estimate using a precise list of the items and amounts required (see Top-down).

Certainty Equivalence: The amount where the utility function provides the same result as the expected utility of the risky prospect. $U(X_{CE}) = E\left[U\left(\tilde{X}\right)\right]$

Constant Proportion Portfolio Insurance: Constant Proportion Portfolio Insurance (CPPI) is a risk management method for dynamically rebalancing a portfolio to keep constant the proportionate risk of falling below a minimum amount. CPPI is a useful method for dynamically allocating assets that allows for enhancing expected yield by coupling with enhanced vigilance to ensure that some specified minimum level portfolio value is preserved.

CPPI Notes: CPPI notes are structured notes based on CPPI methodology that provide principal protection and upside exposure.

Consumption Floor: The minimum amount of funding needed per period to satisfy the client's subjective minimum consumption needs. The amount needed depends on the lifestyle that the client minimally feels it necessary to maintain.

Credit Risk: The risk that a counterparty will renege or be unable to pay a contractually obligated amount owed to you.

Decreasing Relative Risk Aversion: Decreasing Relative Risk Aversion (DRRA) is the type of risk-averse behavior that most people exhibit. Client's exhibiting DRRA behavior will be more willing to risk a proportion of their wealth as their wealth rises. Conversely, during retirement, when wealth is being consumed, DRRA behavior is consistent with increased risk aversion.

Diversification: Diversification is the act moving one's eggs into multiple baskets. Diversification spreads the risk around in attempt to reduce the influence of any element of a particular risk. Diversification may reduce risk, but it is only under special circumstances that diversification eliminates risk. As many have recently rediscovered, diversified portfolios reduce the specific risk of a particular asset but still contain risk related to the overall condition of financial markets.

Dynamic Allocations: An allocation of funds to investments where the proportions are changed by design is known as a dynamic allocation. The two main types of dynamic allocations are discretionary and formulaic. Discretionary allocations are changed based on a flexible but defined standard. Formulaic allocations change based on rules that are preset (see Static Allocation).

Floor: (see Consumption Floor)

Income Statement: Display of income from all sources and expenses paid out.

Market Risk: The probability that the market value of assets held in a client's portfolio could change in a way that adversely affects the portfolio. For a long position, the risk is a reduction in price.

Onboarding: An admittedly awful bit of jargon referring to the process of bringing in a new client and integrating the client relationship into the business practices of the advisor.

Point of Smoothest Transition: The point in time or age of the client when the allocation to fixed-income securities is closet to that client's proposed allocation to flooring in a retirement-income portfolio is known as the point of smoothest transition.

Present Value: The value as of today for something that will not occur until a future date. For example, it is the value that would be placed on receiving $100 one year from today. At the personal level the present value that you would place on receiving $100 a year from today depends on your rate of impatience and the risk of the prospect. In aggregate the market value of receiving $100 one year from today is observable by reference to the one-year rate of interest.

Risk Pooling: Related to insurance. For well-behaved risks, pooling allows risk to be spread across a spectrum of individuals.

Risk Sharing: (see Risk Pooling)

Risk Transference: Risk transference allows the risk of an event to be completely transferred to another party. Typical risk-transference instruments include option instruments such as puts and calls.

Static Allocations: An allocation of funds to investments where the proportions remain fixed from inception to maturity is known as a static allocation. This includes allocations that are rebalanced periodically to remain on a static target (see Dynamic Allocation).

Top-Down Estimates: A process of estimating amounts by beginning at a very high level; an attempt to estimate starting with an approximation of where you think you might end up before adding detail (see Bottom Up).

Back Cover

RIIA's Advisory Process
How To Benefit From "The View Across The Silos": From Investment Management to Retirement Income and Retirement Management

RIIA's RETIREMENT MANAGEMENT ANALYST rma ©

François is co-founder, Chairman and Executive Director of the Retirement Income Industry Association, (RIIA). Based in Boston and drawing members from all segments of the financial services industry, RIIA (www.riia-usa.org) provides "the View Across the Silos." The association serves both as a think tank to analyze retirement income issues and as an incubator to facilitate the exchange of new ideas, concepts and knowledge among institutions interested in building retirement income businesses.

For more than 20 years, François has led teams that build successful technology solutions for the financial industry. His background combines a history of entrepreneurship, line experience at financial service organizations, and corporate strategy consulting.

He is a Chartered Financial Analyst, a member of the CFA Institute and a Lecturer at Boston University's School of Management, MS in Investment Management Program. He is a graduate of the Ecole Superieure de Commerce de Paris and earned an MBA degree from J. L. Kellogg Graduate School of Management at Northwestern University.

Mike Zwecher is a leading expert in both Risk Management and the emerging area of Retirement income. Mike is co-chair of the curriculum committee of the Retirement Income Industry Association and a co-developer of the educational program for retirement professionals.

Mike worked at Merrill Lynch for over 10 years. On the Wealth Management side, Mike worked in the Financial Products Group (FPG), where he ran the Strategic Solutions team and developed a platform for retirement income. Mike was recruited into the FPG after spending a number of years as a senior-level Risk Manager. He previously held positions as the Global Head of Commodities Risk and as the Global Head of Quantitative Risk Management. Prior to joining Merrill, Mike had been a consultant at Deloitte, an assistant professor at the Graduate School of Business Administration at Fordham University and a Visiting Associate Professor at the University of Wisconsin - Madison. Mike holds a Ph.D. in Finance from the University of Wisconsin - Madison and has published influential articles in both the areas of derivatives pricing and investment analysis.

Retail Price: $150